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FOREIGN INCOME

Transfer Pricing: Rules and Practice in Selected Countries (M–P)

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Transfer Pricing: Rules and Practice in Selected Countries (M–P)

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Transfer Pricing: Rules and Practice in Selected Countries (M–P)*, No. 6965, presents the rules and practice related to transfer pricing in Mexico, the Netherlands, New Zealand, and Norway.

Chapter 110, "*Transfer Pricing Rules and Practice in Mexico*," provides a detailed discussion of Mexican transfer pricing rules and practice. The chapter provides an explanation of the origin of the current transfer pricing regime, the background for the enactment of the arm's-length standard, the peculiarities of the Mexican documentation and disclosure requirements, and the technical aspects of the rules on transfer pricing methods and comparability standards. The audit process and the procedural rules for APAs and Competent Authority are also discussed extensively and one section is dedicated to the *maquiladora* industry. Controversial issues and recent developments from transfer pricing examinations are discussed throughout the chapter. The chapter was written with non-Mexican practitioners in mind. Emphasis has been put on the interaction between U.S. and Mexican transfer pricing rules, but the discussion is accessible to all readers with a background in transfer pricing. For Mexican tax issues, 7240 T.M., *Business Operations in Mexico*, should be consulted.

Chapter 115, "*Transfer Pricing Rules and Practice in the Netherlands*," describes the Dutch legal transfer pricing framework, i.e., the statutory transfer pricing provisions included in Dutch tax law. These provisions aim to: (1) authorize the adjustment of consideration paid in related-party transactions; and (2) force taxpayers to maintain transfer pricing documentation. However, these provisions do not prescribe the use of a specific transfer pricing method or deal with how transfer pricing adjustments are accounted for. Therefore, OECD Guidelines, jurisprudence, and certain decrees issued by the Dutch Ministry of Finance are discussed. In addition, the authors focus on how taxpayers can defend themselves against transfer pricing adjustments imposed by the Dutch Tax Authorities. They also highlight the tax treatment of secondary transfer pricing adjustments and the tax treatment of penalties and fines related to adjustments. The burden of proof in the case of transfer pricing adjustments generally rests with the Dutch Tax Authorities. The chapter concludes with a description of other dealings with the Dutch Tax Authorities with respect to transfer pricing, such as requesting an Advance Pricing Agreement, entering into a Mutual Agreement Procedure, as laid down in all Dutch income tax treaties, or protocols for commencing an arbitration procedure under the EU Arbitration Convention.

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The Worksheets are designed to assist practitioners with helpful resources in preparation for submission to the tax authorities.

Chapter 120, "*Transfer Pricing Rules and Practice in New Zealand*," provides an analysis of the transfer pricing regime in New Zealand. The New Zealand taxation system is a broad-base, low-rate tax system, based on taxpayer self-assessment. New Zealand has a comprehensive international regime, including transfer pricing rules closely based on the OECD Guidelines. These rules apply to international related-party dealings between individuals, trusts, partnerships, and corporations engaged in cross-border transactions. Transfer pricing adjustments are required when New Zealand taxpayers incur greater than arm's-length costs or receive less than arm's-length compensation in relation to cross-border arrangements. The New Zealand tax authority, the Inland Revenue Department, has an active audit program, with a specialist transfer pricing team which focuses on monitoring taxpayers and negotiating advance pricing arrangements. To date, audit activity has not resulted in litigation, with all matters resolved through the disputes process, reassessments, and/or negotiation of advance pricing agreements (APAs). The Inland Revenue Department has an active APA program with unilateral, bilateral, and multilateral arrangements negotiated with a range of taxpayers and countries.

Chapter 125, "*Transfer Pricing Rules and Practice in Norway*," provides a detailed discussion of Norwegian transfer pricing rules and practice in Norway. The chapter provides an overview of the tax system and the tax administration in Norway, as well as an overview of the corporate tax system. In addition, the chapter provides an explanation of the origin of the current transfer pricing regime, the background for the enactment of the arm's length standard, the peculiarities of the Norwegian documentation and disclosure requirements, and the technical aspects of the rules on transfer pricing methods and comparability standards, with emphasis on transfer pricing legislation and case law. The audit process and the procedural rules for Advanced Pricing Agreements and Competent Authority are also discussed extensively. Controversial issues and recent developments from transfer pricing examinations are discussed throughout the chapter.

This Portfolio may be cited as:

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Chapter 115 — Van Dam and Dijkstra, 6965:115 T.M., *Transfer Pricing Rules and Practice in the Netherlands.*

Chapter 120 — Harrison, 6965:120 T.M., *Transfer Pricing Rules and Practice in New Zealand.*

Chapter 125 — Kristoffersen, 6965:125 T.M., *Transfer Pricing Rules and Practice in Norway.*

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CHAPTER 110: TRANSFER PRICING RULES AND PRACTICE IN MEXICO

For more than 15 years, Marta Milewska has been practicing transfer pricing, while advising companies to best navigate the ever-evolving international business landscape. She has helped multinationals with the planning and execution of efficient international operational structuring, with the design and implementation of their global transfer pricing policies. Her experience covers nearly all areas of intercompany dealings, with principal focus on licensing transactions, transfers of intangibles, financial services dealings, and services arrangements. In particular, she has performed projects in the consumer goods, pharmaceuticals, mining, heavy and industrial equipment industries. She has also been involved in resolving controversy issues with tax authorities in audit defense environments.

Marta has authored numerous publications on the economics of transfer pricing dedicated to impact of behavioral economics on transfer pricing, transfer pricing in resource dependent developing countries, as well as a series of articles on value creation and second-brand strategies for the International Transfer Pricing Journal, International Tax Review, Financier Worldwide, Tax Notes International, and *Puntos Finos*. Marta is also a frequent speaker at transfer pricing conferences and training workshops.

Marta is part of Transfer Pricing Economists for Development, a think tank aimed at promoting the development and sharing of business economics knowledge in transfer pricing as an enabler of development of emerging economies and developing countries.

CHAPTER 115: TRANSFER PRICING RULES AND PRACTICE IN THE NETHERLANDS

Harmen van Dam heads the Loyens & Loeff N.V. Transfer Pricing Team. Harmen holds a law degree from the University of Leiden (1991) and an LLM in Taxation from the New York University School of Law (1996). He teaches regularly at the International Tax Center in Leiden and the SOB (Academy of the Dutch Association of Tax Advisers). Harmen advises clients on Dutch and EU corporate tax, particularly in respect to transfer pricing (advance pricing agreements, general audits, corresponding adjustments, mutual consultation procedures, state aid, etc.).

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CHAPTER 120: TRANSFER PRICING RULES AND PRACTICE IN NEW ZEALAND

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CHAPTER 125: TRANSFER PRICING RULES AND PRACTICE IN NORWAY

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DETAILED ANALYSIS

CHAPTER 110: TRANSFER PRICING RULES AND PRACTICE IN MEXICO

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I. Overview of Mexico's Tax System

The tax system in Mexico has three main groups of taxpayers: legal entities resident in Mexico, individuals who are resident in Mexico, and foreign residents with a permanent establishment (PE) or Mexican-source income. Companies are considered Mexican residents if they are incorporated in Mexico or if their principal center of administration or the effective place of management is located in Mexico, pursuant to the Mexican Federal Tax Code (FTC). The Mexican taxation system ties together two key types of taxation: direct taxes that tax income and indirect taxes that tax activities related to consumption. This chapter focuses only on the direct taxation of companies in Mexico.

Corporate income tax (CIT) applies to Mexican resident taxpayers' income obtained from worldwide sources, as well as to foreign residents on the income attributed to their PE located in Mexico. All corporate entities, including civil associations and branches (with specific rules), are subject to the tax rules applicable to Mexican corporations unless specifically exempted, such as not-for-profit organizations. The federal CIT rate in Mexico is 30%. Taxpayers engaged in agriculture, livestock, fishing, and forestry activities are given a reduction of their tax liability to the extent they do not exceed specific revenue thresholds.

Companies are also subject to an employee profit sharing tax (10%),[1] and some of them may be also subject to special excise taxes, depending on their production and services. The transfer of real estate is subject to a local tax at rates ranging from 2% to 5%, on the highest of: the value of the transaction, the property's fair market value, or its registered municipality value. Companies engaged in oil exploration and production are subject to a special tax regime in addition to the corporate income tax, as set out in the Hydrocarbons Revenue Law (HRL).

Capital gains arising from the sale of fixed assets, shares, and real property are considered ordinary income and are subject to the standard corporate tax rate. Non-residents that sell shares of a Mexican company are subject to 25% tax on the gross proceeds or 35% tax on the net gain if the non-resident has a representative in Mexico (provided the non-resident is neither subject to a preferred tax regime nor benefits from a territorial tax regime) and to the extent other requirements are met. Capital gains on the sale of publicly traded shares can be subject to reduced rates if certain requirements are met.

Companies are allowed certain deductions and tax credits mainly for federal taxes levied on a company (not including those required to be withheld from other parties and CIT). Technical assistance, the transfer of technology, or royalty payments represent deductible expenses for CIT purposes if they are made directly to companies with the required technical capabilities to provide the corresponding service. Non-deductible items include penalties, unauthorized donations, contingencies, indemnities, goodwill, and pro-rata expenses paid abroad, among others. Beginning in 2020, payments from Mexican companies to foreign-related parties, which are subject to a preferred tax regime (not subject to taxation or taxed at less than 75% of the income tax that are due under Mexican rules) are non-deductible items. There are certain exceptions for qualified recipients performing business activities.

There are certain considerations for Mexican companies that engage in loan transactions, including among others, thin capitalization rules and a net interest expense limitation equal to 30% of the adjusted taxable income.

Mexican entities should perform a computation of an inflationary gain/loss which is basically a phantom income/deduction derived from the economic change on the value of monetary assets and liabilities.

The Mexican tax year follows the calendar year. Net operating losses can be carried forward for up to 10 years, subject to adjustments for inflation. However, the carryback of losses is not permitted in Mexico.

Non-Mexican residents receiving income having a source of wealth within Mexico are subject to taxation in Mexico. This includes income from the performance of services in Mexican territory, income derived from technical assistance services provided to Mexican residents (regardless of where the service is performed), and royalties paid by a Mexican tax resident, or when the good is enjoyed in Mexico, as well as the transfer of Mexican shares (including certain indirect transfers), among others.

The use of an income tax treaty benefit allows the application of reduced withholding tax rates for non-Mexican residents obtaining Mexican-sourced income, to the extent that the requirements provided by the Mexican income tax law and the applicable income tax treaty are satisfied including those of the Multilateral Instrument such as the Principal Purpose Test.

[1] Every year, 10% of a company's taxable profits are distributed to employees, except managing directors or board members, in the form of employee profit-sharing. The amount of profit-sharing per employee is calculated on the basis of the number of working days completed during the year and the salary received.

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Taxpayers with income mainly from certain zones along the north border of Mexico are allowed a credit equal to one third of the income tax due. In addition, taxpayers performing taxable activities in the north border zone, including rendering of services, leasing of goods, or alienation of goods can apply an 8% value-added tax (VAT) rate instead of the general 16% rate. Certain notifications and requirements must be satisfied in order to apply these benefits.

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II. Evolution of Mexican Transfer Pricing Rules

A. Transfer Pricing Rules Before 1997

Mexico did not apply international standards to its transfer pricing legislation until 1997. However, the Mexican tax authorities had the capacity to modify intercompany prices when such prices were not market value. This provision applied to taxpayers with common interest. However, there was no specific guidance on applicable methods to determine market prices. In practice, these provisions were only applied in extreme cases, for instance, where the taxpayer did not have the necessary accounting evidence to support its transactions.

In May 1994, Mexico became the first Latin American country to join the Organisation for Economic Co-operation and Development (the "OECD"). When Mexico joined the OECD, it became apparent that additional transfer pricing regulations were needed.

B. The 1996 Reform

In December 1996, significant tax reforms were enacted in Mexico, introducing the arm's length principle and other anti-avoidance measures. During the first years of implementation of the transfer pricing legislation in Mexico, taxpayers were given the opportunity to gradually become familiar with the new regulations. Consequently, the Mexican Tax Administration postponed the audit program and focused on advance pricing agreements (APAs) for the *maquiladora*[2] industry.

C. The 2022 Reform

The Tax Reform in force as of January 1st, 2022 included relevant aspects for transfer pricing compliance work. The changes included updated deadlines for FY2022, new requirements that must be met for local transactions and a broadening of the scope of entities required to prepare a Local File. The Tax Reform eliminated the pre-existing distinction between documentation requirements for international and local intercompany transactions. Taxpayers now must disclose all of their intercompany transactions in the applicable returns.

A significant change included in the 2022 Reform was the use of contemporaneous financial information in the benchmarks. Benchmarks must now consider the comparable information corresponding to the period under analysis, and one year must be used unless a longer business cycle is supported. Additionally, the interquartile range is now mandatory for every transfer pricing analysis.

[2] *See* XIII.A., below.

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III. Transfer Pricing Rules

A. Legal Authority

1. The Arm's Length Principle

a. Statutory Requirement

Most of Mexico's statutory transfer pricing rules are contained in Articles 76 (Sections IX, X, and XII), 179, 180, and 182 of the Mexican Income Tax Law ("MITL").[3] These rules require Mexican taxpayers' gross receipts and allowable deductions for each fiscal year arising from intercompany transactions to be consistent with amounts that would have resulted had these transactions taken place with unrelated parties under similar conditions. Taxpayers must produce and maintain documentation demonstrating that these conditions are met, and the Mexican tax authorities may adjust income or deductions that have not done so.

b. Authority to Make Adjustments

Under Article 179 of the MITL, if the taxpayer fails to comply with the arm's length principle, the Mexican tax authorities are entitled to make an adjustment to income as reported by a taxpayer.

c. Presumption for Transactions with Persons in Tax Preferential Regimes

Transactions between Mexican residents and legal entities or entities that receive preferential tax treatment are deemed as made between related parties where the parties do not use the prices and consideration amounts that would have been used by independent parties in comparable transactions. A preferred tax regime is one in which a non-Mexican resident's income is not subject to taxation or is taxed at a rate lower than 75% of the tax that would be paid in Mexico.

d. Exceptions

Although taxpayers carrying out local and cross-border intercompany transactions, regardless of their value, must normally prove that the transactions are at arm's length, the Mexican legislation provides certain exceptions from the transfer pricing documentation requirement for small taxpayers.[4]

e. Role of the OECD Transfer Pricing Guidelines

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Transfer Pricing Guidelines") are specifically referenced in the Mexican tax legislation. They are an interpretative source of the transfer pricing provisions of the Mexican Income Tax Law (MITL) and are used for guidance and interpretation in transfer pricing-related issues. The MITL's reference to the OECD Transfer Pricing Guidelines is consistent with this law and with international treaties signed by Mexico.

In 2010, the Mexican Tax Court issued legal criteria through which it established that the OECD Transfer Pricing Guidelines are an "interpretative source" for the application of the transfer pricing obligations of the taxpayers, even for those assumptions that are not strictly contained in the MITL.[5] Therefore, in any case where the OECD Transfer Pricing Guidelines contain an additional benefit that is not stated in local Mexican law, there may be legal arguments to support that they should be applicable as a supplement to the content of the law.

As for the use of the OECD Transfer Pricing Guidelines in applying Mexico's income tax treaty provisions regarding transfer pricing, the provisions of the Vienna Convention on the Law of Treaties signed by Mexico on May 23, 1969 (Vienna Convention) apply in general, and normal interpretation rules apply. Specifically, with regard to OECD Model Convention Article 9, or similar provisions of a treaty that follow the same wording as the Model Convention, the OECD Transfer Pricing Guidelines are part of the "context" and a "source of interpretation" of those provisions. In 1999, the Supreme Court of Justice ruled that income tax treaties are hierarchically superior to Federal Laws but are subordinate to the Mexican Constitution.[6] Therefore, as the OECD Transfer Pricing Guidelines are a "source of interpretation" of Article 9 of the Model Convention (or an applicable income tax treaty), they should be considered an integral part of income tax treaties.[7]

2. Related Parties

Under Article 179 of the MITL, two or more persons are considered to be related parties if one directly or indirectly participates in the management, control, or stockholders' equity of the other, or when a person or a group of persons directly or indirectly participates in the management, control, or stockholders' equity of said persons. Members of partnerships are considered to be related, as are the persons who in accordance with this article are considered related parties of said members. Similarly, the head office or other PEs of an entity are considered related parties.

3. Transfer Pricing Methods

a. Based on Article 180 of the MITL

(1) Comparable uncontrolled price (CUP) method.

(2) Resale price method (RPM).

(3) Cost plus (CP) method.

(4) Profit split method (PSM).

(5) Residual profit split method (RPSM).

[3] While the Federal Tax Code addresses various types of taxes, the MITL specifically covers income tax.

[4] For more details, *see* V., below.

[5] *See* "Transfer Pricing OECD Guidelines on the Agreements for the Contribution of the Payment of Costs Between Related Parties — Interpretation of the Guidelines" Administrative Contentious Judgment No. 13403/09-17-01-4/503/10-PL-07-09.- Resolved by the Plenary of the Superior Chamber of the Federal Court of Fiscal and Administrative Justice, in the session of August 16, 2010, by a majority of 8 votes in favor, 1 vote with the operative paragraphs, and 1 vote against. - Speaker Judge: Silvia Eugenia Díaz Vega.- Secretary: Adriana Domínguez Jiménez.

[6] "International Deals. They are Located Hierarchically above the Federal Laws but Subordinate to the Federal Constitution" Thesis P. LXXVII/99.

[7] "International Deals. They are Located Hierarchically Above the Federal Laws but Subordinate to the Federal Constitution" Thesis P. LXXVII/99. A list of jurisdictions with which Mexico has an income tax treaty in force can be found on the Bloomberg Tax platform: https://www.bloomberglaw.com/product/tax/search/results/a08bda77c4770f092195a376a1072c07/.

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(6) Transactional net margin method (TNMM).

As is applicable under the OECD standards, both traditional transactional methods (one through three) and profit-based methods (four through six) are acceptable in Mexico.

b. Best Method Rule

(1) Law Prior to 2006

Before 2006, the MITL did not impose an explicit hierarchy of transfer pricing methods. A Mexican taxpayer could determine which method most accurately reflected arm's length prices for their related party transactions, and the Mexican Tax Administration verified the results using the chosen method. To accommodate these objectives, taxpayers preferred to use the Transactional Net Margin Method (TNMM) and did not attempt to use other traditional methods.

(2) Current Law

In 2006, the best method rule was added to the MITL (Article 180 of the MITL). It applies to all transactions carried out between related parties. Article 180 of the MITL states that taxpayers must first apply the CUP method, which is described in Article 180, section I of the MITL, and may only use the other methods indicated in Article 180, sections II, III, IV, V, and VI of the MITL when the CUP method set is inappropriate for determining if the transactions were conducted at market prices.[8] This effectively places the burden on the taxpayer to prove and document the reasons for not applying this method. The law also provides a second preference to apply the Resale Price Method (RPM) and the Cost Plus (CP) method, implicitly imposing the burden of providing documentary evidence as to why these methods were not appropriate if a profit-based method is used.

According to legal criteria issued in 2010 by the Mexican Supreme Court of Justice, the best method rule does not imply that an applicable method is the only one that taxpayers must use; nor is the application of any other in particular rejected.[9]

c. Description of the Permitted Methods

(1) Comparable Uncontrolled Price Method

Article 180, Section I of the MITL describes the comparable uncontrolled price (CUP) method. The application of the CUP method consists of comparing the prices agreed by related parties for the sale of goods or the rendering of services to the prices paid for identical or similar goods or services in operations carried out between independent parties. The degree of comparability required for applying this method is very high. An operation is considered to be comparable only if tangible ownership or the services and circumstances of the operation carried out between related parties are substantially the same as those of operations carried out between independent parties.

(2) Resale Price Method

Article 180, Section II of the MITL describes the resale price method (RPM). The application of the RPM consists of determining the price of a purchase or sale by taking as a reference the gross profit margin obtained in similar operations with unrelated parties. This method is generally appropriate for cases that involve the purchase and resale of tangible goods when the purchaser (distributor) does not add substantial value to the goods either by modifying them physically or by using commercial intangible assets. Under this method, comparability is based more on similarity of functions performed, risks assumed, and other relevant factors between the distributor carrying out the operation with related parties and the one carrying out operations independently, than on the similarity of the goods sold.

(3) Cost Plus Method

Article 180, Section III of the MITL describes the cost plus (CP) method. The application of the CP method consists of determining the price of an operation carried out between related parties through the analysis of profit margins over costs for comparable operations with unrelated parties. The CP method evaluates the value of functions performed and is ordinarily appropriate in the rendering of services and manufacturing of tangible goods for sale to related parties.

(4) Profit Split Method

Article 180, Section IV of the MITL describes the profit split method (PSM). In order to apply the PSM, a taxpayer is first required to establish a global profitability as a sum of individual profits of each entity engaged in the transaction. The PSM subsequently evaluates distribution of combined profits and/or losses attributable to operations carried out between related parties, considering the relative value of the contribution of each related party to said profits and/or losses (for instance assets, costs, and expenses of each related party).

(5) Residual Profit Split Method

Article 180, Section V of the MITL describes the residual profit split method (RPSM). To apply the RPSM, a taxpayer is required to establish a global profitability as a sum of individual profits of each entity engaged in the transaction. Then, the minimum profit corresponding to each related party is determined based on the functions, assets owned, and risks assumed. The residual profit is calculated by subtracting the minimum profit earned in the aforementioned terms from the global profit. The residual profit is then assigned to each of the related parties, considering how independent parties would distribute residual profits in comparable transactions.

(6) Transactional Net Margin Method

Article 180, Section VI of the MITL describes the transactional net margin method (TNMM). The TNMM evaluates the prices of operations carried out between related parties by comparing the operating profit earned by one of the entities participating in said operations, to the operating profit earned by unrelated parties in comparable operations carried out with third parties. This method offers a certain flexibility in the degree of comparability with independent entities, since it accepts the ex-

[8] According to the text of article 180 of the MITL, taxpayers are first required to consider the method described in section I of article 179 of the MITL (CUP) and may apply the other methods described in sections II, III, IV, V, and VI of article 179 of the MITL only if the CUP method is not appropriate according to the OECD TP Guidelines.

[9] "Rent. The former paragraph of Article 216 of the law of relative tax, does not violate the principle of normative hierarchy" Thesis: 1a. CXXIX/2010.

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istence of differences in products sold, focusing on the similarity of functions performed by the entity under review and the independent entities used as comparable companies.

(7) Use of Non-Specified Methods

The MITL does not consider the use of any other transfer pricing method, although as mentioned above, the Mexican Supreme Court of Justice has indicated that the use of other methods is not prohibited. However, the taxpayer would have to prove that none of the transfer pricing methods specified in Article 180 of the MITL are applicable to the transfer pricing analysis and that another method would give a more precise result for the analysis.

B. Comparable Companies and Benchmarks

1. Tested Party

The MITL is silent regarding tested party selection so, in general, transfer pricing practitioners should follow the OECD Transfer Pricing Guidelines. Nevertheless, the MITL requires the application of Mexican Financial Reporting Standards (FRS) for the purpose of the transfer pricing analysis. Therefore, in practice, there is a preference for a local tested party, especially in cross-border intercompany transactions.

2. Product and Business Life Cycles

A new paragraph to Article 179 was introduced, effective January 1, 2022, making clear that benchmarks must only consider the comparable information corresponding to the period under analysis. As Mexico transfer pricing compliance is linked to tax compliance, this analysis must be conducted every year. Previously, the MITL included a reference to the use of several years for the comparable transactions only when the tested party had a business cycle of more than one year. Under current law, the taxpayer can only consider comparable information from multiple years when the taxpayer's business considers a cycle covering more than one year. In this case, the business cycle must be proved.

3. Use of Secret Comparables

The Mexican tax authorities have the power to use confidential information of third parties ("secret comparables"). Use of secret comparables is case specific. The taxpayer has limited access to this data through two designated representatives who must agree to be personally liable to criminal prosecution if the data is disclosed.

In December 2020, the Federal Tax Code[10] was amended to allow the Mexican tax authorities to provide taxpayers with parameters (benchmark analysis) regarding profit, deductible concepts, effective tax rates and profit margins based on economic sector or industry. On June 13, 2021, the Mexican tax authorities issued expected effective income tax rates for large taxpayers related to forty economic activities. This benchmark is the result of analysis performed by the Mexican tax authorities on the annual returns, tax reports, informative returns, digital tax receipts, and importation documents of various Mexican taxpayers. The source of the information has not been disclosed.

The effective tax rate for the purpose of this analysis is defined as the ratio of income tax to taxable revenue. Information on the effective tax rate for each industry published by the Mexican tax authorities for the 2016-2021 period is available in the Worksheets.

The Mexican tax authorities' goal is to encourage taxpayers to analyze their effective tax rates voluntarily. If their tax rate is lower than the benchmark data, it is advisable to review whether it is due to the market characteristics, business strategy, or other circumstances and document it properly.

4. Use of Foreign Comparables

Comparable information is required to determine arm's length prices and should be included in the taxpayer's transfer pricing documentation. However, there is frequently little reliable financial information on Mexican companies that is publicly available. Therefore, information on foreign companies is used, particularly U.S. companies (often referred to as U.S. comparables).

5. Profit Level Indicators

The transfer pricing regulations in Mexico do not specify the preferred Profit Level Indicators to be used. In practice, the markup on total costs, return on sales, return on assets, or return on capital employed are commonly used. Other types of Profit Level Indicators (like the Berry ratio) that may be sensitive to differences in accounting criteria for classifying charges either as costs or as expenses are less common in use.

6. Use of Mexican Financial Reporting Standards

Taxpayers in Mexico must determine their income, costs, gross profit, net sales, expenses, transaction profit, assets, and liabilities according to the Mexican FRS. This raises issues regarding comparability adjustments when comparables used are foreign companies. The most common issue may be related to how costs and expenses are classified, which impacts profitability tested at gross and operating levels.

7. Use of Statistical Measures

According to Article 180 of the MITL, when obtaining a range of prices, amounts, or profit margins from the application of a transfer pricing methodology, such ranges must be adjusted by applying the interquartile method. The prices are considered to be at arm's length if they fall anywhere in that range. Different statistical methods may be used if the method is agreed to as part of a mutual agreement procedure provided for in the income tax treaties that are signed by Mexico or when the method is authorized by the Mexican tax authorities. In the case of a transfer pricing adjustment assessed by the Mexican tax authorities, the price is adjusted to the median of the comparable price range.

C. Transfer Pricing Analysis

1. Definition

Article 179 of the Mexican Income Tax Law (MITL) states that transactions or enterprises are understood to be comparable when there are no differences among them that signif-

[10] Article 33, first paragraph, section I, subsection i of the FTC.

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icantly affect the price, the consideration amount, or the profit margin referred to in the transfer pricing methods, or when any such differences that do exist are eliminated through reasonable adjustments. In determining the differences, consideration is given to the elements required in accordance with the method used, mainly as follows:

- Characteristics of the transaction;
- Functions, risks, and assets;
- Contractual terms;
- Economic circumstances; and
- Business strategies.

2. Characteristics of the Transaction

Following Article 179 of the MITL, the transfer pricing analysis should take into consideration the following characteristics of the transaction:

In the case of financing operations, factors such as

- the amount of the principal,
- the term,
- the guarantees,
- the debtor's solvency, and
- the interest rate.

In the case of services rendered, factors such as

- the nature of the service and
- whether the service involves technical experience or knowledge.

In the case of the use, lease, or sale of tangible goods, factors such as

- the physical features,
- quality, and
- availability of the goods.

In the case of exploitation or transfer of intangible goods,

- it must be determined whether they are patents, trademarks, commercial brands, or transfers of technology, and
- the duration and degree of protection.

In the case of sales of shares, elements such as

- the issuer's restated stockholders' equity,
- the present value of profits,
- the projected cash flows, or
- the stock quote of the issuer's last sale for the day.

3. Functions, Risks, and Assets

Article 179 of the MITL states that the transfer pricing documentation should include an analysis of the functions performed, assets employed, and risks borne by both parties for each transaction.

In 2018, the Mexican tax authorities published non-binding criteria,[11] which state that the taxpayers carrying out transactions with related parties must identify and consider any valuable contributions as part of the functional analysis. In this context, valuable contributions are understood as those that generate significant value and that are a key source of potential economic benefits, such as:

- Intangibles created or used; or
- Comparability factors that determine a competitive advantage for business, including Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) activities.

In that respect, the authorities warned particularly against:

(i) failure to recognize the taxpayer's own unique and valuable contributions or those of the comparable companies in its functional analysis; and

(ii) considering transactions or companies to be comparable when there are significant differences between the analyzed party or transaction and the potentially comparable transactions or companies as a result of unique and valuable contributions or assistance.

They further warned that advising, providing services, or participating in the execution or implementation of these aforementioned practices are considered to be incorrect tax practice.

Through the amendment of Article 76, section IX of the MITL, in force as of January 1, 2022, transfer pricing documentation must include a functional analysis that considers all relevant parties of the transaction.

4. Contractual Terms

The MITL does not provide detailed guidance regarding the contractual terms of the transfer pricing analysis. Nevertheless, the Mexican tax authorities would expect to analyze the form of payment, volume, warranties provided, the duration of the agreements, and termination or renegotiation rights, and extension of credit and payment terms. The legal agreements supporting the intercompany transactions are expected to be available.

5. Economic Circumstances

The MITL does not provide details regarding documentation of economic circumstances as part of the transfer pricing analysis. Nevertheless, the Mexican tax authorities would expect a taxpayer to analyze whether economic circumstances of the comparables' country of origin are comparable with the economic conditions of the Mexican business.

6. Business Strategies

The MITL does not provide details regarding documentation of business strategies as part of the transfer pricing analysis. Nevertheless, if pricing is expected to support a business strategy, the Mexican tax authorities would expect a taxpayer to analyze the timing of the return, plausibility of the expected returns, and consistency with the existing business model, among others.

[11] Rule 39/ISR/NV of the Miscellaneous Tax Resolution.

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7. Adjustments for Differences in Geographic Markets

Even though it was common in the past for no country risk adjustment to be applied to foreign comparables, in 2018 the Mexican tax authorities published on their webpage recommendations on the use of country risk adjustments for foreign comparable companies.[12] According to the Mexican tax authorities, the net sales of foreign comparable companies should be adjusted by adding the country risk premium using the following formula:

$$Adjusted\ Sales_C = Sales_C + Country\ risk\ premium,$$

where country risk premium is calculated as follows:

$$Country\ risk\ premium = Operating\ assets_C * EMBI$$

where EMBI refers to the Emerging Market Bond Index published by JP Morgan. The EMBI can be used to establish the difference in interest rates from bonds denominated in dollars, issued by emerging countries, compared to U.S. Treasury bonds.

This proposal has generated a great deal of controversy among transfer pricing practitioners in Mexico. Even though this recommendation is not obligatory for Mexican taxpayers, the Mexican tax authorities have been using the country risk adjustment approach during transfer pricing audits. Consequently, taxpayers should evaluate the viability of the country risk adjustment on a case-by-case basis. For instance, a statistical analysis of differences in the economic and business environment in Mexico as compared to the foreign market may be performed to test whether there is any significant difference between both results.

8. Working Capital Adjustments

Working capital adjustments have the goal of increasing comparability. They do so by taking into account differences between the Cash Conversion Cycle (CCC) of the tested party and that of the comparable companies. The formula for the CCC is shown below:

$$CCC = DRO + DIH - DPO$$

where DRO are days receivable outstanding, DIH are days inventory held, and DPO are days payable outstanding. It is important to see these adjustments jointly, as seeing any of the CCC components separately could lead to an inaccurate picture of the financing terms. In line with this, applying only one of the working capital adjustments could lead to less comparability instead of more. For example, omitting the accounts receivable adjustment, whose formula appears a couple of paragraphs below, is equivalent to saying that the tested party and the comparable companies have DRO.

The MITL does not provide details regarding the working capital adjustments. However, in 2018, the Mexican tax authorities published formulas for the working capital adjustments as part of an effort to answer frequently asked questions.[13] In this section, we present the formulas contained in the Mexican tax authorities' publication.

• Accounts receivable adjustment

The formula suggested by the Mexican tax authorities to adjust for accounts receivable (A/R) is presented below:

$$A/R_{adj} = [\frac{A/R}{S} tp - \frac{A/R}{S} comp] * [S_{comp} * (\frac{i}{1 + (i * \frac{A/R}{S} comp)})]$$

where,

A/R_{adj} = A/R adjustment

A/R = Average annual A/R

comp = Comparables

tp = Tested party

i = Interest rate

S = Sales

If the A/R turnover of the comparable company is lower than that of the tested party, then the inventory adjustment should be added to the sales of comparable companies. Otherwise, the inventory adjustment should be subtracted from the sales of comparable companies. The objective of this calculation is to reflect additional financing costs, if any, related to the A/R turnover difference.

• Accounts payable adjustment

The formula suggested by the Mexican tax authorities to adjust for accounts payable is presented below:

$$A/P_{adj} = [\frac{A/P}{COGS} tp - \frac{A/P}{COGS} comp] * [COGS_{comp} * (\frac{i}{1 + (i * \frac{A/P}{COGS} comp)})]$$

where,

A/P_{adj} = A/P adjustment

A/P = Average annual A/P

comp = Comparables

tp = Tested party

i = Interest rate

COGS = Costs of goods sold

If the A/P turnover of the comparable company is lower than that of the tested party, then the inventory adjustment should be added to the COGS of comparable companies. Otherwise, the inventory adjustment should be subtracted from the COGS of comparable companies. The objective of this calculation is to reflect additional financing costs, if any, related to the A/P turnover difference.

[12] *See* https://www.gob.mx/sat/acciones-y-programas/preguntas-frecuentes-en-materia-de-precios-de-transferencia-con-respecto-a-ajustes-de-comparabilidad-195410.

[13] *See* See https://www.gob.mx/sat/acciones-y-programas/preguntas-frecuentes-en-materia-de-precios-de-transferencia-con-respecto-a-ajustes-de-comparabilidad-195410.

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• Inventory adjustment

The formula suggested by the Mexican tax authorities to adjust for inventory is presented below:

$$Inv_{adj} = [\frac{Inv}{COGS}tp - \frac{Inv}{COGS}comp] * [COGS_{comp} * (\frac{i}{1 + (i * \frac{Inv}{COGS}comp)})]$$

where,

Inv_{adj} = Inventory adjustment

Inv = Average annual inventory

comp = Comparables

tp = Tested party

i = Interest rate

COGS = Costs of goods sold

If the inventory turnover of the comparable company is lower than that of the tested party, then the inventory adjustment should be added to the COGS of comparable companies. Otherwise, the inventory adjustment should be subtracted from the COGS of comparable companies. The objective of this calculation is to reflect additional financing costs, if any, related to the inventory turnover difference.

For example, the formula for the adjusted Return On Sales, with all values taken from comparables, would be:

$S_{adj} = S + A/R_{adj}$,

$OI_{adj} = OI + A/R_{adj} + Inv_{adj} = A/P_{adj}$,

$ROS = OI_{adj}/S_{adj}$

where,
S = Sales
A/R = Accounts receivable
OI = Operating income
Inv = Inventory
A/P = Accounts payable
ROS = Return on sales
adj = Adjusted

9. Unusual Comparability Adjustments

The MITL does not require unusual comparability adjustments that differ from what is suggested in the OECD Transfer Pricing Guidelines. In practice, working capital adjustments are mainly performed to increase the level of comparability.

Through the amendment of Article 76, section IX of the MITL, which was in force as of January 1, 2022, transfer pricing documentation must include a functional analysis that considers all relevant parties to the transaction.

10. Transactional Approach and Aggregation

Article 76 IX (c) of the MITL requires having the transfer pricing analysis performed for each transaction and for each related party (i.e., multiple transactions are not aggregated for purposes of the analysis). In practice, transfer pricing practitioners perform the transfer pricing analysis for each transaction.

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IV. Specific Transfer Pricing Rules

A. Tangible Property

The Mexican transfer pricing regulations do not contain detailed guidance specific to the pricing of controlled transactions involving tangible property but, by reference to the OECD Transfer Pricing Guidelines in the Mexican Income Tax Law (MITL), the OECD's tangible property guidance is applicable.

In the case of acquisition or disposal of assets, Article 58-A of the Mexican Federal Tax Code (FTC) states that the Mexican tax authorities may modify the taxable income or loss referred to in the MITL by presumptive determination of the price at which taxpayers acquire or dispose of assets, as well as the amount of the consideration in the case of operations other than disposal when:

- The operations are agreed at less than the market price or the acquisition cost is greater than that price;
- The sale of the goods is carried out at or less than cost, unless the taxpayer verifies that:
  1. the sale was made at the market price on the date of the operation, or
  2. the goods suffered deterioration and there were circumstances that determined the need to carry out the sale under these conditions; and
  3. that there are costs pertaining to import or export operations, or generally, payments abroad.

B. Intangibles

1. Transactions Involving Intellectual Property

The Mexican transfer pricing regulations do not contain detailed guidance specific to the pricing of controlled transactions involving intangibles but, by reference to the OECD Transfer Pricing Guidelines in the MITL, the OECD's intangibles-related guidance is applicable. However, when there is a transfer of hard-to-value intangibles, the transaction should be reported to the Mexican tax authorities using the applicable reportable transaction form.[14]

In terms of royalties and license agreements, the Mexican tax authorities have been challenging strict indispensability (and in consequence deductibility) of marketing, promotion, and advertising expenses. Furthermore, in 2019, the Superior Chamber of the Federal Tax Court issued two separate rulings relating to marketing and advertising expenses. The first ruling concluded that marketing expenses are considered strictly nondeductible for taxpayers whose principal activity relates to goods or product distribution, regardless of any royalty payment incurred for brand use.[15] The second ruling stated that advertising expenses are linked directly to the brand positioning in the market and are not considered strictly nondeductible for taxpayers if they are not the brand owners.[16]

2. Legal Ownership of Intangibles

The Mexican regulations do not contain transfer pricing guidance specific to the legal ownership of intangibles. The OECD Transfer Pricing Guidelines should be used as a reference.

In terms of royalties, there is often a concern addressed by the Mexican tax authorities that there are companies paying royalties for intangible assets that are not used or do not generate a profit for the Mexican taxpayer. The Mexican tax authorities maintain that royalty payment must be consistent with the operation of the company, should be proportionate to (or commensurate with) the profit margin earned by the company, and must be agreed based upon the arm's length principle.

3. Transfer of Going Concern and Goodwill

The Mexican regulations do not contain transfer pricing guidance specific to the transfer of going concern and goodwill. The OECD Transfer Pricing Guidelines should be used as a reference. Moreover, normative criteria 22/ISR/N states that for the purpose of the Mexican income tax law, goodwill is not deductible.[17]

C. Services

1. General Considerations

The Mexican regulations do not contain transfer pricing guidance specific to corporate allocations and management fees. The OECD Transfer Pricing Guidelines should be used as a reference. Nevertheless, the Miscellaneous Tax Resolution provides specific guidelines regarding deductibility of expenses, which may be applicable in the corporate allocations and management fees context, especially if the expenses are allocated on a pro-rata basis.

2. Pro Rata Allocations

According to Article 28, paragraph XVIII of the MITL, expenses incurred abroad by a non-resident and assigned to a Mexican entity on a pro-rata basis are not deductible for income tax purposes.

Nevertheless in 2014, the Mexican Supreme Court issued a decision in which it expressed its position about the prohibition against Mexican entities deducting pro-rated expenses incurred outside Mexico.[18] In this regard, it concluded that the limitation for Mexican entities to deduct pro-rata expenses for income tax purposes need not be applied strictly and automatically. Rather, the tax authorities must verify if other requirements are satisfied before disallowing a tax deduction.

As a result of this case, a miscellaneous tax rule was issued by the Mexican tax authorities in order to regulate the specific information and documentation needed for taxpayers to take a deduction for pro-rata expenses. Rule 3.3.1.27 of the Miscella-

[14] *See* https://portalconerp.clouda.sat.gob.mx/.
[15] R.T.F.J.A. Octava Época. Year IV. No. 36. July 2019 at 284.
[16] R.T.F.J.A. Octava Época. Year IV. No. 36. July 2019 at 285.
[17] Source: https://www.sat.gob.mx/articulo/64845/criterio-25/isr/n.
[18] "Época: Décima Época, Registro: 2006747, Instancia: Segunda Sala, Tipo de Tesis: Aislada, Fuente: Gaceta del Semanario Judicial de la FederaciÓn, Book 7, June 2014, I, Subject: Administrative, Thesis: 2a. LIV/2014 (10a.), Page: 821.

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neous Tax Resolution states that the pro-rata expenses can be deductible as long as the following requirements are met:

- The expense must be a strictly indispensable cost of the taxpayer for the taxpayer's business activities;
- Residence of the person by whom the pro-rata expense is charged must be in a country that has a comprehensive exchange of information agreement with Mexico;
- Proof must be given that the service related to such expense was effectively rendered;

If services were rendered between related parties, the taxpayer should demonstrate the following:

- Proof that the third party would be willing to pay for such services or perform them by itself;
- Proof that there is no payment of stewardship services;
- Proof that the service is not already charged by another related party or a third party;
- Proof that the service is not already charged as commissions, royalties, technical assistance, publicity, or interest.
- Proof that the price/compensation is at arm's length if the expense was carried out between related parties; and
- Proof that a reasonable relationship exists between the expense and the benefit received.

Furthermore, the taxpayer should have in place an agreement in line with Article 179 of the MITL and Chapter VIII of the OECD Transfer Pricing Guidelines, as well as certain documentation and information for each of the transactions for which the pro-rata expenses were incurred abroad.

On the basis of the foregoing, according to this rule, it is possible to deduct pro-rata expenses. However, the taxpayer needs to satisfy all the requirements established by the Mexican tax authorities and secure all the relevant documentation.

3. Intercompany Services

The Mexican regulations do not contain transfer pricing guidance specific to the corporate allocations and management fees. The OECD Transfer Pricing Guidelines should be used as a reference.

4. Retroactive Charges

The Miscellaneous Tax Resolution allows for retroactive charges (voluntary or compensatory transfer pricing adjustments). The taxpayer must notify the Mexican tax authorities if a retroactive deduction or income decrease has been made and deliver certain information.[19]

D. Financial Transactions

1. Interest and Other Financing Related Charges

The Mexican regulations do not contain transfer pricing guidance specific to interest and other financing related charges. The OECD Transfer Pricing Guidelines should be used as a reference. Nevertheless, the MITL provides specific guidelines regarding thin capitalization and limits on the amount of interest deductions.[20]

2. Special Considerations for Transfers of Shares

a. In General

The Mexican regulations do not contain transfer pricing guidance specific to the transfer of shares. The OECD Transfer Pricing Guidelines should be used as a reference. Nevertheless, the Mexican law imposes income tax on income derived by non-residents on the sale of stock or quotas issued by Mexican resident companies. In this case, the 25% rate on the gross proceeds is applicable. Alternatively, taxpayers may elect to apply the 35% rate on the net gain to the extent that certain requirements are complied with, including the appointment of a legal representative in Mexico, and the income of the non-Mexican resident should not be subject to a tax haven/preferred tax regime or a territorial regime. In this case, a tax audit report prepared by a Mexican independent public accountant must be filed certifying compliance with tax obligations on the share or quota transfer unless the transaction is exempt under a tax treaty. This obligation applies even if the transaction qualifies as a tax-deferred reorganization under domestic law.

The tax audit report on the alienation of shares must include a report on the tax basis of the shares, and the independent accountant must state which valuation methods were taken into account and why. For example:

- Inflation-adjusted capital of the entity;
- Present value of future cash flows (income approach); and
- The last quote in the case of a publicly traded stock.

In the first case, the information must include details on the amount of the historical capital and the corresponding adjustments. In the second case, the regulations under the MITL require detailed information on the name(s) of the methods used for the discounted value of the cash flows, discount rates, and the existence of residual values, the number of projected time periods, and the economic sector of the company whose stock was alienated. In any case, the independent accountant is required to explain in the report the reasons for the selection of one of these three alternatives.

Compliance with these provisions effectively requires a detailed appraisal of the company, and it should be noted that there is no *de minimis* rule for small transactions or small companies. Moreover, a detailed tax basis calculation must be prepared and opined on.

b. Losses

Non-Mexican tax residents cannot utilize losses derived from the sale of shares against gains obtained on the sale of Mexican shares.

E. Commodities

According to Articles 51 and 53 of the Hydrocarbons Revenue Law (HRL), when an Exploration/Extraction Assignation Holder transfers hydrocarbons (oil, natural gas, condensates,

[19] *See* VII., below.

[20] *See* XII., below.

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natural gas liquids, or methane hydrates) to related parties, they must consider the prices and amounts of the consideration they would have used with or between independent parties in comparable transactions, effectively applying the Comparable Uncontrolled Price (CUP) method. Regarding other commodities, there is no specific guidance in the Mexican legislation.

F. Cost Sharing Arrangements

No specific transfer pricing guidance is contained in the Mexican Income Tax Law (MITL) but through reference to the OECD Transfer Pricing Guidelines in the MITL, the OECD's cost contribution arrangement guidance (Chapter VIII of the OECD Transfer Pricing Guidelines) is applicable. Payments made by Mexican taxpayers participating in a Cost Sharing Arrangement may not be deductible if they are made to a foreign resident on a pro-rata basis.[21]

Comment: The MITL states that the OECD TP Guidelines may be applied to the extent that they are consistent with the MITL. Where there is no consistency, then the MITL should be applied.

G. Business Restructurings

No specific transfer pricing guidance is contained in the Mexican Income Tax Law (MITL) but through the reference to the OECD Transfer Pricing Guidelines in the MITL, the OECD's business restructuring guidance is applicable.

In line with Action 12 of the OECD Base Erosion and Profit Shifting (BEPS) action plan, the FTC requires the mandatory disclosure by tax advisors (and, in certain cases, taxpayers) of business restructuring with no compensation for redeployment of functions, risks or assets, and business restructuring which results in a decrease in local profitability by up to 20%. This requirement applies beginning January 1, 2021.

H. Attribution of Profits to PE

A permanent establishment (PE) and its home office, other establishments, and their related parties, as well as their PE, are deemed to be related parties. No specific transfer pricing guidance is contained in the MITL regarding attribution of profit to PE, but the OECD Transfer Pricing Guidelines are applicable.

Comment: When dealing with a country with a treaty (which is in most cases), the AOA is applicable in line with the treaty.

In 2020, the MITL expanded the concept of PE to align with the recommendations of BEPS Action 7 and the Multilateral Instrument. According to the new definitions, a foreign resident acting in Mexico through a person other than an independent agent has a PE if the Mexican person plays the main role in the concluding contracts. However, it is presumed that a person is not an independent agent when acting exclusively or almost exclusively on behalf of residents abroad who are related parties.

The new rules also modify exemptions for certain listed preparatory and auxiliary activities. The amendments require all the exemptions to be subject to the preparatory and/or auxiliary test by including the term "preparatory and/or auxiliary" in the introduction to the list of activities that should not be considered to give rise to a PE. Furthermore, the exemptions do not apply if the foreign resident, either through various places of business or through related parties, performs activities of a cohesive business that, in combination, would not be considered preparatory or auxiliary activities.

[21] *See* IV., above, regarding Specific Transfer Pricing Rules — Pro Rata Allocations.

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V. Documentation and Reporting Requirements

A. Master File and Local File

Beginning in 2016, the Mexican Income Tax Law (MITL) established the obligation for Mexican taxpayers to prepare and submit the Master File and Local File informative returns. The Master File should be filed before December 31 of the year following the relevant taxable year. There are specific submission dates for filing the Master File if there is a difference between the fiscal year of the group and that of the Mexican taxpayer. The deadlines are based on the month in which the foreign parent's year ends, as follows:

- If it ends in June, July, August, September, October, November, or December, the deadline is December 31 of the year immediately following the fiscal year;
- If it ends in January, the deadline is January 31 of the following year;
- If it ends in February, the deadline is February 28 (29) of the following year;
- If it ends in March, the deadline is March 31 the following year;
- If it ends in April, the deadline is April 30 of the following year; and
- If it ends in May, the deadline is May 31 of the following year.

The filing date for the Local File for fiscal year 2024 is May 15, 2025.

Taxpayers that must file the 2024 Master and Local File and include entities with taxable revenues in the prior year exceeding MXN 1,016,759,000 (approximately USD $50,837,950), [22] or whose shares are placed among the general investing public, stock exchanges, optional tax regime entities, federal para-state entities, PEs of foreign entities in Mexico and (since 2022) related party entities of an entity obligated to submit Dictamen Fiscal and which carried out transactions with related parties. Taxpayers that have a *maquila* operation [23] or an APA are excluded from the Local File obligation.

Taxpayers can file the Master File jointly with other Mexican entities of the group and can file the Master File prepared in English by a foreign headquarters, as long as the document is aligned with BEPS Action 13.

The requirements established by the Mexican law for the filing of the Local File and Master File in Mexico exceed the minimum requirements established in OECD's BEPS Action Plan 13. For instance, the Local File requires disclosure of certain financial and tax information of all related parties that carried out transactions with the taxpayer (current assets, fixed assets, sales, costs, operating expenses, net income, taxable base, and tax payment).

Any entity obliged to submit the statutory tax audit report (*dictamen* fiscal) for fiscal year 2023 will also have to file its Local File by May 15, 2024 (as long as they have intercompany transactions and even if the related parties do not meet the threshold).

B. Country-by-Country Reports (CbC Rules)

Under the OECD's BEPS Action 13, all large multinational enterprises ("MNEs") are required to prepare a Country-by-Country ("CbC") report with aggregate data on the global allocation of income, profit, taxes paid, and economic activity among the tax jurisdictions in which they operate. This CbC report is shared with tax administrations in these jurisdictions for use in high-level transfer pricing and BEPS risk assessments. [24] Beginning in 2016, the MITL established the obligation for Mexican taxpayers to submit the CbC information return before December 31 of the following year. The CbC report must be filed by Mexican multinational controlling entities with consolidated income in the prior year of at least MXN $12 billion (approximately USD $600,000,000). [25]

On October 17, 2017, the United States and Mexico signed a Competent Authority Arrangement ("CAA"), [26] which become operative on the same day. Pursuant to the provisions of the CAA, the two countries undertook to exchange CbC reports about the activities of multinational enterprise groups ("MNEs") that conduct economic operations within their borders. This CAA is a bilateral effort between the two countries to implement the recommendations of Action 13 of the OECD's 2015 BEPS Report regarding exchange of CbC reports by countries in which MNEs operate.

C. Annual Tax Return Disclosures

1. Reporting and Disclosure Requirements

a. Disclosure Requirements Under the Mexican Financial Reporting Standards

The Mexican Income Tax Law (MITL) requires the application of Mexican financial reporting standards (FRS) for the purpose of transfer pricing analysis. The reporting standards detailed in the NIF C-13 document[27] provide accounting disclosure guidance for transfer pricing.

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[22] This amount is applicable to fiscal year 2024 and may be modified for future years.

[23] A *maquila* operation is an economic development incentive program that was enacted by Mexico under the Decree for the Promotion of Manufacturing, *Maquila*, and Export Services Industry ("IMMEX Decree"). This program was designed to incentivize foreign principals to locate manufacturing operations in Mexico. Under the program, a resident Maquiladora company must perform the manufacturing activity; the foreign principal must retain title to the raw materials, component parts, and inventory during the manufacturing process, and then take title to and sell the finished goods. *See Whirlpool Financial Corporation & Consolidated Subsidiaries v. Commissioner of Internal Revenue*, 154 T.C. No. 9 (May 5, 2020), *pp 12-13.*

[24] *See* https://www.oecd.org/tax/beps/beps-actions/action13/.

[25] This amount is applicable to fiscal year 2024 and may be modified for future years.

[26] Arrangement Between the Competent Authority of the United States of America and the Competent Authority of the United Mexican States on the Exchange of Country-by-Country Reports, available at: https://www.irs.gov/pub/irs-utl/mexico_competent_authority_arrangement.pdf.

[27] *See* https://iqdata.com.mx/NIFs/39.%20NIF%20C-13%20Partes%20Relacionadas.pdf.

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b. Information Return on Related Party Transactions (Appendix 9 of DIM)

Starting in 2022, Article 79, Section X of the MITL establishes that all corporations and individuals engaged in business activities are required to file an information return on transactions with related parties, both local and foreign (Declaraciòn Informative Mùltiple – DIM). This Information Return on Related Party Transactions (Appendix 9 of DIM) for fiscal year 2024 is due before May 15, 2025.

The Appendix 9 of DIM requires

- a confirmation of the existence of transfer pricing documentation for each intercompany transaction,
- the amount of the transaction, the type of transaction,
- the gross or operating margin obtained by the tested party for one of the transactions,
- the transfer pricing method used for each transaction,
- the taxpayer identification number of the related party,
- and the country of residence and address of the tax domicile of the related party.

Maquiladora companies that comply with Article 182 of the MITL are not obligated to provide such a filing for their maquiladora operations.

c. The Dictamen Fiscal

(1) In General

In addition to the audit of financial statements, certain taxpayers in Mexico should also file a statutory tax audit report (*dictamen* fiscal). The main benefit of filing a statutory tax audit report (*dictamen* fiscal) is that in case of an audit, the Mexican tax authorities must first require information from an independent auditor and then, if that information is not available, they may require it from the taxpayer.

The statutory tax audit report (*dictamen* fiscal) is mandatory for taxpayers who in previous year had declared income greater than MXN $1,855,919,380 (approximately USD $92,795,969), as well as companies that have shares placed among the general investing public and on the stock market. A statutory tax audit report (*dictamen fiscal*) for 2024 will have to be filed no later than May 15, 2025.

Since 2014, a Mexican taxpayer (not obligated to submit *Dictamen Fiscal*) is no longer required to have a certified independent public accountant in Mexico audit his or her financial statements for tax purposes. Rather, taxpayers may engage an external auditor to prepare and file a statutory tax audit report if they meet one of the following criteria for fiscal year 2024:

- Aggregate prior year revenues of over MXN $157,785,270 (approximately USD $7,889,264); [28]
- Total assets of over MXN $124,650,380 (approximately USD $6,232,519); [29]
- During the year on average have 300 or more employees; or
- Control by another company (Mexican or foreign) that falls under one of the three criteria mentioned above.

If the taxpayers engage an external auditor to prepare and file a statutory tax audit report, the independent accountant must file the audited financial statements with the tax authorities, along with a statutory tax audit report (*dictamen* fiscal) that includes an opinion as to whether the taxpayer complied with its federal tax obligations.

(2) Obligation to Disclose Non-Compliance with Federal Tax Law

If the taxpayer presents the statutory tax audit report (*dictamen* fiscal), the independent accountant must state whether the intercompany transactions were reflected on an arm's length basis, disclose the transfer pricing methods used, note whether any transfer pricing adjustment was made, disclose existing APAs and favorable resolutions issued by the Mexican tax authorities on intercompany transactions, and confirm filing of the Information Return on Related Party Transactions, among other pieces of information. The Miscellaneous Tax Resolution also requires disclosure of the personal tax identification number of the individual preparing or advising on the transfer pricing report for the applicable year. Failure to prepare the transfer pricing documentation must be disclosed by the independent accountant in the statutory tax audit report.

d. Tax Situation Information Return

The Tax Situation Information Return (ISSIF) is a report prepared by the taxpayer (or a third-party advisor) in which tax compliance information is disclosed (this report does not apply to companies that are obliged to file a statutory tax audit report). For Fiscal year 2024, Mexican taxpayers must file the Tax Situation Information Return if they meet any of the following criteria:

- Have aggregate prior year revenues over MXN $1,016,759,000 (approximately USD $50,837,950)[30] or have shares traded in the public stock exchange;
- Report under the optional tax regime for groups of companies under Title II, Chapter VI of the MITL;
- Are parastatal entities (i.e., entities that serve the government) of the federal public administration;
- Have PEs in Mexico; or
- Conduct transactions with foreign-based parties.

Mexican resident companies conducting transactions with foreign residents may, however, choose not to file the Tax Situation Information Return if the transactions amount to lower than MXN $100 million (approximately USD $5,000,000) in the aggregate.[31]

[28] This amount is applicable to fiscal year 2024 and may be modified for future years.

[29] This amount is applicable to fiscal year 2024 and may be modified for future years.

[30] This amount is applicable to fiscal year 2024 and may be modified for future years.

[31] This amount is applicable to fiscal year 2024 and may be modified for future years.

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The taxpayer must file the Tax Situation Information Return together with its tax return with the Mexican tax authorities by the end of March following the end of the calendar year.

e. Public Company Disclosure Requirements Under the Stock Market Act

There are no specific transfer pricing requirements are established for companies under the Stock Market Act.

2. Documentation Requirements

a. Taxpayers Obligated to Produce Documentation

Taxpayers conducting intercompany transactions with local and foreign-related parties are required to produce the transfer pricing documentation on a yearly basis.[32] Taxpayers engaging in business activities whose income in the immediately preceding fiscal year did not exceed MXN $13 million (approximately USD $750,000)[33] and taxpayers whose income from the provision of professional services did not exceed MXN $3 million (approximately USD $150,000)[34] are, however, excused from preparing transfer pricing documentation, unless they:

- Enter transactions with entities in low tax jurisdictions; and
- Are contract or assignation holders under the Hydrocarbons Revenue Law ("HRL").

Nevertheless, taxpayers who fall below the threshold for specific transfer pricing documentation must still prove, when audited, that their intercompany transactions, including those with both domestic and foreign-related parties, are at arm's length.

b. Detailed Discussion of Documentation Requirements

The documentation requirements for all intercompany transactions established in Article 76, Section IX of the MITL include the following elements:

- General information, such as the name of the reporting company, address, taxpayer identification number, name of the related parties with which transactions were conducted, and a description of the reporting taxpayer's ownership structure covering all related parties engaged in transactions of potential relevance;
- An overview of the taxpayer's business, including an analysis of the economic factors that affect the pricing of its products or services, such as a description of the functions performed, assets employed, and risks borne by the taxpayer for each type of transaction;
- A description of the controlled transactions and the amount of the transactions (including the terms of sale) for each related party on a transactional basis according to Article 179 of the MITL; and
- A description of the selected methodology applied as established in Article 182 of the MITL, including information and documentation of intercompany transactions or comparable companies for each type of intercompany transaction, and the application details of comparable adjustments.

c. Scope of the Obligation

All intercompany transactions between related parties, including local and foreign-related parties, must be reflected arm's length prices for income tax purposes, including transfers of tangible and intangible property, services, rental or licensing of assets, loans, and transfers of shares (whether publicly traded or not). This obligation applies to intercompany transactions entered by individual and corporate taxpayers.

d. Deadline

Taxpayers are required to determine tax obligations and file returns on a calendar year basis for income tax purposes. If taxpayers have their financial statements audited by a certified independent accountant in Mexico, the independent accountant must file the audited financial statements with the Mexican tax authorities along with a statutory tax audit report (*dictamen* fiscal) that includes an opinion as to whether the taxpayer complied with its transfer pricing obligations, which is usually required to be filed by the middle of the year following the end of the calendar year. If the transfer pricing documentation has not been prepared, such failure must be disclosed by the independent accountant in the statutory tax audit report (*dictamen* fiscal).

In the case of taxpayers that are not obliged to file the statutory tax audit report, the due date is March 31 following the end of the calendar year (due date for filing the Income Annual Tax Return or the ISIF).

e. Language Requirements for Documentation

Transfer pricing documentation is considered part of the taxpayer's accounting records, and it must be prepared in Spanish. The supporting documentation, like business description of comparable companies or comparable agreements, which often are in English, should also be translated into Spanish.

f. Items Not Required as Part of the Transfer Pricing Documentation

The transfer pricing regulations do not mention specific items not required as part of the transfer pricing documentation.

g. Documentation Conclusions

The Mexican transfer pricing regulations establish that any result of the tested party or tested transaction, which is within the interquartile range, is at arm's length.

h. Documentation of Domestic Intercompany Transactions

The tax Act, which is in force as of January 1, 2022, amended Articles 76 and 179 of the MITL to eliminate the pre-existing distinction between documentation requirements for international and local intercompany transactions. Now the

[32] The MITL contains two separate articles: one for transfer pricing documentation and another for Local File and Master File.

[33] This amount is applicable to fiscal year 2024 and may be modified for future years.

[34] This amount is applicable to fiscal year 2024 and may be modified for future years.

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transfer pricing requirements apply to all transactions with related parties, regardless of their place of residence.

D. Penalties and Other Sanctions on Transfer Pricing Compliance

1. Failure to Prepare Transfer Pricing Documentation

There are no immediate penalties for failure to prepare transfer pricing documentation. However, any related deduction or cost of goods sold may be at risk if the documentation is not prepared.

2. Failure to File Local File, Master File, and CbC Report

For a Mexican taxpayer's total or partial non-compliance with the Local File and Master File regulations, the following potential penalties apply:

- Economic sanctions ranging from MXN $199,630 (approximately USD $9,982) to MXN $284,220 (approximately USD $14,211);[35]
- Limitation on the taxpayer's ability to enter contracts with the government; and
- Cancellation of import and export registration.

3. Failure to File Appendix 9 of DIM

Failure to file the Information Return on Related Party Transactions (Appendix 9 of Declaración Informativa Múltiple (DIM) must be disclosed in the statutory tax audit report (*dictamen* fiscal). The fines range from MXN $99,590 (approximately USD $4,980) to MXN $199,190 (approximately USD $9,960),[36] and these penalties are in addition to those that could apply in case of a tax deficiency.

[35] This amount is applicable to fiscal year 2024 and may be modified for future years.

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VI. Transfer Pricing Audits

A. *Types of Audits and Ordering Rules*

1. *Review of the Dictamen Fiscal*

Transfer pricing is reviewed using regular procedures; the Mexican tax authorities in specific cases initiate the procedure through a summons to the company's independent auditor who prepared the statutory tax audit report (*dictamen* fiscal) before initiating a written request for information directly with the taxpayer.

2. *Written Requests for Information*

The Mexican tax authorities can apply the verification procedure established by the Mexican Federal Tax Code (FTC) through written requests for information. This is the first step before initiating a written request for information directly with the taxpayer. During the examination, the Mexican tax authorities may request information, and access to the accounting records of the company must be allowed. During the examination, the audit cannot be completed without providing the taxpayer a written statement of findings. If a taxpayer does not comply with an information request during an audit, the Mexican tax authorities may impose fines that range from MXN $22,400 (approximately USD $1,280) to MXN $67,210 (approximately USD $3,840).[37]

3. *On-Site Examinations*

The Mexican tax authorities can also perform an on-site examination. During an on-site examination, the taxpayer is under obligation to provide all the information that demonstrates compliance with tax obligations, including transfer pricing documentation. However, taxpayers are not required to produce special reports for the tax authorities.

4. *Burden of Proof*

In accordance with the Federal Civil Law, the burden of proof is on the party that makes an affirmation. Therefore, any affirmation by the taxpayer within a tax audit must be supported by documentation or information. Similarly, the Mexican tax authorities have the burden of proof to support their position(s) if they argue that:

(1) a certain transaction was not carried out;

(2) there is a lack of documentation for any transaction; or

(3) that a certain transaction must be re-characterized.

5. *Notice of Deficiency*

Once the Mexican tax authorities have concluded the tax examination, they issue an observations memorandum/last partial act or pre-assessment that contains the main facts and omissions found during the tax audit process. The taxpayer is provided the opportunity to rebut the facts and omission found.

Once the taxpayer responds to the pre-assessment, the Mexican tax authorities have up to six months to issue a tax assessment, which is the final determination of the audit procedure. This tax assessment may be challenged through an administrative appeal.

This audit stage is one of the most important stages since if the taxpayer does not make any statement within the periods established in the FTC, the audit facts are deemed to be true, and the taxpayer may have to challenge those facts or omissions in subsequent controversy procedures once the tax assessment has been determined. In a transfer pricing audit, the taxpayer has two months to refute the observations by the tax authority and may request an additional month (different legal terms may be applicable to other kinds of audits).

6. *Collateral*

Once the tax assessment is received, the taxpayer has the option to: (i) challenge it through an administrative appeal; or (ii) challenge it through a nullity petition trial. Appeals and the litigation alternative are discussed in IX., below.

If the taxpayer decides to use the appeal procedure, there is no requirement for collateral to be offered by the taxpayer. However, if the taxpayer opts for the nullity petition trial, the taxpayer must furnish a collateral guarantee of payment to the tax court.

B. *Statutes of Limitations*

1. *Statute of Limitations on Assessment*

The statute of limitations for the Mexican tax authorities to initiate a tax review is generally five years for all federal tax matters, including transfer pricing cases, counting from the filing of the annual tax return (general rule). In some special cases, this period can be extended up to 10 years. The running of the period is suspended during an on-site audit (no suspension applies to other types of examinations) or if the taxpayer files a petition before the courts.

2. *Statute of Limitations on Tax Collection*

Transfer pricing examinations must be completed within 24 months from when the audit is initiated and may be suspended in cases where the taxpayer initiates a trial before a local or foreign court.

3. *Statute of Limitations on Refund Claims*

Taxpayers that have a favorable tax balance can request a tax refund. The Mexican tax authorities should answer the request within 40 working days, but they can request supporting documentation, which suspends the above period. The process should be concluded within 60 working days. If there is no response from the Mexican tax authorities, taxpayer may initiate a judicial procedure through the tax court to require the Mexican tax authorities to resolve whether the favorable balance may be refunded. This kind of process normally takes between 12 and 18 months to be concluded. Taxpayers lose the right to request a favorable balance after 5 years, counting from the time at which the favorable balance was generated.

C. *Settlement and Closing Agreements*

Once the Mexican tax authorities make a qualification of the findings, but before the notification of the assessment, the

[37] This amount is applicable to fiscal year 2024 and may be modified for future years.

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taxpayer can initiate a Closing Agreement before the Tax Ombudsman (PRODECON) to mediate on the observations found by the Mexican tax authorities. In practice, many taxpayers, and sometimes even the Mexican tax authorities, make an economic proposal through the PRODECON procedure in order to reach an agreement. The filing of the conclusive agreement procedure before PRODECON suspends the time that the Mexican tax authorities have to notify the tax assessment. Starting in 2021, new regulations entered into force, which specify that taxpayer has 20 days to initiate a conclusive agreement process, counting from the date on which the observations memorandum, discussed in VI.A.5., is notified.

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VII. Transfer Pricing Adjustments

A. Self-Initiated Adjustments

Rules 3.9.1.1, 3.9.1.2, 3.9.1.3, and 3.9.1.4 of the Miscellaneous Tax Resolution provides for the possibility of a taxpayer self-initiated adjustment, which can be "real" (with effect on both the tax and accounting results) or "virtual" (with effect only for tax purposes). The rule establishes that transfer pricing adjustments should have the same concept or nature as the transaction subject to the adjustment.

For adjustments that increase the price, the consideration amount, or the profit margin, the taxpayers should do the following:

- If the adjustment generates additional income, the new increased amount must be considered taxable income for monthly tax prepayments in the month in which the adjustment is made.
- If the adjustment generates additional deduction, the taxpayer must comply with specific rules established in the Miscellaneous Tax Resolution.
- Any applicable withholding tax should be adjusted accordingly.

For adjustments that decrease the price, the consideration amount, or the profit margin, the taxpayers should do the following:

- Taxpayers who have obtained taxable income due to intercompany transactions may increase their deductions by an amount equivalent to the adjustment, and the taxpayer must comply with specific rules established in the Miscellaneous Tax Resolution.
- Taxpayers who have obtained deductions due to intercompany transactions may reduce their deductions by an amount equivalent to the adjustment.
- Any applicable withholding tax should be adjusted accordingly.
- When adjustments of income or deductions derived from transfer pricing adjustments are made, the adjustments for VAT and excise tax also must be made.

The Miscellaneous Tax Resolution establishes a series of deductibility requirements for transfer pricing adjustments.

If the transfer pricing adjustment is made after the established deadlines (after the year the transaction or its effect was recognized is closed), the taxpayer may deduct the adjustment in the tax year in which the income or deduction(s) derived from the related party transaction were recognized, provided a notice is filed. The notice should also be filed as a consequence of a primary adjustment.

A taxpayer may request the deduction of transfer pricing adjustments derived from an APA and the foreign correlative adjustment to vary between the tax years.

In terms of self-initiated adjustments, in 2018 the Mexican tax authorities published a non-binding criteria, which states that it is an incorrect practice for the taxpayer to change the price or profit margin agreed for intercompany transactions, if these amounts were already within the interquartile range. Also, assisting, advising, providing services, or participating in the execution or implementation of the aforementioned practice is considered an incorrect practice for advisors or others.

B. Audit-Related Adjustments

When a tax audit process is finalized and a transfer pricing adjustment is determined, to conclude the revision, the taxpayer must prove and pay the corresponding taxes derived from the adjustment.

C. Effect on Tax Attributes

1. Net Operating Losses

As a consequence of the assessment, many tax attributes might need to be adjusted. If the adjustment turns losses into profits, the amount of net operating losses decreases.

2. CUFIN and FTC

The foreign tax credit limitation may increase if the taxable income increases as a consequence of an adjustment to an international operation, the amount of the net after tax earnings account (CUFIN) will also increase as a consequence of any increase to the taxable income. Withholding taxes and estimated payments might also require an adjustment. Constructive dividends may be subject to a corporate level tax if the constructive distribution does not arise from the CUFIN, and actual distributions that may have been made could become subject to corporate level tax if the CUFIN is reduced/increased by transfer pricing adjustments reducing/increasing after-tax earnings.

3. Profit Ratio for Estimated Payments

The transfer pricing adjustment may modify the profit ratio for estimated payments if it modifies the revenue/expense transaction.

D. Additions to Tax

1. Monetary Correction

In the past, Mexico had significant inflation. That is why, in addition to the tax, monetary correction is also imposed to reflect an inflation adjustment. Monetary correction for the late payment is adjusted on a monthly basis, considering the monthly inflation index published by the Mexican tax authorities.

2. Interest

In addition to the inflation adjustment, a late payment interest (surcharge) is also imposed for the period between the date on which the tax return was filed and the date that additional tax is paid. Surcharges for late payments are adjusted on a monthly basis.

E. Mandatory Profit Sharing

Transfer pricing adjustments may also be subject to an employee profit sharing expense.

F. Corresponding Adjustments

The Miscellaneous Tax Resolution defines a domestic correlative adjustment that a taxpayer may apply as a result of a primary adjustment by the taxpayer's Mexican related party. A foreign correlative adjustment is an adjustment that a taxpayer

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resident in Mexico or a foreign taxpayer with a PE in Mexico may apply as a result of a primary adjustment made directly to the taxpayer's foreign related party.

G. Secondary Adjustments

The Miscellaneous Tax Resolution defines a secondary adjustment as resulting from the application of a contribution, in accordance with applicable tax legislation, after having determined a transfer pricing adjustment to an operation that is generally characterized as a deemed dividend.

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VIII. Transfer Pricing Penalties During Transfer Pricing Audits

A. Penalties

In the case of a transfer pricing adjustment imposed by the Mexican tax authorities, the regular penalties for failure to pay are normally imposed, ranging from 55%–75% of the inflation-adjusted amount of the assessment. If the amount of a loss is reduced, the penalty ranges from 30%–40% on the difference between the reported and the actual loss, to the extent any portion of the misstated loss is utilized. Besides the penalties and the inflation adjustment, late payment interest (surcharges) is also imposed.

B. Reduction for Penalties and Surcharges

The penalty for failure to pay is reduced to 50% if the payment is made during the audit and prior to the notice of deficiency.

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IX. Appeals and Litigation Matters

A. Administrative Appeal

A transfer pricing adjustment may be appealed before the Mexican tax administration (*recurso de revocación*), or a lawsuit may be filed before the Tax Court. It is not necessary to use the appeals procedure within the administration before going to the tax court.

In either case, the taxpayer has 30 working days from its issuance to appeal a determination made by the Mexican tax authorities (discussed in VI.A.5., above). The administrative appeals process does not require the taxpayer to provide any kind of bond until the tax administration has reached a conclusion regarding the administrative appeal. This exemption from the payment of a bond also applies to competent authority procedures.

B. Reconsideration

In accordance with the Mexican Federal Tax Code (FTC), the Mexican tax authorities may review administrative resolutions issued by their subordinates that are not favorable to an individual taxpayer. The Mexican tax authorities may, on a one-time basis (per administrative resolution that is being challenged), modify or revoke the administrative resolution for the benefit of the taxpayer. They will allow this modification, provided the taxpayer has not invoked a defense[38] and the timeframe for the tax authorities to collect the tax assessment has not expired.

In practice, this procedure is initiated by taxpayers who did not initiate any legal means of defense against the resolution, provided that such resolution is against the tax provisions. In that case, the taxpayer would have to file a writ before the authority superior to the one that issued the resolution, and the writ should contain the explanation of the legal arguments for which the taxpayer believes that the resolution is against the legal provisions.

C. Tax Litigation

Once the taxpayer has been notified of a tax assessment, they may choose between initiating an administrative appeal, which is conducted by the Contentious department of the Mexican tax authorities, or a nullity petition process (tax litigation), which is conducted before the Tax Court. Also, if the taxpayer has chosen to challenge the resolution through an administrative appeal procedure before the Contentious department of the Mexican tax authorities, and the resolution of such procedure is not favorable to the interest of the company, it may challenge that resolution through the nullity petition process.

The taxpayer has 30 working days from the notification of the tax assessment to initiate either of the two means of defense. Once the conclusive agreement process is closed, the taxpayer must pay the assessment within six months. The taxpayer has 30 days after obtaining a liquidation letter to file a petition with the tax court.

Also, where the taxpayer chooses to challenge the resolution through an administrative appeal procedure before the Contentious department of the Mexican tax authorities and the resolution of such procedure is not favorable to the interest of the company, they may challenge such resolution through the nullity petition process.

The Tax Court can only decide whether a determination by the tax authorities was made according to the law. It cannot change the amount of an adjustment made by the Mexican tax authorities.

Determinations by the courts are not binding except on the parties involved in the specific litigation. Within the Tax Court, there is no subject matter specialization and therefore, in principle, any division of the court may hear a transfer pricing case. It also has been pre-established that the Sala Superior (the highest authority within the Tax Court) will hear any transfer pricing case where the statute is construed for the first time.

If the case goes directly to the Tax Court, the taxpayer is required to provide a guarantee (bond, deposit, and/or mortgage) for the amount of the deficiency and an estimate of the additions to the tax for one year.

D. Constitutional Litigation (Amparo Trial)

The constitutional appeal is an extraordinary process through which the taxpayer may challenge the resolution of the Tax Court if it is not in accordance with the Mexican Constitution or the tax treaties and is contrary to the taxpayer's rights. This procedure is the last legal resource for the taxpayer to challenge a tax assessment.

The amparo trial can be initiated 15 days after the notification of the resolution of the Tax Court, and the amparo writ should contain the legal arguments or reasons explaining why the Tax Court's resolution is contrary to the Constitution or tax treaties.

E. Juicio de Lesividad

Juicio de Lesividad is a legal means through which the Mexican tax authorities have the authority to reverse a resolution that they issued themselves in favor of an individual or legal entity which they consider contrary to the law and causes damage to the state.

[38] This procedure is for taxpayers who lose the right to file an administrative or judicial procedure (i.e., for example, if the taxpayer did not file the appeal on time nor the nullity petition, they may use a reconsideration procedure).

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X. Competent Authority

A. Mutual Agreement Procedure

There can be a mutual agreement between two residents of different countries regarding the interpretation and application of Tax Conventions. Form 244/CFF includes specific information regarding how and where to file a MAP request.[39]

Taxpayers may file a request to initiate a Mutual Agreement Procedures (MAP) that is related to transfer pricing issues before the Competent Authority, which is the Transfer Pricing unit of the Mexican tax authorities. Taxpayers should file a writ by complying with the requirements stated in the miscellaneous tax regulations. If needed, the tax authorities may notify taxpayers of an information requirement and request additional supporting information. There is no timeframe for the Mexican tax authorities to resolve a MAP, but commonly a resolution may take between 24 and 36 months.

The main characteristics of the MAP are the following:

- Bilateral mechanism to solve controversies regarding the application of an income tax treaty to eliminate double taxation;
- Procedure outside domestic law in addition to local remedies;
- Commonly contained in Article 25 of Mexican income tax treaties, Article 25 of the OECD Model Tax Convention and OECD Commentaries, as well as the OECD Manual on Effective Mutual Agreement Procedures;
- Filing time pursuant to each bilateral tax convention signed between contracting states;
- Suspension of time limits to continue with local remedies (i.e., appeal resolution); and
- Requested by the resident taxpayer before the competent authority of the country of its residency.

In the case of Mexico and the U.S., there is a pre-filing process that must be followed by the taxpayer prior to the expiration of the period wherein a MAP ought to be filed. According to the Miscellaneous Tax Resolution, if a taxpayer determines that there may be measures of one or both of the contracting states that may result in an imposition that is not in accordance with the provisions of the U.S.-Mexico Income Tax Treaty, it may request the suspension of the period for notifying the commencement of the MAP. This notification aims to suspend the term to formally begin the MAP. Also, according to U.S. tax laws, a taxpayer may file a preventive notification in case of a future measure not in accordance with the income tax treaty.[40] Both preventive filings should be filed before the lapse of the period stated in the relevant income tax treaty to begin a MAP.

The form 244/Còdigo Fiscal de la Federaciòn (CFF) includes specific information regarding how and where to file MAP request.

B. Exchange of Information

Mexico is actively exchanging tax information and best audit practices with its treaty partners, especially the United States.[41] The exchange of information may be automatic, upon specific request, or maybe spontaneous in nature.

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[39] *See* https://www.dof.gob.mx/2021/SHCP/ANEXO_1_A_RMF_2021.pdf.

[40] Dual Protective Claim and Treaty Notification Pursuant to Sections 11 and 12 of Rev. Proc. 2015-40.

[41] Apart from the exchange of CbC reports under the U.S.-Mexico CAA discussed previously, Mexico also has a tax information exchange arrangement with the United States. *See* Competent Authority Arrangement between the Competent Authorities of the Department of the Treasury of the United States of America and the Ministry of Finance and Public Credit of the United Mexican States, available at https://www.irs.gov/pub/irs-utl/unitedmexicanstatescompetentauthorityarrangement.pdf and the Foreign Account Tax Compliance Act ("FATCA") Intergovernmental Agreement ("IGA") Model 1, for the exchange of FATCA information. *See* Agreement between the Department of the Treasury of the United States of America and the Ministry of Finance and Public Credit of the United Mexican States to Improve International Tax Compliance including with Respect to FATCA, available at https://home.treasury.gov/system/files/131/FATCA-Agreement-Mexico-4-17-2014.pdf. A list of jurisdictions with which Mexico has an income tax treaty in force can be found on the Bloomberg Tax platform: https://www.bloomberglaw.com/product/tax/search/results/a08bda77c4770f092195a376a1072c07/.

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XI. Advance Pricing Agreements and Rulings

A. APAs as Administrative Determinations

APAs have been included in the law as a legal possibility since 1997. They are issued as unilateral rulings under domestic law or as bilateral determinations under the competent authority procedure in a treaty. An APA approves a methodology and not a specific result. In a bilateral APA, the tax authorities are entitled to waive late payment interest.

B. Scope: Transactions, Persons, and Fiscal Years

1. Transactions

Transactions are considered involved in the APA or BAPA if they relate to the methodology used in determining the prices or amounts of the consideration, in operations with related parties, under the terms of Article 179 of the MITL, provided that the taxpayer submits the information, data, and documentation necessary for the issuance of the corresponding resolution.

2. Persons

Persons refer to taxpayers who are involved in an operation with a local or foreign related party.

3. Fiscal Years

A unilateral APA covers up to five fiscal years, namely: (i) the current fiscal year, (ii) the three subsequent fiscal years, and (iii) a one-year roll-back. A bilateral APA may be issued for more than five years, in accordance with the agreement with the competent authority of the other country.

C. Pre-Filing Meetings

Pre-filing meetings on a no-name basis are possible. These pre-filing meetings have the purpose of generally explaining to the Mexican tax authorities the operation under analysis, as well as for the taxpayer to receive some input from the tax authorities prior to the formal filing of the APA.

D. Submission Requirements

Under general rules issued by the Mexican tax authorities, the information and documentation requirements for an APA application that should be filed with the Mexican tax authorities are substantial and include the following:[42]

- Power of attorney of the legal representative;
- Name of the company, tax address, tax identification number and country of residence of the taxpayer, and the person or persons with equity interest in the taxpayer;
- Certified copy of the corporate books of the taxpayer where the shareholders are registered;
- The names of the related parties in Mexico or elsewhere that have a contractual or business relationship with the taxpayer;
- A description of the principal activities, including the place where the activities are undertaken, describing the transactions between the taxpayer and its related parties;
- Organizational chart of the group (including a breakdown of shareholding percentages);
- Balance and income statement, as well as a breakdown of costs and expenses incurred by the taxpayer for the three prior years to the period to be covered by the APA, or if taxpayer is under the obligation to file a statutory tax audit report (*dictamen* fiscal), the audited financial statement with the report issued by the registered independent auditor;
- Tax returns of the taxpayer, including amended returns for the past three years;
- Copies of all the contracts and agreements between the taxpayer and its related parties (resident and non-resident related parties) in Spanish;
- Beginning and closing dates of the fiscal years of the related non-resident entities with which a contractual or business relationship exists, or the indication that they use a calendar year;
- Currency used in the main transactions;
- The transactions to be covered by the APA;
- Detailed description of activities undertaken by the company and its related parties with which it has a contractual or business relationship, including a description of the assets and risks assumed by such person;
- The method or methods proposed to determine the price or amount of consideration in transactions undertaken with related residents and non-residents, including criteria and other elements for considering that the method applies to the mentioned transaction or company;
- Information on comparable transactions or companies, the adjustments made to the comparables, and the explanation of rejected comparables and adjustments;
- Financial and tax information corresponding to the fiscal years for which the ruling is requested, applying the method or methods proposed, and forecast of the financial statements; and
- A disclosure stating whether the non-resident related parties are involved in a transfer pricing examination elsewhere.

E. On-site Visit

The Miscellaneous Tax Resolution establishes that as a part of the APA process, the Mexican tax authorities may perform on-site visits to perform a functional analysis if:

- The information provided by the taxpayer requesting the APA is inconsistent or insufficient to understand the func-

[42] *See* rule 2.11.8 of the Miscellaneous Tax Resolution and the procedure form 103/CFF, contained in Appendix 1-A of the Miscellaneous Tax Resolution, available at https://www.dof.gob.mx/2021/SHCP/ANEXO_1_A_RMF_2021.pdf.

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tions or activities carried out by the Mexican or related foreign taxpayers;

• The Mexican tax authorities would like to corroborate information, data, and documentation provided by the taxpayer to understand the assets and risks assumed by the Mexican or related foreign taxpayer;

• The Mexican tax authorities disagree with the proposed method to test the intercompany transactions subject to the APA; or

• The Mexican tax authorities would like to corroborate the application of the transfer pricing method proposed by the taxpayer.

The visit may also confirm the business purpose for the intercompany transactions, as well as reconcile comparability criteria utilized by each related party in order to conclude the APA process.

The functional analysis may be carried out at the taxpayers' office facilities as well as its other establishments, including warehouses, storage rooms, ships, platforms, or in any area in which functions are carried out in order to obtain additional qualitative and quantitative data, information, and documents that may not have been provided by the taxpayer.

F. Procedure

The law provides that a unilateral APA should be resolved in a maximum period of eight months. In practice, most APAs take longer, given that in most cases the Mexican tax authorities issue information requests.

G. Annual Report

Unlike rulings on international tax issues, the Mexican tax authorities are not required to publish APAs and only provide general statistical data from the OECD.

H. User Fee

The fee for an APA is MXN $310,247 (approximately USD $15,512).[43] Once the APA is issued, an annual report must be filed with the Mexican tax authorities to apprise the tax authorities of the taxpayer's compliance with the APA. The fee for the APA's annual review is MXN $62,049 (approximately USD $3,102).[44]

I. APA-Related Litigation

The Supreme Court of Justice has ruled that the confirmation criteria derived from consulting the taxpayer (i.e., an APA) does not constitute a definitive resolution for the purposes of the nullity procedure.

J. APAs in the Examination Environment

Once the taxpayer initiates an APA, in most cases the tax authorities only request information in order to verify the transfer pricing methodology requested by the taxpayer. The information requests issued by the tax authorities have the purpose of enabling the tax authorities to fully understand the transaction under analysis.

K. Termination of APAs

In general, the APA may be terminated if the underlying critical assumptions of a final APA vary. The validity of the resolutions may be conditioned on the fulfillment of requirements that demonstrate that the operations covered by the APA are carried out at prices or amounts of consideration that would have been used by independent parties in comparable operations.

L. Other Administrative Determinations

No other administrative determinations exist.

[43] This amount is applicable to fiscal year 2024 and may be modified for future years.

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XII. Other Rules Relating to Transfer Pricing

A. Thin Capitalization

The Mexican Income Tax Law (MITL) establishes thin capitalization rules, which state that interest paid to foreign related parties that results in indebtedness exceeding a ratio to their stockholders' equity of 3:1 is not deductible. The taxpayer can compare the liabilities to either: (1) the equity (following Mexican FRS) or (2) the sum of the tax basis equity accounts.[45]

Mexican entities that have an excessive debt-to-equity ratio due to loans with related parties can apply for an APA ruling from the Mexican tax authorities on the arm's length nature of the financing in order to maintain the excessive ratio.

The thin capitalization rules are not applicable to companies in the financial sector, which comply with the capitalization rules pertaining to their sector.

B. Limitation on Interest Deduction

In addition to existing thin capitalization rules, the MITL establishes that, starting in 2020, Mexican taxpayers need to calculate a second limitation on the interest deduction and apply the more unfavorable of the two limitations. The new rule restricts a Mexican entity's deduction for net interest expense to 30% of the entity's adjusted taxable income. Under the new rule, taxpayers could carry forward the non-deductible excess amount to 10 subsequent years.

A MXN $20 million (approximately USD $1,000,000)[46] *de minimis* exception from this limitation applies at the Mexican group level to allow interest below this threshold to be deducted.

The new limitation applies to net interest expense, including third-party debt. Certain foreign exchange income or loss related to debt is excluded from the interest definition for purposes of determining the net interest expense. Applicable withholding tax would not, however, be reduced due to non-deductibility of any part of the interest expense. Finally, the computation of inflationary income is adjusted for the non-deductible interest limitation.

C. General Anti-Avoidance Rule

Starting in 2020, a provision of the Mexican Federal Tax Code (FTC) that applies to the interpretation of all Mexican tax law provides that legal acts that lack business purpose and that result in a direct or indirect tax benefit can be recharacterized.

The rule allows the Mexican tax authorities to presume that there is not a valid business purpose when the expected, quantifiable economic benefit is less than the tax benefit. The Mexican tax authorities can also presume that a series of legal acts lacks business purpose when the same economic benefit could have been obtained through a simpler set of transactions, even with a higher tax cost.

It is presumed that a transaction lacks a business reason when the quantifiable economic benefit is lower than the tax benefit received. "Tax benefit" is defined as any reduction, deferral, or elimination of a contribution. The reasonably expected economic benefit includes generation of revenue, cost reduction, increase in the value of assets, and better market positioning.

The Mexican tax authorities, as part of an open audit, can presume that the legal acts lack business purposes based on facts and circumstances that become known as a result of the tax controversy process.

D. Reportable Transactions

Effective in 2021, tax advisors, including transfer pricing experts, must disclose to the Mexican tax authorities the reportable transactions described in the Mexican Federal Tax Code (FTC). In some instances,[47] the taxpayer is required to report the transactions. The reporting requirements will apply not only to transactions carried out as of January 1, 2021 but also to previously implemented transactions that continue to have tax effects post-2020.

This new mandatory disclosure requirement applies to any transaction that generates a Mexican tax benefit and has one of the following characteristics:[48]

- The transaction avoids the exchange of tax or financial information between foreign and Mexican tax authorities;
- The transaction avoids the application of Mexican tax rules for investments in transparent tax entities or preferential tax regimes;
- The transaction consists of one or more legal acts that allow for the transfer of tax losses to a party that did not generate the loss;
- The transaction consists of a series of interconnected payments or transactions that return all or a portion of the initial payment to the original payer, its shareholders or related parties;
- The transaction involves a nonresident applying an income tax treaty with Mexico with respect to income that is not subject to tax or is subject to tax at a beneficial rate compared to the general corporate rate in the country or jurisdiction of the nonresident's residence;
- The transaction involves certain intercompany transactions such as:
    - o the transfer of hard to value intangible assets;
    - o business restructuring with no consideration for the transfer of assets, functions, or risks or resulting in a re-

[45] This amount consists of the Capital Contributions Account (CUCA, as it is known in Spanish), plus the CUFIN balances.

[46] This amount is applicable to fiscal year 2024 and may be modified for future years.

[47] Examples include the following situations: (i) the tax advisor does not provide the proper documentation to demonstrate that either the disclosure has been done or the transaction is considered non-reportable; (ii) the reportable transaction has been designed, organized, implemented, and administered by the taxpayer; (iii) the taxpayer obtains tax benefits in Mexico from a reportable transaction that has been designed, marketed, organized, implemented, or administered by a person that is not considered a tax advisor; (iv) the tax advisor is resident abroad without a permanent establishment in Mexico; (v) there is a legal impediment for the tax advisor to disclose the transaction; and (vi) under an agreement between the tax advisor and the taxpayer, the taxpayer agrees to take care of any disclosure obligation. *See* article 198 of the FTC.

[48] *See* Article 82-A of the FTC.

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duction of more than 20% of the Mexican operating income;

o the transfer or the granting of the temporary use of assets or rights without consideration; performing services or functions that are not compensated;

o the use of unreliable comparables for benchmarking unique and high value transactions; and

o the use of a unilateral protection regime pursuant to the laws of a foreign country.

• The transaction avoids creating a PE in Mexico under income tax laws and tax treaties;

• The transaction involves the transfer of a fully or partially depreciated asset and allows the related party to depreciate the asset;

• The transaction involves a hybrid mechanism;

• The transaction avoids identifying the beneficial owner of income or assets;

• The transaction generates income for a taxpayer to avoid the expiration of tax loss carryforwards and creates a future deduction for the taxpayer or a related party;

• The transaction avoids the application of dividend withholding tax on individuals or foreign residents;

• The transaction is a sales and lease back to the original party or a related party; and

• The transaction has accounting and tax values that differ by more than 20%.

In addition, any mechanism that is designed to avoid these mandatory reporting requirements must be reported.

E. Relationship to Other Taxes

When adjustments are made to income or deductions derived from transfer pricing adjustments, adjustments to value added tax, excise tax, customs duties, and local taxes should also be considered, as applicable.

F. Limited Risk Structures

1. Conversion Issues

A business restructuring with no consideration for the transfer of assets, functions, or risks, or resulting in a reduction of more than 20% of the Mexican operating income must be reported to the Mexican tax authorities. For the purpose of this provision, the OECD Transfer Pricing Guidelines' definition of "business restructuring" should be used.[49]

2. Structural Issues

According to the legal criteria issued by the Tax Court, the Mexican tax authorities may ignore the characterization of an operation formally carried out between related parties and recharacterize it in accordance with its economic substance.[50] Following the OECD Transfer Pricing Guidelines, there are two exceptions in which the tax authorities may disregard the structure followed by the taxpayers in related party transactions and carry out its recharacterization for tax purposes.

The first of these occurs when the economic substance of the operation differs from its form. The second exception occurs in the case in which the form coincides with the substance of the operation, but the agreements related to it, globally valued, differ from those that would have been adopted by independent companies acting rationally from a commercial point of view, and its real structure prevents the tax authorities from determining an appropriate transfer pricing adjustment.

3. Audit Activity

In terms of business restructuring, the business reasons, exit taxes, disruption or cancellation payments, PE, and foreign trade issues, among others, are closely reviewed by the Mexican tax authorities during audits.

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[49] Thesis approved April 16, 2013 and published in TFJFA, 7. Year III. No. 19 Feb-2013, page 732.

[50] The guidelines define a business restructuring as a "cross-border reorganisation of the commercial or financial relations between associated enterprises," including the "termination or substantial renegotiation of existing arrangements." Portfolio 6936-2nd: Transfer Pricing: OECD Transfer Pricing Guidelines, X. Chapter IX: Transfer Pricing Aspects of Business Restructurings, A. Introduction.

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XIII. Special Considerations

A. *The Maquiladora Industry*

1. *Background*

Maquila operations are defined as those with the following characteristics:[51]

- Raw materials are supplied by a foreign principal and are temporarily imported to be processed, transformed, or repaired and are subsequently exported, including, for these purposes, virtual import-export operations.
- The *Maquila* entity is permitted to import goods in accordance with the permanent importation regime. Additionally, local purchases are allowed, as long as such goods are consumed in production and/or exported with the temporarily-imported inventory.
- The processing, transformation, or repair of goods must be performed with temporarily imported machinery and equipment that is the property of the foreign principal.

The term *maquiladora* originally referred to a particular customs regime facilitating temporary imports and reducing costs for imports such as customs fees, value-added taxes, etc. This customs regime was combined with the Temporary Import Programs to Produce Export Articles program (Programa de Importación Temporal para Producir Artículos de Exportación or PITEX) in 2006, and the new scheme is now called the Manufacturing, Maquila and Export Services Industries Program (Industria Manufacturera, Maquiladora y de Servicio de Exportación or IMMEX).

The IMMEX program provides a tax incentive that allows Mexican companies to temporarily import goods that will then be used in the manufacture or repair of products, without having to pay general import tax and VAT on those imported goods. However, within a set timeframe, the finished manufactured product must then be exported, transferred to another IMMEX company in Mexico, or granted a "definitive importation" status.

2. *History of the Tax Treatment of the Maquiladoras*

Prior to 1995, *maquiladoras* were regarded as cost centers and were not required to report significant profits. Since 1995, the Mexican tax authorities have requested maquiladoras to choose one of the following alternatives:[52]

- Prepares and maintains transfer pricing documentation determining an arm's length level of profitability for the *maquiladora* and adding to the result 1% of the net book value of the machinery and equipment owned by the foreign-related company that is used by the *maquiladora*; Or
- Reports taxable income of at least the higher of the following values (safe harbor):
  - 6.9% of assets used in the *maquiladora* activity (including the inventories and fixed assets owned by the foreign-related party).
  - 6.5% on operating costs and expenses of the *maquiladora; Or*
- Prepares and maintains transfer pricing documentation considering a return on the net book value of machinery and equipment owned by the foreign-related company that is used by the *maquiladora*; Or

These alternatives were regulated by administrative rules subject to annual renewal. Failure to comply with one of these rules could result in a transfer pricing adjustment and the application of PE rules to the foreign principal.

With the 2014 tax reform in Mexico, the *maquiladoras* have been left with only two alternatives to determine their compensation: (i) request an APA; or (ii) application of the existing safe harbor rule.

The 2022 tax reform eliminated the APA alternative from the Income Tax Law. The maquiladoras have been left with only the existing safe harbor rule.

3. *Current Rules*

a. *Permanent Establishment*

A foreign principal is not considered to have a PE in Mexico as long as certain requirements are met. The requirements include the condition that the non-resident must be a resident in a tax treaty country and that the *maquiladora* complies with the transfer pricing provisions to determine its tax profit through the safe harbor as provided in the Mexican Income Tax Law (MITL).

b. *Maquila Compensation*

Article 182 of the MITL allows the *maquiladora* to determine its taxable income in an amount equivalent to the higher of the following: (i) 6.9% of the value of the total assets of the maquiladora; or (ii) 6.5% of total costs and expenses of the *maquila* operation. Both calculations are subject to a number of exemptions and special rules.

For instance, for the purpose of calculating the 6.9% of the value of the assets, all the assets used in the maquiladora operation during the fiscal year must be considered for the calculation. The only assets that may be excluded from the calculation are those leased at arm's length to the *maquiladora* by a Mexican resident or a non-resident related party, except if they were previously owned by the *maquiladora.*

For the purpose of calculating 6.5% of the total costs and expenses, the costs must be determined under Mexico's financial reporting standards (FRS) except for certain items. For instance, the total amount of purchases is used instead of the cost of goods sold, and tax depreciation is used instead of accounting depreciation, inflation adjustments, or financial charges.

4. *Key Maquila-Related Issues*

a. *Machinery and Equipment on Consignment*

For the purpose of the *maquila* program, the foreign principal must own at least 30% of the machinery and equipment

[51] *See* article 2 of the Manufacturing, Maquila and Export Services Industries Program (Industria Manufacturera, Maquiladora y de Servicio de Exportación or IMMEX) Law and article 181 of the MITL.

[52] *See* Article 182 of the MITL.

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used during the *maquila* process in Mexico. This machinery and equipment may not have been previously owned by the *maquila* or by any other Mexican-related party.

b. Export Threshold

There are several requirements that must be met in order to obtain and hold an IMMEX program authorization, including, among others, that the *maquila* company exports sales of at least $500,000 USD or its equivalent in MXN, or exports at least 10% of the taxpayer's total annual invoicing.[53] A *maquiladora* must return to the principal, 100% of the inventory in consignment and cannot sell any product in Mexico

c. VAT Credit

To obtain the benefit of the 100% credit of the VAT triggered upon the importation of goods under the IMMEX program, the taxpayer can request a VAT certification from the Ministry of Finance. For this, several requirements must be met, including among others, that at least 60% of the raw materials imported on a temporary basis return abroad.

d. Other Non-Maquila Activities of Maquiladoras

To qualify for the *maquila* benefit, the company must receive at least 90% of its revenue from the *maquila* operation.

B. The Labor Reform

Many companies operating in Mexico had separate service companies that provided administrative, accounting, tax, legal, financial, human resources, IT, or marketing services to its related operating companies. Such structures allowed for the labor companies to assume the burden arising from the labor perspective risk.

On April 23, 2021, Mexico published legislation that modified the tax and labor treatment of subcontracted services. As a result of this reform, outsourcing is now prohibited from a labor and tax perspective and services structures should be discontinued or restructured.[54] As a result of this labor reform, employees are hired by the operating entity, and the effects of this change encompass different areas, including transfer pricing, as it relates to the transfer of employees from the service company to the operating entity.

There are no specific transfer pricing provisions in the Mexican Income Tax Law (MITL) regarding the transfer of employees. Therefore, the OECD Guidelines should be used as a reference. The transfer pricing analysis should consider the specific characteristics and circumstances of the service structure, including personnel involved, service provided, the possibility of intangibles being transferred as part of the transaction, and so on.

In most cases, it is unlikely that a transfer of employees constitutes a transfer of an intangible; however, in some cases the assignment of an employee may be associated with the potential transfer of intangible assets, such as a transfer of the company's know-how.

Furthermore, labor liabilities (NIF D-3)[55] generated by the services company should be considered in transfer pricing analysis. It is also advisable to review the intercompany agreements and their termination clause to determine if the transfer of personnel or the ceasing of the services provision could trigger any compensation.

[53] This amount is applicable to fiscal year 2024 and may be modified for future years.

[54] *See* Mexico's Federal Labor Law and Social Security Law.

[55] NIF is the Spanish language acronym for the previously established Mexican financial reporting standards (FRS) that is used throughout the Portfolio.

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XIV. Other Transfer Pricing Aspects Relevant in Mexico

A. *Constitutional Considerations*

1. General Considerations

The Mexican Constitution contains the main provisions that every federal or local law must follow. All individuals are entitled to the human rights granted by the Mexican Constitution and the international treaties signed by the Mexican State, as well as to the guarantees for the protection of these rights. Such human rights must not be restricted or suspended, except in cases and conditions established by the Mexican Constitution itself.

All authorities, in their areas of competence, are obliged to promote, respect, protect, and guarantee human rights, in accordance with the principles of universality, interdependence, indivisibility, and progressiveness. Consequently, the state must prevent, investigate, penalize, and rectify violations to human rights, according to the law.

2. Fundamentación and Motivación

The *fundamentación* concept of an official letter must be understood as requiring that the legal provision applicable to the case at hand be expressed with accuracy. In administrative matters, to be able to consider an administrative act as properly founded on an official letter, it is necessary to quote:[56]

- The legal bodies and provisions that are being applied to the specific case, that is, the normative assumptions in which the conduct of the governed is framed so that it is obliged to pay, which will be indicated with complete accuracy, specifying the subsections, fractions, and precepts applicable, and
- The legal bodies and precepts that grant competence or powers to the authorities to issue the act to the detriment of the governed.

The *motivación* concept consists of the special circumstances, particular reasons, or immediate causes that have been taken into consideration in the issuance of the act, and it is also necessary that there be an adequacy between the reasons given and the applicable rules, that is, that in the specific case the hypothesis is configured normative.

Fundamentación and *motivación* are provided by Article 16 of the Mexican Constitution, which states, "No person shall be disturbed in his private affairs, his/her family, papers, properties or be invaded at home without a written order from a competent authority, duly explaining the legal cause of the proceeding."

3. Article 5 of the Mexican Constitution

Article 5 of the Mexican Constitution states that no person may be prevented from performing the profession, industry, business, or work of his choice, provided that it is lawful. This right may only be banned by judicial resolution, when third parties' rights are infringed, or by government order, issued according to the law when society's rights are infringed. No one can be deprived of legal wages, except by a judicial ruling. Also, it provides that no one can be compelled to work or render personal services without obtaining a fair compensation and without his full consent, unless the work has been imposed as a penalty by a judicial authority.

4. Transfer Pricing and Legality

According to the legality principle, no one can be deprived of his freedom, property, or rights without a trial before previously established courts, complying with the essential formalities of the proceedings and according to those laws issued beforehand. In the case of transfer pricing, legality is understood as the obligation of the Mexican tax authorities to use the wording stated in the law to determine whether a taxpayer complied with its transfer pricing obligations.

If the Mexican tax authorities determine that the taxpayer did not comply with its transfer pricing obligations, they may determine a transfer pricing adjustment but only if the authority is based on the procedure stated in the law and the resolution is founded on the wording of the law.

5. Transfer Pricing and Equity

The principle of tax equity requires equal treatment of taxpayers, under the premise of treating equal to equal and unequal to unequal. The principle of tax equity is based on equality before the same tax law of all taxpayers of the same tax, those who under such conditions must receive identical treatment regarding the accumulation of taxable income and deductions allowed.

6. Transfer Pricing and Proportionality

According to Article 31 section IV of the Mexican Constitution, taxpayers have to contribute to the public expenditures of the Federation, the Federal District, the States, or the Municipalities in which they have residence in the proportional and equity manners that the law has established.

The Supreme Court of Justice has held that the principle of tax proportionality means that taxable persons, both individuals and companies, must contribute to public expenses based on their respective taxable capacity, and contribute a fair and adequate part of their income, profits, returns, or manifestation of taxed wealth.

In accordance with this principle, taxes must be set according to the capacity of each taxable person based on his or her real potential to contribute to public expenses, such that taxpayers with the highest taxable wealth pay taxes or contribute in a different manner and superior to those who pay a smaller proportion.

7. Practical Considerations

On the practical considerations, each legal provision stated in the law and each official determination from the Mexican tax authorities must be analyzed under the principles stated in the Mexican Constitution, in order to determine whether there is any violation of the constitutional body. If there is, the taxpayer must follow the corresponding legal means of defense.

[56] *See* Article 38 of the FTC.

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B. Transfer Pricing and Economic Substance

Through the incorporation of Article 5-A in the Mexican Federal Tax Code (FTC), a general anti-abuse rule was included in the law, with the aim of preventing companies from carrying out certain transactions without any economic justification for the sole purpose of obtaining a favorable tax treatment. Unless there is evidence to the contrary, it is presumed that a series of legal acts does not have a business reason when the economic benefit sought could be achieved through the performance of fewer legal acts and the tax effect of these would have been more burdensome.

C. Peer Review

Mexico was first reviewed by the OECD under its BEPS initiative during the 2017/2018 peer review. Then, the supplementary OECD BEPS Action 13 peer review of Mexico was issued in 2019. The conclusion of the review was that Mexico's implementation of the OECD BEPS Action 13 minimum standard met all applicable terms of the OECD framework reference.

D. OECD BEPS

Mexico has been incorporating various BEPS actions into its local tax and transfer pricing regulations. The actions that were incorporated into the Mexican legislation are presented below:

- Action 2. Neutralize the effects of hybrid mismatch arrangements.
- Action 3. Strengthen CFC rules.
- Action 4. Limit base erosion via interest deductions and other financial payments.
- Action 5. Counter harmful tax practices more effectively, taking into account transparency and substance.
- Action 6. Prevent treaty abuse.
- Action 7. Prevent the artificial avoidance of PE status.
- Action 8. Aligning transfer pricing outcomes with value creation: intangibles.
- Action 9. Aligning transfer pricing outcomes with value creation: risks and capital.
- Action 10. Aligning transfer pricing outcomes with value creation: other high-risk transactions.
- Action 12. Require taxpayers to disclose their aggressive tax planning arrangements.
- Action 13. Re-examine transfer pricing documentation.
- Action 14. Make dispute resolution mechanisms more effective.
- Action 15. Develop a multilateral instrument.

Action 1. *Address the tax challenges of the digital economy* and Action 11. *Measuring and monitoring BEPS* are still pending full implementation in the Mexican legislation.

The Mexican legislative measures relative to transfer pricing as affected by these BEPS actions relates mainly to:

- Action 4: Limit base erosion via interest deductions and other financial payments.[57] In summary, the rule restricts interest's deduction to 30% of the adjusted taxable income.
- Actions 8-10: Aligning transfer pricing outcomes with value creation: intangibles. Aligning transfer pricing outcomes with value creation: risks and capital. Aligning transfer pricing outcomes with value creation: other high-risk transactions. Those actions are applicable to the transfer pricing analysis as per the use of the OECD Transfer Pricing Guidelines.
- Action 12: Require taxpayers to disclose their aggressive tax planning arrangements. In summary, the taxpayer and/or tax advisors are required to disclose information on the transfer of hard-to-value intangible assets, business restructuring, transactions without compensation, the unique and high value transactions analysis, and the use of a unilateral protection regime.
- Action 13: Re-examine transfer pricing documentation.[58] In summary, this action requires taxpayers to file the Master File, Local File, and the Country-by-Country Report.

[57] *See* XII., above.
[58] *See* V., above.

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DETAILED ANALYSIS

CHAPTER 115: TRANSFER PRICING RULES AND PRACTICE IN THE NETHERLANDS

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I. Overview of the Netherlands Tax System

A. Income over Which the Netherlands Asserts Taxing Jurisdiction

1. General

The Dutch corporate tax system is a so-called classical system. Corporate profits are taxed at the level of the corporate entity, and distributions of assets, to the extent of these profits, are taxed in the hands of the receiving shareholder. A distribution is not deductible from the taxable income of the distributing entity, and the corporate tax levied on the distributing entity is not creditable by the shareholder. A classical system in principle results in double taxation of corporate profits. The double taxation is, however, mitigated in various ways. Distributions to shareholders that are corporations will often remain exempt due to the applicability of the participation exemption. Taxation of distributions to substantial individual shareholders is mitigated through a lower flat rate (25%) of income tax. Individual shareholders (other than substantial shareholders or shareholders receiving dividends attributable to a business enterprise) are no longer taxed on the actual dividends received. Alternatively, individual shareholders are deemed to have realized a progressive fictitious income that is updated annually. This fictitious income is taxed at a 30% rate. For 2020, the progressive fictional income is divided into two classes:

1. The deemed return of class 1 is 0.07% of the underlying investment; and

2. The deemed return of class 2 is 5.28 % of the underlying investment.

The underlying investment is apportioned to the abovementioned classes as follows:

The Part of the Underlying Investment Which Is More Than	But Not More Than	Apportioned to Class 1	Apportioned to Class 2	Average Deemed Return
€0	€72,798	67%	33%	1.789%
€72,798	€1,005,573	21%	79%	4.185%
€1,005,573	–	0%	100%	5.28%

This section will focus on the Dutch taxation of resident and nonresident corporate entities subject to corporate income tax. Corporate income tax is levied by virtue of the Corporate Income Tax Act of 1969 (hereafter the CITA).[1]

The Netherlands levies corporate income tax on corporate entities that are resident in the Netherlands or that are nonresident but derive income from Dutch sources.

2. Income Derived by Netherlands-Based Entities from Transactions Involving Foreign Activities or Payments

a. General

Article 2(1) of the CITA lists the entities that are subject to income tax as corporations.

These entities include:

- Public companies (*Naamloze Vennootschap, N.V.*), private companies (*Besloten Vennootschap, B.V.*), open limited partnerships (*open commanditaire vennootschappen*), and other entities, the capital of which is wholly or partly divided into shares;[2]
- Cooperatives and other entities having a cooperative basis;
- Mutual insurance associations and other mutual associations acting as insurance or credit organizations;

[1] For an in-depth description of the Dutch tax system, *see* 7250 T.M., *Business Operations in the Netherlands.*

[2] A European public limited liability company (or Societas Europaea) is treated as a *Naamloze Vennootschap.*

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• Associations and other non-public entities to the extent they conduct a business;

• Mutual funds; and

• Certain public legal entities.

Entities listed in the bullet points above that are incorporated under Dutch law are deemed to be resident in the Netherlands (Article 2(4) of the CITA).[3] Entities listed in the first bullet above that are not incorporated in the Netherlands or organized under Dutch law are treated as residents if they have their place of effective management in the Netherlands. A company resident in the Netherlands by virtue of the incorporation fiction may be effectively managed outside the Netherlands.

If the country in which a company is effectively managed also considers the company as a resident, a dual residency may result. Generally, if the Netherlands has concluded a tax treaty with the relevant country, such dual residency is resolved for treaty purposes by means of a tie-breaker rule. Most treaties concluded by the Netherlands provide for a tie-breaker rule allocating treaty residency to the country in which the effective management of the company is situated. However, such a tie-breaker provision is not included in the Netherlands-U.S. Income Tax Treaty, which only provides that the dual residency be settled through the Mutual Agreement Procedure. As of January 1, 2020, the Multilateral Instrument[4] may modify treaties concluded by the Netherlands with anti-tax avoidance measures.[5]

Comment: The impact of the Multilateral Instrument on the Netherlands' treaties will depend on the dates the treaty partners have ratified the MLI, and on the choices they have made with respect to specific articles. A number of the Netherlands' treaties are already impacted by the MLI's Article 4, which deals with dual residency. Under these treaties, the dual residency of entities will no longer be resolved by a tie-breaker rule, but by mutual agreement between the treaty jurisdictions.

b. Tax Rate

The corporate income tax rate is 25% of taxable income (2020).[6] The first €200,000 of taxable income was subject to a rate of 16.5% through 2020. However, effective in 2021, that lower rate was reduced to 15% for the first €245,000 in taxable income. The tax rate for qualifying investment companies is 0%. Because an investment company has no business activity of its own beyond investing, its existence should not give rise to an additional tax burden.

The Netherlands uses a "classical system" and does not integrate (by way of imputation, split rate, etc.) the corporate income tax with the individual income tax.

c. Taxable Income

(1) General

Resident companies are subject to corporate income tax on their worldwide income. Tax is imposed on the taxable income (i.e., the taxable profits of the year after the set-off of any carryover losses from other years).[7] Taxable profits are defined as the annual business profits less deductible gifts.

Taxable income includes all income and capital gains unless an exemption applies. Expenses and losses are deductible unless a specific provision renders them non-deductible. Profits must be computed for each accounting year. The allocation of income and expenses to a particular year is governed by sound business practice (*goed koopmansgebruik*). Sound business practice is not defined in law but is a principle developed in case law. In principle, sound business practice aligns with generally accepted accounting principles. However, a deviation therefrom is possible if required by any tax regulation or basic principle of tax law.

Comment: A key aspect of sound business practice is the principle of prudence, under which profits need not be taken into account until actually realized, whereas expected but unrealized losses may be deducted.

Business profits are in principle determined in euros. Dutch companies that use a foreign functional currency for commercial accounting purposes are allowed, on request, to report their taxable income in that currency.

(2) Fixed Asset Investments

For investments in fixed assets, an investment allowance may be obtained. Investment allowances are applied in addition to depreciation and may have the form of a small investment allowance, energy investment allowance, or an environmental investment allowance.

Capital assets may be depreciated for fiscal purposes. A depreciation method is permitted provided it is in accordance with sound business practice. Methods often used are the straight-line method or the declining-balance method.

The maximum annual depreciation rate for fixed assets is set at 20% of the costs. Acquired goodwill, as opposed to self-generated goodwill, may be recorded as an asset and amortized. The maximum amortization of acquired goodwill is set at 10% of the acquisition costs. Goodwill that is obtained when the shares in a participation are acquired cannot be amortized. A limitation exists for the annual depreciation rate on buildings. Depreciation is discontinued once a building's so-called *bodemwaarde* (minimum value) exceeds its book value for tax purposes. For corporate income tax purposes, the *bodemwaarde* of buildings is set at the building's value established under the Dutch Valuation of Immovable Property Act (*Wet waardering onroerende zaken* (WOZ)).[8] For certain designated assets, a provision for accelerated and random depreciation applies in order to stimulate investments.

[3] A European public limited liability company that was governed by the laws of the Netherlands when incorporated is deemed to have been incorporated under the laws of the Netherlands.

[4] *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, OECD (2017).

[5] Subject to domestic ratification in the jurisdiction of the treaty partner. A list of jurisdictions with which COUNTRY has an income tax treaty in force can be found on the Bloomberg Tax platform: https://www.bloomberglaw.com/product/tax/search/results/c46028cdafdb0d13be4b0b3394e901b7/.

[6] The rate is 25.8% as of January 1, 2022.

[7] The loss carry-forward is limited to six years (nine years for financial years up to and including 2018), and loss carry-back(s) is limited to one year.

[8] Art. 3.30a Dutch Income Tax Act 2001 jo. Art. 8 (6) Corporate Income Tax Act of 1969.

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(3) Reinvestment Reserve

A gain realized on the disposal of tangible or intangible business assets may be deferred if the company intends to reinvest the proceeds of the sale. To defer the taxation, a tax-free reinvestment reserve is formed to which the difference between the sales proceeds and book value of the business asset may be contributed. Upon reinvestment, the amount of the reserve is deducted from the acquisition price of the new business asset. In principle, the reinvestment must take place within a period of three years. Further limitations apply with respect to assets that are generally depreciated over a period of more than 10 years or not depreciated at all. In relation to these assets, the reinvestment should be made in assets with the same economic function.

(4) Participation Exemption

The most important exception to the rule that all income and capital gains are included in taxable income is the participation exemption.[9] Provided certain requirements are met, dividends and capital gains derived from shareholdings in companies in which a Dutch company holds at least 5% of the outstanding share capital are exempt from taxation. The objective of the exemption is to avoid double taxation of profits that are distributed through a chain of companies. The participation exemption may apply to qualifying participations in both resident and nonresident companies. The subsidiary must not be a portfolio investment. However, if the subsidiary is a portfolio investment, the participation exemption may still apply if the subsidiary is considered to be a qualifying portfolio investment.

In short, a subsidiary is considered to be held as a portfolio investment if the taxpayer's objective is to obtain a return that may be expected from normal active asset management. A subsidiary is not considered to be held as a portfolio investment if the subsidiary is engaged in the same line of business as the taxpayer. Subsidiaries of a top holding company that, based on its activities in the areas of management, policy, and/or finance, or subsidiaries of a company that has an essential function within the group as an intermediate holding company that fulfills a linking role within a chain of companies (*schakelfunctie*) are not considered to be held as a portfolio investment. A participation is deemed to be held as a portfolio investment if: (1) more than half of the participation's consolidated assets consist of shareholdings of less than 5%; or (2) the predominant function of the participation — together with the lower-tier subsidiaries — is to act as a group finance company.

A subsidiary that is considered to be a portfolio investment can still qualify for the participation exemption if it is a qualifying portfolio investment. A subsidiary is a qualifying portfolio investment if either: (1) the portfolio investment is subject to a profit-based tax that results in a realistic levy by Dutch tax standards (i.e., a regular statutory tax rate of at least 10%); or (2) the assets of the portfolio investment participation generally consist, directly or indirectly, of less than half of low-taxed free passive investments.

Expenses connected with the acquisition of a participation (including interest and currency exchange results on loans concluded to finance the acquisition of a participation) are not deductible.

The Dutch withholding tax on dividends distributed by a resident subsidiary, normally 15%, is reduced to 0% on distributions to an EU parent company if the requirements in the Parent-Subsidiary Directive are met and the EU parent company holds at least 5% of the stock of the distributing subsidiary.[10]

(5) Innovation Box

The innovation box regime (Innovation Box) provides for the possibility to be effectively taxed at a reduced rate of 9% as of January 1, 2021, with respect to qualifying benefits derived from qualifying intangible assets. The purpose of the Innovation Box is to stimulate innovative R&D in the Netherlands. As of January 1, 2017, the Innovation Box differentiates between: (a) small- and medium-size taxpayers (SMEs); and (b) other taxpayers.

SMEs are defined in this context as taxpayers: (i) deriving benefits from qualifying intangible assets of less than €37,500,000 in the respective financial year and the four preceding financial years combined; and (ii) having an aggregate net turnover of less than €250,000,000 for the respective financial year and the four preceding financial years combined. If the taxpayer is part of a group of companies, the second test is applied to the turnover of the total group. For SMEs, the revised Innovation Box applies to self-developed intangible assets from research and development (R&D) activities for which so-called R&D wage tax certificates have been obtained from the competent Dutch governmental agency.

With respect to other taxpayers that are not SMEs, an additional condition applies for qualifying intangible assets. In addition to having obtained R&D wage tax certificates in respect of these intangible assets, the intangible assets should also have one of the following characteristics:

1. A patent or plant breeder's right has been obtained by the taxpayer;[11]

2. A patent or plant breeder's right has been applied for by the taxpayer;

3. The intangible asset qualifies as software;

4. Authorization to market and use biological pesticides has been granted for the intangible asset, as referred to in Article 18 of the Act on Plant Protection Products and Biocides;

5. An EU marketing authorization for medicinal products has been granted for the intangible asset;

6. A supplementary protection certificate has been granted by the competent Dutch government agency for the intangible asset;

7. A registered utility model for the protection of innovation has been granted for the intangible asset; or

[9] Arts. 13–13l of the CITA.

[10] Art. 4, paragraph 2, Dutch Dividend Tax Act.

[11] For a definition of "patent," the statute refers to the 1995 Patents Act. Requirements similar to those for a Dutch patent must be met for a foreign patent to qualify.

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8. The intangible asset is related to an intangible asset(s) as defined under 1–7, above.

The Innovation Box provides for separate tax treatment for income derived from intangible assets. If the taxpayer chooses to include a self-developed intangible asset in the Innovation Box, 9/25[12] of the net proceeds generated will be taxable. The 9% effective rate applies to the extent the proceeds derived from the intangible asset exceed a threshold amount equal to the R&D expenses incurred with respect to the intangible assets in the Innovation Box. Operating losses are deductible against the normal tax rate.

The Innovation Box can be applied to income from transactions within a group, as well as to income from transactions with third parties. The choice of whether to apply the Innovation Box to a Patent or R&D asset is made in the corporate income tax return at the latest. However, the application of the Innovation Box will, in nearly all cases, be discussed in advance with the Dutch tax authorities.

One of the difficulties in applying the Innovation Box is the question of which profits can be allocated to the Innovation Box and which costs can be allocated to the patents and the R&D assets (the threshold). In the parliamentary history, a reference is made to the doctrine of transfer pricing.[13] In practice, to determine the profits that can be allocated to the Innovation Box, the tax authorities often apply a profit split based on the weighted importance of R&D within the company.

d. Relief from Double Taxation

(1) General

Resident companies are subject to corporate income tax on their worldwide income. Generally speaking, foreign income is fully included in the gross taxable income of a resident taxpayer. Relief provided for in the Dutch tax treaties and the 2001 Decree for the Avoidance of Double Taxation (2001 Decree) may eliminate or mitigate international double taxation by means of a proportional tax exemption or foreign tax credit.

(2) Dividends, Interest, and Royalties

Dividends, interest, and royalties received from abroad are in principle included in the taxable income of a Dutch resident company. Dividends may be exempted if the requirements for the applicability of the participation exemption are met. Dividends, interest, and royalties will generally have been subjected to a withholding tax in the country from which the income is derived. If the Netherlands has concluded a tax treaty with the relevant foreign country, the tax will generally have been withheld at reduced rates. In such a case, relief from double taxation will generally be available in the form of a foreign tax credit. The amount of the foreign tax credit is limited in two ways. First, the credit cannot exceed the actual foreign tax paid (unless the respective tax treaty provides for a tax-sparing credit). Second, the credit cannot exceed the Dutch tax due with respect to the foreign income. For purposes of computing this latter limitation, the income received will have to be taken into account on a net basis (i.e., after deduction of the expenses directly attributable to the income). Excess credits that cannot be set off in the current year can be carried forward indefinitely.

In principle, relief in the form of foreign tax credits is computed on a per country basis. However, a taxpayer may elect to apply the overall method. This means that for purposes of computing the foreign tax credit with respect to foreign withholding taxes on dividends, interest, and royalties, the taxpayer may opt for a pooling of these types of income from different countries.

If no tax treaty is applicable, relief from double taxation may be obtained on a unilateral basis under the 2001 Decree. Under the 2001 Decree, only dividends, interest, and royalties received from listed developing countries qualify for relief from double taxation by means of a foreign tax credit.

(3) Foreign Business Income and Foreign Real Property

Tax treaties generally grant a right to tax business income to the country in which the income is generated, provided the taxpayer has a presence in that country in the form of a permanent establishment. Under Dutch tax law, in relation to treaty countries the meaning of the term "permanent establishment" is determined based on the definition given to it in the relevant tax treaty.

As of January 1, 2012, Dutch tax rules provide a full exemption for foreign business profits (the object exemption). In principle, to the extent that profits or losses are attributable to a foreign permanent establishment or foreign real property, the annual profits and losses are excluded from the Dutch taxable base. For profits realized in treaty countries, the object exemption only applies to the extent that the Netherlands is required to grant an exemption to prevent double taxation under a treaty or other applicable arrangement. For non-treaty countries, a definition of "permanent establishment" has been included in the CITA. This definition is based on Article 5 of the OECD Model Treaty.

In non-treaty situations, the taxpayer must be subject to a tax on its profits in the other country. The object exemption does not apply to low-taxed foreign investment businesses unless the Netherlands is required to grant an exemption from the tax under the applicable tax treaty. The object exemption also does not apply if the permanent establishment is not recognized in the other jurisdiction.

Unlike normal losses, a loss arising on the termination of a permanent establishment is deductible in certain circumstances.

3. Income Derived by U.S.-Based Entities from Transactions Involving Netherlands Activities or Payments

An entity that is neither incorporated under Dutch law nor effectively managed in the Netherlands may still be subject to tax as a nonresident on income derived from Dutch sources.

Under domestic tax law, the Netherlands may impose corporate income tax on the following types of income of nonresident corporate taxpayers:

• Business profits derived from an enterprise carried on in the Netherlands through a permanent establishment or permanent representative in the Netherlands. A Dutch enterprise is (among others) deemed to include real property sit-

[12] The current corporate income tax rate for profits over €245,000 (2021) is 25%.

[13] Memorandum of Reply, parliamentary documents, 30 572, page 5 (*MvA, Kamerstukken I, 30 572, blz 5*).

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uated in the Netherlands and profit-sharing rights in an enterprise the effective management of which is situated in the Netherlands; and

• Taxable income from a substantial shareholding in a company established in the Netherlands (not being a tax-exempt investment institution). A non-Dutch resident entity with a so-called substantial interest in a Dutch resident entity (as a general rule, 5% or more in the share capital or membership interest in a cooperative) will be subject to a corporate income tax if: (1) the substantial interest is held with the main purpose (or one of the main purposes) being to avoid Dutch individual income tax of another person; and (2) an artificial construction exists. A construction can consist of several parts and will be considered artificial in case it is not based on business reasons that reflect economic reality.

Dividends distributed by a Dutch resident company will generally be subject to Dutch dividend withholding tax at a 15% tax rate. Dutch resident shareholders may credit the dividend withholding tax against their income tax liability or obtain a refund. As of January 1, 2018, the scope of the Dutch domestic withholding tax exemption has been extended from corporate shareholders in the Member States of the European Union (EU) and the European Economic Area (EEA) to corporate shareholders in all countries with which the Netherlands has concluded a tax treaty that contains a dividend article. In order for the withholding tax exemption to apply, the shareholder should hold a participation in the Dutch entity that would qualify for application of the Dutch participation exemption if the shareholder was established in the Netherlands (in general: a 5% or more shareholding). In addition, the beneficial shareholder should comply with the anti-abuse rule. In brief, abuse is considered present if the principal purpose or one of the principal purposes of holding the shares in the Dutch company or the membership rights of a holding cooperative is avoiding the levy of dividend withholding tax of another person and the holding of the shares is part of an artificial arrangement or transaction.

If the Dutch withholding tax exemption does not apply, dividend withholding tax on dividends distributed to foreign shareholders may be reduced as a result of an applicable tax treaty.

The Netherlands-U.S. Income Tax Treaty provides for a reduced dividend tax rate of 0% if the entity that is the beneficial owner of the dividends is a company that is a resident of the other state that has directly owned shares representing 80% or more of the voting power in the company paying the dividends for a 12-month period ending on the date the dividend is declared and:

(i) owned, directly or indirectly, shares representing at least 80% of the voting power in the company paying the dividends prior to October 1, 1998; or

(ii) meets the specific tests of the limitation on benefits clause in the treaty.

A reduced rate of 5% applies if the U.S.-receiving shareholder is a corporate entity holding at least 10% of the voting power of the Dutch distributing company. In other cases, the applicable rate is 15%.

The Netherlands currently does not levy withholding taxes on interest and royalty payments. Interest on certain profit-sharing loans may be treated as dividends. However, a conditional withholding tax on interest and royalty payments to related entities in low-tax or EU blacklisted jurisdictions and in cases of abuse is imposed as of January 1, 2021.

B. Assessment of Income

Companies that are liable for tax in the Netherlands make an annual declaration that shows the assessment basis. The tax authorities subsequently issue the tax assessment.

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II. Evolution of Netherlands Transfer Pricing Rules

A. General

Effective January 1, 2002, Dutch tax law contains a specific statutory provision (Article 8b of the CITA) expressly providing the general principle that the tax authorities may adjust prices agreed to between related parties if such prices cannot be considered arm's length. Before this codification, general tax law principles generally ensured that the profits derived from a business were determined on the basis of the arm's-length principle. Most of the important transfer pricing court cases have been rendered under the "old" legislation. As this jurisprudence generally remains applicable under the new legislation, basic understanding of the "old" legislation is necessary for understanding the new legislation.

B. Historical Perspective

Before the codification of Article 8b of the CITA, tax law principles generally ensured that the profits derived from a business were determined on the basis of the arm's-length principle. Article 3.8 of the Dutch Income Tax Act 2001 (ITA) (and its predecessors) and Article 10 of the CITA enable both the courts and the tax authorities to adjust the reported taxable income to the extent that such income (or lack thereof) does not result from the business but rather can be attributed to the relationship between a company and its shareholders.

Article 3.8 ITA defines profits as the total benefits derived from a business, under whatever name and in whatever form.[14] Article 10 of the CITA provides that direct and indirect distributions of profits may not be deducted in determining a company's profits. At various times the State Secretary of Finance has, on the basis of Article 3.8 ITA and Article 10 of the CITA, indicated that the Netherlands accepts the principles set out in the OECD Transfer Pricing Guidelines (OECD Guidelines).[15]

Article 3.8 ITA and Article 10 of the CITA form the basis for adjusting reported taxable income to the extent that the income is influenced by a shareholder relationship. Adjustments are made by taking into account a disguised distribution to the shareholder or an informal capital contribution to the company. In case law, profit distributions have been defined as "shift of capital from the company to the shareholder as a result whereof money or other valuables, covered by profit potential, are extracted from the capital of the company for the benefit of the shareholder."[16]

In BNB 1978/252 (Supreme Court, May 31, 1978), the principle of Article 3.8 ITA was applied by the Supreme Court in relation to a corporate entity. In that case, a Dutch company was granted the benefit of an interest-free loan by its Swedish shareholder. This benefit was held not to constitute a business profit for the Dutch company but rather a contribution to the capital by its Swedish shareholder. If the shareholder in this case had been a Dutch company, the profits of the Dutch company would have been increased with a deemed interest receipt determined on the basis of the market interest rate for loans concluded under comparable conditions. In this way, the transaction between the related entities would be cleared from the non-arm's-length aspects resulting from the shareholder relationship.

A distinction has been made by the Supreme Court between the situation in which the shareholder making the informal capital contribution is an entrepreneur whose profits are subject to tax and the situation in which the shareholder is not acting as an entrepreneur. In BNB 1986/295 and BNB 1986/296 (Supreme Court July 8, 1986), an individual shareholder benefited his company by not charging certain costs that would have been chargeable under arm's-length conditions. On the basis of the Swedish parent decision, such benefit should be eliminated from the company's profits since it was not a profit derived from the business. However, since any deemed charge could not be included in the taxable income of the individual shareholder (since the shareholder was not an entrepreneur and could only be taxed on income actually received), the Supreme Court ruled that the company should remain taxable on the benefit received. The Supreme Court did not want to create a leak in those cases where the benefit could not be taxed at the level of the shareholder. The elimination of the benefit at the level of the company was made dependent on the ability to tax the benefit at the level of the shareholder.

It is consistent with case law that a deemed dividend can only be taken into account if both: (1) the company intends to benefit its shareholder; and (2) the shareholder is aware of that intention (so-called double awareness). Some legal authors are, however, of the opinion that the single awareness of the company is sufficient by itself.[17] The Supreme Court, in a decision on May 28, 1969,[18] seems also to suggest that no awareness by the benefiting shareholder is required. In later cases, notwithstanding that, the Supreme Court decided that the existence of a disguised distribution was clearly conditional on awareness by both the company and the shareholder.[19] The Supreme Court there, however, interpreted the awareness requirement on the side of the shareholder slightly more objectively, by adding that awareness could be deemed to exist if the shareholder should reasonably have been aware.

Benefits conferred by one company to another company with a common shareholder will be traced through the shareholder. Such a benefit will be treated as a deemed dividend distribution to the common shareholder followed by a capital contribution to the benefiting company. If the common shareholder is a Dutch resident shareholder, the dividend income may, de-

[14] Case law related to Art. 3.8 ITA focuses on whether and when a profit is actually derived from and related to a business and whether any assets should be allocated to the business enterprise or should be considered to be private assets. The latter distinction is relevant since capital gains on assets are generally only taxable if such assets are held as business assets.

[15] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* This was most explicitly confirmed by the Decree of March 30, 2001, No. IFZ2001/295M, as amended by Decree of 21 August 2004, IFZ2004/680M, and replaced by the Decree of November 14, 2013, No. IFZ 2013/184M, which was replaced by the Decree of April 22, 2018, nr. 2018-6865.

[16] *See* Supreme Court, March 17, 1954, BNB 1954/130, and December 30, 1953, BNB 1954/61.

[17] *See*, for example, Aardema, *De directeur-groot aandeelhouder met zijn B.V. en de fiscus* (Deventer: Kluwer, 1988), at 14–16.

[18] BNB 1969/164.

[19] For example, BNB 1970/62 (Supreme Court, January 7, 1970), BNB 1983/233 (Supreme Court, May 4, 1983), and BNB 1985/271 (Supreme Court, May 15, 1985).

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pending on the tax position of such shareholder, be included in its taxable income.

Dutch case law mainly focuses on the correction of non-arm's-length transactions between a company and its shareholders. However, it is acknowledged that a shareholder does not always act in its capacity of shareholder but may also act in another capacity — for example, as a creditor. If a shareholder waives the right to interest on a loan to its subsidiary by virtue of the negative equity position of the subsidiary, the question arises whether the waiver took place in the person's capacity of shareholder or creditor. If the financial situation of the subsidiary-debtor is so pitiable that a non-related creditor would also have waived the right to interest, the shareholder may be considered to have acted in his capacity as creditor rather than shareholder. In that case, the waiver may have been arm's length.[20]

[20] See, for example, Lower Court Amsterdam, March 14, 2001, no.99/2387, where, as a result of the shareholder acting in its capacity as creditor, the debtor could not deduct an imputed interest expense.

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III. Transfer Pricing Rules

A. Legal Authority

1. Current Law

Effective from January 1, 2002, the Dutch CITA contains a specific article (Article 8b of the CITA) in which the arm's-length principle is defined. The Explanatory Memorandum to the legislation states that the codification was considered necessary to accommodate international criticism to the effect that the arm's-length principle was not sufficiently guaranteed in the Netherlands. The codification should ensure the applicability of the arm's-length principle as defined in Article 9 of the OECD Model Treaty. When drafting Article 8b of the CITA, the government strove for as much similarity to Article 9 of the OECD Model Treaty as possible. As a result, according to the Explanatory Memorandum, a good correlation between the international transfer pricing practice and the OECD Commentary and OECD Guidelines should be ensured. In the Decree of April 22, 2018, No. IFZ 2018/6865 (2018 Transfer Pricing Decree),[21] the State Secretary stated that the OECD Guidelines in principle have a direct effect on Dutch tax law. This position contradicts case law to date and parliamentary history of Article 8b of the CITA. Both case law and parliamentary history indicate that the OECD Guidelines form an important source of inspiration and that they have a similar ranking as important scientific literature, which is different from having a direct effect. However, as the Dutch Tax Authorities are bound by the 2018 Transfer Pricing Decree, taxpayers may rely on "direct application" of the OECD Guidelines. Taxpayers, however, need not follow the principles included in the 2018 Transfer Pricing Decree in cases where the OECD Guidelines and/or the 2018 Transfer Pricing Decree deviate from transactions as they occur between unrelated parties.[22]

Article 8b of the CITA reads as follows:[23]

> (1) In case:
>
> *[a]* an entity, directly or indirectly, participates in *[i]* the management or supervision, or *[ii]* the capital, of another entity; and
>
> *[b]* the agreed or imposed conditions (transfer prices) of the transactions between these entities differ from conditions that would have applied in the market between independent parties,
>
> the entity's profit is determined as if the "arm's length" conditions applied.
>
> (2) The first paragraph applies in a similar manner in case a person, directly or indirectly, participates in [i] the management or supervision, or [ii] the capital, of the one and the other entity.
>
> (3) In their records, entities mentioned in the first and second paragraphs must include information:
>
> *[a]* which shows in which manner the transfer prices that are referred to in the first paragraph have been established; and
>
> *[b]* from which it can be deduced that, in the market, the established transfer prices would have been agreed to between independent entities.
>
> The article has two effects:
>
> (i) to authorize the adjustment of conditions (contractual terms) of related-party transactions for purposes of determining Dutch corporate income tax; and
>
> (ii) to force taxpayers to maintain transfer pricing documentation.

2. Statutes

Irrespective of the type of transaction, Article 8b of the CITA does not prescribe the manner in which a transfer pricing adjustment should be made. Even though Article 8b of the CITA intends to integrate the OECD Guidelines into Dutch practice, the Explanatory Memorandum to Article 8b indicates that the OECD Guidelines can be applied in different ways, and clarification is requested. For the determination of transfer pricing adjustments, the State Secretary has also referred to the 2018 Transfer Pricing Decree, in which the interpretation of the Dutch Ministry of Finance of the OECD Guidelines is clarified. The 2018 Transfer Pricing Decree, however, does not provide a legal basis for making a transfer pricing adjustment. Taxpayers may rely on the 2018 Transfer Pricing Decree but are not legally bound to it. This means taxpayers need not follow the principles included in the 2018 Transfer Pricing Decree in cases where the OECD Guidelines or 2018 Transfer Pricing Decree deviate from transactions as they occur between unrelated parties — for example, the OECD's guidance on financial transactions leave room for requalification of part of a debt as equity where the guarantee permits a borrower to borrow a greater amount of debt than it could in the absence of the guarantee. The OECD provides that in such a situation, a portion of the loan from the lender to the borrower may be accurately delineated as a loan from the lender to the guarantor followed by an equity contribution from the guarantor to the borrower.[24] However, Dutch case law has established that, in such a situation, only when the lender calls in the guarantee from the guarantor, the write-down of the corresponding recourse claim of the guarantor is treated as an equity contribution to the borrower by the guarantor.

[21] An unofficial English translation is provided in Worksheet 22.

[22] One could take the position that the EU General Court of Judgment's decision in the Starbucks State aid case has changed the position of Dutch taxpayers with respect to direct application of the OECD Guidelines. In its decision of September 24, 2019, the EU General Court of Judgment followed the position of the European Commission that an EU arm's-length principle may be applied when assessing if a measure constitutes a selective advantage. It considered in paragraph 151 that "the arm's length principle, as described by the Commission in the contested decision, is thus a tool for making that determination in the exercise of the Commission's powers under Article 107(1) TFEU." The description of the arm's-length principle by the European Commission is largely based on the OECD Guidelines. It could be argued that the decision of the EU General Court of Judgment, therefore, entails that as a result of application of the EU arm's-length principle, the OECD Guidelines have direct application in EU Member States.

[23] Unofficial translation, numbering in italics added by author.

[24] Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8–10, paragraph D.1.1.2.

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3. Administrative Instructions and Jurisprudence

As mentioned above, the Dutch Tax Authorities apply the OECD Guidelines as supplemented by the 2018 Transfer Pricing Decree. Consequently, in addition to the traditional CUP, Cost-Plus, and Resale-Minus methods, the Dutch Tax Authorities allow entity-based methods (TNMM) and profit-split methods. The authorities generally accept pan-European database-based TNMM transfer pricing reports. They are reluctant to accept expert economic or industry evidence to establish "correct" transfer prices.

Comment: The 2018 Transfer Pricing Decree below refers specifically to the 2017 Guidelines. However, the State Secretary of Finance indicated that he will amend the Transfer Pricing Decree where necessary to incorporate the changes to the rapidly developing OECD Guidelines.

Although case law does not consider the OECD standards as binding, the courts take serious notice of their content. A summary of the specific administrative instructions and relevant jurisprudence is provided below. In addition, the Netherlands has an extensive ruling practice.[25]

B. General Principles, Definitions and Scope

1. Transactions Subject to the Rules

a. General

The transactions affected by Article 8b of the CITA are all transactions (tangible property, intangible property, services, loans, guarantees, etc.) that are:

(i) not concluded under arm's-length conditions;

(ii) agreed and imposed; and

(iii) between related entities.

The application of Article 8b of the CITA is limited to transactions between entities (primarily corporations). Transactions with individuals are not covered. These transactions remain subject to the general tax law principles that ensure that parties act at arm's length.[26] The criteria laid down in Article 8b of the CITA apply to cross-border transactions as well as to domestic transactions.

b. Not at Arm's-Length Conditions

Article 8b of the CITA refers to conditions (transfer prices) of transactions that differ from conditions that would have been applied in the market between independent parties.

In the 2018 Transfer Pricing Decree, the following excerpt provides the basis for the arm's-length principle:

> The starting point of the arm's length principle is that for tax purposes associated enterprises are assumed to act towards each other under the same conditions as independent companies would act in similar circumstances. This means that a result must be achieved in which the taxable profit achieved by associated enterprises on their mutual transactions is comparable with the profit which independent enterprises would achieve in similar circumstances with similar transactions.
>
> Each transfer pricing analysis must be based on a good understanding of the role of each unit of the multinational enterprise and the commercial and financial relations between these units and the transactions … in which those relationships are expressed (see par. 1.34, 1.35 and 1.50 OECD Guidelines). Before the price of a specific transaction between affiliated parties can be determined, the transaction must be characterized as such. This requires an analysis of the economically relevant characteristics of the transaction … (par. 1.36 OECD Guidelines).
>
> The starting point in characterizing the transaction … is the transaction as it is structured between the affiliated parties with contractual terms in the mutual agreement(s) … . This information should then be supplemented with an analysis of the other economically relevant characteristics of the transaction. All this information together provides insight into the actual conduct of the parties involved. If the actual conduct does not correspond to the contractual elements of the transaction, the actual conduct will in general determine the characterization of the transaction… . [A]n analysis is also made of the functions exercised and the economically relevant risks associated with the transaction. It is also important that the comparison of the conditions should take place from the perspective of all parties involved in the transaction.
>
> … On the basis of the characterized transaction, an appropriate price must be determined, taking into account the arm's length risk allocation. In principle, this should be done on the basis of similar transactions between unaffiliated parties that result from a comparability analysis. The economically relevant characteristics mentioned above also form the elements of this comparability analysis.
>
> … Scrutinizing a transaction as such is only possible if the characterized transaction (including the possible adjustment of the risk allocation), viewed in its totality, differs from that of unrelated parties acting in a commercially rational manner, would have been agreed in similar circumstances, so that it is not possible to set a price acceptable to all parties (par. 1.121–1.124 OECD Guidelines). If only the price of the related transaction deviates from the price that would have been realized between independent third parties, a price adjustment can be made for tax purposes.[27]

The 2018 Transfer Pricing Decree further elaborates that arm's-length compensation must, in principle, be determined on a transactional basis. Such a determination on a transactional basis can cause problems in practice. If an assessment per transaction is not "properly" possible, for example, because there

[25] This ruling practice is described in XI., below. For a more detailed discussion of the OECD Guidelines, *see* 6936 T.M., *Transfer Pricing: OECD Transfer Pricing Guidelines.*

[26] *See* II.B., above.

[27] *See* paragraph 2.1 of the 2018 Transfer Pricing Decree.

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are a large number of similar transactions, in order to determine the arm's-length character, the transactions can be assessed by aggregating the transactions.[28] In that situation, the taxpayer is expected to substantiate that the transfer price taken into account with regard to the aggregated transactions complies as a whole with the arm's-length principle.

The legislation does not explain what is meant by "independent companies." However, the Explanatory Memorandum clarifies that this term includes all parties that are not "related entities" as described in the same article.[29]

In relation to the question of which conditions differ from conditions that would have applied in the market between independent parties, the Explanatory Memorandum indicates that, as a result of market circumstances, not just one but a range of arm's-length prices exists. The transaction is not at arm's length if the price would never have been agreed to with an independent market party. All prices within the range are acceptable. Such a criterion is very mild in comparison with requirements in other countries. The 2018 Transfer Pricing Decree mentions that an adjustment will be applied if the compensation is outside the range and the taxpayer cannot explain the deviation on valid grounds. The OECD Guidelines prescribe that in such a case the adjustment takes place up to the point within the range that corresponds best with the facts and circumstances of the respective intra-group transaction. If it is plausible that one specific point within the range corresponds best with the conditions of the inter-group transaction, an adjustment can be applied up to that point. If such a specific point cannot be identified, the Dutch Ministry of Finance is of the opinion that there will be an adjustment up to the median (the central observation in the range).

c. *Agreed or Imposed*

Transactions that are "agreed or imposed" between related entities are covered by Article 8b of the CITA. This terminology stems directly from Article 9 of the OECD Model Treaty. The inclusion of the words "or imposed" ensures that cases in which Dutch subsidiaries have little or no influence on the determination of the transfer prices in respect of transactions with their parent company are also covered.

2. *Definition of "Related Parties" Subject to Transfer Pricing Reallocation Rules*

a. *Introduction*

Before the codification of the arm's-length principle, there was no definition of the term "related party" for purposes of the transfer pricing rules. It was beyond doubt that a correction could be made in case a benefit was conferred by a company to its shareholder. Article 10 of the CITA expressly provides that direct and indirect distributions of profits may not be deducted in determining a company's profits. It was generally assumed that the ability to impose corrections was limited to shareholder relationships. Additionally, transactions benefiting close relatives of a shareholder were covered (BNB 1968/112).

Neither statutory law nor case law sets clear standards as to when companies should be considered related. Two cases (BNB 1995/15 and BNB 1995/16) gave rise to some confusion with respect to the issue of whether corrections should be limited to shareholder relationships. In these cases, certain expenses were disallowed for corporate income tax purposes although the tax authorities could not show that beneficiaries of the expenses were related in some manner to the paying company.

b. *"Related Parties" Under Statutory Rules*

(1) *Main Rule*

In order to make a transfer price correction, Article 8b(1) of the CITA requires that an entity, directly or indirectly, participates in: (1) the management or supervision of another corporate entity; or (2) the capital of another corporate entity. Article 8b(2) of the CITA extends this concept to horizontal relations (i.e., where the same person (entity or individual) participates, directly or indirectly, in the management, supervision, or capital of two corporate entities dealing with each other). The applicability of Article 8b of the CITA is limited to transactions between entities. The term "entity" includes companies, partnerships, trusts, and so on, but does not include individuals.

Following the introduction of Article 8b of the CITA it is certain that the scope of the term "related party" extends beyond shareholder relationships. Parties may also become related by virtue of influence exercised through (common) management or supervision. Increasing globalization, the expansion of multinational groups, and the corresponding difficulties of determining shareholder relationships between separate parts of such groups have been a relevant reason for the legislature to expand the concept of related entities. It was even considered that groups increasingly make use of entities without capital divided into shares, such as foundations or trusts, in which case there is no shareholder relationship at all. Consequently, limiting the concept of "related entity" to shareholder relationships was considered undesirable.

Entities must be related at the moment a transaction is entered into. Consequently, Article 8b of the CITA also applies if the entities were related parties when the transaction was entered into but are subsequently no longer related.

(2) *No Statutory De Minimis Exception*

Intentionally, and in accordance with Article 9 of the OECD Model Treaty, the concept of "affiliated parties" is not further defined or qualified for purposes of Article 8b of the CITA. The Article does not provide any de minimis exception concerning the extent of the relation between the entities. The Explanatory Memorandum to Article 8b, however, states that the shareholder, supervisor, and/or manager should have sufficient authority to influence the determination of transfer prices between the parties involved in order for Article 8b of the CITA to apply. Whether this is the case should be determined on a case-by-case basis. If a taxpayer is of the opinion that there is not sufficient authority to influence the determination of the transfer prices, the taxpayer may apply for advance certainty from the tax authorities.

[28] *See* paragraph 2.2 of the 2018 Transfer Pricing Decree.

[29] Explanatory Memorandum, clarification to article IV (*Memorie van Toelichting, Toelichting op artikel IV).* If the courts take a strict reading of this remark in the Explanatory Memorandum, all transactions with individuals could be used as transactions with independent parties. However, it is unlikely that courts will take such a strict view (especially if the "independent" transaction is between a company and one of its individual shareholders).

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Moreover, according to the Explanatory Memorandum, a common member of the supervisory boards would generally not trigger the application of Article 8b of the CITA. According to the Dutch State Secretary of Finance, the taxpayer has only a limited duty to inquire whether another party to a transaction is related. In case the relation is not presented or confirmed by the taxpayer, the tax inspector needs to demonstrate that the parties are in fact related. The burden of proof is in the first instance on the tax inspector.

When codifying the arm's-length principle in Netherlands tax law, the *Raad van State* (an advisory board that reviewed the proposed legislation) requested the legislature to quantify a shareholding threshold below which no relatedness for transfer pricing purposes would exist. Such quantification was already included in Netherlands tax law with respect to other provisions. However, to avoid manipulation, the legislature specifically chose not to include such a quantification in Article 8b of the CITA.

In the case of Court of Appeals, Den Bosch, May 19, 2011, No. 09/00465, the tax inspector stated that the requirements of Article 8b, paragraph 3, of the CITA (documentation obligation with regard to related-party transactions) were not fulfilled. The point at issue was the marketing payments made by a Dutch company to a 20% shareholder company. Although this concerned a minority shareholder, it was not in dispute whether these companies were related parties according to Article 8b of the CITA.

C. Transfer Pricing Analysis

1. Comparability Analysis

In the Netherlands, the comparability analysis is an essential part of the transfer pricing regime. In the 2018 Transfer Pricing Decree, the State Secretary of Finance refers to the OECD Guidelines with respect to the comparability analysis. More specifically it provides that the functional analysis of the parties involved in the transaction is important in the characterization of the transaction and an essential part of the application of the arm's-length principle and the required comparability analysis. The functions performed, the associated risks, and the assets used determine the remuneration for the parties involved.

The 2018 Transfer Pricing Decree further mentions that transfer pricing documentation should describe the five comparability factors of the related transactions as described in Chapter I of the OECD Guidelines, including:

(i) The contractual terms of the transaction;

(ii) The functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the multinational group to which the parties belong, the circumstances surrounding the transaction, and industry practices;

(iii) The characteristics of property transferred or services provided;

(iv) The economic circumstances of the parties and of the market in which the parties operate; and

(v) The business strategies pursued by the parties.

2. Transfer Pricing Method

a. General

The Dutch Tax Authorities apply the OECD Guidelines as supplemented by the 2018 Transfer Pricing Decree to transfer pricing questions. In line with Chapter III of the OECD Guidelines, in addition to the traditional transaction-based transfer pricing methods (Comparable Uncontrolled Price (CUP) Method, Cost-Plus Method, and Resale-Minus Method), the Dutch Tax Authorities allow profit-based methods (Transactional Net Margin Method (TNMM) and the Profit-Split Method).

The State Secretary indicated in the 2018 Transfer Pricing Decree that the Dutch Tax Authorities will always start their transfer pricing investigation from the perspective of the method used by the taxpayer at the time of the transaction. The taxpayer is in principle free to choose a transfer pricing method, provided that the chosen method leads to an arm's-length result for the specific transaction. In line with the Explanatory Memorandum to Article 8b of the CITA, the State Secretary further mentioned that when choosing a transfer pricing method, it is explicitly not the intention that the taxpayer assesses all methods and then substantiates why the method chosen under the given circumstances leads to the best outcome (the so-called best method rule). In some situations, a combination of methods can also be used. However, a taxpayer is not obliged to use multiple methods, but must make a plausible case for its choice.

b. Comparable Uncontrolled Price Method

The Dutch Tax Authorities accept the use of comparable uncontrolled transactions to substantiate the arm's-length character of a price. However, in the 2018 Transfer Pricing Decree, the State Secretary of Finance notes that the CUP Method generally is difficult to apply in practice due to the fact that comparable uncontrolled transactions are almost impossible to find. In practice, it appears that this is one of the reasons the TNMM is in many cases applied as the transfer pricing method.

c. Cost-Based Methods

When applying the Cost-Plus Method and the TNMM (with costs as a "profit level indicator"), the determination of the cost base is an essential part of applying the method. In the 2018 Transfer Pricing Decree, the State Secretary of Finance indicates the following points of attention when applying cost-based methods.

Budgeted Versus Actual Costs

In general, prices will be determined in advance on the basis of the budgeted costs. If the actual expenses related to the transactions are higher than these budgeted costs, the difference may lead to a price adjustment, depending on the reason for the deviation. In general, it can be assumed that a higher expenditure due to inefficiency will be borne by the contracting party performing the services. After all, it is the contracting party that can influence these expenses. An independent party will generally not accept a price adjustment in this situation.

In order to correctly determine transfer prices on the basis of budgets, these budgets should be determined in line with accounting and business economics standards.

Cost Base and Disbursements

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Section 2.98 of the OECD Guidelines indicates that a transfer pricing method that uses costs to determine the profit related to a transaction is an appropriate method if the costs are the relevant indicator of the value of functions performed, assets used, and risks assumed. Costs that are not a relevant indicator for this value should not be included in the cost base for calculating the profit.

Although paragraph 2.99 of the OECD Guidelines states that when the TNMM is applied, the full costs are often included in the cost base, but it also leaves room for excluding part of the costs from the cost base if an unrelated party in a similar transaction would be prepared to not make a profit in relation to such costs. The State Secretary refers to paragraph 7.34 of the OECD Guidelines to illustrate the above, which provides that when an associated enterprise is acting as an agent or intermediary in the provision of services, it is important in applying a cost-based method that the return or mark-up is appropriate for the performance of an agency function rather than for the performance of the services themselves. In such a case, it may not be appropriate to determine arm's-length pricing as a mark-up on the cost of the services but rather on the costs of the agency function itself. In such a case, costs with a so-called disbursement character should not be included in the cost base but should be passed on to the group recipients without a mark-up. Examples of so-called disbursements are costs that were initially paid by the contracting party but are generally charged separately to the client, such as dues, legal charges, court fees, and service costs.

The cost of raw materials processed by a producer that does not incur the risks in relation to the raw materials should in the opinion of the State Secretary of Finance generally not be included in the cost base. The reason for this is that in principle only the operational costs of a producer are a relevant indicator for the value of the functions performed, the assets used, and the risks incurred by this party. In the situation described above, the producer performs no relevant functions with respect to the purchase of the raw materials and does not run any risks with regard to those raw materials.

3. The "Tested Party"

With reference to paragraph 3.18 of the OECD Guidelines, the State Secretary of Finance mentions in the 2018 Transfer Pricing Decree that if a transfer pricing method is chosen that compares the results of the controlled transaction to the results of similar transactions of unaffiliated parties (such as the TNMM), the party that allows the most reliable comparison should be chosen as the Tested Party. The usual way to meet this objective is to make this comparison with the party having the least complex functions. In general, a party that, in view of its functions, assets and risks, is entitled to the proceeds strongly related to intangible fixed assets used will not be considered the Tested Party.

4. Comparable Companies and Benchmarks

a. General

The next step in a transfer pricing analysis is finding comparable companies using a benchmark study.

(1) Internal and External Comparable Companies

The Dutch Tax Authorities accept the use of internal and external comparable companies or transactions. There is no guidance on the use of internal comparable companies or transactions. When using external comparable companies, the Dutch Tax Authorities generally require that the data sources are publicly available.

(2) Regional Comparable Companies

The Netherlands generally accepts European comparable companies, provided that the data on these companies is from a publicly available data source. Due to the small size of the Netherlands, publicly available sources often contain insufficient third-party transactions between Dutch parties. Companies based in the EU are generally considered to operate under similar market circumstances as companies in the Netherlands.

(3) Secret Comparables

The OECD Guidelines mention in paragraph 3.36 that tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, the OECD Guidelines mention it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.

The Dutch Tax Authorities may claim on the basis of Article 67 of the General Tax Act (GTA) that they are required to maintain the confidentiality of all information with respect to Dutch taxpayers and that, as a consequence of these confidentiality requirements, they are unable to disclose data on comparable transactions of other taxpayers. On the basis of Article 8:29 of the GTA, parties in a court procedure may only include information in the procedure that is shared with both parties. An exception to this general rule is when there are sufficient reasons to do so. However, Article 8:29, paragraph 5, of the GTA provides that the court may only take into account such confidential information in its judgment if the other party agrees to it. This means that the court would only be able to take into account secret comparables in its judgment if the taxpayer agreed to it.

The State Secretary indicated in a letter to Parliament that the Dutch Tax Authorities do not use secret comparables when substantiating transfer pricing corrections, except in cases that involve a shift of the burden of proof from the tax authorities to the taxpayer.[30]

b. Databases

The Dutch Tax Authorities are familiar with Bureau van Dijk Electronic Publishing's Amadeus and Orbis databases, Bloomberg, Moody's RiskCalc and LossCalc, and Thomson Reuters LPC's DealScan, but this should not limit the choice

[30] Letter of the State Secretary dated December 21, 2001 (no. AFP 2001/933).

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of the taxpayers, as long as the data sources used are publicly available.

Comment: In the authors' experience, the Dutch Tax Authorities are reluctant to accept data from a database they are not familiar with if they cannot reproduce the search. In practice, the Dutch Tax Authorities require the use of three years of data when applying the TNMM.

c. Qualitative and Quantitative Criteria

In the Netherlands, a reference group of comparable companies or transactions is typically determined on the basis of a qualitative comparison of the uncontrolled transactions and the transaction under review. After the reference group is set, it is determined whether corrections are needed to improve comparability. In addition, quantitative criteria can be applied to improve comparability.

d. Comparability Adjustments

In accordance with the OECD Guidelines, comparability adjustments are applied in practice in the Netherlands. These adjustments are primarily made to account for differences in capital, functions, assets, and risks. For example, working capital adjustments are made in practice.

e. Arm's-Length Range

The Explanatory Memorandum to Article 8b of the CITA indicates that, as a result of market circumstances, generally not just one, but a range of arm's-length prices exists. In line with the Explanatory Memorandum, the State Secretary of Finance acknowledges in the 2018 Transfer Pricing Decree that the determination of transfer prices cannot be considered an exact science. Therefore, the application of a transfer pricing method will often lead to a range of values within which the transfer price to be applied can be fitted. He further mentions that the reliability of the comparables may be improved by applying statistical methods, such as the interquartile range.

An adjustment to a price will generally only be made if the compensation is outside the range and the taxpayer cannot explain the deviation on valid grounds.[31] If it is plausible that one specific point within the range corresponds best with the conditions of the inter-group transaction, an adjustment can be applied up to that point. If such a specific point cannot be identified, the Netherlands is of the opinion that there will be an adjustment up to the median (the central observation in the range). A change to a price that already falls within the arm's-length range will, based on the 2018 Transfer Pricing Decree, only be accepted if the taxpayer can justify the change based on changed circumstances and if the changed price is documented in agreements between the parties involved and actually charged.

f. Multiple-Year Data

In the 2018 Transfer Pricing Decree, the State Secretary of Finance mentions that when assessing a transaction, it might be useful to look at data covering multiple years. The use of multiple-year data can prevent adjustments being applied in a certain year, even though the group receives — when several years are taken into consideration — a compensation that is in line with the arm's-length principle. However, application of multiple-year data can also lead to insights that are developed subsequently being used to assess a situation that occurred previously (hindsight). The OECD Guidelines indicate that tax administrations are not allowed to apply such insights developed with hindsight. Therefore, the State Secretary of Finance suggests working with a moving average, using data from the year under review and preceding years, as follows:

- First, it is assessed whether the compensation for the transaction under review is within the arm's-length range determined for the year under review. If the compensation is within the annual range, no adjustment will be applied.
- If the compensation falls outside the annual range, then the assessment is repeated on the basis of (moving) averages over several years. The length of the period included will partly depend on the length of the life cycle of the product. If the average compensation for the transaction under review falls within the multiple-year range, no adjustment is applied.
- If the compensation under review falls outside the annual arm's-length range as well as outside the multiple-year arm's-length range, an adjustment will be made in line with what has been described under III.C.4.e., above.

g. Intentional Set-offs

The Dutch Supreme Court ruled that Dutch tax law does not require testing the arm's-length nature of every individual transaction or every group of transactions separately. Testing the arm's-length nature of the complete set of conditions applicable to the total of transactions between a taxpayer and its shareholder(s) is under certain conditions allowed under Article 8b of the CITA.[32] This ruling authorizes the consideration of set-offs to prices in appropriate situations.

The State Secretary of Finance provides the following with respect to set-offs in the 2018 Transfer Pricing Decree. In a tax audit, the taxpayer can apply for a correction of a proposed transfer price if the taxpayer is of the opinion that the adjustment proposed by the Dutch Tax Authorities does not sufficiently take into account offsetting transactions.[33] According to the OECD Guidelines, the tax authorities in their discretion may or may not grant this request. The distinction made in the OECD Guidelines between demonstrating an intentional set-off upon submission of the tax return and bringing up (and demonstrating) an intentional set-off at the moment corrections are proposed in connection with a tax audit, are not relevant to Dutch practice. In both cases the taxpayer retains its statutory right of objection and appeal.

5. The "Additive" and "Deductive" Approaches

The Dutch Tax Authorities generally prefer the use of the deductive approach. The additive approach, however, is regu-

[31] In certain situations, the tax authorities may take the position that the median outcome from the benchmark study must be reported and that the Q1 outcome is too low given the specific facts.

[32] Dutch Supreme Court, 28-06-2002, ECLI:NL:HR:2002:AE4718, BNB 2002/343.

[33] *See* paragraph 2.6 of the 2018 Transfer Pricing Decree.

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larly used in case of discussion on the results of the deductive approach to provide a rationale for the analysis.[34]

[34] The "additive" and "deductive" approaches are described in the OECD's Transfer Pricing Guidelines, Chapter III, paragraphs 3.41 and 3.42, respectively. Briefly, the "additive" approach involves building a list of identified third parties that are believed to carry out potentially comparable transactions, and then analyzing them for comparability; the "deductive" approach starts by extracting a wide set of companies in the same or similar sectors of activity, and then refining that list by using various selection criteria through screens and analysis of publicly available information. The two overall methods can be combined.

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IV. Specific Transfer Pricing Rules

A. Tangible Property

In the 2018 Transfer Pricing Decree, the State Secretary takes the position that a transaction cannot be considered arm's length if, and to the extent that, tangible or intangible assets are transferred to an affiliated party that does not add value to these tangible or intangible assets, due to the fact that it does not have appropriate functionality to control the risks in relation thereto.

In BNB 1969/217 (Supreme Court, July 1, 1969), a Dutch subsidiary of a Swiss AG supplied goods to its parent at prices significantly lower than the prices used in relation to independent purchasers. The Swiss parent acted as a sales company for the Benelux area. The Court of Appeal concluded that the intra-group transfer at lower prices was not at arm's length and took into account a corrected transfer price. This led to an increased profit and a deemed dividend distribution by the Dutch company to its Swiss parent in the amount of the difference between the intra-group price and the third-party price. The Supreme Court, however, ruled that the Court of Appeal had not sufficiently analyzed whether the position of the Swiss parent was comparable to the position of third-party purchasers. Since the Swiss parent also acted as the sales company, its position could well deviate from that of independent purchasers. Before applying the CUP Method for correcting transfer prices, the courts need to determine the comparability of the transaction, taking into account the functions and positions of the relevant parties.

To determine the appropriate transfer price, the activities performed and risks undertaken by the group companies will always need to be reviewed. Another example of such functional analysis is the case BNB 2001/142c (Supreme Court, October 11, 2000). The case concerned a Dutch company, X BV, forming part of a multinational group engaged in the business of producing and selling coated boards. Through 1990, X BV purchased uncoated boards from a Swiss group company, Y AG. X BV added the coating and partly resold the coated boards back to Y AG at a price equal to the cost price (80% of which constituted the cost of uncoated boards) plus a 1% profit margin. From 1991, the activities of X BV were limited to the coating of the boards for the risk and account of Y AG. The boards remained in the ownership of Y AG. The consideration paid by Y AG for these more limited intra-group services was determined as the cost price of the coating process increased by a 2% profit margin. Following this change in transfer pricing (as a result of the change in business carried out by X BV), the profit margin realized by X BV had decreased by 60%. The Court of Appeal ruled that the decrease in transfer price could not be justified and, therefore, the price should be corrected to reflect a profit margin in 1991 comparable to the profit margin realized by X BV in previous years. The Supreme Court, however, ruled that the Court of Appeal's decision lacked sufficient justification. The Supreme Court stated that intra-group transfer prices should, among other things, be based on the activities performed and risks undertaken by the relevant group companies. Because X BV no longer owned the boards and no longer ran inventory risks, the activities performed and risk undertaken by X BV had significantly changed, and these changes should have been taken into account by the Court of Appeal.

The cost-plus method is generally an acceptable method for determining arm's-length consideration in the case of contract manufacturing. Due to the lack of risks, the production company should generally not be granted a profit in excess of a fixed percentage of the production costs (BNB 1986/13, District Court, The Hague, June 13, 1984).

In BNB 1983/109 (Court of Appeal, The Hague, January 22, 1982), the court determined whether the transfer price used for purchasing certain goods was at arm's length by referring to the margin earned by the foreign related company acting as a purchasing and selling agent. In this case, a Dutch company, X BV, had incorporated a Netherlands Antilles company, A NV, to avoid trading restrictions that resulted from the fact that the U.S. supplier of the group was, under restrictions laid down in a license agreement with a European company, no longer able to deliver goods to the European market. A NV purchased goods without a brand and without factory guarantee from the U.S. supplier for the risk and account of X BV. A NV transferred the goods to X BV for the significantly higher price applicable in the European market for goods with a brand and a factory guarantee. The Court ruled that X BV could not be said to have acted under arm's-length conditions. Third parties would never have granted A NV a profit in excess of a commission of 7.5% on the purchased goods. Because A NV did not hold any inventory and did not require any supplier's credit, the Court determined the commission to be 7.5% of the purchase value.

In BNB 2013/77 (Supreme Court, January 4, 2013), the interested party was a fiscal unity. One of the companies in the fiscal unity, G BV, was engaged in the purchase and sale of paper. The shareholder of the fiscal unity and director of G BV was Y. Y also performed activities for a Swiss AG that was engaged in the same line of business as G BV. Y carried out the purchase and sale of paper by the Swiss AG, and Y decided whether a trading transaction would be performed by G BV or by the Swiss AG. Third parties experienced no difference in doing business with G BV or the Swiss AG. In both cases, Y was the contact person. In carrying out the business, Y used the same office accommodations and business facilities. The Swiss AG and G BV had the same supplier, the same products, made use of the same logistics companies and the same purchasers. In the opinion of the tax inspector, the turnover of the Swiss AG should have been allocated to G BV. The Court of Appeal determined that the result of the activities performed by Y should be considered results of G BV. In the opinion of the Court of Appeal Amsterdam, no business reasons existed to allocate this turnover to the Swiss AG, only shareholder motives. However, the Swiss AG did carry on a business and, in respect of specific business activities conducted by the Swiss AG, a result should be allocated to the Swiss AG equal to 15% of the costs. The Supreme Court confirmed the decision of the Court of Appeal.

In NTFR 2009/1254 (Court of Appeal Amsterdam, February 11, 2009), a foreign subsidiary acquired business assets (machinery) from its Dutch parent company and subsequently rented out this machinery to its Dutch parent company (sale and lease-back). The following subjects were discussed: (1) the transfer price for the machinery; (2) the amount of the lease rentals; and (3) the question whether or not there was a transfer of "profit potential" (a.k.a. "goodwill"). The Court ruled that there was a clear link between the amount of the lease

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rentals and the transfer price for the machinery. The amount of the transfer price and the lease rentals should, according to the Court, be determined on the basis of various factors (e.g., prices of comparable machinery, method of calculating rental fees, risk premium, discount factor, etc). More important, the Court ruled that there was no goodwill realization in this specific case. The Court determined that, prior to the transfer of the machinery, the Dutch parent company was not involved in renting out machinery and that no business assets (other than machinery) to perform this activity were transferred to the foreign subsidiary to perform the rental activities. Furthermore, the Court attached importance to the fact that no personnel were transferred from the Dutch parent company to the foreign subsidiary (i.e., new personnel were hired by the foreign subsidiary). On the basis of these facts and circumstances, the Court ruled that no goodwill was realized. This case confirms that the transfer of profit potential does not necessarily result in goodwill realization.

B. Intangibles

1. Ownership of Intangibles

Under Dutch tax law, the actual contractual arrangements between parties must be taken into account to determine a company's taxable profit. Consequently, the party that holds legal title to an asset should in principle also be considered the owner of the asset for tax purposes.[35]

In the 2018 Transfer Pricing Decree, however, the State Secretary of Finance took the position that only a limited remuneration can be attributed to the legal owner of the intangible asset that does not perform the relevant functions in respect of the asset. The State Secretary referred to the Development, Enhancement, Maintenance, Protection, and Exploitation (DEMPE) functions as described in the OECD Guidelines as relevant functions with regard to intangible fixed assets. In general, the functions of Development and Enhancement are given more weight in the assessment of the relative contribution to the value of the intangible asset in question.

2. Income from the Transfer or Use of Intangibles

a. Transfer and Valuation

Based on the 2018 Transfer Pricing Decree, Dutch taxpayers may, based on the facts and circumstances, use valuation methods, and in particular the discounted cash flow method, as part of the five transfer pricing methods described in Chapter II of the OECD Guidelines or as a valuation method to determine the arm's-length price for the use or transfer of an intangible asset. The State Secretary further mentions that valuations must take place from the perspective of all parties involved in the transaction in order to determine an arm's-length price. The arm's-length price will be set between the value of the intangible asset from the seller's perspective and the value from the buyer's perspective. If the value from the seller's perspective is higher than that from the perspective of the buyer, according to the State Secretary the transaction would not be entered into between "commercially rational acting independent parties." In addition, the State Secretary provides that the effects of taxation must be taken into account in the valuation, including taxation on capital gains for the seller and potential tax benefits from depreciation for the buyer of the intangible asset.

It may be difficult to determine the fair market value of intangibles at the time of their transfer since the future profits and risks are still uncertain. Under certain circumstances, the Dutch Tax Authorities take the view that it is not in accordance with the arm's-length principle to determine the transfer price at a fixed price if the value at the time of transfer is extremely uncertain and independent parties would, in a comparable position, not agree upon a fixed price but rather a variable price.

In line with paragraphs 6.186 to 6.195 of the OECD Guidelines the State Secretary in the 2018 Transfer Pricing Decree states that in case of the transfer of hard-to-value intangibles, as described in paragraph 6.189 of the OECD Guidelines,[36] the Dutch Tax Authorities may consider ex post (i.e., later) outcomes as presumptive evidence of the appropriateness of the pricing arrangements at the moment of the transfer. In case of a significant deviation between the actual results and the forecasted results, which cannot be explained based on facts and circumstances occurring after the date of the transfer, the tax authorities can still question the price as determined at the time of the transaction with a reference to the actually realized results. The State Secretary considers a deviation of more than 20% from the financial projections that formed the basis for the original price to be a significant deviation. If a significant deviation occurs after a period of five years has passed following the moment the intangible first generated unrelated party revenues for the transferee, the intangible will not be regarded as a hard-to-value intangible asset. In relation to this rule, it should be noted that a Decree does not have the force of law; it is simply the position of the tax authorities.

In BNB 1998/385 (Supreme Court, August 17, 1998), the arm's-length pricing of transferred know-how was under discussion. In this court case, a Dutch real estate development company, X BV, incorporated a separate company for each new development project. Once X BV had obtained sufficient know-how about a possible location for a project, this know-how was transferred to a separate project company for no or low consideration. Subsequently, the project company instructed X BV to examine the feasibility of the project and later, if the project turned out to be feasible, X BV was instructed to develop and realize the project for a consideration of 4%–6% of the total contract price. This way the majority of the profits realized with the project was transferred to the BV project. The problem in this case for the courts was to find a comparable non-controlled transaction since generally independent parties would not transfer the know-how and projects to another party

[35] Dutch Supreme Court, November 3, 1954 (BNB 1954/357). However, on the basis of NL: HR, May 8, 1985 (BNB 1986/75), the legal owner will not be considered the owner for tax purposes if: (i) the entire beneficial interest with the asset lies with another party pursuant to a legal relationship between the owner of the asset; and (ii) that other party (i.e., the economical owner) should have the entire upside potential as well as the downside risk on the asset.

[36] Hard-to-value intangibles are defined as intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises: (i) no reliable comparables exist; and (ii) at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible, are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.

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in the early stage of the process. Therefore, there was no comparable uncontrolled transaction to rely on. However, the courts held that the transactions could only be arm's length if X BV would have preserved the major part of the profit potential. The courts determined the arm's-length profit of the project company at 2% of the building costs and project costs (with a reference to the fact that such reimbursement would provide the BV project a reasonable return on equity).

In BNB 2010/93 (Supreme Court, June 25, 1969), a taxpayer transferred patents and patent requests to a subsidiary in the Netherland Antilles for a price equal to the development costs. The Court of Appeal was of the opinion that the results earned with the exploitation of the patents must be characterized as informal capital contributions of the taxpayer to its subsidiary. The Supreme Court ruled that even if it is plausible that a taxpayer transfers intellectual property rights to a foreign group company to benefit from a lower effective tax rate, this does not mean that future royalties should be allocated to this taxpayer in the years that the royalties accrued. According to the Supreme Court, the transfer value must be determined at the moment the intellectual property rights are transferred.

In VN 2012/32.2.1 (District Court Breda, December 21, 2011), a private individual, X, developed a chain for use in cars. He sold his know-how to a Japanese firm. Two contracts were concluded. The first was a Patent License Agreement between (an entity of) X and the Japanese firm. This agreement gave the Japanese firm the right and license to use the patents to produce, use, and sell the product. The second agreement was a Know-How License Agreement concluded between the Japanese firm and a trust organized under the laws of Switzerland. This agreement gave the Japanese firm all necessary information about the product. The trust was controlled by X. In the year in question, the trust received €1,500,000 in royalty income from the Japanese firm. The point at issue was whether the royalties paid by the Japanese firm were taxable in the Netherlands as a "result from other activities" of X. In the opinion of the District Court, the know-how relating to the royalty payments was provided through S's personal services, and it was therefore likely that there was a source of income for X. In the opinion of the Court, X did not transfer his know-how to the trust. The only task of the trust was to temporally hold the funds belonging to X. Therefore, the €1,500,000 were taxable to X.

In the 2018 Transfer Pricing Decree, with respect to the purchase of shares in an independent company, followed by a transfer of its intangible assets to a group company, the State Secretary of Finance takes the position that although the price of the purchased shares is at arm's length because the seller is an independent party, this does not imply that the value of the shares for the buyer is equal to this price. On the contrary, the buyer will generally only make a purchase if it expects to create more value with the acquired company than the price it has to pay for it. In the view of the State Secretary of Finance, the value that the buyer of the shares has attributed to the intangible asset in the acquired company may well be a positive indicator of the minimum price it would like to receive when transferring the assets. This gives the Dutch Tax Authorities room to argue that the price for the intra-group transfer of the intangible asset should exceed the purchase price of the shares. In this respect, the State Secretary provides that the seller will, taking into account the corporate income tax payable, wish to see at least a sales return equal to the value it attributes to the intangible assets plus the tax due on a possible book profit.

The 2018 Transfer Pricing Decree further discusses the situation where the associated intangible assets of an acquired company are transferred to another group company, leaving behind routine functions. Dutch taxpayers sometimes determine the transfer price in this scenario as the difference between the discounted cash flow valuation of: (i) the value of the acquired company; and (ii) the routine function using a terminal value. Even though the State Secretary accepts this valuation method, the Dutch Tax Authorities will generally take the position that using a terminal value in the valuation is incorrect. This position is based on the view that routine functions can easily be substituted in the market and that contracts based on such routine functionality will, therefore, generally have a relatively short term.

b. Remuneration for the Use of an Intangible Asset

In practice, the remuneration for the use of intangible assets by taxpayers is often determined using royalty percentages from various databases. In the 2018 Transfer Pricing Decree, the State Secretary questions whether this publicly available information is sufficiently detailed to conduct a comparability analysis in a responsible manner. The OECD Guidelines state in any event that a comparability analysis in the case of intangible assets will often show that no comparable uncontrolled transactions can be found. The Dutch Tax Authorities will therefore critically assess the use of such databases.

c. Comparable Uncontrolled Price

If the taxpayer succeeds in finding an acceptable independent comparable, the courts are generally willing to accept the transfer price resulting from such a comparable.[37] The case of a Dutch company renting films to a third party provides a good example. Here, the rights to the movies were granted by the U.S. parent company. The Dutch company paid 79% of its rental income to the U.S. parent company. After taking into account losses available to be set off against income, the Dutch company would have had a positive income only if the arm's-length charge payable to the parent company for the movie rights were lower than 66%. By referring to margins payable by independent movie rental companies, the company had sufficiently demonstrated that the U.S. company would at least have charged 66% of the rental income when dealing with a third party.

d. One-Sided Transfer Pricing Methods

Paragraph 6.141 of the OECD Guidelines stipulates that one-sided methods — the Resale-Minus Method, the Cost-Plus Method, or the TNMM — are not reliable methods for directly determining the value of an intangible asset. In the 2018 Transfer Pricing Decree, the State Secretary of Finance takes the position that under certain conditions, these methods can result in a residual profit attributable to the intangible asset by first determining the remuneration for the tested party. This resid-

[37] *See, e.g.,* the decision of the Court of Appeal, The Hague (May 10, 1984, BNB 1986/8), which concerned a Dutch company renting out movies to third parties.

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ual profit then forms the reward for the intangible asset used and the related functions performed. A condition for applying a one-sided method is that the residual profit must be allocated to the intangible asset, after all other functions, risks, and assets have been sufficiently remunerated.

3. Goodwill Valuation

The market value of goodwill is generally determined by multiplying the excess profit by a certain factor, depending on the type of organization, the market position of the organization, and the period during which the organization is expected to make a profit. The excess profit is the excess of the normalized profit (taking into account past profits and anticipated profits) over the normal entrepreneurial remuneration, the yield of the equity, and interest on debts.

4. Contract Research

The 2018 Transfer Pricing Decree states that a payment for contract research activities based on the Cost-Plus Method can be regarded as being at arm's length. This is the case if the contract research activities are developed by a group company, while another group company manages the research activities, bears the costs and risks, and will have the economic ownership of the developed assets. This must be evaluated on the basis of the facts and circumstances.

C. Services

1. General

The 2018 Transfer Pricing Decree (an update to the 2013 Transfer Pricing Decree) provides guidance on transfer pricing aspects of intra-group services. An intra-group service is defined as an activity carried out for the benefit of a group member that adds economic or commercial value and for which that group member would normally be willing to pay. This excludes activities that are carried out in the capacity of a shareholder.

The 2018 Transfer Pricing Decree does not provide clear guidelines as to how to determine the arm's-length remuneration for intra-group services.[38] It indicates that, in practice, often a cost-based remuneration is chosen to remunerate group services. In principle, remuneration (based on costs) for group services will be considered arm's length only if an appropriate profit mark-up is provided. According to the 2018 Transfer Pricing Decree, a Cost-Plus Method usually can only be applied if so-called routine services are provided. However, it does not provide any authority to support such limitation.

The Dutch Tax Authorities allow no mark-up to be charged if the situation is as described in paragraph 7.37 of the OECD Guidelines (i.e., the estimated or actual cost of a supplier is in excess of the market price, but the services are still rendered to increase profitability).

2. Group Services and Shareholder Activities

According to the Dutch Tax Authorities, group services comprise either: (1) shareholders' activities; or (2) intra-group services. Shareholders' expenses must be borne by the headquarters company, whereas expenses incurred for the provision of intra-group services must be charged to the group companies that benefit from these services.

The 2018 Transfer Pricing Decree provides a non-exhaustive list of shareholder activities; if incurred by a Dutch company,[39] these costs are generally deductible in the Netherlands by the company incurring them. The following is a list of viable shareholder activities:

1. Activities that relate to the corporate structure of the company.

1.1. Compliance with the corporate legal requirements of the Dutch Civil Code:

- Organization, preparation, and holding of shareholders' meetings;
- Activities with regard to the preparation and approval of the annual accounts and the submission to the Chamber of Commerce;
- The activities of the Supervisory Board to the extent it concerns the statutory supervisory tasks; and
- The activities of the council.

1.2. Tax compliance, including:

- Maintaining accounts and records;
- Complying with the obligation to retain documentation and records;
- Filing tax returns; and
- Complying with the obligation to provide information.

2. Activities relating to the issuance of company shares on capital markets, or comparable securities and activities with regard to the application for and maintenance of a listing on a foreign stock exchange, such as:

- Meeting the admission requirements for a listing on a stock exchange;
- Activities that relate to the listing — for example, preparation of forms, that are submitted to the U.S. Securities and Exchange Commission in connection with the listing, annual accounts, and annual reports; and
- Membership in associations and other bodies that represent the stock exchanges.

3. Activities relating to compliance with the regulatory control of trading in securities, such as:

- The introduction and maintenance of the registration system based on the Securities Transactions (Supervision) Act 2006; and
- Reporting of securities transactions by employees of the company subject to the Securities Transactions (Supervisions) Act 2006.

[38] Except for low value-adding services. *See* IV.C.3., below.

[39] 2018 Transfer Pricing Decree, paragraph 6.2 (Worksheet 22).

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4. Activities relating to corporate governance of the company or the group,[40] including:

• The implementation of corporate governance prescribed by law or regulations, including the inclusion of a paragraph in the annual report in this respect; and

• Reporting on the environmental policy, social policy, and corporate responsibility policy.

5. Activities that relate to reporting to several stakeholders concerning the company or the group, including:

• Press conferences and other communications with shareholders and stakeholders, such as financial analysts, but only to the extent the communications relate to the financial reporting, financial performance, and future expectations of the company itself or the group as a whole.

This portion of the 2018 Transfer Pricing Decree also provides guidance regarding the treatment of "mixed" activities (i.e., activities that qualify partially as shareholder activities and partially as intra-group services), with a number of examples illustrating specific situations and how to assign the costs to shareholder or intra-group categories.

3. Low Value-Adding Intra-Group Services

Unlike the 2013 Transfer Pricing Decree, the 2018 Transfer Pricing Decree provides guidance for low value-adding intra-group services. The State Secretary recognizes the simplified method for the remuneration of low value-adding intra-group services contained in the OECD Guidelines.

The application of the simplified method is optional and provides an alternative to extensive benchmarks for low value-adding intra-group services. Application of the simplified method leads to a cost +5% remuneration. Low value-adding services have the following characteristics:

— They are of a supportive nature;

— They are not part of the core business of the Multinational Enterprise (MNE);

— They do not require the use of unique and valuable intangible assets and do not lead to their creation; and

— They have no relation to the significant risks as run within the company.

Application of the simplified method has certain documentation requirements, among which is that the following must be included:

• A description of the categories of low value-adding intra-group services provided; the identity of the beneficiaries; the reasons justifying the fact that each category of services constitutes a low value-adding intra-group service within the definition set out in the OECD Guidelines; the rationale for the provision of services within the context of the business of the MNE; a description of the benefits or expected benefits of each category of services; a description of the selected allocation keys and the reasons justifying that those allocation keys produce outcomes that reasonably reflect the benefits received; and confirmation of the mark-up applied;

• Written contracts or agreements for the provision of services, and any modifications to those contracts and agreements, reflecting the agreement of the various members of the group to be bound by the allocation rules of this section. Such written contracts or agreements could take the form of a contemporaneous document identifying the entities involved, the nature of the services, and the terms and conditions under which the services are provided;

• Documentation and calculations showing the determination of the cost pool as described in the OECD Guidelines, and of the mark-up applied thereon, in particular a detailed listing of all categories and amounts of relevant costs, including costs of any services provided solely to one group member; and

• Calculations showing the application of the specified allocation keys.[41]

4. Intra-Group Procurement Activities

With regard to central purchasing activities, reference is made to Chapter I, section D.8, of the OECD Guidelines. The State Secretary acknowledges that—after performing a functional and risk analysis—an appropriate transfer pricing method should be chosen to determine an appropriate remuneration. Such a remuneration can vary from a routine-remuneration (based on the entity's operational costs or based on a fee over the purchasing price) for routine activities to a profit-split remuneration when the activities of the central purchasing activity entity are part of the core activities of the MNE.

The State Secretary indicates that local, unrelated purchasing agents usually perform supporting activities and that they usually receive a remuneration based on purchase value. The remuneration is higher when responsibilities of the agent increase, and the remuneration is lower as purchasing volumes increase. The State Secretary recognizes that in practice it is very hard to find reliable comparables that use a percentage of the purchase value as a remuneration. The tax authorities generally like using the TNMM (based on costs) to assess the arm's-length character of a transaction. The cost-base is, in principle, limited to the operational costs of the CPA entity. The purchase value of the purchased goods is not part of this.

The State Secretary indicates the view that if central purchasing activities lead to higher rebates and discounts as a result of centralization, then the benefit derived therefrom should generally not be allocated to the central purchasing activity entity. Accordingly, such benefits should be attributed to the parts of the MNE group that (by centralizing their purchasing activities) cause the central purchasing activity entity to realize such discounts.[42]

[40] The group as a whole comprises the company itself and its direct and indirect subsidiaries.

[41] More information on the specific requirements for the simplified method and examples can be found in paragraph 6 of Worksheet 22.

[42] 2018 Transfer Pricing Decree, paragraph 8 (Worksheet 22).

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5. Relevant Jurisprudence

Whether an intra-group service in fact adds economic or commercial value should be determined on the basis of a functional analysis. If and to the extent there is a real function performed by a group service company, some profits must be allocated to that function. The following illustrative case concerns a Dutch BV that had incorporated a Swiss AG to commence a foreign sales office.[43] Goods sold were directly transferred from the BV to the local purchasers and invoiced to the AG. Most of the activities were carried out by the shareholder and employees of the BV. The AG, however, had a rented office at its disposal and had hired an administrative employee. Even though the existing cost allocation needed to be amended to ensure that the BV would receive an arm's-length consideration for the activities performed for the AG, it was not demonstrated by the tax inspector that the sales activities of the AG did not represent a real function. Consequently, not all profits realized in Switzerland could be attributed to the BV.

In the so-called *Bankgirocentrale* case,[44] the Amsterdam Court of Appeal and the Supreme Court determined the profits of a Dutch company rendering group services on a cost-plus basis. In this case, the banker's association and two Dutch banks were the shareholders in a company engaged in the processing of payments for its participants. Expenses were charged to the respective participants on the basis of the number of payments processed. No profit mark-up was charged. The argument of the taxpayer that arm's-length pricing generally does not require a more-than-reasonable yield on the equity of the servicing company was not accepted. In the view of the Supreme Court, every separate legal entity should strive for profitability and, therefore, it was not arm's length not to impose at least some margin for services rendered. The arm's-length price was determined to be cost plus 5%.

In VN 2004/27.17 (Supreme Court, April 23, 2004), a Belgian subsidiary of a Dutch BV was the central purchasing entity of a multinational. Rebates relating to the purchases of the CPA entity were directly paid to the CPA entity. The Court of Appeal in Den Bosch was of the opinion that the profits were relatively high compared to the activities and costs of the CPA entity and that this was caused by the shareholder relationship between the Dutch BV and the CPA entity. Part of the profit was, therefore, allocated to the Dutch BV (relating to the purchasing of goods for the Dutch BV), based on a cost-plus remuneration of 5% for the CPA entity.[45]

D. Financial Transactions

1. Loan Transactions

Information on loan transactions is included in Chapter 11 of the 2018 Transfer Pricing Decree. The State Secretary indicates that financial transactions must be provided in conformity with the arm's-length principle. This includes all conditions of the transaction, including risk allocation and price.

The 2018 Transfer Pricing Decree provides that it first must be considered whether comparable financial transactions between independent third parties can be identified. If, and to the extent, the conditions of an intra-group financial transaction deviate from the conditions under which a similar third-party financial transaction is executed, such conditions must be adjusted. If a transaction cannot be made arm's length by an adjustment of the price and/or other conditions, the State Secretary takes the position that — in such extreme cases — the loan can be ignored or re-characterized on the basis of paragraph 1.122 of the OECD Guidelines.

The 2018 Transfer Pricing Decree states that the perspective of each of the parties involved is an important factor in the arm's-length test (the bilateral perspective):

> The unassociated lender wishes to limit its risks as much as possible, taking into account its functionality in the market and in the related choices regarding the acceptance of risks. . . . The unassociated borrower will strive to ensure that the financing of its business activities takes place as efficiently as possible, so that the costs of capital is kept as low as possible.

Subsequently, the State Secretary takes the position that a case where loans are provided to group companies that have a credit rating lower than BBB− (non-investment grade) (or where the credit rating becomes lower than BBB− due to entering into the financial transaction) are deemed to lead to a non-arm's-length result and, in his view, the taxpayer should then provide further evidence that entering into the financial transaction will lead to an arm's-length result for both the lender and the borrower. The State Secretary takes the same position in relation to an "arm's length mix of equity and debt:" if and to the extent that as a result of intragroup financial transactions the credit rating of a group company falls below BBB− this is deemed to lead to a non-arm's-length outcome unless the taxpayer can demonstrate otherwise.

In the Netherlands, as a general rule, an instrument that qualifies as a loan under Dutch civil law in principle also qualifies as a loan under Dutch tax law. Nevertheless, under certain specific circumstances, it is possible for a loan to be reclassified as "equity" (as opposed to debt) for Dutch corporate income tax purposes. This will be the case if the loan qualifies as a "sham loan" (*schijnlening*), a "bottomless pit loan" (*bodemloze putlening*), or a "participating loan" (*deelnemerschapslening*). A loan is a sham loan if the parties in fact intended to provide equity rather than debt. A loan is considered a bottomless pit loan if it is clear from the start that the loan cannot be repaid in full. A loan qualifies as a participating loan if the following conditions are cumulatively met:[46]

> 1. The remuneration on the loan is (for the most part) contingent on the profit of the debtor (nearly the whole amount (i.e., >90%) of the interest due needs to be profit depending);
>
> 2. The loan is subordinated to all other unsecured creditors; and

[43] *See* BNB 1979/188 (Court of Appeal Amsterdam, June 15, 1978).

[44] BNB 1989/114, Supreme Court, November 28, 1984.

[45] Reference is also made to the case BNB 2013/77, as discussed in IV.A., above.

[46] BNB 1998/207, Supreme Court, March 11, 1998.

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3. The loan does not have a fixed term, but is only repayable in the case of bankruptcy, suspension of payment, or liquidation, or the loan has a term of at least 50 years.

2. Non-Businesslike Loans

In the 2018 Transfer Pricing Decree, the State Secretary also elaborates on the transfer pricing aspects that are related to landmark case law concerning so-called non-businesslike loans. In its November 25, 2011, decision, the Supreme Court ruled that in order to qualify a loan as non-businesslike, it should be determined whether the interest rate is at arm's length or can be adjusted to an arm's-length rate without the loan becoming profit participating. If it is impossible to determine a fixed interest rate at which an independent third party would grant a loan under the same conditions and circumstances, the Supreme Court assumes that by providing such loan to a group company the lender would entail a debtor risk that the third party would not have taken, resulting in a non-businesslike loan.

If a loan is considered to be non-businesslike, this has, inter alia, the following consequences:

1. Impairment on a non-businesslike loan is not allowed (for tax purposes); and

2. A low-risk arm's-length interest rate must be applied for tax purposes.

The following are two methods prescribed by the Supreme Court to determine the interest rate that must be considered for tax purposes: (i) the rule of thumb;[47] and (ii) the market value rule.[48] According to the State Secretary, the lower of the two will be designated as the applicable interest rate for tax purposes.

(i) The Rule of Thumb

This method determines the arm's-length interest rate on a non-businesslike loan as the rate that the debtor would have paid for a loan from an independent third party under a guarantee from the shareholder (deemed guarantee). For tax purposes, the interest determined under this rule is deductible for the borrower as interest expense and taxable by the lender as interest income. The difference between the interest actually charged and the interest rate determined under this rule is booked as an informal capital contribution or a deemed dividend distribution.

(ii) The Market Value Rule

The application of the market value rule is particularly relevant if the non-businesslike loans are interest free or where the agreed upon interest rate remains open. The interest to be taken into account for tax purposes is determined based on the market value of each interest installment at the time it becomes due. Effectively, the interest rate for each payment is what would be the market rate for the loan at that time, and not the higher nominal value.

Based on case law, a material test should be applied to determine whether a loan is a non-businesslike loan. The question is whether it is possible to determine a non-profit-sharing interest rate on the loan at which a third party would have provided the loan under otherwise the same conditions and circumstances. Formal circumstances such as the lack of a loan agreement, lack of repayment schedules, and lack of collateral provide indications but are not decisive when determining whether a loan is a non-businesslike loan. When examining the character of a loan, lower court judges often seem to take into consideration whether there is enough certainty that the borrower will fulfill its obligations under the loan agreement. However, the most important test remains the question whether it is possible to find an interest rate where an independent third party would grant the same loan under the similar conditions.

The State Secretary indicates that a loan is deemed to be non-businesslike if the debtor has a credit rating that is lower than BBB (or becomes lower than BBB as a result of the loan) unless the taxpayer can prove otherwise.

It should be noted that such a non-businesslike loan is not reclassified as "equity." For tax purposes it remains a loan.

3. Guarantees

The determination of the arm's-length fee for guarantees issued on behalf of another group company is often an issue of discussion between taxpayers and the tax authorities.

In case of a guarantee between related parties, it must be investigated whether arm's-length conditions can be found where third parties acting in a commercially rational matter would be prepared to enter into such a transaction. According to the 2018 Transfer Pricing Decree, this must be assessed from the perspective of the enterprise issuing the guarantee and from the perspective for the enterprise of which the guarantee is issued.

In determining whether under the arm's-length principle in the Netherlands a guarantee must be charged, it is important to determine whether the provision of the guarantee fee constitutes a service.

In Chapter 9 of the 2018 Transfer Pricing Decree, the State Secretary describes three situations in which group companies benefit from intra-group guarantees:

1. A third-party lender would not be willing to provide loans (or only a lower amount) without an intragroup guarantee;

2. The lender is willing to provide a loan without an intragroup guarantee, but under less favorable conditions; and

3. The lender wants to avoid actions from the parent company possibly leading to a situation that a debtor becomes less solvable.

The State Secretary indicates that if, and to the extent, a debtor is not able to attract loans on a stand-alone basis from third parties, an intra-group guarantee that enables such third-party financing is only granted as a result of shareholder motives. Consequently, such a guarantee cannot constitute a service according to the State Secretary. In this case, the loan changes character from a loan from a third party to a loan from the related entity providing the guarantee. The result is that in the Netherlands for tax purposes: (1) no guarantee fee needs to be charged by the guarantor; and (2) any payments made by the guarantor are effectively not tax deductible.

[47] Supreme Court judgment, November 25, 2011, no. 08/05323.
[48] Supreme Court judgment, March 15, 2013, no. 11/02248.

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Furthermore, the State Secretary indicates that, if the group company were to initiate a loan independently, then it must be assessed to what extent it would be able to stipulate more favorable loan conditions than a comparable independent company without an explicit guarantee from an associated company, solely because it is a member of a group. According to the State Secretary, in this case it will obtain more favorable loan conditions on the basis of an implicit guarantee. This implicit guarantee is the assumption of the capital market that the group will enable the group company in question to fulfill its obligations. If and in so far as this is the case, this does not constitute a group service for which a fee must be charged.[49]

The State Secretary further indicates that an intragroup service only exists in cases where a debtor can benefit from more favorable conditions pursuant to an explicit intragroup guarantee (a guarantee for which third parties would be willing to pay). In these cases, a guarantee fee must be charged by a Dutch guarantor (or can be charged by a foreign guarantor).[50] This implies that it should be possible for a Dutch guarantor to effectively deduct any payments that it makes to a third party pursuant to the guarantee.

The State Secretary also elaborates on how to determine a guarantee fee. He indicates that the credit rating of the group as a whole and the credit rating of the group company concerned are relevant when determining the guarantee fee. For tax purposes, the guarantee fee cannot be more than the difference between the interest where the debtor would be able to attract loans on a stand-alone basis and the interest where the debtor can actually attract funding under the guarantee.

The State Secretary expresses the view that the contents of the 2018 Transfer Pricing Decree are in line with case BNB 2013/109 (Supreme Court, March 1, 2013), in which the Supreme Court concluded that, in connection with a guarantee under a so-called umbrella credit facility, the acceptance by a company of joint and several liability for all the debts of other companies taking part in the credit arrangement had its root in the intra-group relationships between this company and those other companies. The acts of the companies in that case are governed by the group interest and they, thereby, accept a liability exceeding the liability that exists when capital is borrowed independently. Such a comparable joint-and-several liability will rarely be found among independent enterprises and, in addition, it will be difficult to determine an arm's-length compensation for the mutual guarantee of the various associated enterprises.

The European Court decision ECJ 31 May 2018, no. C-282/16 (Hornbach Case), provides support for the State Secretary's point of view regarding charging guarantee fees in case of shareholders' motives. In this case, Hornbach (Germany) provided loan guarantees to a Dutch subsidiary at no charge. The German Tax Authorities challenged this position. Ultimately, the European Court ruled that transfer pricing adjustments violate EU law when it can be demonstrated that certain "non-arm's length" actions are taken for commercial reasons due to shareholder motives.

[49] In this respect, the State Secretary makes a reference to paragraph 7.13 of the OECD Guidelines.

[50] This is subject to the condition that the guarantee does not take place in the shareholders' sphere as explained in this section.

4. Currency Exchange Results

If intra-group invoices are always denominated in the same currency, a currency exchange result on such an invoice should not be subject to transfer pricing corrections. On November 8, 1995, the Supreme Court ruled in a case in which the tax authorities argued that a currency loss on an intra-group transaction should be treated as a non-deductible deemed dividend.[51] Deviating from a previously concluded agreement, intra-group invoices were consistently issued in U.S. dollars as opposed to Dutch guilders and a currency loss was incurred. The Supreme Court ruled that since invoicing in U.S. dollars could be both advantageous and disadvantageous to the taxpayer, invoicing in U.S. dollars was at arm's length and the currency exchange loss was a tax-deductible loss.

In another case,[52] the taxpayer received invoices stated in Dutch guilders and could choose to pay them in U.S. dollars either at the currency exchange rate at the time of invoicing or, if preferred, at the currency exchange rate at the time of payment. Since such a choice would never have been available in case of a third-party transaction, the currency exchange gain resulting from this agreement was not considered to be arm's length and was treated as an informal capital contribution by the shareholder to the benefiting Dutch company.

5. Captive Insurance Companies

In practice, multinational groups often reinsure their activities with a central group insurance company (a captive), generally established in a tax haven country. In Chapter 10 of the 2018 Transfer Pricing Decree, the State Secretary confirms that group companies may act as internal insurance and/or reinsurance companies only "on paper," when they lack the ability to execute the necessary functions and to control the associated risks. He claims that in these cases there is often also a lack of "active" risk diversification. He further elaborates on two types of captive insurance companies that he sees in practice, namely: (1) so-called passive poolers; and (2) companies that combine insurance with other products.

A "passive pooler" is, in the view of the State Secretary, an entity that insures only group-related risks. Such a company generally insures risks that are not insurable by third parties, and it does not diversify any risks. The remuneration that should be allocated to such a company will be modest. The functions of such a passive pooler are, according to the State Secretary, similar to the functions of a company that performs administrative or auxiliary insurance-related services.

The State Secretary indicates that he also encounters situations where insurance is provided to third-party clients if they purchase a product that is not insurance related (e.g., cancellation insurance or insurance to obtain extended-product guarantees). The insurance policy is generally issued in the name of a third-party insurance company, but the third-party insurance company reinsures this risk with a captive reinsurance company. In the view of the State Secretary, the captive reinsurance company does not in fact perform an insurance function. Consequently, the remuneration that should be allocated to such a

[51] BNB 1996/64.

[52] Supreme Court, February 28, 2001, BNB 2001/199c*.

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company should be modest, as it is deemed to perform auxiliary or administrative services.[53]

Both paragraphs are clearly aimed at the avoidance of "abusive situations" where foreign captive insurance companies have limited substance. In BNB 1985/301 (Supreme Court, August 21, 1985) and BNB 2006/114 (Supreme Court, October 21, 2005), the Supreme Court concluded that premiums that were paid to a Netherlands Antilles captive could be deducted to the extent the insurance premiums for the insurance of risks transferred were at arm's length. A District Court case[54] held that limited remuneration should be allocated to a company that performs functions similar to those of companies that combine insurance with other products and that has limited operational expenses.[55]

E. Commodities

The updated OECD Guidelines include guidance on the pricing of cross-border commodity transactions. The OECD Guidelines confirm that the CUP Method generally is the most appropriate method for pricing commodities. The OECD Guidelines further mention that in order to assist tax administrations in conducting an informed examination of the taxpayer's transfer pricing practices, taxpayers should provide reliable evidence and document the price-setting policy for commodity transactions, the information needed to justify price adjustments based on the comparable uncontrolled transactions or comparable uncontrolled arrangements represented by the quoted price, and any other relevant information, such as pricing formulas used or third party end-customer agreements. The OECD Guidelines acknowledge that a particularly relevant factor for commodity transactions determined by reference to the quoted price is the pricing date. If the taxpayer can provide reliable evidence of the pricing date agreed upon by the associated enterprises at the time the transaction was entered into, and this pricing date is consistent with the actual conduct of parties, this date may be considered the pricing date.

The Netherlands has not provided specific guidance or rules on the pricing of cross-border commodity transactions. In practice the Dutch Tax Authorities generally accept application of the CUP Method for pricing commodities.

F. Cost-Sharing Arrangements

The Netherlands does not specifically define the concept of a cost contribution arrangement (CCA or cost-sharing arrangement) but refers to the OECD Guidelines.[56] The concept of concluding CCAs to centralize certain activities and costs that may benefit all contributing group companies, such as research and development costs or costs of central management, is generally accepted.

In principle, participants of a CCA must be remunerated on an arm's-length basis, based on the functions (considering the assumed risks and assets used) it performs. The Ministry of Finance takes the view that, in principle, a profit mark-up is not required where a party makes a similar contribution and receives relatively similar benefits, so that the mutual relationship is fairly in balance. Whether or not such a balance has actually been achieved in practice is a matter that must be assessed on a case-by-case basis.

Pursuant to the 2018 Transfer Pricing Decree, a problem when embarking on a CCA is how to make a correct assessment of the likely contributions and benefits for the various participants. The State Secretary indicates that the relative contribution of a participant to a CCA should be aligned with the relative share of that participant in the anticipated benefits thereof. He states that the relative contribution of the participant and the relative share in the anticipated benefits should be determined at fair market value. However, if it is plausible that the average proportionate value of the individual services contributed by the various participants to a CCA is roughly equal, it is permissible under the arm's-length principle to use the cost price of the contributions to determine whether each participant's share of the overall expected benefits is proportionate to each participant's share of the contribution.

The Ministry of Finance acknowledges that certain countries will not accept the charge of a mark-up. If such countries, on the other hand, permit a fee to be charged for the capital tied up in the relevant activities, effectively the same result may be achieved. In such a case, the Dutch Tax Authorities may, in light of the acceptability of charges in certain countries, give its consent to a particular method, provided such method is in accordance with the OECD Guidelines.

G. Business Restructurings

The arm's-length principle also applies to transactions undergoing a business restructuring. Dutch tax law does not contain specific transfer pricing rules relating to business restructurings. However, in the 2018 Transfer Pricing Decree, reference is made to business restructurings and to the guidance included in Chapter IX of the OECD Guidelines, which is applied by the Dutch Tax Authorities in practice.[57]

In line with the OECD Guidelines, the Dutch Tax Authorities take the position that the transfer of profit or loss potential does not in itself justify or require compensation. Rather, the question is whether there is a transfer of something of value — for example, assets, functions, or rights.

The Dutch Tax Authorities generally also refer to the OECD Guidelines for determining an arm's-length remuneration for the transfer of a business, right, or asset. Based on the OECD Guidelines, an entity with considerable rights or other assets at the time of the restructuring should be appropriately remunerated in order to justify the sacrifice of such profit potential. To determine whether at arm's length the transfer itself would give rise to a form of compensation, it is, among oth-

[53] The total premium is paid by third-party clients to the third-party insurer. The premium is on-paid to the captive reinsurance company after deduction of a remuneration for the third-party insurer. In the view of the Dutch State Secretary, the remuneration that should be allocated to the captive reinsurance company should be modest, as it is deemed to perform auxiliary or administrative services, as not this company but the entity carrying out the group's main activity sells the insurance and provides diversification. The excess amount should therefore be attributed to the group entity carrying out the group's main activity.

[54] District Court of the Hague, July 11, 2011, AWB08/9105 and District Court of Zeeland-West Brabant, January 17, 2014, AWB11/3717.

[55] However, the returns on the portfolio investments that were held by the foreign captive insurance company to insure the risks continued to be allocated to the foreign captive insurance company.

[56] 2018 Transfer Pricing Decree, paragraph 7.

[57] 2018 Transfer Pricing Decree, paragraph 5.4 (Worksheet 22).

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er things, essential to understand the restructuring, including the changes that have taken place, what the business reasons for and the anticipated benefits from the restructuring were, and what options would have been realistically available to the parties. This analysis must be made from the perspective of both the buyer and the seller. In response to the decision of the Dutch Court of Appeals in the case discussed below, the State Secretary mentioned that in case of a transfer of functions and risks of a business, the transferor should receive a compensation taking into account the value of the functions, risk, and profit-earning capacity transferred.

If it is concluded that a compensation should be paid when transferring certain activities, in absence of comparable transactions, a valuation method could be used to approach the fair market value of the transferred assets or activities. In the authors' experience, the Dutch Tax Authorities have a preference for valuation methods that are based on the Discounted Cash Flow method.

In a recent case, while the appeal was pending in the Dutch Court of Appeals, the Dutch Tax Authorities and the taxpayer settled a dispute regarding the value of transferred activities and the remuneration of the transferor after the transfer. The case concerned a business restructuring of an international group active in the zinc industry. A Dutch group entity exploited a production business within the group and was entitled to the residual profit. The Dutch entity had over time outsourced some activities (such as purchasing, sales, and logistics) to another group entity. This entity was remunerated on a cost-plus basis. As part of a restructuring, all sales, purchasing, logistics, and planning activities of the group were centralized in Switzerland. To compensate the Dutch entity for the lost functions and profit-earning capacity, a conversion fee was paid to the entity. This is necessary under the arm's-length principle, as generally a third party would not transfer profit-earning capacity without receiving a proper remuneration. The tax inspector challenged the amount of the conversion fee.

After the restructuring, the most important functions were no longer performed by the Dutch entity. The Dutch taxpayer viewed itself as a toll manufacturer, which should receive a cost-plus remuneration for routine activities, instead of being entitled to the residual profit. The Dutch entity further took the position that over the years some functions had already transferred and that the tax inspector had lost its right to levy taxes over this transfer.

The tax inspector argued that, even after the reorganization, the main functions were still being performed in the Netherlands. According to the Dutch Tax Authorities, the Dutch entity's functionality should lead to a higher remuneration than a routine cost-plus remuneration. Ultimately, the taxpayer and the tax inspector reached a settlement. In the settlement, the conversion fee was determined at an amount significantly higher than the amount first brought forward by the taxpayer.

This case highlights the importance of accurate and elaborate transfer pricing documentation, as well as the actual conduct of the taxpayer being in line with the documentation. In a reaction to the case, the State Secretary stated that if a taxpayer presents itself as an entrepreneur in its transfer pricing documentation, annual reports, and tax returns, it cannot successfully take the position that it is not entitled to the residual profit. In addition, the case shows the importance of a functional analysis in determining an arm's-length remuneration for the transfer and the restructuring. A remuneration for toll manufacturing activities is likely insufficient if the entity performs additional functions for which it does not receive remuneration.

H. Attribution of Profits to Permanent Establishment

Article 8b of the CITA applies to companies resident in the Netherlands but, by reference to Article 18 of the CITA, also applies to nonresident corporate taxpayers that have taxable income arising from a business in the Netherlands. It is questionable whether transactions between a Dutch permanent establishment and other parts of the nonresident entity, the so-called dealings, are covered by the text, as no "other entity" exists (the transactions are within one legal entity).

Comment: These transactions that are not covered under Art. 8b of the CITA would not impact the determination of the permanent establishment's profit but would, rather, avoid triggering the documentation requirement.

The Dutch policy regarding the attribution of profits to foreign permanent establishments of Dutch resident entities is in line with the OECD's *Report on the Attribution of Profits to Permanent Establishments*. In short, the profits to be attributed to a permanent establishment are the profits that the permanent establishment would have earned at arm's length if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used, and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.[58]

On November 11, 2019, the Zeeland-West-Brabant District Court rendered a decision covering, among other things, the allocation of interest expenses to the foreign permanent establishment of a Dutch taxpayer. The Dutch taxpayer had a limited partnership interest in a (transparent) limited partnership established under Dutch law (*commanditaire vennootschap* or CV). The CV operated a factory outside the Netherlands, which constituted a permanent establishment for Dutch tax purposes. The Dutch taxpayer made contributions into the CV, financed by a loan from a group company. In the financial years under review, there was a war in the jurisdiction of the factory, leading to a higher-risk profile of the permanent establishment.

The taxpayer took the position that, on the basis of the separate entity approach, no interest could be allocated to the permanent establishment because the balance sheet of the CV solely reflected capital and no debt. The taxpayer and the tax inspector agreed that interest should be allocated to the permanent establishment on the basis of an annual risk weighting. The taxpayer took the subsidiary's position that no interest could be allocated to the permanent establishment because no third party would have granted a loan due to the war situation in the factory's jurisdiction. Finally, the tax inspector took the position that interest could be allocated to the permanent establishment on the basis of a 75:25 debt-to-equity ratio. The tax inspector substantiated this ratio on the basis of the capital struc-

[58] For more details regarding the viewpoint of the Dutch State Secretary of Finance, see the Decree of January 15, 2011, no. IFZ2010/457M.

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ture of the parent company, as well as the security situation in the factory's jurisdiction.

The District Court followed the position of the tax inspector but did not provide the analysis underlying its ruling. The District Court did, however, accept the position of the taxpayer that the capitalization at the level of the fiscal unity must be taken into account, rather than the capitalization at the parent company level because the allocation of interest expense to the permanent establishment is aimed at determining the taxable amount of the fiscal unity. The District Court seemed to apply a combination of the capital allocation approach (allocating income by reference to the capital structure of the general enterprise) and the thin capitalization approach (taking into account the security situation in the factory's jurisdiction for determining the appropriate capitalization of the permanent establishment). Although both methods are part of the Authorized OECD Approach for allocating profits to a permanent establishment, the Dutch State Secretary of Finance has indicated a preference for the capital allocation approach.

I. Financial Service Companies

1. General

According to Article 3a of the Implementing Decree to the Law on International Assistance in the collection of Taxes (*Uitvoeringsbesluit internationale bijstandsverlening bij de heffing van belastingen,* the International Assistance Decree), a financial service company is a company the activities of which consist, legally or in fact, directly or indirectly, mainly of receiving and on-paying interest, royalties, rent, and/or lease amounts within a group on the basis of interrelated transactions in whatever form or under whatever name (e.g., Financial Service Company).

Mainly

The activities of a company should fall "mainly" within the above definition. The word "mainly" means 70% or more of the company's activities. The determination as to whether the 70% test is met must be made on the basis of all relevant facts and circumstances. Activities in relation to the holding of participations will not be taken into consideration, both in the numerator and the denominator for computing the 70%. The activities of a company must be analyzed by assets, turnover, and employees. It is likely that the determination of a financial service company status will be determined on the basis of similar factors.

A Group

A group includes the taxpayer, together with the entities and individuals related to it. An entity or individual is considered to be related if:

- The taxpayer holds an interest of one-third or more in the entity;
- The entity or individual holds an interest of one-third or more in the taxpayer; or
- Another entity or individual holds an interest of one-third or more in the entity while also holding an interest of one-third or more in the taxpayer.

Receiving and Paying Interest and/or Royalties Within a Group

Companies that borrow funds from related entities and lend the funds to related entities are included in the definition of a financial service company (provided they meet the 70% test). The same applies with respect to a company that licenses intangible property or rents or leases tangible property from a related party and sublicenses or rents or leases such property to other affiliates.

In the view of the Dutch Tax Authorities, a company that borrows from unrelated parties (e.g., through a bond issue under a guarantee by its parent) and lends the funds to related parties will in principle be considered to have in fact borrowed from a related party and will therefore be considered to be a financial service company. The result is different if the company can demonstrate that it would have been able to borrow the same amount on a stand-alone basis and that the guarantee only serves to enhance the terms and conditions of the borrowing (e.g., the interest rate).

2. Substance Conditions

A financial service company must meet the substance requirements included in the International Assistance Decree.[59] If financial service companies do not meet the minimum substance requirements, the Netherlands intends to spontaneously exchange information with the relevant foreign tax authorities. This serves to assist source countries in assessing whether financial service companies should properly be entitled to treaty benefits.

The following conditions must be met on a cumulative basis.[60] There is no de minimis exception with respect to any one of the criteria listed below.

(i) At least 50% of the total number of statutory directors, corporate or individual, with decision-making authority must be resident in the Netherlands.

(ii) The directors of the company that are resident in the Netherlands must have sufficient expertise to carry out their functions. The tax authorities have stated that the directors should be able to manage the transactions performed by the financial service company and the risks that are being incurred. The functions of the local board of directors include, at a minimum, decision making (on the basis of their own responsibility for the company and within the framework of normal group control) with respect to transactions to be entered into by the company, and also arranging for the further handling of transactions.

(iii) The company must have qualified personnel (by itself or through a third party) for the adequate execution and registration of the transactions entered into by the company.

(iv) The management decisions must be made in the Netherlands. This requirement entails a material test, meaning that the board meetings must be held regularly in the Netherlands with the directors being physically present. All important decisions must be made during such board meetings.

[59] Decree of December 22, 2011, Stb 2011, 674.
[60] Article 3.1 of the International Assistance Decree.

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(v) The main bank account of the company must be in the Netherlands. This is interpreted to mean that at least 50% of the company's directors are Dutch residents who have decision-making powers in respect of the bank accounts. It is not required that the account be kept with a Dutch bank.

(vi) The bookkeeping of the company must be performed in the Netherlands. This entails that the bookkeeping be physically present in the Netherlands, and the transactions be accounted for entirely in the Netherlands. However, the company need not conduct its bookkeeping in the Netherlands if the corporate group of the company has centralized its bookkeeping activities outside of the Netherlands and this group has sufficient operational activities in the Netherlands.

(vii) The office address as registered with the Chamber of Commerce of the company must be in the Netherlands.

(vii) The company must, to the best of its knowledge, not be considered a resident for tax purposes of a country other than the Netherlands.

(ix) The company must incur real risk in respect of the received and paid interest, royalties, rents or leases as meant in Article 8c, paragraph 2, of the CITA (discussed below).

(x) The company must have equity that is adequate in relation to the functions performed by it (taking into account the risks incurred).

As of January 1, 2021, financial service companies must meet the following additional substance requirements to prevent spontaneous exchange of information by the Dutch authorities with treaty partners:

— The financial service company must incur annual salary costs of at least €100,000, which amount must constitute a remuneration for the financing, licensing, renting, or leasing activities; and

— The financial service company must have its own office space at its disposal in the Netherlands for a period of at least 24 months. The property must be used to effectively carry out its financing, licensing, renting, or leasing activities.

Real Risk Requirements

A financial service company only fulfills the substance requirements if it incurs real risks. The risks related to financial service activities consist in particular of credit risks (debtor and currency risks), market risks, and operational risks. Merely incurring operational risks will generally not result in the existence of real risk. Risks subcontracted to third parties (non-related entities) will be considered to be risks of the financial service company. For purposes of determining whether the financial service company incurs real risks, it is significant, according to the Question and Answer Decree on Financial Service Companies of June 3, 2014 (Question and Answer Decree), to what extent the financial service company incurs one or more of the risks mentioned above and whether the financial service company maintains sufficient equity to bear these risks.

The Question and Answer Decree contains a safe harbor for determining whether a financial service company incurs sufficient risk in case the activities of the financial service company consist of extending loans. In such a case, it will be considered to incur real risks if the equity necessary to bear the risks incurred is at least the lower of 1% of the loan or loans extended, or an amount of €2 million, provided that there is a realistic possibility of recourse to this equity if the events, for which the financial service company is at risk, occur. With regard to companies receiving and paying royalties, rents, or lease amounts, the determination of the minimum equity at risk relating to those activities should be based on specific circumstances. However, the Question and Answer Decree introduces a rule of thumb that the equity at risk should at least be equal to 50% of the yearly royalties, rent, or lease amounts received by the company or EUR 2 million. In addition, at least half of the risks incurred should be related to market risks.

Financial service companies that incur sufficient risk in respect of their financial services activities will be given a full credit for foreign withholding tax.

No credit for foreign withholding tax will be given if the financial service company does not incur sufficient risk in respect of its financial services activities. The denial of a tax credit is motivated by the theory that a financial service company that does not incur sufficient risk in fact functions as an intermediary and, as a consequence thereof, these transactions are not included in the Dutch tax base of that entity.[61]

3. Article 8c

Article 8c of the CITA was introduced on January 1, 2002. According to this provision, interest and royalties received and paid on loan and licensing or sublicensing arrangements with related entities or individuals will not be included in taxable income if no real risks are incurred by a Dutch company with respect to these arrangements.

The consequence of not including the interest or royalties received and paid in the taxable income is that no credit is allowed for any foreign withholding taxes incurred on that interest or those royalties. Moreover, a Dutch company is still required to report an arm's-length fee as taxable income for the limited financing and licensing services rendered in connection with the transactions generating that interest or those royalties.

For the purposes of Article 8c of the CITA, a company is deemed to be related to another company under ownership conditions that are the same as those that define a "group" for purposes of the financial services company provisions generally,[62] briefly, ownership or common ownership of one-third.

An individual is generally deemed to be related to a company if it holds an interest of at least one-third in the company or in another company that is related to the first company.

4. Arm's-Length Remuneration

No specific guidance is provided with regard to the determination of the arm's-length remuneration of financial services companies receiving and paying royalties, rent, and/or lease amounts. However, a number of practical benchmark methods are available, such as methods using the Capital Asset Pricing Model, methods using the Loanconnector database, and methods using royalty databases. The model that is most appropriate should be determined on a case-by-case basis.

[61] *See* Article 8c of the CITA.
[62] *See* IV.I.1., above.

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The Question and Answer Decree does provide a method to determine a remuneration for intra-group financing entities. This method is described below.

Remuneration of Intra-Group Financing Entity

In the Question and Answer Decree, the Dutch Tax Authorities issued guidance on determining remuneration for an intra-group financing entity, which is determined based on two components:

(1) A remuneration for the equity put "at risk" (Equity Risk Remuneration, or ERR); and

(2) A remuneration for the activities in respect of the funds borrowed and the funds on-lent (Financial Remuneration or FR).

Under this conceptual approach, both results must be aggregated and accounted for in an interest margin — namely, the difference between the interest rate on incoming loans and the interest on the loans outstanding. From this remuneration, the other expenses incurred by the Dutch entity must be paid.

Equity Risk Remuneration (ERR) — As follows from the Question and Answer Decree, the ERR could be computed by multiplying the difference between: (1) the interest on subordinated loans (RA); and (2) the interest on comparable secured loans (RS) with the equity at risk (EV) and dividing the outcome by the amount of loans outstanding (LUG). In order to express the subordinated character of the equity capital in relation to the remainder of the loan, the following formula can be used:

$$ERR = \frac{((RA\text{-}RS) \times (EV))}{LUG}$$

RA — Based on the practical method applied by the Dutch Tax Authorities, the RA is computed using the applicable interest rate on the incoming loans increased with a margin for subordination. In practice, this margin for subordination is often computed as the difference between the following two elements:

— The interest rate on subordinated loans; and

— The interest rate on secured loans.

The guidance issued by the Dutch Tax Authorities states that the RS can be calculated by benchmarking comparable secured loans. However, in their practical method, the Dutch Tax Authorities prescribe that the RS component should be compared to the interest rate on a risk-free loan.

Pursuant to the Question and Answer Decree, the applicable range must preferably be composed of well-chosen comparable transactions. If only less-accurate reference material is available, the 2018 TP Decree states that the reliability of the reference material can be increased by calculating an interquartile range.

RS — On the basis of their practical method, the Dutch Tax Authorities prescribe that the RS element should be benchmarked against a risk-free loan. The website of *De Nederlandsche Bank* (www.dnb.nl) can be used to find comparable loans. For example, the interest rate on government bonds for the euro area may be determined as a reliable comparable risk-free loan.

The Financial Remuneration (FR) is comparable to a remuneration that is charged by banks and other financial institutions when raising funds from capital markets for corporate clients.

The activities in respect of such a transaction will generally not only be conducted by the Dutch entity but will normally be conducted jointly with a company group's treasury department. Consequently, this requires an allocation of the remuneration between the Dutch entity and the treasury department, taking into account objective criteria. Generally, the allocation takes place on a 50/50 basis (unless the taxpayer demonstrates that a different allocation is at arm's length). The resulting number of basis points on the outstanding loans forms the FR component.

Interest on an inter-company loan means interest on an outstanding loan (in Dutch abbreviated as RLUG) consisting of the interest on the incoming loans (in Dutch abbreviated as RLOG) plus the ERR and the FR: RLUG = RLOG + ERR + FR.

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V. Documentation and Reporting Requirements

A. Master File and Local File

1. General

As of January 1, 2016, the Netherlands requires transfer pricing documentation in line with Action 13 of the OECD's G20 Base Erosion and Profit Shifting (BEPS) project, which is incorporated in Chapter V of the OECD Guidelines. The documentation requirements are incorporated in Dutch legislation in Article 29b–29g of the CITA. Further explanation of the documentation requirements are provided in the Decree on Additional Documentation Obligations.[63] The documentation requirements are: (i) the master file; (ii) the local file; and (iii) the Country-by-Country (CbC) report (the CbC Report).

2. Master File

It is obligatory for a Dutch taxable entity to keep the multinational group's master file in its administration if the entity belongs to a multinational group that has consolidated revenues of more than €50 million (or a near equivalent amount in domestic currency) in the year preceding the reporting year. The master file of the reporting year should be available in the administration of the taxpayer by the due date of filing the tax return for that year. Often, a Dutch taxable entity can utilize the group's master file that has been prepared in other countries.

According to Chapter V of the OECD Guidelines, the master file should provide a high-level overview of the MNE's global business structure and its transfer pricing policies divided into five categories:

(i) The MNE group's organizational structure;

(ii) A description of the MNE business(es);

(iii) The MNE's intangibles;

(iv) The MNE's intercompany financial transactions; and

(v) The MNE's financial and tax position.

The Dutch Tax Authorities regularly request the master file from a taxpayer.[64]

3. Local File

It is obligatory for a Dutch taxable entity to prepare a local file if the entity belongs to a multinational group that has consolidated revenues of more than €50 million (or a near equivalent amount in domestic currency) in the year preceding the reporting year. The local file of the reporting year should be available in the administration of the taxpayer by the due date of filing the tax return for that year.

The local file is meant to supplement the master file and is intended to deliver a more detailed overview of the specific intra-group transactions that are entered into by a specific taxpayer and the reconciliation of the transfer pricing policies with the actual result.

The objective of the local file is to ensure that the MNE has complied with the arm's-length principle in its material transfer pricing positions affecting a specific jurisdiction. The local file should provide information relating to specific intercompany transactions entered into in a specific country. Such information would in general include:

(i) Relevant financial information regarding those specific transactions;

(ii) A comparability analysis; and

(iii) The selection and application of the most appropriate transfer pricing method.

The Dutch Tax Authorities regularly request the local file from the taxpayer.[65]

B. Country-by-Country Report (CbC Report)

1. CbC Report

A Dutch taxable entity that is part of a multinational group with consolidated revenue in the year immediately preceding the current reporting year of more than €750 million (or a near equivalent amount in domestic currency) falls within the scope of the CbC Report requirements.

If the Dutch entity is the ultimate parent entity of a group of consolidated entities, it is responsible for filing an annual CbC Report in the Netherlands. In addition, the Dutch entity would have a reporting obligation in the following circumstances:

1) No foreign entity of the MNE group (an ultimate parent company) exists that:

a) is required to prepare consolidated financial statements on the basis of the ownership of shares in other entities of the MNE group, or would have had this requirement if its shares would be listed on a stock exchange in its jurisdiction of residence;

b) is the only entity of an MNE group that directly or indirectly owns shares qualifying under (a) above;

c) is resident of a jurisdiction that has introduced CbC reporting obligations;

d) is resident of a jurisdiction that has concluded an agreement with the Netherlands as regards the automatic exchange of CbC reporting; or

e) is resident of a jurisdiction that has not suspended the automatic exchange of CbC reporting with the Netherlands or, for other reasons, systematically fails to exchange CbC reporting with the Netherlands (systematic failure); or

2) No entity of the MNE group (a surrogate parent entity) exists: (i) in an EU Member State; or (ii) outside of the European Union that:

[63] Decree of December 30, 2015, no. DB/2015/462M.

[64] For a more detailed description regarding the master file obligations (i.e., the specific information that should be included in the master file), see Worksheet 26.

[65] For a more detailed description regarding the local file obligations (i.e., the specific information that should be included in the local file), see Worksheet 26.

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a) has been appointed by the MNE group to file the CbC report in its jurisdiction of residence;

b) is resident of a jurisdiction that has introduced CbC reporting obligations and that has filed a CbC report in that jurisdiction within a period of 12 months after the end of the reporting year;

c) is resident of a jurisdiction that has concluded an agreement with the Netherlands as regards the automatic exchange of CbC reports;

d) is resident of a jurisdiction that is not in systematic failure; and

e) has notified its jurisdiction of residence and the Dutch tax inspector of its status as the entity of the MNE group that files the CbC report in the Netherlands.[66]

In the CbC Report, MNEs must report their revenue, profit (loss) before income tax, income tax paid (on cash basis), income tax accrued in the current year, number of employees, stated capital, accumulated earnings, and tangible assets other than cash and cash equivalents per tax jurisdiction. It is not required to specify this information per Constituent Entity.[67]

Comment: The revenue, profit (loss) before income tax, income tax paid (on cash basis), income tax accrued in the current year, number of employees, stated capital, accumulated earnings, and tangible assets other than cash and cash equivalents may be reported on an aggregated basis per tax jurisdiction.

The CbC Report must include a list of all constituent entities per tax jurisdiction of residence. This should include the tax identification number and addresses of the entities. In addition, the tax jurisdiction of organization or incorporation must be included if it is different from the tax jurisdiction of residence. For each entity, the main business activity(ies) should be listed.

Worksheet 26 contains an overview of the above-mentioned requirements.

Deadline for Filing the CbC Report

The CbC Report must be filed no later than 12 months after the last day of the year (consolidated reporting period for financial statement purposes) to which the CbC Report relates.

2. CbC Notification

Constituent entities of an MNE Group that are a resident for tax purposes of the Netherlands must notify the inspector ultimately on the last day of the reporting year of the MNE Group whether the entity is the ultimate parent entity, the surrogate parent entity, or the appointed group entity that will file the CbC Report. If the constituent entity performing the notification is not the ultimate parent entity, the surrogate parent entity, or the appointed group entity, then that entity must inform the tax inspector which entity of the MNE group will file the CbC Report. This notification includes information pertaining to the entity's tax residency.

C. Other Documentation Requirements

1. Documentation Requirement in Article 8b of the CITA

As part of the codification of the arm's-length principle in Dutch tax law, effective January 1, 2002,[68] a documentation requirement was introduced in Article 8b, paragraph 3, of the CITA.

Article 8b of the CITA reads as follows:[69]

(1) In case:

[a] an entity, directly or indirectly, participates in *[i]* the management or supervision, or *[ii]* the capital, of another entity; and

[b] the agreed or imposed conditions (transfer prices) of the transactions between these entities differ from conditions that would have applied in the market between independent parties,

the entity's profit is determined as if the "arm's length" conditions applied.

Paragraph 3 reads as follows:

(3) In the administration of entities, provide information:

[a] that shows in which manner the transfer prices referred to in the first paragraph have been established; and

[b] from which it can be deducted if, in the market, the established transfer prices would have been agreed to between independent entities.

According to the Explanatory Memorandum, if an entity does not fulfill the documentation requirements, the burden of proof with regard to the arm's-length character of the applied transfer prices shifts from the tax inspector to the taxpayer. If the taxpayer complies with the documentation requirements, the burden of proof is generally with the tax inspector.

According to the parliamentary history of the CITA, the documentation supporting the arm's-length character of a transaction should be established at the moment the transaction is entered into. However, the parliamentary history also indicates that, if a taxpayer cannot provide the documentation when requested, taxpayers in all cases will be granted a reasonable time to correct their failure to comply. Depending on the complexity of the situation, such reasonable time will be between four weeks and three months.

The Explanatory Memorandum states the following in view of the documentation requirement:

[66] Article 29c, CITA.

[67] A constituent entity is defined as: (i) any separate business unit of an MNE group that is included in the consolidated financial statements of the MNE group for financial reporting purposes, or would be so included if equity interests in such business unit of the MNE group were traded on a public securities exchange; (ii) any such business unit that is excluded from the MNE group's consolidated financial statements solely on size or materiality grounds; and (iii) any permanent establishment of any separate business unit of the MNE group as referred to in (i) or (ii) above, provided the business unit prepares a separate financial statement for such permanent establishment for financial reporting, regulatory reporting, tax reporting, or internal management control purposes. *See* Article 29b, CITA.

[68] *See* II.A., above.

[69] Unofficial translation, numbering in italics added by the author.

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In Chapter I of the (1995) OECD Guidelines, guidelines are provided for the application of the arm's length principle (paragraph 1.15–1.70).[70] In paragraph 1.15 it is indicated that the application of the arm's length principle is generally based on a comparison of conditions of a related-party transaction with the conditions of a transaction between independent enterprises. The facts that could be of importance in relation to the comparability are mentioned in paragraphs 1.19–1.41.[71] It includes the characteristics of the goods and services, the functional analysis, the contractual terms, the economic conditions, and the business strategies. As shown in the OECD Guidelines, the importance of these facts is determined by the facts and circumstances of the specific case. On the basis of the relevant facts the taxpayer should be able to support its decision for the applied transfer pricing method. It is explicitly not the intention that the taxpayer contemplates each method and subsequently substantiates why the chosen method leads to the best results under the specific circumstances (best method rule).

According to the State Secretary of Finance, the information to be documented should include the factual information about the transaction. In his view, the relevant documentation should generally be readily available within the group as such information is also necessary for the management of the group. The additional administrative burden should therefore be limited. Moreover, the State Secretary confirmed that taxpayers are not required to show that the transfer prices used would have been agreed to between independent parties. Following questions raised by the parliament, it was confirmed by the State Secretary that the obligation to maintain documentation should, in fact, be interpreted as a limited obligation.

The lack of clear requirements results in uncertainty. Taxpayers may, however, ask the tax authorities for advance certainty with respect to their compliance with the administrative obligations under Article 8b(3) of the CITA. This does not need to include advance certainty with respect to the arm's-length character of the transfer prices used. However, if this is required, the taxpayer could file a request for an Advance Pricing Agreement. In practice, many practitioners supply as minimum documentation a list similar to that set forth in Worksheet 21. Generally, taxpayers also make an attempt to substantiate the correctness of the price by including objective third-party information.

2. *Coordination with U.S. Documentation Requirements*

The basic documentation requirement of Article 8b of the CITA intentionally does not include an exhaustive list of required documents. According to the Explanatory Memorandum, this has the benefit of allowing a taxpayer to harmonize the documentation to be maintained in the Netherlands with the documentation requirements imposed by other countries. The other requirements are aligned with OECD standards to allow efficient preparation.

D. Penalties and Other Sanctions

1. *General*

Not complying with the above-mentioned documentation requirements may result in fines and other sanctions. The sanctions for each of the documentation requirements are discussed below. In addition to fines and sanctions, not complying with the documentation requirements may lead to the reversal of the burden of proof.

2. *Master File and Local File*

As described above, the master file and local file are part of the administration requirements in Dutch tax law. Therefore, failure to provide the master file and local file may result in sanctions, among them a reversal of the burden of proof (normally on the tax authority in transfer pricing cases). This sanction is only imposed if the administration of an entity is clearly insufficient.

In addition to the reversal of the burden of proof, a taxpayer may also face criminal prosecution. The penalty for a taxpayer not fulfilling the documentation requirement could be a maximum of six months of imprisonment or a fine up to €8,700 (2021). In case of willful misconduct, the maximum penalty could be four years imprisonment or a fine up to €21,750 (2021). When the lost tax revenue is higher than the maximum fine, the fine could be set to the amount of the lost tax revenue.

There is no requirement to file the master file and local file with the Dutch Tax Authorities. Therefore, there is no penalty in case of no, incorrect, incomplete, or non-timely filing.

3. *Country-by-Country Report*

The sanctions for not complying with the CbC Report or notification requirements are included in Article 29h of the CITA. If the CbC Report requirements are: (i) not fulfilled; (ii) not fulfilled timely; (iii) not fulfilled completely; or (iv) not fulfilled correctly due to willful misconduct or due to gross negligence, a fine up to €870,000 (2021) could be imposed or imprisonment of four years. The amount of the fine is determined by a coordinator under procedural law and takes into account aggravating and mitigating circumstances.

4. *Documentation Requirement Under Article 8b of the CITA*

The documentation requirements under Article 8b of the CITA should be included in the administration of an entity. Therefore, absence of the required documentation under Article 8b of the CITA results in sanctions. One of the sanctions is the reversal of the burden of proof. This sanction is only imposed if the administration of an entity is clearly insufficient.

In addition, a taxpayer may also face criminal prosecution similar to the penalty exposure for failure to submit a master file or local file, respectively.

[70] Paragraphs 1.33–1.173 in the 2017 OECD Guidelines.
[71] Paragraphs 1.36–1.118 in the 2017 OECD Guidelines.

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VI. Transfer Pricing Audits

A. General

In the Netherlands, audits are generally held after the tax return has been filed. Frequently post-filing audits develop into discussions covering years for which the returns have not been filed yet. Tax authorities normally start an audit for a number of years for which the tax returns have been filed. If the audit concerns potential transfer pricing adjustments, before discussing these adjustments the tax authorities generally review the impact these adjustments would have in the years for which tax returns have not yet been filed.

Any company can be confronted with an announcement from the tax administration that the company will be audited for tax purposes. There can be numerous reasons for such an audit. In most cases, the purpose of the audit is to establish the tax position of the company itself. However, it is also possible that the audit is performed to gain information about other taxpayers (or at the request of a foreign tax administration). The depth and length of an audit can vary greatly, depending on the purpose of the audit and the availability and accessibility of the relevant data. In general, an audit is performed by a special tax auditor, and the tax auditor keeps in contact continuously with the competent inspector.

Once a tax audit has been announced or an announcement can reasonably be expected, adjustments on already filed tax returns will be regarded as adjustments following the outcome of the audit. This may result in penalties that would not have been applicable if there had been no announcement of a tax audit. The tax administration is obliged to disclose to the company the purpose of the audit. An appointment will be made for an introductory meeting and the location of the audit (which is normally at the premises of the company) will be discussed.

The Dutch Tax Authorities are pursuing a high level of transparency with taxpayers (enhanced monitoring) and are prepared to commit themselves to resolving material issues more quickly, including transfer pricing. Moreover, they are stressing the importance of a tax control framework. In view of the large impact of transfer pricing on the determination of the taxable profit for an MNE, transfer pricing is an essential element to be included in a tax control framework.

B. Extent of Obligations

The obligations of taxpayers toward the tax administration are part of the General Tax Act, Articles 47 to 56. Furthermore, all obligations toward the tax inspector also apply toward other officers of the tax administration. Thus, where "tax inspector" is stated, one may read "tax auditor" and vice versa.

Articles 47 to 50 GTA deal with the obligation to provide information and to allow inspection. The obligation to provide information when asked by the tax inspector applies to data and explanations of data that could be relevant for taxation. The taxpayer should allow inspection of all records, documents, and other data relevant for taxation. This also includes electronic data storage, microfilms, and sound recordings (of, for instance, board meetings).

The obligation to provide data and to allow inspection can even involve the records, documents, and other data of foreign subsidiaries, including:

- The taxpayer's liability;
- The liability to wage tax on behalf of a taxpayer's employees; and
- The liability for taxation of third parties (e.g., suppliers and clients).

The company has a legal obligation to "administer," which is much broader than bookkeeping, as it is not limited to financial data but also involves other documents and data. The documents and data should be kept for seven years.

Refusal of access or insufficient access to required data, which also involves providing incomplete information, can lead to a reversal of the burden of proof and can be considered a criminal offense by the company. Missing data also lead to a reversal of the burden of proof and can be considered a criminal offense, unless the taxpayer can make a plausible case that the absence is caused by circumstances beyond its control.

The information must be provided clearly, completely, and without reservation. According to the case law, showing just a part of a document is not allowed. Moreover, the inspector can demand that information be provided in writing. The information does not have to stem from the period that is being audited.

C. Right to Refuse to Provide Information

Only clergy, notaries, attorneys, medical doctors, and pharmacists have the right to refuse to provide information about others. They must answer all questions and provide all documents concerning their own liability for taxation. The tax legislation respects their oath to secrecy in client affairs.

The position of the tax advisor and the public accountant is somewhat complex. In principle, they have to provide information and allow inspection of books and data with respect to the tax positions of their clients. However, the tax authorities have agreed to a code of behavior which states that the tax inspector will not review files containing correspondence covering solely tax advice and/or tax considerations. It is, therefore, advised that a company stores all its external correspondence on tax advice and tax considerations separately from files covering tax compliance and facts. However, this separation is hard to implement in practice. In practice, the tax authorities appear to be reserved with respect to advisory correspondence.

An important limitation on the right of review is that the tax inspector is not allowed to "nose about." This means that he may ask or request to review specific books, information, or data but is not allowed on his own to open files, books, and closets. In other words, he can ask for information but cannot take the liberty to obtain that information.

D. Introductory Meeting

An audit typically starts with an introductory meeting. At the introductory meeting, the tax inspector should inform the company of the legal basis on which the audit is based. On the basis of this information, the taxpayer can determine whether the audit concerns a third-party inspection or its own tax position. The tax inspector should also inform the company which taxes are the subject of the audit and which taxable periods will be audited.

It is important that during the introductory meeting clear agreements are made regarding the subject of the audit and the

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manner in which the company will be audited. The tax inspector will ask which person(s) is/are authorized to represent the company and to answer his/her questions and which facilities he/she can use (office, copier, hardware). The tax inspector will also request information concerning the administration of the company and a short summary of the actual financial position of the enterprise. Normally the tax inspector would appreciate a tour of the enterprise. An indication of the timeframe of the audit and the approach of the tax inspector can be useful information for the taxpayer. Making clear working agreements and putting these in writing during the introductory meeting provides the company with clarity and can also be of help in a later stage.

If a certain issue has been the subject of an audit, the company can rely on the conclusions of the audit for the tax treatment of that issue in later years.

The tax auditor must be able to show adequate identification for proof of identity. All employees of the tax administration are sworn to secrecy on all facts that become known to them as employees of the tax administration.

E. Audit Report

At the end of the audit, an audit report is drafted containing the tax consequences of the audit in the view of the tax authorities. The company receives the general part of the audit report. It is advised to discuss the outcome of the audit *before* the final audit report is prepared. In practice, this discussion takes place based on an intermediate draft audit report. At that time all suggested adjustments on reported profits are still negotiable. Generally, the draft serves as a tool to make the taxpayer aware of its maximum exposure, considering the outcome of the audit.

To avoid undesired surprises, the company should try to stay updated on the findings of the auditor during the progress of the audit. By doing so, it may be possible to anticipate difficulties at an early stage, and possibly to prevent or limit profit adjustments.

If the discussion is only started after the final audit report has been completed (describing the conclusions of both parties in detail), the only option left to the company is to file a formal objection to the assessments that will follow on the basis of the final report (if any).

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VII. Transfer Pricing Adjustments

A. Defenses to Transfer Pricing Adjustments

1. General

In the Netherlands, taxpayers have a solid position in disputes regarding transfer pricing adjustments: (i) often the Dutch Tax Authorities have the burden of proof in relation to a proposed adjustment; (ii) both entities involved in the transaction must be (or should have been) aware that the prices were incorrect in order to make an adjustment; (iii) the tax authorities can only marginally verify the soundness of a business decision, (iv) market share strategies can be used to explain pricing; and (vi) set-offs are possible.

On June 28, 2002, the Supreme Court rendered a landmark decision concerning several defenses to transfer pricing adjustments. It concerned the arm's-length nature of prices charged for goods supplied by a Japanese manufacturer to its Dutch subsidiary, an importer. The shares in both the Dutch BV and the Japanese production company were held by the same Japanese parent company. The case concerned the intra-group transfer prices paid by the Dutch company acting as distributor. The goods mainly involved four different products and their spare and replacement parts. The four products had a similar element (which element was undisclosed in the published version of the Court's decision). Overall, the BV was profitable but the budgeted and actual results for one product (cars) were negative for a substantial period. The trade of the spare and replacement parts of the cars was modestly profitable. In summary, the Supreme Court ruled that:

- Even if transfer prices "were not established on arm's length terms" or "the profit deviates from what is customary," the tax inspector has the burden of proof to show that the transactions were not arm's length;
- It is not mandatory to test the arm's-length nature of every individual transaction or every group of transactions separately. Testing the arm's-length nature of the complete set of conditions applicable to the total of transactions between a taxpayer and its shareholder(s) is allowed;
- Treaty provisions regarding the arm's-length principle do not have direct effect. The arm's-length principle is effective in the Netherlands by virtue of Article 3.8 ITA and Article 8b of the CITA. For this reason, an adjustment may be made only when the taxpayer has surrendered a benefit based on the shareholder relationship (so-called awareness required); and
- In principle, all methods included in the OECD Guidelines may be applied in the Netherlands.

2. Burden of Proof

Dutch tax law does not contain strict rules for the division of the burden of proof between the taxpayer and the tax authorities. Generally, the burden of proof is attributed so as to be considered fair and reasonable. Generally, the party that claims an adjustment (normally, in an audit, the tax authority) should be required to demonstrate that it is likely that the transfer price was not at arm's length. However, the taxpayer has the burden of proof if it does not provide sufficient information, maintain proper accounts, or timely file a tax return.

Article 27e GTA provides for a shift of the burden of proof to the taxpayer if the tax inspector has issued an irrevocable information decision.[72] This is possible when the obligations under Article 52 GTA are not complied with.

Article 52 GTA imposes on taxpayers the obligation to maintain books and records, including information relevant for the levy of tax. The documentation requirement included in Article 8b(3) of the CITA is intended to clarify that the obligation under Article 52 GTA includes transfer pricing documentation. In practice, the Dutch Tax Authorities take the position that Article 8b(3) extends the applicability of Article 52 GTA to documentation that may be relevant for the determination of transfer prices but is not generally included in information that should be obtained on the basis of Article 52 GTA. This could, for example, be the case if the transfer prices are mainly determined on the basis of information and documentation available at a foreign group company.

The State Secretary of Finance confirmed that the burden of proof on taxpayers with respect to the correctness of transfer prices under Article 8b of the CITA is only a limited one. Taxpayers are specifically not required to carry out an examination or study to determine the price that would have been payable for a similar transaction between independent parties. The absence of a transfer pricing study will, therefore, not result in a shifting of the burden of proof. The Explanatory Memorandum also suggests a partial shift of the burden of proof if the documentation requirements are not met. However, it seems difficult to fit such a partial shift under the text of Article 27e GTA. Because a full shift of the burden of proof has a major impact on the taxpayer, tax courts may be reluctant to take this step.

The Court of Appeal case Den Bosch, May 19, 2011, BA 2011/19.7, is illustrative of a shift in the burden of proof. The interested party, X, concluded a contract with a company, H, that provided services for direct mail and direct marketing. As compensation for the services, X paid a service fee to H, and H acquired 20% of the shares in X for an amount of €1. According to the Court, the fees could be considered business expenses. The Court of Appeal did not concur with the argument of the tax inspector that the taxpayer did not fulfill the documentation requirements of Article 8b(3) of the CITA. X made a plausible argument that the payments were related to the business interests of the company, and that there was no disparity between the expenses and the obtained services. Therefore, Article 8b(3) of the CITA was not infringed. This shows that the taxpayer is not obliged to include a transfer pricing study in its books and records in order to shift the burden of proof in connection with Article 8b(3) of the CITA.

3. Double Awareness

As discussed in II.B., above, with respect to transfer pricing disputes stemming from a taxable year before 2002, it is consistent case law that a deemed dividend can only be taken into account if both: (1) the company intends to benefit its shareholder; and (2) the shareholder reasonably should have

[72] This is a formal decision that the taxpayer has failed to comply with documentation requirements under article 52 GTA.

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been aware of that intention (so-called double awareness). In many cases, taxpayers have made a fair attempt to use the correct arm's-length price. In these cases, it is unlikely that the double awareness test is met.

Potentially this argument is not as strong under the legislation applicable from 2002. According to the Explanatory Memorandum to Article 8b of the CITA, the rule that an adjustment may be made only if the parties were aware that a transaction was not undertaken under arm's-length conditions should be interpreted objectively in the case of transfer pricing corrections. Thus, if a transfer price is not arm's length, it will be presumed that this is attributable to the fact that the parties are affiliated and were aware of non-arm's-length conditions.

4. Marginal Test: Prudent Business Behavior or Motivation

The power of the tax authorities and courts to adjust profits is limited by the general principle that they are not empowered to judge the soundness of a taxpayer's business decision. A tax inspector may not disallow a deduction on the basis that an expense is in his view unreasonable. A tax inspector may determine the motive for an expense (business or private). However, once it is clear a business motive exists, the inspector may only test the arm's-length character of the expense. A private motive may be inferred if there is a clear mismatch between the business benefit and the expense.[73]

5. Market Share Strategies

In VN 2000/39.10 (Court of Appeal, Amsterdam, May 23, 2000), the Court of Appeal accepted the argument that a relatively low transfer price could still be considered to be arm's length as such price was justified by the fact that the taxpayer intended to penetrate a new market. The OECD Guidelines also acknowledge that business strategies, including market penetration schemes, should be examined in determining comparability for transfer pricing purposes.[74] A taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its products that is lower than the price charged for otherwise comparable products in the same market. Although the Amsterdam Court did not explicitly refer to the relevant paragraph in the OECD Guidelines, it ruled in conformity therewith.

6. Set-offs

To determine the arm's-length transfer price, any compensating transactions will be taken into account. If an asset or activity is transferred intra-group below its market value, the transfer price will be adjusted. However, such adjustment should be corrected with any benefits granted by the transferee to the transferor in other non-arm's-length intra-group transactions. In BNB 1999/326 (Supreme Court, April 14, 1999), a Dutch BV, X BV, had transferred its automobile business to a related Dutch BV, Y BV, for no consideration. However, Y BV claimed to have undertaken a compensating transaction by transferring real estate to X BV for its book value. According to the Supreme Court, when determining the correction, the Court of Appeal should have further investigated the compensating transaction and established whether a set-off was justified.

The 2018 Transfer Pricing Decree provides that in the event of a tax audit the taxpayer can apply for a correction of a proposed transfer price if the taxpayer is of the opinion that the adjustment proposed by the Dutch Tax Authorities does not sufficiently take into account off-setting transactions.

B. Treatment of the Secondary Transaction (Secondary Adjustments)

1. Introduction

An adjustment of transfer prices (in OECD terms, a primary adjustment) may lead to a higher or lower fiscal profit. In the Netherlands it is not required to adjust the commercial terms of the transactions. If no change is made in the commercial terms of the transaction, the commercial equity of the company does not change as a result of the fiscal correction. To realign the commercial terms with the fiscal adjustment, a secondary "transaction"[75] is necessary. With respect to the consequences of such a secondary transaction, it is important to realize that transfer pricing corrections in the Netherlands are directly linked to actual shareholder relations, if any. If, for example, a sister company has granted a benefit to a Dutch company, for Dutch tax purposes that transaction will be analyzed as if the sister company granted a benefit to its parent company and the parent company granted a benefit to the Dutch company. Therefore, five scenarios need to be distinguished: (1) a foreign parent company has granted a benefit to a Dutch subsidiary; (2) a Dutch subsidiary has granted a benefit to its foreign parent company; (3) a Dutch parent company has granted a benefit to its foreign subsidiary; (4) a foreign subsidiary has granted a benefit to a Dutch parent company; and (5) a Dutch company has granted a benefit to an unrelated person.

The 2018 Transfer Pricing Decree states that the Dutch Tax Authorities always require a transfer pricing adjustment to be processed by means of a secondary *transaction*.[76] However, a *secondary adjustment* in the form of a deemed dividend does not need to be made if the taxpayer is able to demonstrate that, in light of the difference between the tax systems used by the two states, the dividend withholding tax paid cannot be credited and there is no situation of abuse aimed at the avoidance of dividend withholding tax.

2. Foreign Parent Company Grants a Benefit to a Dutch Subsidiary

If a foreign parent company has granted a non-arm's-length benefit to a Dutch subsidiary acting in the course of a business, the benefit will be eliminated from the Dutch sub-

[73] See Supreme Court, March 9, 1983, BNB 1983/202, in which a medical specialist used a Cessna aircraft to enable him to travel quickly on business trips. In that case the court ruled that no reasonable entrepreneur would use a private plane in those circumstances and therefore there could not have been a business motive for purchasing the plane.

[74] OECD Guidelines, para. 1.59.

[75] Often this "secondary transaction" is referred to as a secondary adjustment. In accordance with §§4.66 – 4.77 of the OECD Guidelines, the Dutch Tax Authorities distinguish the two terms. A secondary transaction is the accounting correction; a secondary adjustment is the tax effect of the secondary transaction. Paragraph 4 of the Transfer Pricing Decree.

[76] 2018 Transfer Pricing Decree, par. 4.

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sidiary's taxable profit.[77] Consequently, the corporate income tax due will decrease. The amount should be treated as an informal capital contribution by the parent company to the Dutch subsidiary.

3. Dutch Subsidiary Grants a Benefit to Its Foreign Parent Company

If a Dutch subsidiary has granted a non-arm's-length benefit to its foreign parent company, the benefit should be taken into account by the Dutch subsidiary as a business profit.[78] The corporate income tax due should increase. The amount will be treated as a deemed dividend. Therefore, unless reduced by the domestic dividend withholding tax exemption or under tax treaties or EU regulations, this constructive dividend could be subject to a 15% dividend withholding tax in the Netherlands, which needs to be grossed up, unless the dividend withholding tax paid cannot be credited and there is no situation of abuse aimed at the avoidance of dividend withholding tax.[79] Penalties of 0%–100% of the tax due may apply to the dividend withholding tax.

4. Dutch Parent Company Grants a Benefit to Its Foreign Subsidiary

If a Dutch parent company has granted a non-arm's-length benefit to its foreign subsidiary, the benefit should be taken into account by the Dutch company as profit from its business.[80] Therefore, the corporate income tax due should increase. In addition, the amount will be treated as an informal capital contribution that will increase the basis of the shares in the subsidiary.

5. Foreign Subsidiary Grants a Benefit to Its Dutch Parent Company

If a foreign subsidiary has granted a non-arm's-length benefit to its Dutch parent company, the Dutch company should treat the benefit as a deemed dividend from the subsidiary[81] and not as profit from its own business. Such a deemed dividend could qualify for the Dutch participation exemption, provided that the participation exemption applies in respect of benefits derived from this particular subsidiary. If the participation exemption applies, no corporate income tax may be due on the deemed dividend.[82]

6. Dutch Company Grants a Benefit to an Unrelated Person

If a Dutch company grants a non-arm's-length benefit to an unrelated person, the Dutch Tax Authorities could take the position that the amount should be taken into account by the Dutch company as a business profit (i.e., the expenses are not deductible).[83] In BNB 1995/15, the Supreme Court decided that these expenses were not deductible, although it was not clear that the shareholder of the company deliberately benefited from these expenses. The Supreme Court did not decide whether the expenses should be treated as a deemed dividend.

[77] Supreme Court, May 31, 1976, BNB 1978/252.
[78] E.g., Supreme Court, March 27, 1968, BNB 1968/112.
[79] *See* II.F.1., above.
[80] *E.g.*, Supreme Court, April 3, 1957, BNB 1957/165.
[81] *E.g.*, Supreme Court, April 23, 1958, BNB 1958/179.
[82] For more details on the participation exemption, see 7250 T.M., *Business Operations in The Netherlands.*
[83] *See* Supreme Court, September 21, 1994, BNB 1995/15.

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VIII. Transfer Pricing Penalties

A. Penalties

The tax authorities may adjust the taxable income if they can show that the profit reported in the tax return is incorrect, even if a taxpayer has the required documentation available. Under the GTA, if the tax authorities can show that the taxpayer intentionally misrepresented the profit reported in the tax return or if the taxpayer is responsible for misrepresentation, penalties of, respectively, 50% and 25% of the additional tax due may be levied. (However, in the parliamentary history of Article 8b, it is noted that penalties would only apply in the case of intentional misrepresentation.) In case of fraud, the penalty can be 100% of the additional tax due.

If the taxpayer does not have available the required documentation, the burden of proof in relation to the correctness of the reported profit may shift to the taxpayer. In addition, the tax authorities could even start a criminal procedure against the taxpayer. The parliamentary history indicates that the criminal procedure will only be used as a last resort.

In addition, the Dutch Tax Authorities have the authority to issue a penalty if the CbC Report obligations or the master file or local file obligations are not met. When a taxpayer does not fulfill a timely, correct, or complete report, or fails to provide a duly filled-out report due to willful misconduct or due to gross negligence, the taxpayer may have to pay a penalty up to €21,750 (2020) in case of non-compliance with the master file or local file requirements. Failure to submit the CbC Report may lead to penalties of up to €870,000 (2020).

In the past, the Dutch Tax Authorities rarely levied transfer pricing penalties. More recently, however, these penalties have been regularly applied.

B. Tax Amnesty

The Netherlands applies only limited tax amnesty rules. If the offender notifies the tax authorities in time, before he or she knows or should presume that the tax authorities are or will be aware of his criminal actions, he or she will not be punishable.

C. Deferral of Payment

In general, if an objection is filed against an imposed assessment, an extension of payment is granted by the tax authorities without the need for a specific request.[84]

According to the Decree on Mutual Agreement Procedures,[85] where the Netherlands is the state making the adjustment, the Dutch Tax Authorities will, upon request, grant a deferral of payment on that part of the tax charge that is related to the adjustment. In principle, deferral would be granted until the date on which both the domestic and the international procedures for resolving the dispute have been completed. This would mean that the entities involved will, apart from the obligatory collection and assessment interest, not have to pay any other form of interest. This resolves the interest and financing problems that may be caused by mutual agreement and arbitration procedures.

D. Interest Charges

In addition to the actual transfer pricing adjustment, regular interest charges may be due. The tax interest starts accruing six months after the end of the relevant fiscal year and will accrue through six weeks after the date of the assessment. The interest rate is, as far as a corporate income tax is concerned, equal to the statutory interest rate for commercial transactions with a minimum rate of 8%. As part of the COVID-19 measures, the interest rate was temporarily reduced to 0.01% beginning from June 1, 2020, until October 1, 2020. For the period October 1, 2020, to December 31, 2021, the revised interest rate was set at 4%.

Interest compensation is paid if the tax due is lower than the advance levy. Interest will only be paid if an assessment is not issued within 13 weeks after the date on which the return was filed. In this case, interest compensation will be paid during the period between the date on which an assessment should have been issued and the date the assessment was issued. No interest compensation is paid if a settled assessment is subsequently reduced because of an appeal.

In some cases, the amount of interest due may be larger than the tax due. For this reason, Article 30k of the GTA and Article 31a of the Tax Collection Act 1990 *(Invorderingswet 1990)* provide for the possibility of including interest payments in any compromise reached in a Mutual Agreement Procedure.

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[84] Art. 25, Para. 1, Tax Collection Act 1990 (*Invorderingswet 1990*). The tax authorities may impose conditions such as the provision of security for the outstanding amounts of tax due.

[85] Decree of June 11, 2020, no. 2020-0000101607.

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IX. Appeals and Litigation Matters

A. Administrative Appeals of Disputed Audit Findings

A taxpayer may file an objection against an imposed assessment containing a transfer pricing adjustment. The objection is addressed to the responsible tax inspector and must be filed within six weeks after the date of the assessment.[86] In principle, the tax authorities must decide on the objection filed within six weeks, although this period may be extended by an additional six weeks.[87] No administrative fees are due.

The taxpayer can represent himself, or he can be represented by someone else. There are no specific requirements applicable to a representative. A representative cannot be refused, other than in exceptional cases.

A signed letter of objection must be filed in writing and meet the following requirements in order to be complete:

- The name and address of the person filing the objection;
- The date on which the objection is filed;
- A description of the decision to which the objection is filed; and
- The reasons for the objection.

The objection can be dismissed if one of these requirements is not met.[88] If an objection has been dismissed, the decision to dismiss can be appealed. However, if a decision to dismiss on the procedural ground that an objection failed to meet the requirements for completeness was taken on the correct grounds, the substantive issue of the objection can no longer be reviewed by a court.

Any objection to a tax assessment, regardless of whether the outcome will be a decision on the procedural completeness or the underlying substantive issues, must be considered by a different tax inspector than the one who issued the assessment. Failure to do so will result in a reversal of the decision taken on the objection. A different tax inspector will then have to decide on the objection.

At the request of the taxpayer, a hearing will be held before the tax administration renders a decision on the objection, as part of the objection procedure. The hearing must be conducted by a person who was not involved in the preparation of the decision to which the objection is made. Certain procedural rules must be observed during the hearing process. For example, the taxpayer has the right to submit documents, the right to review documents relevant to the case, and the right to bring witnesses and experts. Furthermore, there is a requirement to make a report of a hearing. Failure to observe these rules can result in a reversal of the decision taken on the objection. If a court establishes such a failure, it can either refer the case back to the tax administration or handle the case itself by taking a decision on appeal.

If the statutory limitation period for rendering a decision is exceeded, the taxpayer can file an appeal on the basis that no decision has been rendered. In such an appeal, the court will then render a judgment on the assessment in dispute because of the lack of a decision by the tax administration. Furthermore, the court can decide that rules regarding the obligation of the taxpayer and certain third parties to provide information to the tax administration are still applicable. Such rules are normally not applicable anymore if the objection has been filed with a court.

B. Judicial Appeals of Disputed Audit Findings

1. Appeals at the District Court and the Courts of Appeals

With their decision on the objection, the tax authorities will specify with which District Court (*rechtbank*) an appeal against the decision may be lodged.[89] The term for filing the appeal is six weeks. Court fees of €48 (2020) are due for a natural person and €354 (2020) for a legal entity, which are reimbursed if the taxpayer prevails. A letter of appeal must be lodged in writing.

In principle, filing an appeal does not stay the decision of the tax authorities against which the appeal is made, and payment could be required while the appeal is pending. In tax cases, however, it is the official policy to grant an extension for payment for the entire period of the appeal. The tax collector can ask for security for the payment of tax if it believes such security is necessary to protect the interests of the Dutch Tax Authorities as a creditor. Interest accrues on the amount of tax due during the appeal. The applicable interest rate is published quarterly. Interest is calculated on a daily non-compounded basis.

A taxpayer can further appeal against an adverse decision of a District Court at the Court of Appeals (*Gerechtshof*). The term for filing the appeal is six weeks. Court fees of €131 (2020) for a natural person and €532 (2020) for a legal entity are due, which are reimbursed if the appellant prevails. An appeal against a decision of a District Court stays the execution of the decision so appealed.

In principle, the competent court at which the appeal is lodged will process the appeal. However, if it takes the view that the case could be better processed by another court, the court is allowed, whether or not at the request of the taxpayer, to refer the case to a court in a different part of the Netherlands that handles similar cases.

A court has the competence, whether or not at the request of the taxpayers involved, to jointly process pending cases that involve the same or an affiliated issue. These can either be cases brought before the court by one plaintiff or by two or more different plaintiffs. In practice, joining cases in which different plaintiffs are involved occurs only occasionally. Cases will not be joined if it is inappropriate given the type of dispute or the positions of the parties.

At the District Court, a case will, in principle, be dealt with by a magistrate's court, at which a single judge presides. However, if the magistrate's court takes the view that the case is

[86] Art. 6:7, General Act on Administrative Law (*Algemene wet bestuursrecht*, hereinafter GAAL).

[87] Art. 7:10, GAAL. The taxpayer and tax inspector can agree to further extend the period with in which the tax inspector should decide on the objection.

[88] The taxpayer filing the objection letter should first be provided with the opportunity to correct its objection to meet the relevant requirements (Article 6:6, GAAL).

[89] Art. 3:45, GAAL.

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not appropriate for treatment by one judge, it will refer the case to a full court (three judges). Before the Court of Appeals, a case will, in principle, be dealt with by a full court, consisting of three judges, unless the Court takes the view that the case is suitable for further treatment by one judge. Judges in tax cases are almost always specialized in tax law.

There is no requirement of legal representation before the District Court or the Court of Appeals. This means that the taxpayer itself is allowed to carry on the proceedings at these stages. If it chooses legal representation, a representative can only be refused in exceptional cases.[90]

Before the District Court and the Court of Appeals, the taxpayer can bring up factual as well as judicial issues, because both courts will look at the facts and issues of law. The District Court and the Court of Appeals must limit their examination to the issues of dispute brought up by the parties (i.e., they can only give a decision on the elements of a final tax assessment about which the parties have a dispute). However, a court is not bound to the legal interpretation of the parties. It does not expand the dispute beyond the borders set by the parties when it gives a legal qualification to the facts that differs from the legal qualification given by the parties. It must apply the law and complement the legal bases of the dispute ex officio.

Comment: It is not always clear when a court does or does not go beyond the issues that are in dispute. In addition, an exception applies to issues of public order, which have to be examined by a court *ex officio*. The following issues qualify as issues of public order:

- Timely lodging of the appeal;
- Competence of the judge;
- Competence of the plaintiff;
- Competence of the respondent; and
- Exceeding the reasonable term within which a judgment with respect to penalties must be reached in accordance with Article 6 of the European Human Rights Convention.

In principle, a court is not allowed to judge factual aspects not disputed by the parties. However, if a court doubts the correctness of facts presented by the parties, it can raise questions about them or supplement the facts ex officio, but it is still not allowed to expand the dispute beyond the borders set by the parties.

In tax proceedings before the District Court and the Court of Appeals, three phases can be distinguished:

- The preliminary phase;
- The examination in court; and
- The judgment.

The preliminary phase is in practice mainly limited to exchanging the following documents:

1. The letter of defense (*verweerschrift*) by the tax administration, or by the taxpayer if the tax administration appealed a decision of the District Court. The letter of defense must be submitted within four weeks after the date of the appeal. Upon request, an extension of four weeks can be granted.

2. The notice of reply (*conclusie van repliek*) by the plaintiff. The notice of reply must be submitted within a time set by the court.

3. The notice of rejoinder (*conclusie van dupliek*) by the respondent. The notice of rejoinder must be submitted within a time set by the court.

In addition, during the preliminary phase the District Court and the Court of Appeals have the following competences:

- Making inquiries in writing to the parties involved and third persons;
- Hearing the parties involved;
- Hearing witnesses;
- Seeking the opinion of experts;
- Seeking the assistance of an interpreter; and
- Conducting an on-the-spot inspection.

In practice, the courts rarely use their competences during the preliminary phase, mainly because of the lack of sufficient employees who can carry out these competences. Therefore, as mentioned before, in practice, the preliminary phase in tax cases is limited to exchanging documents.

After the preliminary phase, the parties are invited, at least three weeks in advance, for a court session. The parties may grant permission not to hold a court session. The parties may also request an extension of the date for a court session. If the request is filed in time and is based on valid arguments, the court must grant the request, unless there are valid arguments that more important interests dictate otherwise.

The court session is not public, except as otherwise provided by the court or if the case involves a decision against a penalty.

Parties can submit additional documents until 10 days before the court session. The 10-day term is to enable parties to sufficiently prepare themselves for the court session. In practice, parties can present new facts, additional documents, and new arguments after the 10-day term has elapsed and even during the court session. However, if the other party will be affected adversely in the procedural position, the judge can decide that the new elements will not be taken into consideration or that the tribunal hearing will be adjourned.

The court can order the taxpayer to appear in person, and it can summon witnesses and experts. If only one of the parties brings witnesses or experts, the court may decide not to hear them if it believes they cannot reasonably contribute to the outcome of the case.

During the court session, the party other than the party last filing a document in writing will have the first opportunity to plead its case. Then the other party can verbally explain its arguments. Next, the court can put questions to the parties. After that, the plaintiff will have the opportunity to further explain its case. Subsequently, the respondent will have the last word. In practice, parties often write down their comments in a notice of pleading (*pleitnota*) that they present during the court session. Reading these pleadings during the court session can be skipped if they were already sent to the respondent and the

[90] Under exceptional circumstances, the Court may deny a particular representative, but not legal representation in general.

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judge before the date of the court session. To be sure that the pleadings are taken into account by the judge, the parties should file a request that the pleadings be included in the decision of the court.

The court may conclude the court session in one of the following ways:

- Adjourning the examination in court and planning another court session;
- Adjourning the examination in court and resuming the preliminary phase; or
- Closing the examination in court and rendering a judgment.

A judgment can have one of the following outcomes:

- The court is not competent;
- The appeal is inadmissible;
- The appeal is unfounded; or
- The appeal is founded.

If the appeal is founded, the judgment can either replace the decision against which the appeal was made, or it can invalidate that decision with an order to the tax administration to render a new decision, taking into account the decision of the court and subject to other conditions (such as timing). The Court of Appeals can decide that the case must be reviewed again by a District Court.

A judgment can be passed orally or in written form. An oral judgment must be passed at the closing of the court session, or within two weeks thereafter. The court clerk prepares a written report of an oral judgment. An orally spoken judgment must be converted into a written judgment if the judgment is appealed to the Supreme Court. A written judgment must be rendered within six weeks after the closing of the court session. The six-week period can be extended by another six weeks. Both oral and written judgments are passed in public.

Third parties, including tax journals, can obtain copies of judgments. In practice, courts only provide redacted copies to protect the names of the parties and preserve confidential information.[91]

2. *Appeals at the Supreme Court*

A decision of the Court of Appeals can be appealed to the Supreme Court (*Hoge Raad*), which is situated in The Hague. If both parties agree, a judgment of the District Court can also be appealed directly at the Supreme Court (i.e., bypassing the Court of Appeals). The term for filing the appeal is six weeks. Court fees of €131 (2020) for a natural person and €532 (2020) for a legal entity are due, which are reimbursed if the appellant prevails. An appeal against a decision of the Court of Appeals stays the execution of the decision so appealed.

Before the Supreme Court, tax cases will always be dealt with by a multi-judge section, which can consist of three or five judges, depending on the financial interests involved and the complexity of the case. The judges are usually specialized in tax law.

In principle there is no mandatory legal representation for cases brought before the Supreme Court. However, if a court examination is requested, only a lawyer (*advocaat*) can represent the parties.

The Supreme Court renders its decision solely on the basis of the facts established by the Court of Appeals (or the District Court); it does not establish facts. It decides the case on the basis of the grounds raised in the notice of appeal and reviews solely whether the Court of Appeals (or the District Court) has correctly applied the law and whether it has used arguments that can carry its decision. The Supreme Court can, however, supplement the grounds of the notice of appeal. If the Court of Appeals (or the District Court) has based its decision on facts that have not been established or if the reasoning of such court is unclear, the Supreme Court will invalidate the decision of the court and will send the case back for further review.

After one of the parties has filed a notice of appeal (*cassatieberoepschrift*), the respondent has eight weeks to write a letter of defense (*verweerschrift*). (In general, the term of eight weeks cannot be extended.) Next, the plaintiff can submit a notice of reply (*conclusie van repliek*), after which the respondent can submit a notice of rejoinder (*conclusie van dupliek*). The Supreme Court will set the terms within which the notices have to be submitted.

A court examination will only take place upon the written request of one of the parties. The Supreme Court can summon the parties to appear in person, summon witnesses, and appoint experts, as in cases before the District Court and the Court of Appeals.

The court session is not public, except as otherwise provided by the court or if the case involves a decision against a penalty.

The Advocate-General to the Supreme Court (a neutral advisor to the court under the Netherlands' legal system) can decide that it is necessary to give its opinion on a case brought before the Supreme Court. Within two weeks after the Advocate-
General has rendered its advice, the parties may provide the Supreme Court with a written reaction. There is no term within which the Advocate-General must render its advice.

A judgment of the Supreme Court is always in written form. The Supreme Court either decides the case itself or, if the decision is dependent on facts that have not been established yet, refers the case back to the Court of Appeals (or the District Court) for further handling, taking into account the judgment of the Supreme Court. If the Supreme Court is of the opinion that the Court of Appeals (or the District Court) has rendered the correct decision on the correct grounds, the Supreme Court may decide that the grounds for the appeal are unfounded and that the lower court judgment needs no further elaboration. There is no term within which the Supreme Court must render a judgment. The decision is passed in public. Third parties, including tax journals, may obtain copies of judgments of the Supreme Court. In practice, these copies are provided in redacted form. However, if preliminary questions are presented to the European Court of Justice, the names of the parties are generally no longer kept anonymous.

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3. Reimbursement of Legal Costs and Court Fees

If a taxpayer succeeds in its actions, even partly, the court will, in general, order the tax authorities to reimburse the taxpayer for its legal costs. For obtaining a reimbursement of legal costs, it is not necessary, but nevertheless advisable, to file a request as part of the appeal procedure. Generally, the legal costs of the taxpayer will not be reimbursed for the full amount but will only be reimbursed for a fixed amount depending on the various procedural acts involved and the importance of the case. Under certain circumstances (e.g., when the tax authorities had no grounds at all for their assessment), a court can decide that a taxpayer should receive a reimbursement for more than the fixed amount.

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X. Competent Authority

A. *Application for Dutch Competent Authority Assistance*

1. *Mechanics of Application*

All Dutch income tax treaties contain a clause that is comparable to Article 25 of the OECD Model Treaty (i.e., the Mutual Agreement Procedure).[92] Requests for the application of the Mutual Agreement Procedure may be submitted if a profit adjustment made by the tax authorities results in international double taxation. The request has no specific formal requirements but should be signed by the taxpayer and must contain the following information:[93]

— Name, address, and tax details of:

- The private individual or business;
- The other parties involved; and
- The tax authorities involved;

— The tax period in which double taxation occurred;

— The other country or countries to which the request applies;

— Relevant facts and circumstances (e.g., information on the relationship with the other parties);

— The legislation on which the request is based: a tax treaty or the EU Arbitration Convention;

— An explanation why the levy is in violation of the tax treaty. If the request is based on the EU Arbitration Convention, an explanation on why Article 4 has not been satisfied;

— Copies of tax assessments, tax inspection reports, if applicable, or other measures that have caused double taxation;

— Information on any objections or legal proceedings outside the Netherlands;

— An undertaking to comply as quickly as possible with all reasonable requests made by the International Tax Policy and Legislation Directorate (IFZ), which is the Dutch Competent Authority, including submission of all documentation;

— If applicable, a statement as to whether the request is filed with the other competent authorities involved, and if so, whether the request was filed on the same basis; and

— If applicable, information on whether the case has been handled before.

The request must be filed with:

Ministerie van Financiën

c/o The International Tax Policy and Legislation Directorate

PO Box 20201

2500 EE Den Haag

The Netherlands

E-mail: internationalezaken@minfin.nl with subject: *Onderlinge Overlegprocedure*

The competent authority will send a copy of every application to the Coordination Group on Transfer Pricing (*Coördinatiegroep verrekenprijzen*) for its advice.

The Supreme Court does not consider itself to be bound by the outcome of a Mutual Agreement Procedure if it is subsequently requested to interpret the application of the treaty provision in the same treaty.[94] One of the main disadvantages of the Mutual Agreement Procedure is that it does not guarantee a solution. The competent authorities are only obliged to use their best efforts to eliminate double taxation and are not required to achieve that result.[95]

Comment: However, on October 10, 2017, a new directive was adopted by the EcoFin, Council Directive 2017/1852. As a consequence, EU Member States are obliged to implement the directive in their national legislation (June 30, 2019, at the latest) effective as of July 1, 2019, under which EU Member States can be obliged by their national courts to pursue the Mutual Agreement Procedure.

In addition, tax treaties can provide for a mechanism that will allow an agreement to be reached even if there are issues on which the competent authorities have been unable to reach agreement through negotiations.[96]

2. *When Assistance Can Be Requested*

Article 25 of the OECD Model Treaty provides that the request must be presented within three years from the first notification of the action resulting in double taxation. If a specific tax treaty includes a different term for presenting the request, such term may be followed.[97]

Comment: Most Dutch treaties already provide for at least a three-year period, and the OECD's Multilateral Instrument will modify any of those not already providing such a period, so that they either will so do or so that the other countries will be required to provide equivalent relief.[98]

B. *Degree of Foreign Taxpayer Involvement with the Dutch Competent Authority*

The Dutch government takes the position that a Mutual Agreement Procedure is a government-to-government process and is dealt with by the competent authorities involved. The

[92] A list of jurisdictions with which COUNTRY has an income tax treaty in force can be found on the Bloomberg Tax platform: https://www.bloombergtax.com/product/tax/search/results/c46028cdafdb0d13be4b0b3394e901b7/.

[93] *See* Annex B to the Decree of 11 June 2020, Stcrt. 2020, 32689.

[94] Supreme Court, Sept. 29, 1999, BNB 2000/16.

[95] *See* para. 37 of the OECD Commentary to Art. 25.

[96] Art. 25, para. 5, of the OECD Model.

[97] Decree of June 11, 2020, no. 2020-0000101607, paragraph 3.4.

[98] In its post-ratification notification to the OECD of its MLI positions (dated Nov. 25, 2021), of 82 treaties designated as "covered tax agreements," the Netherlands listed 6 as treaties providing for a shorter period. An additional 8 treaties in the designation of CTAs are not listed as having either a period shorter than, or a period at least as long as, 3 years.

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taxpayer is not directly involved in the discussions but may be asked for information during the procedure.

C. Dutch Competent Authority's Willingness to Deviate from Dutch Transfer Pricing Rules

When a foreign contracting state makes a transfer pricing adjustment, often the official statute of limitations to request an adjustment of the Dutch tax assessment has already lapsed. In such an event, a corresponding adjustment will, if necessary, be made in the form of a reduction ex officio in the tax assessment. Generally, an ex officio reduction can only be made within five years after the relevant year. However, in case of a corresponding adjustment, the Dutch tax inspector may, under certain conditions, deviate from the general rule and make the adjustment after expiration of the five-year term.[99]

A request should be sent to the responsible tax inspector, who should decide whether the Netherlands will unilaterally make a corresponding adjustment. The tax inspector should consult with the Coordination Group on Transfer Pricing for its binding advice.

D. Dutch Competent Authority's Willingness to Deviate from Dutch Penalty and Interest Rules

Dutch legislation includes the possibility of including interest payments in any compromise reached in a Mutual Agreement Procedure.[100] When conducting Mutual Agreement Procedures, the Dutch government actually seeks to ensure that the assessment and collection of interest charged by one state and paid by the other state match each other. These attempts are sometimes successful.

If the Netherlands is the state making the adjustment, the Dutch Tax Authorities will, upon request, grant a deferral of payment on that part of the tax charge that is related to the adjustment. In principle, deferral will be granted until the date on which both the domestic and the international procedures for resolving the dispute have been completed.

E. Bilateral Advance Pricing Agreements/Multilateral Advance Pricing Agreements

An advance pricing agreement (APA) provides advance certainty on the arm's-length character of a remuneration. Under the Dutch tax treaties, taxpayers have the option to apply for bilateral or multilateral APAs. The conditions for bilateral advance pricing agreement (BAPA) or a multilateral advance pricing agreement (MAPA) are similar to the conditions for application for a unilateral APA.[101]

F. Administrative Arrangements for the Implementation of the Mutual Agreement Procedure of the Netherlands-U.S. Income Tax Treaty

1. General

The Competent Authorities of the Netherlands and the United States have entered into an agreement under the Mutual Agreement Procedure (Article 29) of the Netherlands-U.S. Income Tax Treaty, signed on December 18, 1992, as amended by Protocols (Treaty), with a view to the effective administration and resolution of cases handled by them under the procedure. The agreement sets certain objectives and practices adopted by the Netherlands and the United States with a view to ensuring taxation in accordance with the Treaty.

2. Progress of the Mutual Agreement Procedure

The Netherlands and the United States have agreed that requests presented under Article 29 of the Treaty shall be dealt with as expeditiously as possible. The objective is to resolve cases accepted for consideration by the competent authorities within 18 months from transmittal of a position paper by one contracting state to the other, excluding time during which the issues presented for competent authority consideration are under consideration by appellate or judicial authorities where permitted under applicable domestic procedures.

In order to ensure timely progress in the Mutual Agreement Procedure, the competent authority of the country that made the adjustment (relevant competent authority) will endeavor to deliver a position paper to its counterpart (responding competent authority) within 120 days of acceptance of the case from the taxpayer. The case will be discussed without a written response unless such a response is needed to facilitate substantive discussion. If a written response is needed in a case involving the attribution of profits or transfer pricing adjustments under Article 7 or 9 of the Treaty, the responding competent authority will endeavor to provide a position paper within 240 days after receipt of the first position paper. In all other cases in which a written response is needed, the responding competent authority will endeavor to deliver a position paper within 120 days of receipt of the first position paper. In cases involving advance pricing agreements or arrangements, the competent authorities will endeavor to agree upon a joint target timetable for each stage of the procedure, taking into account the complexities of the particular case.[102]

3. The Role of the Taxpayer During the Procedure

The Netherlands and the United States agree that the Mutual Agreement Procedure is a government-to-government process. A taxpayer has no legal right to attend negotiations between the competent authorities or to observe the negotiations. However, it is also recognized that the taxpayer is a key stakeholder in the process of the Mutual Agreement Procedure. The competent authorities, therefore, agree that they will keep the taxpayer informed about the progress of a case under the Mutual Agreement Procedure and will invite it to provide such further information as may be helpful in reaching a resolution. At their discretion, they may allow information to be provided to them in a joint presentation by the taxpayer.

[99] Decree of June 11, 2020, no. 2020-0000101607, paragraph 8.2.

[100] Art. 30k of the General Tax Act and Art. 31a of the Tax Collection Act 1990 (*Invorderingswet* 1990).

[101] For more information on APAs, see XI., below.

[102] Administrative Arrangements for the Implementation of the Mutual Agreement Procedure (Art. 29) of the Convention Between the Kingdom of the Netherlands and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains (Signed on December 18, 1992, as Amended by Protocols) (the Convention) (August 25, 2003).

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4. Resolution of Cases

While the staff of the respective competent authority offices will continue to carry on the primary negotiation of cases arising under the Mutual Agreement Procedure article of the Treaty, the Netherlands and the United States agree that, in any case that extends beyond the applicable timeframe agreed upon, senior officials who have not been present at the competent authority meetings when the case was discussed or otherwise personally involved in the decision making on the case will undertake a review of the case to ensure that all appropriate action is being taken to facilitate resolution of the matter. Upon request, the Netherlands and the United States will also seek to resolve the issue for subsequent taxable periods, to the extent permitted under their respective domestic procedures.

5. Collection and Interest

Where the competent authorities are endeavoring to resolve a case pursuant to Article 29 of the Treaty, the Netherlands and the United States generally will not seek to collect the tax in dispute until the Mutual Agreement Procedure has been completed. Any tax that is due upon the completion of the Mutual Agreement Procedure will, however, be subject to interest charges and, if appropriate, surcharges or penalties, to the extent provided by applicable national law. Any tax that is refunded upon completion of the Mutual Agreement Procedure will be subject to interest payable on refunds, to the extent provided by applicable national law.

6. Confidentiality of Taxpayer Information

The Netherlands and the United States are committed to ensuring confidentiality of taxpayer information under the Treaty and their respective laws.

7. Meeting Schedule

The Netherlands and the United States agree to meet at least twice a year to conduct face-to-face discussions. Interim meetings and other communications will also be conducted as necessary in an effort to resolve cases.

8. Refund Claims Following U.S.-Initiated Allocations of Income from Dutch Entities to U.S. Taxpayers

In the Netherlands, no public information is available on the success of refund claims following U.S.-initiated allocations of income from Dutch entities to U.S. taxpayers. However, experience shows that the Dutch Competent Authority is committed to avoiding double taxation. The competent authorities of both countries meet at least twice a year to discuss pending cases.

The Decree on Mutual Agreement Procedures (MAP Decree)[103] allows taxpayers to file for Dutch Competent Authority relief as soon as they have a reasonable expectation of a foreign-initiated adjustment that will result in double taxation.

G. Negotiated Settlements of Dutch-Initiated Adjustments

At the end of 2020, the OECD provided statistics on the MAP caseload per jurisdiction.[104] In 2020, 218 new cases were started, of which 76 were transfer pricing cases.[105] During this same period, 178 cases were closed.[106] The average time needed to close a case that began as of January 1, 2016, was 16.1 months.

In 2021, the EU Joint Transfer Pricing Forum provided statistics on pending Mutual Agreement Procedure cases under the EU Arbitration Convention for the year 2019.[107] This gives insight on the number of Mutual Agreement Procedure cases in the EU under the Arbitration Convention. In 2019, 839 cases were initiated under the EU Arbitration Convention, of which 14 were initiated by the Netherlands. Furthermore, 752 cases were completed, of which 36 were completed by the Netherlands. The average cycle time for cases completed in the Netherlands was 39 months in 2019.[108]

The Netherlands is becoming more amenable to arbitration of bilateral transfer pricing adjustments that cannot be agreed upon by the competent authorities. This was, for example, shown by the 2008 tax treaty between the Netherlands and the United Kingdom and the 2010 tax treaty between the Netherlands and Japan. These treaties provide in Article 24(5) and Article 25(5), respectively, that the respective competent authorities will arbitrate any double-taxation dispute that they are unable to resolve within two years from the presentation of the case. The mutual agreement provision in Article 29 of the 1992 U.S.-Netherlands Income Tax Treaty provides for arbitration in paragraph 5. It provides that if the competent authorities fail to reach an agreement within two years of the date on which the case was submitted to one of the competent authorities, they may agree to invoke arbitration in a specific case, but only after fully exhausting the procedures available under Article 29.

H. Arbitration Within the European Union

1. Introduction

On October 10, 2017, the Council of Ministers of the EU adopted the Directive on Double Taxation Dispute Resolution Mechanisms in the European Union (Dispute Resolution Directive). The Dispute Resolution Directive covers disputes between EU Member States over the interpretation and application of treaties that eliminate double taxation of income and capital. Its dispute resolution mechanism meets the BEPS Action 14 standard. The Dispute Resolution Directive applies to disputes submitted from July 1, 2019, and covers cases of double taxation relating to tax years starting on or after January 1, 2018.

The Dispute Resolution Directive supplements the EU Arbitration Convention (hereinafter the Convention),[109] which

[103] Decree of June 11, 2020, no. 2020-0000101607.

[104] https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-2020-per-jurisdiction-all.htm.

[105] https://www.oecd.org/tax/dispute/2020-map-statistics-netherlands.pdf.

[106] Id. https://www.oecd.org/tax/dispute/2020-map-statistics-netherlands.pdf.

[107] See VII., below, for an explanation of the EU Arbitration Convention.

[108] https://ec.europa.eu/taxation_customs/system/files/2021-04/map_2019.docx.pdf.

[109] The original Convention was in force from January 1, 1995, until December 31, 1999, for an initial period of five years and re-entered into force in November 2004, with retroactive effect to January 1, 2000. The Protocol that arranged for the reentry into force of the Convention provides for an automatic extension of the Convention by periods of five years, unless a Contracting

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covers only transfer pricing and profit attribution to permanent establishments.

The Convention establishes a procedure to resolve disputes where double taxation occurs between enterprises of different EU Member States resulting from an upward adjustment of profits of an enterprise in one Member State. Unlike most bilateral income tax treaties, the Convention imposes a binding obligation on the contracting states to eliminate the double taxation.[110]

The Convention provides for mandatory arbitration in cases where Member States cannot reach mutual agreement on the elimination of double taxation within two years of the date on which the case was first submitted to one of the competent authorities of the Member States involved. In view of difficulties that made the practical implementation of the Convention less efficient than desirable, the European Commission proposed the establishment of the EU Joint Transfer Pricing Forum (JTPF). The JTPF examines transfer pricing issues that can be addressed without legislation — in particular, rules related to the implementation of the Convention. The JTPF's work has resulted in a recommendation for a Code of Conduct (Code), discussed below. The Code is a political commitment and does not affect the Member States' rights and obligations or the respective spheres of competence of the Member States and the European community.

2. The Procedure Under the Convention

The Convention prescribes the following procedure:

- Within three years after the first notification of the adjustment possibly resulting in double taxation, the case must be submitted to the tax authorities of the state of residence of the company involved (three-year period). The states involved try to reach an agreement that eliminates the double taxation.

- If the states involved do not reach an agreement within two years (two-year period), they will establish a European commission that will, within six months after its establishment, produce an opinion containing a proposal for the elimination of the double taxation. Within six months after the opinion is provided by the European commission, both states may try anew to reach an agreement (eliminating double taxation), which may deviate from the opinion of the European commission. The opinion becomes binding if the states fail to reach an agreement within six months after the opinion was produced by the European commission.

- The first phase is referred to as the "mutual agreement phase" and the second phase as the "arbitration phase." In practice, the member states had different interpretations of some of the requirements, and the Code, mentioned above, establishes clearer rules.

3. Code of Conduct with Respect to the Convention

The Council of Ministers of the EU adopted the Code in November 2004. The Code should ensure a more effective and uniform application by all Member States of the Convention by establishing common procedures concerning:

- The starting point of the three-year period by the end of which a company suffering double taxation must present its case to the relevant Member State's tax administration;

- The starting point of the two-year period during which the Member States' tax administrations must attempt to reach an agreement that eliminates the double taxation that is the subject of the complaint;

- The arrangements to be followed during this two-year period (the practical operation of the procedure, transparency, and taxpayer participation); and

- The practical arrangements for the second phase of the dispute resolution procedure that must follow if there is no mutual agreement between the tax authorities within the two-year period (i.e., the establishment and functioning of the Advisory European Commission that must then arbitrate the case).

On December 22, 2009, the Council adopted the proposal for a revised Code for the Effective Implementation of the Arbitration Convention. The revised Code of Conduct is the result of a monitoring exercise carried out by the JTPF to improve the functioning of the Convention by providing common interpretations on the following topics:

- Serious penalties;

- Scope of the Convention (triangular transfer pricing and thin capitalization cases);

- Interest charged or credited by tax administrations when a case is dealt with under the Convention;

- Functioning of the Convention (as regards rules about the deadline for setting up the European Commission and criteria for establishing the independence of arbitrators); and

- The date from which a case is admissible under the Convention, and the interaction of the Convention and domestic litigation.

The Code recommends that Member States also apply the rules to the dispute settlement provisions in their double taxation treaties with each other.

4. Dutch Implementation Dispute Resolution Directive

The bill of law implementing the Dispute Resolution Directive was published by the State Secretary on December 19,

State opposes (Protocol of May 25, 1999). With the enlargement of the EU, the Arbitration Convention was successively extended through different Conventions and Acts of Accession.

[110] The Convention does not contain a definition of the term "permanent establishment" (PE). Consequently, the Convention most likely does not apply to a situation where a member state has a different point of view as to whether a PE is present. Article 3(2) of the Convention stipulates, "[A]ny term not defined in this Convention shall, unless the context otherwise requires, have the meaning which it has under the double taxation convention between the States concerned." This would mean the first step would have to be initiating a Mutual Agreement Procedure under the applicable tax treaty. It should be noted, however, that, with respect to a Mutual Agreement Procedure initiated under a tax treaty, there is no obligation for the competent authorities to reach an agreement, or to finalize the procedure within a specific timeframe. As a next step, the Convention could become applicable if a member state takes a different position with respect to the allocation of profits to such as the presence of a PE.

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2018.[111] On June 12, 2019, the Dutch parliament adopted the bill of law with limited changes. The bill of law provides for the Dispute Resolution Directive to be implemented in a separate law, *Wet Fiscale Arbitrage* (Law on Fiscal Arbitrage, or WFA), due to the fact that the directive provides procedures, terms, and fallback scenarios that substantially deviate from procedures included in the General Tax Act.

The new MAP Decree, dated June 11, 2020, includes a description of the procedure under the WFA.

I. Exchange of Information

1. Legal Framework for the Exchange of Information

As a rule, the Dutch Tax Authorities are under a statutory obligation to keep secret all information with respect to Dutch taxpayers.[112] International treaties and supranational legislation, however, can overrule this provision. Hence, the secrecy provision of Article 67 of the GTA does not apply insofar as international treaties or EU legislation oblige the Netherlands to provide information on Dutch taxpayers. Such obligations can be found in:[113]

- The EU directive on mutual assistance (2011/16/EU, EU directive), as implemented in the *Wet op de internationale bijstandsverlening bij de heffing van belasting* (Act on International Assistance in Levying Taxes, WIB);
- A bilateral tax treaty (e.g., Article 30 of the Netherlands-U.S. Income Tax Treaty); and
- The OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters.

Apart from implementing the EU directive, the WIB regulates the procedures and the restrictions that apply to the exchange of information on the basis of the above-mentioned sources. Pursuant to the WIB, information may be provided upon request of a foreign authority, automatically or spontaneously. If information is requested, the Dutch Fiscal Information and Investigation Service (FIOD) will deal with the request and will formally decide thereon. Normally, the FIOD will send the request to the tax inspector who deals with the tax issues of the "person concerned" (i.e., the Dutch resident person or legal entity that originally produced the information). If the tax inspector does not readily have the requested information at hand, the FIOD may instruct him to start a survey or investigation (Article 8, WIB).

Comment: As indicated below, Article 8, WIB, uses the term "survey" to refer to gathering information. The parliamentary history of Article 8, WIB, is not clear as to the scope of the term "survey" in the context of collecting information. It is generally believed to include an investigation at the office of the taxpayer (to inspect the relevant files of the Dutch taxpayer)[114] and also requests for information made to the Dutch taxpayer. Consequently, this discussion uses both terms.

It should be borne in mind that the tax inspector is formally *not* competent to decide alone about the request of the foreign authority, or to provide fiscal information regarding a Dutch resident taxpayer to foreign authorities (*see* the discussion of Article 67 GTA, above).

If a survey or investigation is initiated on the basis of Article 8, WIB, two stages must be distinguished:

a. The collection of information under Article 8, WIB, by the Dutch tax inspector; and

b. The examination of the collected information by the FIOD in order to formally decide whether this information can legally be provided to the foreign authority.

2. Survey in the Netherlands to Fulfill a Request from a Foreign Authority

As stated above, if the Dutch authorities do not readily have available the information requested by a foreign authority, Article 8, WIB, provides that the Minister of Finance (i.e., FIOD) may instruct the tax inspector to conduct a "survey" in order to collect the requested information.[115] This is a normal procedure. Article 8, WIB, stipulates that such a survey is covered by Chapter §VIII, para. 2, of the GTA. This means in fact that the information rights or obligations under national tax law apply *mutatis mutandis* to such a survey.

Under national information obligations, a Dutch taxpayer is required to provide to the tax authorities all information that could be reasonably relevant for the levying of Dutch taxes on the taxpayer.[116] The information obligations thus have a very broad scope. Under the WIB, these obligations are extended for the purposes of foreign taxation. In general, under Dutch tax law and published policy, it is defendable that a Dutch taxpayer is not obliged to provide to the tax authorities:

- Correspondence between the taxpayer and its attorney (in its function as an attorney); and
- Advice received by the taxpayer from a tax advisor or accountant.

If a Dutch resident does not cooperate with a survey or investigation, or under such a survey provides incomplete or false information, a criminal penalty (fine or imprisonment) can be imposed.[117]

The information collected under a survey will in general be sent by the tax inspector to the FIOD. The FIOD will thereafter formally decide whether the collected information, taking into account the applicable material restrictions and formalities, will be provided to the foreign tax authority.

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[111] Proposal of the Law & the Explanatory Memorandum *(Voorstel van wet, Kamerstukken II 2018/19, 35110, no. 2 and MvT, Kamerstukken II 2018/19, 35110, no. 3).*

[112] Art. 67 of the General Tax Act.

[113] Insofar as there is an overlap between these three sources, the Netherlands may apply the rules that are most far reaching (Art.11, EU directive, and Art. 27, WABB treaty).

[114] Article 10, WIB, specifically states that the taxpayer is obliged to give access to his/her office for the survey within the meaning of Article 8, WIB.

[115] As of January 1, 2002, it is also possible under the WIB to start a survey for the spontaneous exchange of information.

[116] Note that Dutch corporate bodies (*administratieplichtigen*) are also obliged to provide information to the Dutch Tax Authorities that could be relevant for the levying of Dutch taxes on third parties.

[117] See Article 11, WIB, which refers to Section IX of the GTA (i.e., the Criminal Provisions in the GTA). Hence, the taxpayer could be prosecuted.

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3. Exchange of Information

a. Introduction

There are five basic methods of assistance by exchanging information:

1. Exchange of information at the request of a foreign tax authority;

2. Spontaneous exchange of information by the Dutch Tax Authorities to a foreign tax authority;

3. Automatic exchange of information;

4. Presence of foreign officials during a tax audit; and

5.A joint coordinated tax audit.

The relevant treaty or EC Directive should be consulted to determine which of the above methods are permissible in a particular context.

b. Notification, Objection, and Appeal

As of January 1, 2014, due to amendments to Articles 5 and 7 of the WIB, the FIOD is not obliged to notify the Dutch resident of its decision to provide information to a foreign tax authority. Nor is it possible to file objections to the exchange of information. Prior to those amendments, the FIOD was, in principle, required to notify the Dutch resident of its decision to provide information to the foreign tax authority by way of a notification letter, and to provide the requested information proposed to be exchanged within 10 days of the date of the notification letter. Upon notification, the Dutch resident could file objections to that FIOD decision within six weeks of the date of the notification.

c. Reasons for Objection

The provision of information to a foreign tax authority can be denied by the Dutch Minister of Finance for one or more of the following reasons, which are based on the provisions of the WIB or the relevant income tax treaty:

(a) The provision of the information is not based on the obligations of the EU regulation 77/799/EEG or other obligations of international or interregional law;

(b) The exchange of information violates the public interest of the Netherlands;

(c) The information cannot be obtained in the Netherlands on legal grounds or on grounds of administrative practice;

(d) The other country's tax administration has not used the normally available means to obtain the information requested (first use of own resources rule);

(e) The other country's tax administration is not able to provide similar information to the Netherlands in the reverse case (reciprocity principle);

(f) The other country's legislation does not contain an obligation to keep the information confidential;

(g) The information to be provided by the Netherlands originates from a third country and that third country has not authorized the Dutch Tax Authorities to provide the information to the other country;

(h) The information contains a commercial, industrial, or professional secret; and

(i) The information to be exchanged will be used for other than tax purposes (except in certain circumstances).

Besides the restrictions set forth above, in theory the exchange of information should also be in accordance with the "general principles of proper conduct," such as the "(anti) abuse of power principle," the "principle of proportionality," and the principle of "weighing of interests."

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XI. Advance Pricing Agreements and Rulings

A. Certainty in Advance

1. General

In 2019, the State Secretary published a decree containing the latest policy aspects related to international rulings.[118] This decree entered into force on July 1, 2019, and combines and replaces various older decrees that each covered different topics. The 2019 decree contains guidelines on procedure, content, and transparency considerations, and it applies to rulings issued after July 1, 2019. Rulings issued prior to that date are not affected.

The Decree of June 19, 2019, implements the new ruling policy announced by the State Secretary in 2018 and is in line with the international trend of increased transparency and countering international (abusive) structures lacking substance and having motives of tax evasion or tax avoidance. For instance, the new ruling policy contains certain safeguards to ensure that rulings are not provided to groups or entities that try to evade or avoid taxes by using structures that involve entities in the Netherlands. These safeguards are as follows:

— A ruling will not be issued if the main or decisive motive of the taxpayer is to reduce Dutch or foreign taxes;

— A ruling will not be issued on the tax consequences of direct transactions with entities that are established in low-taxed or non-cooperative jurisdictions; and

— A ruling will not be issued if there is insufficient economic nexus with the Netherlands.

2. Economic Nexus

In order to have sufficient economic nexus in the Netherlands, the conditions below should be met by the entity requesting the ruling:

— The entity should be part of an internationally operating group engaged in an operating business in the Netherlands; and

— The entity should carry out an operating business activity by or for the risk and account of the entity through a sufficient number of relevant employees at the group level in the Netherlands. The operating business activity should fit with the company's function within the group.

The new ruling policy also increases transparency. After the conclusion of a ruling, an anonymized summary of the ruling is published on the website of the Dutch Tax Authorities. In addition, the tax authorities publish public annual reports related to rulings. These reports contain information on: (i) all rulings issued during the year; and (ii) requests that are not formalized in a ruling.

In addition, tax inspectors do not have the ability to conclude rulings independently. In order to safeguard the quality of the ruling practice, a so called two-signature policy is in place. Rulings must also be approved by the college of international tax certainty (College *Internationale Fiscale Zekerheid*, the College) before the international ruling can be concluded.

Administrative Pricing Agreements (APAs) are covered by the rulings, practice, and policy described here.

3. Procedure

A ruling request should be addressed to the tax inspector that would process the request.

The Decree of June 19, 2019, further describes the procedures relating to a pre-filing meeting. This provides the opportunity to discuss the ruling request with the tax inspector that would process the request, before the request is actually filed. It gives the taxpayer the advantage of clarification of what information is actually necessary (which reduces the administrative burden) and what elements are essential for the outcome of the formal request. During the pre-filing meeting, the tax inspector will not share any personal opinion about the case.

A ruling request must meet extensive documentation requirements. According to the Decree of June 19, 2019, the following information must be provided:

(a) A detailed description of the relevant facts and circumstances of the intended acts, transactions, products, business, or arrangements that will be covered by the ruling request, and a clear position, stance, vision, or conclusion on the consequences of the intended transactions;

(b) Information about the enterprises and permanent establishments involved in the underlying transactions or arrangements;

(c) The names of the other contracting state(s) to which the request relates;

(d) Information regarding the worldwide organizational structure and history of the applicant's group (including information on the beneficial owners of the applicant's capital);

(e) In the case of a request for an APA:

i. The master file of the consolidated group (if required);

ii. Information about the financial data, products, and functions of the applicant, including information on the assets (tangible and intangible) and risks of any of the associated enterprises involved and an analysis of the financial interest of the APA;

iii. An analysis of the suitability of the proposed transfer pricing methodology (and a description of the transfer pricing methodology), including a comparability analysis that includes comparable data from unrelated market parties and possible adjustments;

iv. The assumptions underpinning the request and a discussion of the effect of changes in those assumptions or other events, such as unexpected results, which might affect the continuing validity of the request; and

v. A general description of the contractual terms, strategy, and market conditions, such as industry trends and the competitive environment;

[118] Decree of June 19, 2019, no. 2019/13003, replacing the following Decrees: DGB 2014/3098, DGB 2014/3099 and DGB 2014/3101, and DGB 2014/3102 to the extent it covers topics also covered in the Decree of June 19, 2019, no. 2019/13003.

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(f) The financial years to be covered;

(g) A statement from the applicant or its representatives stating that none of the entities or their directors are listed on the EU-sanctions list; and

(h) A draft version of the template exchange rulings.[119]

To obtain a ruling, the taxpayer has the burden of proving that the proposed transfer pricing is correct. Outside the context of a ruling request, assuming the taxpayer has satisfied the regular documentation requirements, the burden of proof that the applied transfer pricing is incorrect is on the tax authorities.

4. Term

In the ruling request, the applicant must indicate the term for which it requests certainty in advance. In principle, a cross-border ruling will be valid for a maximum of five years. In case the facts and circumstances justify a deviation from this period, this is also possible (ergo, long-term contracts).

5. Bilateral or Multilateral APAs

Although a taxpayer may choose which type of an APA is requested, the Decree of June 19, 2019, indicates a preference for the conclusion of bilateral APAs (BAPAs) based on Article 25 of the OECD Model Treaty. Conclusion of a BAPA is only possible if the cross-border transaction is in relation to a country with which the Netherlands has concluded a tax treaty providing for the possibility of a mutual agreement. Moreover, the authorities of the other contracting state must be willing to conclude a BAPA. In practice, most Dutch APAs are unilateral APAs.

The conditions for a BAPA are similar to the conditions for application for a unilateral APA. If a request for a BAPA is initiated in another country, generally the competent authority of the other contracting state will inform the Dutch Competent Authority of the request in order to start the bilateral procedure.

In certain circumstances, a taxpayer may wish to seek advance certainty in more than two countries and request a multilateral APA. The Dutch Tax Authorities will, in principle, cooperate with such requests. Should one or more tates have, however, any objections to such a procedure, the request will be regarded as a request for the conclusion of various separate BAPAs. The applicant will be informed by the Dutch Tax Authorities on the division of the request into various separate requests for BAPAs.

B. Practical Experience

The Dutch tax authorities have an open mind with respect to the format and content of the comparability analysis and comparable data from unrelated parties and possible adjustments. In practice, however, a TNMM benchmark report based on a large database sample (very similar to a standard U.S. transfer pricing report) appears most acceptable to them.

It has become clear that the process to obtain an APA is more efficient if the APA request, and specifically the comparability analysis, includes the following information:

(a) A description of the transactions between the affiliated entities, which includes the specifics of the goods and services, the functions performed by the parties, the economic environment, the business strategy, and, if so desired, an analysis of the industry;

(b) The choice of a pricing system: This should be based on the above-described analysis. Depending on the method chosen, a profit level indicator (PLI) should also be included;

(c) A description of the search strategy (i.e., the criteria that third-party transactions had to meet);

(d) The years that were included in the search and why;

(e) The sources used. Sources should be publicly available. The Dutch Tax Authorities are familiar with Bureau van Dijk Electronic Publishing's Amadeus and Orbis databases and Thomson Reuters' Loanconnector database, but other sources may be used.

(f) The comparables used. The reference group is determined on the basis of a qualitative comparison of the uncontrolled transactions and the transactions identified in (a) above. Once the reference group is set, it must be determined whether corrections are needed to improve comparability;

(g) How the data have been corrected based on "financial adjustments"; and

(h) An analysis of the data and a determination of a reliable range. The assumption is that loss-making companies should be excluded. If they are included, one is required to explain why.

Producing the information described above is seen as a dynamic process and depending on the information in points (f) to (h), information set forth in points (b) to (e) may need to be reviewed and adjusted. No particular format is required for the presentation of the information; the only requirement is that the information be fully documented.

The Dutch Tax Authorities publish annual statistics on the number of APAs and Advance Tax Rulings (ATRs) issued. According to the 2020 APA/ATR year report, 240 ATR and 143 APA requests were received in 2020. During that same year, 234 ATR and 119 APA requests were settled. Of the settled requests, 156 ATRs and 72 APAs were granted. According to the statistics from the EU Joint Transfer Pricing Forum,[120] the total number of APAs granted in the EU during 2018 was 769, of which 144 APAs were granted by the Dutch tax authorities.

[119] Available at https://www.belastingdienst.nl/wps/wcm/connect/bldcontentnl/themaoverstijgend/programmas_en_formulieren/template-exchange-rulings.

[120] EU Joint Transfer Pricing Forum Statistics on APAs at the end of 2019.

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The Dutch Tax Authorities have a dedicated APA/ATR team located in Rotterdam. This team is specialized in dealing with APA and ATR requests and therefore are very familiar with the request procedures and process. Tax advisors with transfer pricing experience are able to explain to clients the questions to be expected during the process of obtaining a ruling. Also, a ruling request can be drafted in such a way that the APA is expedited. Experience shows that the APA process becomes more efficient if the taxpayer adopts the standard approaches described above. If a taxpayer wants confirmation of transfer pricing in an unusual or atypical transaction, one should expect more difficulties.

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XII. Other Rules Relating to Transfer Pricing

A. Coordination of Transfer Prices with Dutch Customs Values

For most goods to be imported into the Netherlands, the customs duty is calculated as a percentage of the customs value of the goods. The customs value of goods is based on Article VII of the General Agreement on Tariffs and Trade (GATT). The EU has implemented this Article in the European Community Customs Code (CCC).

Generally, the interests in relation to customs valuation conflict with the interests in relation to corporate income taxation because a taxpayer importing goods will prefer to have a lower customs value, resulting in lower customs duties, and a higher value for corporate income tax purposes, resulting in lower income on a sale. Because of the difference in interests, one must be careful when calculating the value for customs or corporate income tax purposes. The benefits that may be achieved for one can lead to detriments for the other.

B. Valuation Method for Dutch Customs Values

The main valuation method for the customs value is the transaction value. In Article 29 of the CCC, the transaction value is defined as follows: "the price actually paid or payable for the goods when sold for export to the customs territory of the European Community, adjusted, where necessary, in accordance with Articles 32 and 33." However, the transaction value can only be the basis for the determination of the customs value when certain conditions are met. One of these conditions is that the buyer and seller are not related, or, in case the buyer and seller are related, the transaction value is acceptable for customs purposes.

The fact that the buyer and the seller are related is not in itself sufficient to consider the transaction value as unacceptable. The transaction value must be "at arm's length." The Dutch customs authorities use OECD methods to determine whether the transaction value that is used in a sale between related parties is at arm's length.

The transaction value will be accepted as at arm's length if the relationship did not influence the price. In the case of a sale between related persons, the transaction value is accepted if it is demonstrated that the value is similar to:

(1) The transaction value in sales between buyers and sellers who are not related in any particular case of identical or similar goods for export to the European Community (the CUP Method); or

(2) The customs value of identical or similar goods as determined by using the method of Article 30, sub 2, c or d of the CCC (the Resale-Minus Method or Cost-Plus Method).

If the customs value is based on the transaction value, certain conditions apply with regard to the costs included or excluded in the customs value.

Where the customs value cannot be determined on the basis of the transaction value, it must be determined by proceeding sequentially through the methods described in Article 30, sub, a, b, c, and d of the CCC. These methods are the transaction value of identical goods, the transaction value of similar goods, the Resale-Minus Method, and the Cost-Plus Method. If the value cannot be determined by using one of these methods, the customs value can be determined on the basis of a reasonable means. One of these reasonable means is the TNMM, which is often used for the valuation of goods for corporate income tax purposes.

The customs value of goods must be determined by strictly following the rules described above. However, the value of goods for corporate income tax purposes is not determined on the basis of methods that must be followed strictly. Therefore, the TNMM is often used for corporate income tax purposes, whereas this method can only be used for customs purposes when no other method can be applied.

The Dutch customs authorities installed the Appraisement Team Value and Tariffs (Expertise team, *Waarde en Techniek*). This team deals with transfer pricing issues relating to the import of goods (among other issues) and performs audits on customs values based on transfer prices. A concerned taxpayer may request a ruling from the Appraisement Team Value and Tariffs, whereby the taxpayer and the customs authorities can agree upon the methods to be used for determining the customs value of goods to be imported.

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DETAILED ANALYSIS

CHAPTER 120: TRANSFER PRICING RULES AND PRACTICE IN NEW ZEALAND

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I. Overview of New Zealand's Tax System

A. Introduction

New Zealand is a small, democratic country and has an open economy, operating under free market conditions, with few barriers to entry for foreign investment. Government approval for foreign investment[1] is required only in relation to certain sensitive assets (e.g., sensitive land, fishing quotas, and significant business assets), and there are no restrictions on the movement of funds in or out of New Zealand.[2] Foreign businesses are generally subject to the same regulations as New Zealand businesses.[3]

New Zealand has free trade agreements with a number of countries, notably the Closer Economic Relations trade agreement with Australia and also a series of bilateral and multilateral agreements with countries, including the Association of Southeast Asian Nations (ASEAN states), Trans-Pacific states, the United Kingdom, China, Chile, Korea, Malaysia, Singapore, Thailand, and the European Union. In addition, new agreements are being negotiated with countries, including the United Arab Emirates (UAE), the Gulf Cooperation Council states, and India.[4] New Zealand has low levels of tariffs, with most New Zealand imports being tariff free.[5]

New Zealand operates a broad-based, low-rate tax system. The main sources of tax revenue for the government are income tax and a value-added consumption tax, the Goods and Services Tax (GST). There is no capital gains tax, although certain capital gains will be deemed to be income under the income tax rules. New Zealand has a comprehensive international tax regime and, in particular, adopted Organisation for Economic Co-operation and Development (OECD)-based transfer pricing rules starting from the Income Tax Act 1994 (ITA 1994) that has since been repealed and replaced by the Income Tax Act 2007 (ITA 2007).

B. Overview of New Zealand's Tax System

The New Zealand tax system comprises, primarily, an income tax, which applies to New Zealand tax residents and New Zealand-source income, and a Goods and Services Tax (GST), which applies to all taxable supplies of goods and services provided in New Zealand (plus some imported services). The income tax system includes comprehensive international tax and anti-avoidance regimes, including both specific anti-avoidance rules (such as the transfer pricing regimes) and a robust general anti-avoidance regime.

Income tax rates include a flat rate for companies (28%) and trusts (39%)[6] and a graduated scale for individuals (from 10.5% to a top rate of 39% applying to income over NZ$180,000).[7] Generally, for individuals, the same tax rate scales apply for investment income, salaries and wages, rental income, overseas income, and business income, with some minor exceptions. The GST rate is a flat 15% of the taxable value of supplies of goods and services provided in New Zealand (and some imported services).[8]

The statutory authority for levying income tax is the Income Tax Act 2007 (which came into force April 1, 2008)[9] and for levying GST is the Goods and Services Tax Act 1985 (which came into force December 3, 1985).[10] In addition, the Tax Administration Act 1994 governs how the Inland Revenue Department (IRD) administers the tax acts,[11] and the Taxation Review Authorities Act 1994 governs the operation of the Taxation Review Authority (TRA),[12] which handles tax assessment objections and related matters. Amendments to the legislation are made continually and consolidated into the Act periodically. Accordingly, the most recent version of the Act must be read alongside any recent amending acts not yet consolidated.[13]

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[1] For an overview of the overseas investment consent process, *see* Overseas Investment, https://www.linz.govt.nz/overseas-investment.

[2] Subject to certain disclosures required under applicable anti-money-laundering legislation.

[3] For a more detailed overview of the New Zealand economy, *see* The New Zealand Economy, https://www.treasury.govt.nz/information-and-services/new-zealand-economy.

[4] For a list of New Zealand's trade agreements, including those under negotiation, *see* New Zealand Ministry of Foreign Affairs & Trade, Free Trade Agreements, https://www.mfat.govt.nz/en/trade/free-trade-agreements.

[5] *Id.* Note, however, that, although Customs duty is low or zero for most imports, goods entering New Zealand are subject to Goods and Services Tax (GST) on import.

[6] This rate may be lowered to 33% for certain specified trusts e.g., deceased estate trusts and for all trusts with income after deductions of less than $10,000.

[7] Rates current for the taxable year ended March 31, 2025; *see* https://www.ird.govt.nz/income-tax/income-tax-for-individuals/tax-codes-and-tax-rates-for-individuals/tax-rates-for-individuals.

[8] Rates current for the taxable year ended March 31, 2025; *see* https://www.ird.govt.nz/gst/what-gst-is.

[9] Income Tax Act 2007, 2007 S.N.Z. No. 97 (ITA 2007).

[10] Goods and Services Tax Act 1985, 1985 S.N.Z. No. 141 (GST Act 1985).

[11] Tax Administration Act 1994, 1994 S.N.Z. No. 166.

[12] Taxation Review Authorities Act 1994, 1994 S.N.Z. No. 165 (TRA Act 1994).

[13] *See* http://www.legislation.govt.nz/act/public/2007/0097/latest/versions.aspx.

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New Zealand does not have a capital gains tax, although transactions related to the sale of property may be treated as income in selected cases.[14] In the past, New Zealand had a number of other taxes and levies in place, most of which have now been abolished. In particular, there are no estate duties, gift duties, or stamp duties.[15]

C. Overview of New Zealand's Income Tax System

1. Income Over Which New Zealand Asserts Taxing Jurisdiction

The New Zealand income tax system imposes income tax on a person's taxable income. To compute taxable income each year,[16] a taxpayer calculates income (for a resident person, income from all sources worldwide; for a nonresident person, income from New Zealand sources only) and deducts any exempt or excluded income and allowable deductions to arrive at net income. Then, any allowable net losses are offset, which results in taxable income. The applicable tax rate is applied to the taxable income to calculate the gross tax payable. The net tax payable or refundable is calculated as the gross tax payable less available tax credits. Tax credits include tax already paid (e.g., withholding taxes and provisional taxes), foreign tax credits, and credits for certain types of taxpayers (e.g., family tax credits).

New Zealand operates an imputation tax system for New Zealand resident companies. This allows companies to pass tax paid on company income to New Zealand resident shareholders through the payment of imputed dividends (subject to meeting shareholder continuity tests).

Income tax is levied on individuals and all legal entities, including companies and trusts, based on either their residency or the source of their income. In addition, partnerships are required to file annual returns disclosing partnership income, but tax is paid by each partner.

a. Income Derived by New Zealand Resident Entities

New Zealand residents are subject to tax on their worldwide income. The concept of residency, therefore, is important. In the case of individuals,[17] a person is a resident of New Zealand (subject to the applicable tax treaty) if the person:

- Has a "permanent place of abode" in New Zealand, whether or not that person also has a permanent place of abode outside New Zealand. The determination of a New Zealand permanent place of abode depends on whether that individual has an enduring relationship with New Zealand. Factors that may be taken into consideration include the individual's habitual accommodation; employment history; whether the individual's family is in New Zealand; and individual, financial, economic, and social ties; or
- Is personally present in New Zealand for more than 183 days (including part-days), in total, in any 12-month period. The individual will be deemed a New Zealand tax resident from the first day of presence in New Zealand once the stay exceeds 183 days.

If an individual is a New Zealand tax resident, in order to lose residency he or she must be absent from New Zealand for an aggregate period of 325 days in any 12-month period and must not have a permanent place of abode in New Zealand. Provided there is no New Zealand permanent place of abode, the individual will be deemed a nonresident from the first day of absence once the absence exceeds 325 days.

In the case of companies,[18] a company is a resident of New Zealand (subject to the applicable tax treaty) if:

- The company is incorporated in New Zealand;
- The company has its head office in New Zealand;
- The company has its center of management in New Zealand; or
- Control of the company by its directors, acting in their capacity as directors, is exercised in New Zealand, whether or not decision making by directors is confined to New Zealand.

Under the definition of residency for companies, a New Zealand incorporated subsidiary of an overseas corporation is a resident of New Zealand. On the other hand, a New Zealand branch of an overseas corporation is not a resident if the head office, center of management, and control criteria noted above are not met.

New Zealand's international tax rules aim to comprehensively tax New Zealand residents on their worldwide income as it accrues, whether earned directly or indirectly through foreign entities. Two key regimes, the controlled foreign companies (CFC) and the foreign investment fund (FIF) regimes, provide for the taxation of income on an accrual basis in relation to certain foreign investments held by New Zealand residents.[19]

b. Income Derived by Nonresident Entities

A nonresident person is subject to New Zealand income tax to the extent that income is sourced in New Zealand.[20] This includes, for example, income derived from businesses partly or wholly performed in New Zealand, and contracts made or performed in New Zealand. In many cases, this liability to New Zealand income tax is reduced or eliminated by the application of a relevant tax treaty.

If a foreign corporation conducts business in New Zealand through branch operations (i.e., through a permanent establishment), that branch is subject to New Zealand's transfer pricing and branch profit allocation rules, depending on whether the transaction is with another related entity or between the head office and New Zealand branch. The calculation of branch profits for a permanent establishment must result in an amount that

[14] The introduction of a capital gains tax has been suggested by various New Zealand commentators in recent years. and is included in the tax policy of some of New Zealand's minor political parties. To date, neither of the two main parties has adopted a capital gains tax as tax policy.

[15] *See* Estate Duty Abolition Act 1993, 1993 S.N.Z. No. 13 (repealing estate duty), Taxation (Tax Administration and Remedial Matters) Act 2011, 2011 S.N.Z. No. 63 (repealing gift duty), and Stamp Duty Abolition Act 1999, 1999 S.N.Z. No. 61 (repealing all remaining forms of stamp duty).

[16] The standard income tax year ends March 31; nonstandard year ends may be used by taxpayers on application to the Inland Revenue Department (IRD).

[17] Income Tax Act 2007, §YD 1 (ITA 2007).

[18] ITA 2007, §YD 2.

[19] ITA 2007, subpart EX.

[20] ITA 2007, §YD 4.

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is consistent with what would be incurred if the branch were a "distinct and separate enterprise" engaged in the same business,[21] subject to the application of any relevant tax treaty. In this respect, New Zealand has an explicit reservation against the approach of the 2010[22] OECD Model Tax Convention on Income and on Capital (OECD Model Treaty) to the attribution of profits (contained in Article 7), with notional mark-ups allowable only for certain internal transfers.[23]

2. Assessment of Income Tax

New Zealand's tax system requires taxpayers to self-assess their tax obligations and relies on voluntary compliance. In this regard, taxpayers are required to be honest and diligent in meeting their tax obligations. A comprehensive system of rules and penalties exists to enforce compliance. The following subsections set out the key elements of this self-assessment system.

a. Tax Payments and Provisional Tax

Many types of New Zealand-source income are subject to withholding taxes deducted at the source; notably PAYE (pay-as-you-earn) applies to salaries and wages, and resident and nonresident withholding taxes apply to dividends, royalties, and interest payments. For most businesses and other taxpayers who derive income not subject to withholding tax, provisional income tax payments[24] are payable during the income tax year in advance of the annual income tax assessment. Provisional tax payments can be based either on estimated tax liabilities or on prior year tax liabilities or using the Accounting Income Method[25] or using the GST ratio method.[26] Depending on the method selected, provisional tax payments are made in three to 12 installments, with most provisional taxpayers making three installments during the income tax year.

Any balance of tax due when a final assessment of income tax is made is payable as "terminal tax" to the IRD within 11 and 13 months of the balance date of the taxpayer, depending on whether the taxpayer has obtained an extension of time through a tax agent for filing the tax return.[27]

b. Use of Money Interest

New Zealand applies a use-of-money interest (UOMI) system to certain unpaid taxes. The purpose of the UOMI provisions is to charge or pay interest as a means of compensating the Commissioner of Inland Revenue (the Commissioner) when tax is underpaid, or compensating the taxpayer when tax is overpaid. UOMI is not a penalty; rather it is designed to encourage taxpayers to accurately estimate their tax liabilities and to pay the correct amount of tax by the due date. UOMI also applies to a variety of other taxes and duties, most notably GST and Fringe Benefit Tax.

c. Tax Pooling

As the amount of provisional tax paid by a taxpayer during a year may only reflect the taxpayer's best estimate and may well prove to be incorrect, an underpayment of provisional tax may lead to the imposition of UOMI. Given that the interest rates charged by the IRD are relatively high while rates paid to the taxpayers are low,[28] taxpayers are allowed to pool provisional tax payments using an intermediary. The intermediary manages the payments of the taxpayers within the same tax pool, offsetting underpayments with overpayments, thereby reducing the UOMI exposure.[29] A tax pool can include both associated and non-associated taxpayers.

The pooling arrangements are made through a commercial intermediary that arranges for participating taxpayers to be charged or compensated for the offset using market rates of interest rather than the IRD's rates. These intermediaries are able to pay a higher rate of interest than the IRD to taxpayers who have overpaid into the pool and charge a lower rate than the IRD to those who have underestimated their taxes.

d. Penalties

As part of New Zealand's voluntary compliance system, a range of civil and criminal penalties may apply to taxpayers.[30] The main civil penalties relate to shortfalls in the payment of tax; these penalties apply when the shortfall is caused by:

- Failure to withhold tax from nonresident contractor payments in certain circumstances;
- Lack of reasonable care;
- An unacceptable tax position;
- Gross carelessness;
- An abusive tax position; or
- Evasion or a similar act.

[21] ITA 2007, §YD 5B.

[22] The reservation applies to the 2010 and later versions of the OECD Model Treaty.

[23] This is discussed in more detail in III.A.3. *See* Inland Revenue, Transfer Pricing, Branches, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/branches.

[24] ITA 2007, subpart RC.

[25] The Accounting Income Method (AIM) uses a taxpayer's current year accounting results to calculate the amount of provisional tax due. This method is only available for certain taxpayers (e.g., annual gross income less than $5,000,000) provided the taxpayer has an AIM-capable accounting system (ITA 2007, §RC 7B).

[26] The GST ratio method is only available to certain GST-registered taxpayers. Provisional tax installments are calculated based on the ratio of prior year residual income tax divided by prior year total GST taxable supplies multiplied by the GST supplies of the period matching the installment period (ITA 2007, §§RC 8 and RC 11).

[27] A tax agent is a person registered with the IRD as the tax return filing agent for ten or more taxpayers. Taxpayers who use a tax agent have an automatic extension of time to file their tax returns. *See* Tax Administration Act 1994, §34B.

[28] From August 29, 2023, the IRD's paying rate is 4.67%, and its charging rate is 10.91%. *See* Interest on Overpayments and Underpayments (UOMI), https://www.ird.govt.nz/managing-my-tax/penalties-and-interest/interest-on-overpayments-and-underpayments and for details of the latest IRD announcements on UOMI see Updates to rates for UOMI and FBT on low-interest loans, https://www.taxpolicy.ird.govt.nz/news/2023/2023-08-03-sr-uomi-fbt-updated-rates.

[29] ITA 2007, §RP 17–§RP 21.

[30] Tax Administration Act 1994, part 9.

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Shortfall penalties range from 20% to 150%[31] of the tax shortfall and can be reduced through prior good behavior and voluntary disclosure, or increased when there is obstruction of the work of the IRD. There are also criminal penalties (fines and/or imprisonment) for absolute liability, knowledge, evasion, the use of electronic sales suppression tools, or obstruction offenses. Absolute liability[32] offenses generally do not require the Commissioner to demonstrate that the taxpayer had knowledge of the failure to keep or provide information. The categories of absolute liability are failure to keep documents required by tax law, failure to comply with New Zealand's foreign account information sharing agreements, failure to provide information as required under the tax acts to the IRD, failure to issue GST tax invoices or apply for GST registration as required under the GST Act 1985, claiming more than one GST input tax credit for the same taxable supply. Knowledge offenses[33] require the taxpayer to have "knowingly" failed to comply with the tax legislation and, accordingly, the penalties imposed are higher and can include imprisonment in addition to fines. Categories of offenses are similar to the absolute liability offenses but also include providing false information, failing to deduct tax withholding amounts or failing to pay them to the Commissioner, issuing multiple GST tax invoices for the same supply and, in relation to the supply of remote services under the GST Act, providing false information about New Zealand residency or GST registration status, and in relation to distantly taxable goods (goods supplied by certain nonresidents outside New Zealand) under the GST Act, providing false information or failing to provide required documents and information. Use of electronic sales suppression tools offenses[34] includes knowingly manufacturing, supplying, acquisition, or possession of tools that help businesses evade taxes. These types of tools aid in tax evasion by manipulating sales data in electronic point-of-sales systems (e.g. EFTPOS) or by hiding records of income a business has received from customers. Evasion offenses[35] include pretending to be another person for any purpose relating to the tax law. They also extend the knowledge offenses by requiring the offense to have been committed to evade tax or obtain a refund that the person is not legally entitled to, either for themselves or another taxpayer.

In addition, there are penalties for late filing and late payments of income tax, provisional tax, and interest payments.[36] A penalty of up to NZ$500 is payable for the late filing of a tax return. Late payments of tax are subject to an initial penalty of 1% of the tax shortfall. For amounts overdue after the first week, an additional 4% penalty is levied. Thereafter, penalties continue to accrue for each month at the rate of 1% of the tax outstanding. In addition, UOMI applies to all late payments from the original due date.

The penalties regime is described in more detail in VIII., below.

e. General Anti-Avoidance Regime

The New Zealand tax legislation contains a general anti-avoidance provision that operates to make "tax avoidance arrangements" void.[37] "Tax avoidance arrangements" are any arrangements entered into directly or indirectly when the purpose or effect, or one of the purposes or effects, is tax avoidance, and that purpose or effect is not "merely incidental." This provision has been the subject of frequent litigation.[38]

The current approach of the New Zealand courts requires a two-step process. The first step examines whether an arrangement complies with the specific provisions of the tax act applying to the transaction(s). The second step considers whether parliament would have contemplated and intended the specific provision to be used in the way the taxpayer has used it (the contemplation test). If an arrangement does not reflect commercial practice and/or when terms or conditions of the arrangement are artificial, the courts are more likely to consider that the arrangement involves tax avoidance.

The general anti-avoidance provision can apply to any transaction entered into by a taxpayer. In addition, there are a large number of specific anti-avoidance provisions related to particular types of transactions, such as the transfer pricing regime. Both the general and specific anti-avoidance provisions are required to be considered by taxpayers when filing their tax returns.

[31] With the exception of the shortfall penalty related to nonresident contractor payments, which is $250 per month. *See* Tax Administration Act 1994, §141AA.

[32] Tax Administration Act 1994, §143.

[33] Tax Administration Act 1994, §143A.

[34] Tax Administration Act 1994, §141EE.

[35] Tax Administration Act 1984, §143B.

[36] During the COVID-19 pandemic special arrangements were implemented that reduced these penalties and interest in some cases.

[37] ITA 2007, §BG 1.

[38] *See* Julie A. Harrison & Mark Keating, New Zealand's general anti-avoidance provisions: A domestic transfer pricing regime by proxy?, 17 N.Z. J. Tax'n Law & Pol'y, 419–442 (2011).

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II. Evolution of New Zealand's Transfer Pricing Rules

The current transfer pricing regime was introduced in 1995, with effect from the 1996/97 income tax year, as part of a package of international tax reforms contained in the since-replaced Income Tax Act 1994 (ITA 1994). The legislation is closely based on the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) and the OECD Model Treaty and applies the arm's length standard to transfer pricing transactions. In most cases, the regime applies only to international transfer pricing arrangements between "associated persons," and there is no direct equivalent applying to domestic arrangements.

Before the introduction of the current regime, the former version of ITA 1994, §GC 1, applied to transfer pricing arrangements when the profits returned by the taxpayer were less than what "might be expected to arise." This provision was regarded as largely ineffective, as the legislation did not provide any mechanism for the IRD to determine an appropriate level of profit. As a consequence, it was seldom applied. In the more than 60 years that the section (or its equivalent in earlier tax acts) was in existence, only one case was brought before the courts that dealt specifically with its operation.[39] However, the case is of limited assistance, as the arguments focused on administrative rather than substantive issues.

Since the introduction of the 1995 regime, the operative provisions of the transfer pricing rules have remained largely unchanged, with the major change relating to the division and renumbering of sections under the rewrite of the ITA 1994 in 2007. However, in 2018, the rules underwent the first major revision to incorporate changes made in response to the OECD's Base Erosion and Profit Shifting (BEPS) project.[40]

The main part of the regime, contained in §GC 6–§GC 19 of ITA 2007, applies to cross-border arrangements between separate legal entities. Under §GB 2, the scope of §GC 7–§GC 10 can be expanded beyond associated parties to certain collateral arrangements between non-associated parties. The rules related to single legal entities, specifically the apportionment of income between head offices and their branches, are contained in §§YD 5 and 5B. In addition, a new permanent establishment anti-avoidance rule is contained in §GB 54[41] which operates to deem a permanent establishment to exist when certain criteria are met. This new provision is described in more detail in III.A.3.b.

[39] *See* IX.C.

[40] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

[41] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

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III. Transfer Pricing Rules

A. *Legal Authority*

1. Arm's Length Principle

The New Zealand transfer pricing regime is based closely on the OECD transfer pricing model and the arm's length principle. The arm's length principle requires that cross-border associated-party transactions entered into by members of multinational enterprises be priced at a level that is comparable to the pricing charged by independent parties dealing in an open market.

The arm's length principle applies to cross-border transactions between separate legal entities (i.e., associated-party transactions) and also to dealings between separate parts of a single legal entity (i.e., head office-branch dealings).

New Zealand's transfer pricing rules relating to transactions between separate legal entities are principally contained in ITA 2007, §GC 6–§GC 14. These sections apply to cross-border transactions between associated persons, including companies, individuals, trusts, and partnerships. Section GC 7–§GC 10 are subject to a specific anti-avoidance rule contained in §GB 2. The purpose of §GB 2 is to extend the application of the transfer pricing rules to transactions between non-associated persons, when a collateral arrangement has been entered into that has the purpose or effect of avoiding the application of §GC 7–§GC 10.

In addition, with effect from July 1, 2018,[42] new sections were introduced related to controlled inbound financing. Sections GC 15–§GC 19 provide a process for determining the applicable interest rate for affected transfer pricing arrangements.

New Zealand's transfer pricing rules applying to single legal entities dealing cross border (e.g., between a foreign head office and its New Zealand branch) are contained in §YD 5–§YD 5B.

Sections GC 6–§GC 14, §GB 2, and §YD 5–§YD 5B apply to both residents and nonresidents of New Zealand, to the extent that they are liable to New Zealand income tax.

The IRD issued Transfer Pricing Guidelines (IRD Guidelines)[43] in October 2000. The IRD Guidelines provided an overview of the New Zealand transfer pricing regime and were closely based on the OECD Guidelines. The IRD Guidelines have not been substantively updated since 2000. In 2010, the IRD announced that it was now applying the latest 2010 OECD Guidelines and that it did not plan to further update the IRD guidelines. With effect from July 1, 2018, §GC 6–§GC 14 were amended[44] to make specific reference to the OECD Guidelines (2017) in relation to delineating the tested transaction and determining the arm's length amount of consideration. In 2023, this was updated to the OECD Guidelines (2022), effective from January 20, 2022.

Current practice issues are outlined on the IRD's website.[45] Accordingly, in determining the IRD's likely approach to a taxpayer's position in relation to transfer pricing matters, reference should be made to the OECD Guidelines and the IRD's website. However, it should be noted that the practice issues on the IRD's website are administrative interpretations only and do not have the force of law. Similarly, prior to July 1, 2018, the OECD Guidelines did not have the force of law. For further discussion on the status of the OECD and IRD Guidelines, refer to III.A.4.

2. Transfer Pricing Rules for Separate Legal Entities

a. Interaction of the Transfer Pricing Rules with the Dividend Rules

The transfer pricing rules work in conjunction with the non-cash dividend rules contained in ITA 2007, subpart CD. When excess consideration has been paid or inadequate consideration received by a taxpayer in a transfer pricing arrangement, this amount will be a deemed dividend when the arrangement is with the New Zealand taxpayer's parent or a person associated with the parent. The IRD has stated that it considers the market value referred to in subpart CD to be equivalent to the arm's-length amount under the transfer pricing rules.[46]

Deemed dividends arising for foreign parent companies are subject to nonresident withholding tax (NRWT). However, §OB 60(2) and §OB 62 allow a company to apply imputation credits retrospectively. Accordingly, the NRWT liability associated with the deemed dividend may be reduced or eliminated by the retrospective application of imputation credits and the application of applicable tax treaties.[47]

b. Interaction of the Transfer Pricing Rules and the Controlled Foreign Companies Regime

A controlled foreign company (CFC) is defined in §EX 1 and includes foreign companies in which five or fewer New Zealand shareholders have a more-than-50% "control interest," or in which a single New Zealand shareholder has a 40%-or-more "control interest."[48] Control interests include shareholding, decision-making rights, and rights to receive income or other distributions. If a foreign company meets this definition, then New Zealand shareholders owning 10% or more[49] of the CFC have to report their portion of "net attributable CFC income or loss," essentially all passive income, on an accrual basis,[50] subject to a number of exemptions for CFCs engaged in active business and certain Australian CFCs. In calculating at-

[42] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

[43] Inland Revenue Department (2000), "Transfer Pricing Guidelines," Tax Information Bulletin Vol. 12, No. 10 — Appendix, ¶90 (IRD Guidelines), https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/tib/volume-12---2000/tib-vol12-no10-appendix.pdf?la=en.

[44] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

[45] *See* Transfer Pricing, Practice Issues, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues.

[46] Inland Revenue Department (1996), Tax Information Bulletin, Vol. 7, No. 1, p. 9.

[47] *See* the Commissioner's Statement: Withholding obligations arising in relation to transfer pricing arrangements (30 August 2024), https://www.taxtechnical.ird.govt.nz/commissioner-s-statements/2024/cs-24-02

[48] Subject to certain exemptions when there exists a larger non-associated foreign shareholder.

[49] This percentage is calculated including both direct and indirect control, including control by associated persons.

[50] If ownership interests are below this threshold, the New Zealand investor may be subject to the foreign investment fund (FIF) regime, which requires income to be calculated using one of five prescribed methods designed to reflect changes in value of the investment.

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tributable CFC income, a New Zealand shareholder is generally required to apply New Zealand income tax rules as if the CFC were a New Zealand tax resident.

A CFC, as a nonresident company, is not subject to §GC 6–§GC 14 unless it has a fixed establishment[51] in New Zealand. Therefore, the application of the transfer pricing rules to CFCs is similar to the way in which they apply to other nonresident–associated companies (i.e., when a cross-border transaction is entered into between a New Zealand taxpayer and an associated CFC, the rules apply). The IRD has indicated that it is likely to place more focus on CFCs where there are abnormal profit levels, significant fluctuations in profits, intangible transactions, and significant financing arrangements.[52]

However, §GC 6–§GC 14 do not apply to the New Zealand calculation of CFC attributable income. Section EX 21(15) modifies the application of the transfer pricing rules for the purposes of determining the net attributable CFC income or loss and provides that they will only apply to the calculation of CFC attributable income when a transaction entered into between the CFC and an associated person has a purpose or effect of defeating the jurisdictional ring-fencing rules for CFC losses and tax credits.

c. *Interaction of the Transfer Pricing Rules with Other Parts of the Income Tax Act*

The application of §GC 6–§GC 14 affects the calculation of the income tax liability of the taxpayer that is party to a transfer pricing arrangement (i.e., the substituted arm's-length amount is used in determining the income tax liability of the taxpayer). If a substitution is made, the taxpayer should consider whether the substituted amount affects the income tax calculation for other provisions of ITA 2007 that use the consideration payable or receivable in the transfer pricing transaction to calculate the income tax liability of the taxpayer. Relevant provisions include the trading stock regime, the accruals regime, and the depreciation regime.

d. *Section GB 2 — Transfer Pricing Anti-Avoidance Rule*

Section GB 2 expands the application of the transfer pricing rules to arrangements entered into with the purpose or effect of avoiding the application of §GC 7–§GC 10. This section applies to cross-border arrangements that are non-arm's-length in nature, but do not fall within the definitions contained in §GC 6. That is, certain transactions between non-associated parties may be treated as if they were between associated parties by the application of §GB 2.

Section GB 2 contains examples of circumstances that can result in an arrangement having an avoidance purpose or effect, including collateral arrangements with nonresident associated persons or any other arrangements such as market-sharing arrangements, arrangements not to enter markets, back-to-back supply agreements, and income-sharing arrangements.[53]

3. *The Arm's Length Principle Applied to Single Legal Entities*

a. *Apportionment of Income and Expenditure*

Section YD 5 deals with the apportionment of income and expenditure between single legal entities conducting cross-border business activities. The section applies to the following:

- Businesses carried on partly in New Zealand and partly outside New Zealand;
- Contracts made in New Zealand and wholly or partly performed outside New Zealand;
- Contracts made outside New Zealand and wholly or partly performed in New Zealand; and
- Certain debt arrangements made outside New Zealand to a New Zealand resident's overseas fixed establishment that are on loan to another New Zealand resident.

If an arrangement is between New Zealand and a treaty partner country, reference should be made to the applicable treaty.

(1) *Apportionment for a Business or Contract*

Under §YD 5, the taxpayer is required to apportion income and expenditure between New Zealand and overseas by applying the arm's length principle. Specifically, §YD 5(3) requires the apportionment to result in a net income or loss that is the same as would have arisen had the activities in New Zealand been conducted by a "separate and independent person" dealing at arm's length.

The term "arm's length" is not defined for the purposes of §YD 5. In particular, no transfer pricing methods are referred to in this section, and there is no linkage made to the rules for separate legal entities under §GC 6–§GC 14. Further, there has been no litigation on this issue. Therefore, it is uncertain whether the transfer pricing methods prescribed by §GC 13 are applicable.

The IRD has advised that guidance on how to apply this section is contained in the annex to the Commentary to Article 7 of the OECD Model Tax Convention (2017), which contains the earlier version of this Article.[54] New Zealand's current position is that the Authorized OECD Approach to the attribution of profits contained in the 2010 OECD Model Treaty is not applicable under New Zealand's existing tax treaties, nor should it be used if applying domestic law in the absence of a tax treaty.[55] In particular, New Zealand made the following reservation to the new Article 7:

[51] "Fixed establishment" is defined in the ITA 2007, §YA1, to include a "fixed place of business in which substantial business is carried on." It is similar to the term "permanent establishment" found in New Zealand's tax treaties.

[52] *See* Inland Revenue, Transfer Pricing, Controlled Foreign Companies, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/controlled-foreign-companies.

[53] In the IRD Guidelines published in 2000, the IRD's view was that the effect of §GB 2 was to extend the application of §GC 6–§GC 14 to "related parties," rather than the statutorily defined "associated parties." "Related parties" is not a defined term under the transfer pricing legislation, and the IRD Guidelines are no longer referred to by the IRD. However, it is likely that if taxpayers entered into income-sharing arrangement in relation to their arrangements in New Zealand, then the IRD would seek to treat them as related parties subject to the transfer pricing rules by operation of §GB 2.

[54] *See* Inland Revenue Department (1996), Tax Information Bulletin, Vol. 7(11), p. 11, and Inland Revenue, Transfer Pricing, Branches, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/branches.

[55] *See* Inland Revenue, Transfer Pricing, Branches, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/branches.

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> New Zealand reserves the right to use the previous version of Article 7 taking into account its observation and reservations on that version (i.e., the version included in the Model Tax Convention immediately before the 2010 update of the Model Tax Convention) because it does not agree with the approach reflected in Part I of the 2010 Report Attribution of Profits to Permanent Establishments. It does not, therefore, endorse the changes to the Commentary on the Article made through that update.[56]

The IRD's objection to the Authorized OECD Approach relates to the fact that a branch and its parent are the same legal entity and cannot therefore transact with one another in the same way as separate legal entities. The result of this view is that the IRD considers only actual income earned and expenditure incurred can be apportioned. Further, the IRD's view is that notional profits can only be included in relation to items held on revenue account (e.g., trading stock). The IRD considers this treatment only applicable to arrangements covered by a tax treaty. In the absence of a tax treaty, only actual income and expenditure can be included in the calculation of branch profits under §YD 5. Accordingly, under the IRD's approach, different treatments are required as follows:[57]

For branch allocations, internal transfers of goods and services that are normally traded with third parties may be transferred at cost plus a notional mark-up measured using an "arm's-length standard." All other expenditures must be allocated at cost (i.e., with no mark-up). In particular, notional interest charges on internal transfers of capital are not deductible (unless the taxpayer is a financial enterprise whose funds are equivalent to trading stock), no internal guarantee fees are allowed, and no notional royalties can be charged unless these represent an allocation of an actual royalty cost incurred with a third party.

This divergence from the Authorized OECD Approach means there is a risk that allocations made under the New Zealand approach will result in double taxation when the other country uses the OECD approach.

(2) Apportionment for a Debt Arrangement

If a debt arrangement has a New Zealand source under §YD 5(1)(d), interest and/or a redemption payment must be attributed to New Zealand by applying the rules in §YD 5(4)–§YD 5(9) using the following formula:

> *Loan ratio x amount,*
>
> where the amount is the total of the interest and redemption payment on the debt arrangement. The loan ratio is calculated as:
>
> *Financial arrangements producing New Zealand income ÷ total assets.*

If the loan ratio is less than 0.05, then none of the income needs to be attributed to New Zealand; if the loan ratio is more than 0.95 then, all of the income must be attributed to New Zealand.

b. Permanent Establishment Anti-Avoidance Rules

With effect from July 1, 2018, a new permanent establishment anti-avoidance rule was introduced.[58] Section YD 4B and §GB 54 apply to prevent large multinational enterprises from entering artificial sales arrangements designed to avoid having a permanent establishment in New Zealand.[59]

Arrangements subject to this new rule are detailed in §GB 54. This section applies to nonresidents that are part of a large group with annual consolidated group revenue of over EUR750 million. If the nonresident supplies goods or services to a person in New Zealand using an associated "facilitator," then they may be deemed to have a permanent establishment in New Zealand. For this to apply, the facilitator must earn 80% or more of their income from services to the nonresident supplier (or associates of the supplier), the facilitator must be providing sales activities related to the supply, and those activities must be more than preparatory or auxiliary to the nonresident's supply. There is also a requirement for there to be a more than incidental purpose or effect of tax avoidance and that the nonresident supplier is not subject to a double tax agreement that contains the OECD's latest permanent establishment article.

If a multinational is subject to this rule, then it is deemed to have a permanent establishment in New Zealand, and profits are attributable to that branch under §YD 5B(2). This section follows the normal profit attribution rules and requires the amounts of income and expenditure attributed to the permanent establishment to be those expected if the permanent establishment were a separate entity dealing with an independent person. In this respect, the attribution should follow the same rules discussed in section a.(1), above.

4. Status of the IRD and OECD Guidelines — Pillars One and Two

The IRD issued its own transfer pricing guidelines in October 2000.[60] These provided a general overview and guide to the implementation of the New Zealand transfer pricing regime as first introduced in 1996. The guidelines were closely based on the OECD Guidelines, and the IRD considers the application of the New Zealand transfer pricing rules, before the recent amendments, to be substantively consistent with the OECD Guidelines. With effect from July 1, 2018, the transfer pricing legislation was amended to refer to the OECD Guidelines.[61] These legislative amendments make specific reference to the OECD Guidelines (July 2017) in relation to delineating the tested transaction and determining the arm's length amount of consideration — that is, the OECD Guidelines now have the force of law.

Accordingly, in determining a taxpayer's position in relation to transfer pricing matters for periods on or after July 1, 2018 to January 20, 2022, reference should be made to the 2017

[56] OECD (2017), "Commentary to Article 7" in "Model Tax Convention on Income and on Capital (Condensed Version)," ¶95.

[57] *See* Inland Revenue, Transfer Pricing, Branches, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/branches.

[58] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

[59] See Tax Information Bulletin, Vol. 31(3), April 2019.

[60] Inland Revenue Department (2000), "Transfer Pricing Guidelines," Tax Information Bulletin, Vol. 12, No. 10 — Appendix, ¶90 (IRD Guidelines), https://www.taxtechnical.ird.govt.nz/tib/volume-12---2000/tib-vol12-no10.

[61] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

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OECD Guidelines. For income years prior to July 1, 2018, it is still recommended to refer to the relevant OECD Guidelines, as it was the IRD's practice to use these guidelines. However, the OECD Guidelines (prior to July 1, 2018) do not have the force of law, and there has been no case law to determine the New Zealand courts' view of whether taxpayers must apply these guidelines. Reference should also be made to the IRD's practice issues[62] contained on its website, as these provide New Zealand-specific details on the IRD's approach to selected issues. Similarly, the practice issues on the IRD's website are administrative interpretations only and, also, do not have the force of law.

With respect to subsequent versions of the OECD Guidelines (e.g., the 2022 OECD Guidelines), the IRD's intention is that the legislation will be updated periodically to make reference to the latest version of the guidelines. In this regard, the reference to the 2017 OECD Guidelines in the legislation was updated to the 2022 OECD Guidelines, with effect from January 20, 2022.

Following the codification of the OECD Guidelines into the New Zealand transfer pricing legislation, there are limited exceptions between the OECD approach and the New Zealand rules. The only exceptions relate to low-value loans and small wholesale distributors.[63] Strictly, these are not exceptions, as taxpayers may still choose to apply the transfer pricing methods in accordance with the OECD Guidelines. Instead, they are provided in recognition of the high compliance costs associated with preparing comprehensive transfer pricing analyses for these types of arrangements.

In March 2024, the government enacted legislation[64] to adopt the OECD's Global Anti-Base Erosion rules (the OECD's "Pillar Two"). The OECD's rules are incorporated into the New Zealand legislation in §§HP 1 to 4 and Schedule 25B of the Income Tax Act 2007 and in the Tax Administration Act 1994. The "applied global anti-base erosion rules" ("applied GloBE rules") comprise an Income Inclusion Rule (IIR) including a domestic IIR (DIIR) and an Undertaxed Profits Rule (UTPR).[65] The IIR and UTPR apply for income years beginning on or after January 1, 2025. The DIIR applies for income years beginning on or after January 1, 2026. Under these rules, multi-national enterprises (MNEs) with annual global revenues over €750 million will pay a minimum 15% effective tax rate.[66]

With respect to the OECD's Pillar One (Amount B), which relates to the adoption of a simplified transfer pricing treatment for in-country baseline marketing and distribution activities, New Zealand has opted not to adopt this approach.[67]

The New Zealand government has also proposed a new digital services tax targeted at large multinationals. Although the government's preference is to wait for the OECD to develop a multinational agreement in relation to digital services, it has introduced a new bill providing for a 3% tax on digital services revenues connected to New Zealand users or land. The tax would be payable by multinational companies with global digital services revenues of at least €750 million per annum and at least NZ$3.5 million New Zealand digital services revenue per annum. A bill was introduced to parliament on August 31, 2023[68] and provides a start date for the new tax of January 1, 2025. The government[69] has, however, undertaken to postpone the new tax for up to five years, if it is satisfied with the progress on the OECD's Pillar One.[70]

5. Income Tax Treaties

Cross-border associated-party transactions are also subject to the provisions of New Zealand's income tax treaties. New Zealand currently has 40 double tax agreements and 19 tax information exchange agreements in force,[71] covering most of its major trading partners. The transfer pricing provisions in §GC 6–§GC 14 and §GB 2 are consistent with the business profits articles and associated enterprises articles in the double tax agreements — that is, both the domestic law and the income tax treaties are based on the arm's length principle. In the event that the transfer pricing provisions and an income tax treaty are inconsistent, the provisions of the income tax treaty will prevail.

Allocations between branches and head offices, or other arrangements covered by §YD 5 and §YD 5B are subject to the permanent establishment article of the relevant income tax treaty when the other country is a treaty partner. As noted, New Zealand's approach to the allocation of income and expenditure under this article differs from the Authorized OECD Approach and should be considered when determining the arm's-length allocation. In addition, the new permanent establishment anti-avoidance rule must be considered.[72]

B. General Principles, Definition and Scope

1. Application of the Rules

The transfer pricing rules for separate legal entities, contained in §GC 6–§GC 14, apply to all transactions when the following conditions exist:

- There must be a cross-border arrangement;
- The arrangement must be between associated persons; or between a company and a person who is a member of a nonresident owning body that has an ownership interest in the company of 50% or more; or a financial arrangement that is a cross-border related borrowing;

[62] Inland Revenue, Practice Issues, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues.

[63] *See* IV.A.2.

[64] The Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Act 2024.

[65] *See* Tax Technical: TIB Vol. 25 No. 4. May 4, 2024 https://www.tax-technical.ird.govt.nz/tib/volume-36---2024/tib-vol36-no4

[66] *See* OECD/G20 Inclusive Framework Two Pillars Solution https://www.ird.govt.nz/international-tax/business/inclusive-framework-two-pillars-solution.

[67] *Id.*

[68] Legislation containing the new rules is included in the Digital Services Tax Bill.

[69] Since the introduction of the bill, the New Zealand government has changed. To date, there is no indication of a change in policy in relation to this bill.

[70] To date, there has been no progress on enacting this bill.

[71] A list of jurisdictions with which New Zealand has an income tax treaty in force can be found on the Bloomberg Tax platform: https://www.bloomberglaw.com/product/tax/search/results/4e3a03d956b537df9481be3a1a09a8fa/.

[72] *See* III.A.3.b.

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• The arrangement must relate to the acquisition or supply of goods, services, money, other intangible property, or anything else; and

• The consideration must reduce the taxpayer's New Zealand net income.

The rules technically apply to any transaction value when these four conditions are present (i.e., there are no "safe harbor" concessions that exempt transactions under a specified value). However, special administrative practices are available for certain intercompany services,[73] low-value loans,[74] outbound debt arrangements,[75] and small wholesale distributors.[76]

a. Meaning of "Cross-Border Arrangement" and "Cross-Border Related Borrowing"

The term "arrangement" is broadly defined in §YA 1 and includes a contract, agreement, plan, or understanding, whether enforceable or not, and all the steps and transactions by which it is carried into effect. Subject to the anti-avoidance provision contained in §GB 2, §GC 6–§GC 14 generally only apply to cross-border arrangements. The approach taken in the legislation is to include within the potential ambit of the transfer pricing rules all arrangements that are not wholly within the New Zealand tax base. Accordingly, cross-border arrangements are defined in §GC 6(3) to include all of the following:

• An arrangement between a resident and a nonresident, unless: (1) the nonresident enters into the arrangement for the purposes of a business carried on by that person in New Zealand through a fixed establishment; and (2) the New Zealand resident has not entered into the arrangement for the purposes of an offshore business carried on by that New Zealand resident.

• An arrangement between two residents, if either or both enter the arrangement for the purposes of an offshore business. Arrangements conducted wholly offshore are specifically included in the ambit of §GC 6(3) to prevent any potential manipulation of foreign tax credits or losses by New Zealand residents.

• An arrangement between two nonresidents, unless both enter into the arrangement for the purposes of a business carried on in New Zealand through a fixed establishment. Arrangements wholly outside New Zealand may be caught by this definition. However, the operative provisions in §GC 6–§GC 14 only apply to New Zealand taxpayers. Therefore, §GC 6–§GC 14 cannot apply if both nonresident parties to a transaction are not subject to tax in New Zealand, as neither party would be a New Zealand taxpayer.

The transfer pricing rules were also recently modified[77] to capture financial arrangements between parties who may or may not be directly associated. Further, the interest deduction for these types of borrowings may be adjusted from the contractual rate to a rate calculated with reference to the credit rating appropriate for the borrower or the borrower's multinational group.[78]

Under the new provisions in §GC6 (3B) and §GC 6 (3C) cross-border arrangements between two parties to a financial arrangement (as defined in §EW 3) are subject to the rules if that arrangement is a "cross-border related borrowing" — that is, where the borrower is allowed a deduction in relation to the arrangement and the nonresident lender and the borrower are associated persons, or if a person or group of persons have an ownership interest of 50% or more in the borrower and lender, or the lender is a member of a "non-resident owning body" where the total ownership interest is 50% or more, or the borrowing is provided through an "indirect associated funding arrangement." An indirect associated funding arrangement is one in which the indirect lender pays a third-party non-associated person ("the direct lender") to lend money to a borrower who is associated with the indirect lender.

b. Definition of "Associated Persons" and "Non-resident Owning Body"

The transfer pricing regime in New Zealand applies to "associated persons," including companies, individuals, partners, and trusts. In general terms, association arises when there is 50% common shareholding between companies or 25% shareholding by individuals or trusts of companies. In addition, special rules apply to relationships between partners and partnerships, and between trusts, beneficiaries, and settlors. In most cases, tests of association include aggregation rules. Further, there is a tripartite rule where, in certain cases, two persons are treated as associated if they are associated with the same third person.[79]

The rules of association are contained in subpart YB of the ITA 2007. Under these rules, associated persons for the purposes of applying the transfer pricing regime include:

• Two companies with a 50% or more common ownership or control by the same group of persons (including persons associated with that group);

• A company and any person other than a company who holds 25% or more ownership (including the ownership of any person associated with that person) in that company;

• Relatives, including individuals connected by blood relationship within the second degree, marriage or other partnership, or adoption;

• A trustee of a trust and a relative of its beneficiaries (past or future);

• A trustee of a trust (excluding employee and charitable trusts) and its beneficiaries (past or future);

• Any two persons who are trustees of trusts (excluding employee trusts) with at least one common settlor;

• Any two persons when one person is a trustee of a trust (excluding employee and charitable trusts) of which the other person is a settlor;

[73] *See* IV.D.2.
[74] *See* IV.D.3.c.
[75] *See* IV.D.2.
[76] *See* IV.A.2.
[77] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.
[78] *See* IV.D.
[79] Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, 2009 S.N.Z. No. 34. The rules in this act relating to associated persons apply from the 2010/11 tax year.

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• Any two persons when one person is a settlor of a trust (excluding employee and charitable trusts) of which the other person is a beneficiary (past or future);

• A trustee of a trust (excluding employee trusts) and anyone who has the power of appointment or removal of the trustee;

• A partnership and partners of that partnership (excluding limited partnerships);

• A limited partnership and a limited partner who has a 25% or more (including the share of any person associated with that limited partner) partnership share;

• A look-through company and any person who has a look-through interest in that company and is a director or employee of that company;

• A look-through company and any person with a 25% or more (including the ownership of any person associated with that person) look-through interest in that company; and

• Any two persons when each is associated with the same third person.

In addition, §GC 6 was modified with effect from July 1, 2018,[80] to expand the application of the rules beyond associated persons and to include arrangements between a company and any person who is a member of a "non-resident owning body" that has an ownership interest, including linked trustee ownership interests, of more than 50% in that company. Nonresident owning bodies, defined in §YA 1, are groups of nonresident owners who are treated as associated when they have common interest in the ownership of a company.

The tests of association must also consider the application of §GB 2, discussed at III.A.2.d., above. Section GB 2 operates to extend the scope of the transfer pricing rules to non-associated persons when they have entered an arrangement that has "a purpose or effect of defeating the intent and application of the regime."[81]

c. Meaning of "Acquisition" and "Supply"

Section GC 6–§GC 14 apply to the acquisition or supply of goods, services, or anything else and includes financial arrangements that are cross-border related borrowings. The terms "acquisition" and "supply" are specifically defined in §GC 14 for the purposes of the transfer pricing regime, as follows:

• "Acquisition" means obtaining the availability of anything but does not include the mere receipt or retention by a company of consideration for issue of a share (unless the share is a fixed-rate share).

• "Supply" means making anything available but does not include mere payment and subsequently continuing to make available, by a person to a company, of consideration for issue of a share (unless the share is a fixed-rate share).

A "fixed-rate share" (e.g., a preference share meeting the specific definition) is defined in §YA 1 to include shares issued by a company when the rate of dividend is either a fixed percentage of the issue price or fixed to some external index (e.g., an industrial index). Accordingly, dividends paid on fixed-rate shares are within the ambit of §GC 6–§GC 14, but dividends paid on ordinary shares are not.

d. Reduction in the Taxpayer's Net Income

Section GC 6–§GC 14 only apply to arrangements that deplete the New Zealand tax base. This is achieved through the operative provisions in §GC 7, §GC 8, and §GC 12, which require the substitution of an arm's-length amount when:

• The taxpayer is paying excessive consideration for an acquisition; or

• The taxpayer is receiving inadequate consideration for a supply.

Accordingly, transactions that have the effect of increasing a taxpayer's net income generally fall outside the ambit of §GC 6–§GC 14. This restricts the ability of taxpayers to make taxpayer-initiated downward adjustments in their tax returns to amounts that represent excessive consideration received or inadequate consideration paid.

2. Treatment of Non-Arm's-Length Transactions that Reduce a Taxpayer's Net Income

If the amount of consideration paid by a New Zealand taxpayer in a transfer pricing arrangement for an acquisition is greater than the arm's-length amount, §GC 7 provides that the arm's-length amount is deemed to be the amount paid by the taxpayer in substitution for the actual amount. A substitution of an arm's-length amount under §GC 7 applies only to the calculation of the taxpayer's income tax liability. Section GC 12 provides that the substitution neither affects the taxpayer's obligation to deduct any withholding tax in relation to the amount paid nor the tax liability of the other party to the agreement, unless a "request for matching treatment" has been obtained under §GC 11.

If the amount of consideration received by a New Zealand taxpayer in a transfer pricing arrangement for a supply is less than the arm's-length amount, §GC 8(1) provides that the arm's-length amount is deemed to be the amount received by the taxpayer in substitution for the actual amount. An adjustment under §GC 8(1) applies for the purposes of calculating the taxpayer's income tax liability and for determining the obligation of the other person to the arrangement to make withholding payments. For example, if withholding tax is required to be deducted by the other party, this would need to be calculated using the arm's-length amount. However, §GC 12 provides that the substitution does not affect the obligation of the taxpayer to deduct withholding tax (i.e., if withholding tax is required to be deducted by the taxpayer, this would be deducted from the actual consideration received, unless a request for matching treatment is applied for under §GC 11).

Section GC 8(2) and §GC 8(3) restrict the application of §GC 8(1) in certain cases when the supplier is a nonresident. The purpose of these subsections is to ensure that §GC 8(1) applies only if the transfer pricing arrangement depletes the New Zealand tax base when considering the net position of both the

[80] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.
[81] ITA 2007, §GB 2(1).

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supplier and the acquirer. In particular, §GC 8(1) does not apply if: (1) the taxpayer (supplier) is a nonresident and did not enter into the arrangement for the purposes of a business carried on in New Zealand through a fixed establishment; and (2) the amount is a deduction for the other party or would be a deduction in the case of an interest-free loan; and (3) the amount is interest, royalties, or an insurance premium.[82]

For example, if a nonresident company provided an interest-free loan to a New Zealand subsidiary, the nonresident would be a New Zealand taxpayer with respect to the interest income, and the New Zealand company would be allowed a deduction for interest paid. If the arm's length interest charge was $100 and the Commissioner assessed this amount to the nonresident, the deemed interest would be subject to nonresident withholding tax (NRWT) of 10%. However, the New Zealand subsidiary could apply for a consequential adjustment to its tax position, which would allow it a deduction for the $100 deemed interest. This would provide the New Zealand company with a $28 tax shield, and the New Zealand tax base would be reduced by the difference between this amount and the NRWT.

Similarly, §GC 8(1) does not apply if the taxpayer (supplier) is a nonresident and did not enter into the arrangement for the purposes of a business carried on in New Zealand through a fixed establishment, and the amount is a dividend on a fixed-rate share.[83] The effect of this restriction is to ensure that adjustments are not made to amounts that are only subject to NRWT when the New Zealand payer of the amount can claim an income tax deduction for the increased amount.

3. *Treatment of Non-Arm's-Length Transactions that Increase a Taxpayer's Net Income*

Section GC 7 and §GC 8 restrict the application of the transfer pricing rules to transactions that deplete the New Zealand tax base. Transactions in which taxpayers return more than an arm's-length amount of income in New Zealand are not subject to the regime, except in limited circumstances when a compensating or consequential adjustment may be allowed where an upward transfer pricing adjustment has been made.[84] Accordingly, under the New Zealand self-assessment system, taxpayers can make tax return adjustments under these provisions that increase the amount of net income returned, but no similar mechanism exists to reduce the net income returned for non-arm's-length transactions.

Other than in limited circumstances where compensating or consequential adjustments are available,[85] in order to reduce a taxpayer's taxable income to reflect arm's-length transfer prices, it is necessary for the taxpayer either to contract with the other party to pay additional consideration or refund excess consideration received, which should meet the general deductibility criteria in relation to incurring expenses, or make an application under the applicable mutual agreement procedure article of the relevant tax treaty.

4. *Calculating the Arm's-Length Amount*

The arm's-length amount is required to be calculated under §GC 13 by:

(1) Identifying the transfer pricing transaction (identified transaction) or the absence of such a transaction;

(2) Identifying the arm's length conditions that "independent parties after real and adequate bargaining"[86] would have agreed in an arm's length transaction; and

(3) Applying one or more of the prescribed transfer pricing methods.

The method(s) selected must result in the "most reliable measure" of the arm's length amount that independent persons would have agreed to as the price for the identified transaction after "real and fully adequate bargaining."[87] Accordingly, taxpayers cannot choose just any method or manipulate the taxable income by selecting the transfer pricing method that provides the most favorable outcome. Therefore, in order to demonstrate compliance with the legislation, technically the taxpayer must demonstrate that each method was considered and provide reasons for either accepting or rejecting a method.

The determination of the identified transaction requires a taxpayer to accurately delineate the transfer pricing arrangement in accordance with the 2022 OECD Transfer Pricing Guidelines, chapter 1, section D.1.[88] This new requirement to delineate the arrangement applies from July 1, 2018,[89] and legislates the IRD's position that the calculation of the arm's length amount must be made in accordance with the OECD approach. In addition, when the accurately delineated transfer pricing arrangement does not make commercial sense, as set out in paragraph 1.142[90] of the OECD Transfer Pricing Guidelines, the transfer pricing transaction can be disregarded either in its entirety, or a new transaction can be substituted that reflects arm's length conditions.[91] In other words, §§GC 13(1B) and GC 13(1C) incorporate the OECD's current approach with respect to the delineation and non-recognition of transfer pricing arrangements.

In choosing and applying a method to determine the arm's-length amount, taxpayers are required to consider the reliability of the uncontrolled comparable data used. In particular, §GC 13(3) requires taxpayers to consider the degree of comparability between the transactions used for comparison and the transfer pricing transactions of the taxpayer, the completeness and accuracy of the data, the reliability of all assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions.

Section GC 13 provides no explicit hierarchy for selecting the most reliable transfer pricing method. The OECD Guidelines state that the method selected should be the "most appropriate" for the taxpayer.[92] However, they regard the traditional

[82] ITA 2007, §GC 8(2).
[83] *Id.*, §GC 8(3).
[84] *See* VII.
[85] *See* VII.

[86] ITA 2007, §GC 13(1)(b).
[87] ITA 2007, §GC13(1)(c).
[88] ITA 2007, §GC 13(1B).
[89] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.
[90] Previous reference prior to January 20, 2022 was to paragraph 1.122 under the 2017 OECD Guidelines.
[91] ITA 2007, §GC 13(1C).
[92] 2022 OECD Guidelines, ¶2.2.

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transaction methods (being the comparable uncontrolled price method, resale price method, and cost plus method) as the most direct methods and, therefore, they are preferable if they can be applied as reliably as one of the transactional profit methods (the transactional profit split method and transactional net margin method), with the comparable uncontrolled price method considered the most direct method.[93] The OECD notes that taxpayers are not expected to test all methods if it is apparent that there are insufficient data available to reliably apply a particular method. In this regard, the IRD recognizes that there are practical difficulties in obtaining suitable comparable data in New Zealand,[94] and this is likely to restrict the methods available to taxpayers.

Therefore, the arm's length amount of consideration for a transfer pricing arrangement must be calculated by: (1) performing a comparability analysis in accordance with the OECD Transfer Pricing Guidelines, chapter III; and (2) using one or a combination of the five available OECD transfer pricing methods as follows:

- The comparable uncontrolled price method;
- The resale price method;
- The cost plus method;
- The transactional profit split method; and
- The transactional net margin method.

These transfer pricing methods are not defined in the legislation. However, from July 1, 2018, the transfer pricing rules were modified to specifically require that they be applied consistently with the 2017 OECD Transfer Pricing Guidelines,[95] and these references have since been updated to the 2022 OECD Guidelines. Prior to that date, there was no legislative guidance, but the IRD's position was that the OECD Transfer Pricing Guidelines should be followed. Accordingly, the descriptions provided below are based on the OECD's approach.

a. Comparable Uncontrolled Price Method

The comparable uncontrolled price (CUP) method[96] sets the transfer price paid by related parties to a transaction equal to the price paid by independent parties for similar goods or services transferred under similar contract terms. This method imposes the highest degree of comparability between the controlled (i.e., between related parties) and uncontrolled (i.e., between independent parties) transactions and focuses on the product transferred and the price paid.

b. Resale Price Method

The resale price method[97] sets the transfer price in a controlled transaction with reference to the gross margins earned by independent distributors performing similar functions, using similar assets, and undertaking similar risks as the controlled distributor. This method focuses on providing the distributor with an arm's-length return for the functions it performs.

c. Cost Plus Method

The cost plus method[98] sets the transfer price in a controlled transaction with reference to the gross margins earned by independent manufacturers (or service providers) performing similar functions, using similar assets, and undertaking similar risks to the controlled manufacturer. This method focuses on providing the manufacturer with an arm's-length return for the functions it performs.

d. The Transactional Profit Split Method

The transactional profit split method[99] sets the transfer price in a controlled transaction with reference to the combined profit earned by all related parties to the transaction. This profit is split between the controlled parties to the transaction based on an economically valid basis that reflects the relative contribution of functions, assets, and risks made by each party. Both the residual analysis and contribution analysis approaches provided in the OECD Guidelines are acceptable.[100] However, the use of global formulary apportionment (which allocates profit between the related parties across countries based on its sales, assets, and payroll in each jurisdiction) is not allowed.

e. The Transactional Net Margin Method

The transactional net margin method (TNMM)[101] determines the net profit margin of the related parties on a controlled transaction or group of controlled transactions relative to an appropriate base (e.g., operating margin) using the comparable net profit margin earned by uncontrolled entities performing similar functions, using similar assets, and undertaking similar risks.

5. Burden of Proof and Time Bar

From July 1, 2018,[102] the burden of proof in determining the arm's length consideration for a transfer pricing arrangement lies with the taxpayer in the first instance, unless the arrangement is subject to an advanced pricing agreement between the taxpayer and the Commissioner prior to that date. The normal statutory time bar for taxation matters is four years. This period runs from the end of the income tax year in which the taxpayer furnished a return[103] or the Commissioner issued an amended assessment. However, as part of these amendments to the transfer pricing rules, the time bar for transfer pricing assessments was increased to seven years if the Commissioner notifies the taxpayer of a tax investigation within the four-year statutory period.[104]

Prior to July 1, 2018, under §GC 13(4) (since repealed), the burden of proof in determining the arm's-length considera-

[93] *Id.*, ¶2.3.

[94] *See* Inland Revenue, Transfer Pricing, Comparability Analysis, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/comparability-analysis.

[95] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

[96] 2022 OECD Guidelines, Chapter II, Part II: B.

[97] *Id.* Chapter II, Part II: C.

[98] *Id.* Chapter II, Part II: D.

[99] *Id.* Chapter II, Part III: C.

[100] *Id.* Chapter II, Part III: C.3.1.

[101] *Id.* Chapter II, Part III: B.

[102] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

[103] The time bar runs from the end of the tax year in which the return was lodged (tax return year plus 4 years). If the taxpayer lodges late, the time bar does not start until the taxpayer has lodged.

[104] ITA 2007, §GC 13(6).

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tion was on the Commissioner, provided the taxpayer had determined an arm's-length amount in accordance with the legislation. In that case, the Commissioner was only able to ignore the taxpayer's transfer prices if he or she could demonstrate a more reliable measure of the arm's-length amount or if the taxpayer had been uncooperative and this had materially affected the Commissioner's administration of the transfer pricing rules.

C. Comparable Companies and Benchmarks

1. Practice Issues

A number of practical issues arise in the application of the New Zealand rules due to the size of the market and the difficulty associated with obtaining suitable comparable data. The IRD provides suggestions on acceptable approaches in dealing with these issues. In addition, the IRD has signaled a number of policy and practice issues that are currently the focus of IRD investigations. These issues are discussed below.

a. Tested Party

The IRD does not specify whether it expects the New Zealand resident to be the tested party. This reflects the OECD Guidelines' position that the tested party should be the one for which the most reliable comparable data can be found and allow for the selected transfer pricing method to be most reliably applied.[105] However, the IRD is likely to use the New Zealand party as the tested party when reviewing whether a taxpayer's transfer prices are at arm's length. Accordingly, if using the nonresident party as the tested party, it would be prudent to assess whether the impact of the resulting transfer price should also be considered in relation to the New Zealand operations to ensure that it results in an arm's-length return in New Zealand.

b. Analyses Prepared for Foreign Tax Administrations

The IRD may accept a transfer pricing analysis prepared for a foreign tax administration as evidence that a taxpayer's New Zealand transfer prices are at arm's length, provided the analysis results in the most reliable measure of the arm's-length price for the New Zealand taxpayer as required by §GC 13(1)(c).[106] In assessing the acceptability of the foreign transfer pricing documentation, the IRD considers whether the result to the New Zealand operation provided by the analysis reflects the economic contribution and risks assumed and the market conditions for the New Zealand taxpayer. The IRD acknowledges the compliance costs for small businesses may be high and is more likely to accept parent company documentation for low-value transactions. For low-value transactions, it is advisable, at a minimum, to review the results of applying the parent company approach from a New Zealand perspective. However, for high-value transactions, it is less likely foreign documentation will be sufficient.

c. Grouping of Transactions

The New Zealand rules require the transfer pricing methods to be applied by first performing a comparability analysis in accordance with Chapter III of the 2022 OECD Transfer Pricing Guidelines. Accordingly, taxpayers can evaluate transactions on a separate or combined basis using the approach in the OECD Guidelines. In practice, given the data limitations in New Zealand, the IRD has in many cases accepted the use of transfer pricing methods applied to combined transactions as the most practical solution. Further, in the assessment of transfer pricing risk, the IRD often considers taxpayers' transactions on a combined basis.

d. Use of Secondary Methods

There is no legal requirement to apply more than one transfer pricing method to a taxpayer's transfer pricing position. However, the application of one or more secondary transfer pricing methods reduces the likelihood that the IRD will examine a taxpayer's transfer prices in detail. The IRD does not expect analyses performed under a secondary method to be at the same level of detail as the primary analysis. The IRD considers the use of a second profit level indicator (for the TNMM) or application of a second method as a cross-check as a feature of good transfer pricing documentation.[107]

e. Use of Ranges

The IRD does not require the arm's-length price to fall within the inter-quartile range of identified comparable data. Consideration of the quality of the comparable data is expected in the determination of how a range is used. The IRD expects comparable data to be applied consistently from year to year, unless the taxpayer can demonstrate that data are no longer reliable. Further, the IRD considers several years of data (three to five years) useful to construct the range to ensure a reasonable approximation is made of a long-run competitive return. However, the IRD does not accept the inclusion of extreme values or the use of pooled ranges, in which every annual data point is treated separately. Instead, the IRD considers a weighted average data point for each comparable to be preferable when constructing the arm's-length range.[108]

f. Data Sources Commonly Used in New Zealand

(1) New Zealand Data

New Zealand has a small share market with approximately 180 publicly listed companies. This severely restricts the amount of New Zealand's publicly available financial data. In addition, many of these listed companies are part of multinational enterprises and may not provide an uncontrolled comparable benchmark. For this reason, the IRD accepts that the selection of comparable data is likely to include overseas data.[109] However, when searching for comparable data, it would be prudent to consider whether any data for publicly listed New Zealand companies are suitable. These companies are included in many international financial databases, and there are specif-

[105] OECD Guidelines, ¶3.18.

[106] *See* Inland Revenue, Transfer Pricing Documentation, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/documentation.

[107] *See* Inland Revenue, Transfer Pricing Documentation, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/documentation.

[108] *See* Inland Revenue, Comparability Analysis, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/comparability-analysis.

[109] *Id.*

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ic New Zealand financial databases (e.g., NZX Research Centre).[110]

In addition, the IRD and Statistics New Zealand provides information on industry benchmarks.[111] While these cannot be used to support the selection and application of a transfer pricing method, they may be useful in identifying the level of risk for a taxpayer. Specifically, if a taxpayer's profitability is materially lower than the industry benchmark, this may indicate an increased risk of a transfer pricing audit.

(2) Use of Overseas Comparable Data

Given the lack of publicly available comparable data in New Zealand, the IRD allows taxpayers to use comparable data obtained from overseas sources (e.g., data related to uncontrolled companies operating in the "same or similar" countries).[112] However, the IRD expects taxpayers to assess the effect of differences in geographic markets between the New Zealand taxpayer and the overseas comparable. Most of the standard financial databases (e.g., Amadeus, Bloomberg, Compustat, Kompass, Osiris, and One Source) are acceptable, provided: (1) reliability of the data contained in the databases can be demonstrated; and (2) the comparability of the selected data has been properly assessed.

The IRD considers data from the Australian market to be the most comparable to New Zealand, given similarities in the two countries' economies, but it also uses data from Europe and North America in its own analyses. In practice, it is likely that data from other countries would also be acceptable, provided it can be shown that the industry and functional profiles of the comparable data are sufficiently similar to the taxpayer's.

When overseas data are used, the IRD expects recognition of the small size of the New Zealand economy, which does not have the same economies of scale or level of competition as larger economies but does have higher distribution costs given its geographic isolation and low population density. In particular, the IRD expects consideration of differences between the tested party and the comparable data that relate to the geographic location of the markets, the level of competition and availability of substitute goods and services, transport costs, the size of the market, and the level of the market (e.g., retail versus wholesale).[113]

D. Transfer Pricing Analysis

1. Comparable Data

Data comparability is a critical component in determining the most reliable transfer pricing method. The IRD recognizes that several factors affect the degree of comparability between the controlled data and uncontrolled data. Differences in the products, functions, and other economic factors can affect the reliability of the comparable data and thereby the ability to use particular transfer pricing methods. Where differences are identified, this requires either the rejection of comparable data where it is not comparable or adjustment to account for minor differences. The IRD considers the determination of an arm's-length price to be a practical exercise, and it is not expected that every difference in product, functions, assets, and risks should be priced.[114]

a. Product Differentiation

The characteristics of the product or service being transferred are of primary importance when the CUP method is applied, given it relies on the market price for a product transferred in an uncontrolled transaction. The application of the CUP method requires a high degree of product and transaction similarity. For the other methods, product differences are less important, and functional similarity is critical. The legislation requires the transfer pricing methods to be applied by performing a comparability analysis as required by the 2022 OECD Guidelines in detailing the features that may be relevant in comparing two products.[115] For tangible property, relevant features include physical characteristics (e.g., design and functionality), product quality and reliability, and product availability and volume of supply. For services, relevant features include the nature and extent of the services provided. For intangible property, relevant features include the form of transaction (e.g., licensing or sale), the type of property (e.g., patent, trademark, or know-how), the duration and degree of protection, and the anticipated benefits from the use of the property.

b. Functional Analysis

Given the difficulty of locating comparable product data to apply the CUP method, typically one of the other transfer pricing methods — resale price, cost plus, profit split, transactional profit split, or transactional net margin method — must be used. The other methods focus on the comparability of the functions performed, assets used, and risks assumed in the controlled and uncontrolled transactions, rather than on product comparability. A functional analysis prepared in accordance with the 2022 OECD Guidelines should be used in appraising functional differences between controlled and uncontrolled data.

A functional analysis serves to identify the economically significant activities undertaken by the parties to the transaction from which it is reasonable to expect a reward. This analysis identifies the nature and characteristics of the related-party dealings that must be priced and should identify all significant functions performed, assets used, and risks assumed by each related party involved in the economic activity. The IRD's view is that the functional analysis should identify critical economic factors for the transfer pricing arrangements under review.[116]

A functional analysis also serves to help analyze the validity of the comparable data used as a benchmark in the selection and application of a transfer pricing method. The relative importance of each function is relevant in determining the share of the profit to be derived by the related parties. For example, the functions of one party relative to the other related parties may

[110] *See* NZX, https://www.nzx.com.

[111] *See* Industry Benchmarks, https://www.data.govt.nz/use-data/showcase/industry-benchmarking-tool.

[112] *See* Inland Revenue, Comparability Analysis, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/comparability-analysis.

[113] *Id.*

[114] *Id.*

[115] ITA 2007, §GC 13(2).

[116] *See* Inland Revenue, Comparability Analysis, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/comparability-analysis.

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be few, but if they are the most significant functions, that party should be entitled to a major share of the profits.

The functional analysis should also incorporate an assessment of the risks assumed by each related party. The allocation of risk shown in the functional analysis must be consistent with the economic substance and contractual terms of the transaction.

c. Working Capital and Other Comparability Adjustments

The IRD does not consider working capital adjustments or other similar adjustments based on mathematical formulae to be necessary. Instead, the preferred approach is to identify why there are material differences between the comparable data and the taxpayer. If the differences are significant, then the IRD considers it preferable to reject the comparable data. If not, then recognition of these differences should be made when determining the point in the arm's-length range where the taxpayer's transfer prices should be.[117]

d. Business Strategies, Losses, and Market Support Payments

The IRD accepts that particular business strategies, such as strategies related to innovation and new product development, diversification, and market penetration, may decrease profits in the short term. When a taxpayer is engaged in such strategies, the IRD expects these to be documented and that the reduction in short-term profits results in longer-term increases in profit, as evidenced by projected budgets or similar support. The IRD's view is that long periods of losses are likely to reflect "commercially unrealistic transfer pricing policies."[118]

The IRD accepts market support payments made by New Zealand companies to overseas subsidiaries when they are supported by economic analysis which demonstrates that the terms and conditions and pricing are at arm's length. Further, the amounts paid should be analyzed to support the deductibility of the payments (e.g., to demonstrate that amounts are revenue and not capital in nature). The IRD considers normal terms for these arrangements should include regular reviews and a termination date.[119] However, the IRD's view is that interest-free loans provided to support start-up subsidiaries are unlikely to be acceptable as market support and would only be acceptable if supported by evidence that similar support is provided between unrelated parties.

e. Government Policies and Other External Factors

The IRD follows the OECD Guidelines in determining circumstances in which an arm's-length price should be adjusted for government interventions, including price controls, interest rate controls, controls over payments for services or management fees, controls over the payment of royalties, subsidies to particular sectors, exchange control, anti-dumping duties, or exchange rate policy. In addition, the IRD recognizes that external factors outside the control of the taxpayer may have a short-term or long-term impact on profitability.

The IRD has recognized that the COVID-19 pandemic has given rise to "exceptional economic circumstances".[120] The IRD requires transfer pricing transactions to continue to be priced in accordance with the arm's length principle, New Zealand transfer pricing rules, and with reference to the OECD's guidance on the transfer pricing implications of the pandemic.[121] Further, the IRD recommends taxpayers prepare contemporaneous documentation that records the specific facts affecting their compliance with the arm's length principle. This evidence should include details on the material impacts of the pandemic, changes to strategies, contracts or transfer pricing arrangements, and the impact of the pandemic on the profitability of the MNE and the New Zealand taxpayer.

The IRD acknowledges the difficulty of identifying comparable data during COVID-19 and recommends using the pre-COVID-19 expectations as a starting point.[122] However, the IRD notes it would not normally expect to see taxpayers assume risks or losses that they would not normally bear.

During the pandemic the New Zealand government paid wage subsidies to qualifying New Zealand employers. The IRD expects the benefit of these subsidies to be retained by the entity that received the benefit as these subsidies were linked to New Zealand employment-related risks. If the subsidy has any impact on transfer prices, the IRD requires taxpayers to consider the OECD's guidance on the transfer pricing impacts of the pandemic.[123] Specifically, taxpayers should consider the nature of the subsidy and the economic circumstances.

[117] *Id.*

[118] *See* Inland Revenue, Losses, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/losses.

[119] *See* Inland Revenue, Market Support Payments, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/market-support-payments.

[120] *See* Inland Revenue, COVID-19, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/covid-19.

[121] *See* OECD, Guidance on the transfer pricing implications of the COVID-19 pandemic, https://www.oecd.org/en/publications/2020/12/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic_24131c28.html.

[122] *See* Inland Revenue, COVID-19, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/covid-19.

[123] *See* OECD, Guidance on the transfer pricing implications of the COVID-19 pandemic, https://www.oecd.org/en/publications/2020/12/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic_24131c28.html.

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IV. Specific Transfer Pricing Rules

A. *Tangible Property*

1. *Overview*

In general, New Zealand's transfer pricing legislation does not contain any provisions that relate specifically to transactions involving tangible property. In this regard, the normal rules relating to the selection and application of the most applicable method should be used.[124] Similarly, the IRD has not provided any specific guidance in relation to these types of transactions, suggesting the pricing and audit of tangible property transfers do not give rise to any special concerns. The only exception relates to small wholesale distributors.

2. *Small Wholesale Distributors*

The IRD adopted a simplification measure in relation to foreign-owned wholesale distributors with an annual turnover of less than NZ$30 million. With respect to these taxpayers, the IRD stated that a weighted average earnings-before-interest-tax-and-exceptional-items (EBITE) ratio of 3% or greater is treated as being broadly indicative of an arm's length outcome, provided that there is no readily available transactional data for the taxpayer's transfer pricing transactions or other comparable market data for distributors operating with similar risk characteristics. In these circumstances, the IRD does not require further benchmarking to support the arm's length nature of the distributor's weighted average EBITE ratio.[125]

B. *Intangibles*

1. *Overview*

New Zealand's transfer pricing legislation does not contain any provisions that relate specifically to transactions involving intangible property. However, the identification and valuation of intangibles is a challenging area, particularly given the difficulties in locating valid comparable uncontrolled data and the complexity of some arrangements. While there are established markets for some intangibles, such as software, other intangibles, such as brand names and patents, are often unique and have no active market from which to identify comparable data.

Recognizing these difficulties, the IRD provides some recommendations based on the OECD Guidelines[126] regarding transactions involving intangible property. The complexity of this issue is also reflected in the IRD's current attention to this area. In particular, the IRD's main focus is on inbound royalties. The IRD emphasizes that any substantial business has goodwill of some kind, and it is not reasonable to attribute no value to that goodwill when setting royalty rates.

2. *Identification of Intangible Property*

It is important to clearly identify the nature and terms and conditions of intangibles subject to transfer pricing arrangements. The IRD considers the following questions in determining whether any significant transfer of intangible property has occurred:

- Have all intangible profit drivers been individually identified (including goodwill and licensed intangibles)?
- What is the value of all intangibles owned and used by the taxpayer, and have they been valued by an independent valuer?
- Is the intangible property protected?
- Who bore the cost of creating the intangible?
- How and to what extent does the intangible contribute to the profit?
- Has intangible property been sold or assigned, and if so, what was the price paid?[127]

3. *Valuation of Intangible Property*

The New Zealand legislation requires the transfer pricing rules to be applied consistently with the 2022 OECD Guidelines.[128] In this regard, the IRD notes that the treatment of intangible property should be consistent with Chapter VI of the OECD Guidelines.

When valid comparable data can be located to benchmark the transfer price for intangible property (e.g., an internal comparable for the provision of the same property to a third party under the same or similar conditions), the CUP method can be used. However, the IRD recognizes the difficulty in locating comparable data for this purpose.

As a consequence, it is likely that one of the other transfer pricing methods, in particular the transactional profit split method, may be most reliable in the absence of good comparable data. Given the uncertainty and complexity associated with the determination of transfer prices for intangible property, the IRD recommends that taxpayers seek an APA for transactions involving transfers of significant intangible property.[129]

a. *Licenses of Intangible Property and Royalty Rates*

Royalty rates established as arm's length for a foreign member of a multinational enterprise are not necessarily accepted as arm's length in relation to New Zealand, unless an analysis of the differences in the markets was undertaken to demonstrate that the rate is applicable to the New Zealand market. If significant differences exist, adjustments should be made to reflect them, if they can be valued. The IRD has provided a checklist for inbound licensing arrangements it considers useful for taxpayers. This highlights the areas the IRD is likely to examine in the event of an audit, including the nature of the property licensed, agreements and transfer pricing documenta-

[124] *See* the discussion at III.B.

[125] *See* Inland Revenue, Simplification Measures for Transfer Pricing, https://www.ird.govt.nz/international-tax/business/transfer-pricing/simplification-measures.

[126] *See* Inland Revenue, Intangibles, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/intangibles.

[127] *Id.*

[128] ITA 2007, §GC 6(1B).

[129] *See* Inland Revenue, Intangibles, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/intangibles.

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tion prepared, value added by the intangible property to the licensee, and treatment of nonresident withholding tax.[130]

The IRD has identified the 25% rule, in which the royalty is set at 25% of the earnings before interest, tax, exceptional items, and royalties arising from the use of the intangible property, as a cross-check for assessing the risk of royalty rates.[131] The IRD applies this rule when assessing the reasonableness of royalty rates for the use of intangible property. It notes that it considers the 25% on the high end of royalty payments and that any royalties in excess of this amount would be considered high risk. Accordingly, it is recommended that taxpayers consider this cross-check when setting transfer prices using one of the prescribed transfer pricing methods and document the reasons for any significant deviations from this standard. However, it should be emphasized that this is not a method and that taxpayers cannot use it in substitution for a properly applied transfer pricing analysis using one of the prescribed transfer pricing methods.

b. Sales of Intangible Property

The IRD's focus in relation to the sale of intangible property is on transfers out of New Zealand, particularly when the property is licensed back to the original owner.[132] The IRD's view is that when these transfers take place, it is necessary to identify the following:

- The nature of the property being sold;
- The developer of the property;
- The current owner of the property; and
- Whether the property is capable of being sold.

c. Location Savings

The IRD endorses the OECD Guidelines approach that considers location savings not to be intangible property. Accordingly, any value attributed to location savings in the valuation of intangible property should be supported by the specific facts relevant to the taxpayer, and it is likely that any such value will be subject to close scrutiny by the IRD.[133]

C. Services

1. Overview

New Zealand's transfer pricing legislation does not contain any provisions that relate specifically to transactions involving services. However, service charges are a common area of focus for the IRD during investigations. In line with the OECD Guidelines, Chapter VII, the IRD considers the principal issues surrounding the pricing of intragroup services to be the determination of whether a service has been provided and whether the charge for the service is at arm's length. The IRD has provided a checklist of questions that it considers when reviewing international service charges. This checklist highlights the importance of identifying the nature of the services provided and the basis for calculating the charge, ensuring that "duplicated services" and "shareholder activities" are not charged to the local subsidiary and considering whether any withholding taxes apply.[134]

2. Identification of the Service Provided

The key question in determining whether a chargeable service has been provided is whether the recipient of the service receives something that an independent party would be willing to pay for or would perform in house for itself ("the benefit test"). In accordance with the OECD Guidelines, the IRD considers shareholder services, duplicated services, and incidental services not to provide benefits.[135]

3. Determining an Arm's-Length Charge

Consistent with the OECD Guidelines, the IRD accepts two approaches to determining the arm's-length charge for services. The first is the direct charge approach, which can be used when specific services are provided to separately identifiable group entities. This involves identifying an arm's-length charge for the service, usually using the CUP method. The second approach is the indirect charge approach, which is used when the direct charge approach is not available (e.g., when services are provided to a number of recipients and cannot be specifically identified). This approach usually involves using the cost plus method, where the costs are allocated to each recipient using an appropriate allocation key.

The CUP and the cost plus methods are the most common methods applied to services. The CUP method can only be used when comparable data are available to benchmark the arm's-length price (e.g., when the service provider performs similar services for independent parties under similar conditions) or when the service recipient receives similar services from independent parties.

When market prices for services cannot be identified, the cost plus method is used, provided the cost of performing the services can be objectively identified and measured. The application of the cost plus method requires the accurate determination of the cost portion of the transfer price, given its materiality compared to the mark-up applied to the cost. Costs may be identified directly or indirectly using an appropriate allocation key (e.g., time, number of employees, units provided). The IRD expects to see a realistic allocation of costs, consistent with the size and profits of the business.[136]

Once the cost of providing the services is identified, the next step is to identify an arm's-length margin to add to the costs. This step involves using suitable comparable data that allow the identification of the return earned in comparable uncontrolled transactions or by comparable uncontrolled service providers. The IRD's view is that the appropriate level of mark-up must be fair and reasonable in relation to the nature of the services and the risks involved. In particular:

- No mark-up should be applied for the recharge of third-party costs (i.e., when no additional service is provided);

[130] *Id.*
[131] *Id.*
[132] *Id.*
[133] *Id.*

[134] *See* Inland Revenue, Service Charges, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/service-charges.
[135] 2022 OECD Guidelines, Chapter VII.
[136] *See* Inland Revenue, Service Charges, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/service-charges.

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• Minimal mark-ups should be applied to low-risk supporting services; and

• Higher mark-ups should be applied when specialist expertise or know-how is involved.[137]

Alternatively, if the requirements of the IRD's Administrative Practice for services are met, a standard mark-up of 5% can be used. This is discussed further in the next section.

4. Administrative Practice for Services

For income years commencing on or after July 1, 2018, the IRD adopted the administrative practice for services based on the OECD Guidelines, Chapter VII, Section D. The administrative practice is not mandatory, and taxpayers can follow the normal application of transfer pricing methods for services. However, if available, the application of this practice can reduce the compliance costs associated with supporting the transfer price of services.

Initially, this simplification measure applied only to low-value adding services that had a total value of up to $1 million per annum supplied to associates (per provider). For income years commencing after April 1, 2021, this threshold has been removed.

Qualifying services can be priced at cost plus 5% mark-up with no comparable benchmark required for the mark-up. The definition of "low-value adding services" is in the OECD Guidelines and requires that the services must be supportive in nature, not part of the core business of the MNE, and do not involve unique and valuable intangibles or the assumption or control of significant risks.[138]

In previous income years, the IRD applied an administrative practice for services that allowed taxpayers to price certain services at cost plus 7.5% mark-up. This administrative practice applied to:[139]

• "Non-core" services, defined as activities that are not integral to the profit-earning process and are not economically significant activities of the group (e.g., back office functions); and

• Services with costs below a de minimis threshold. The threshold for the total direct and indirect costs of supplying services to associated enterprises is not more than NZ$1,000,000 in a year.[140]

Eligibility for the old administrative practice was determined on a company group basis. Therefore, the cost limits were based on the aggregated costs of services between all New Zealand group members and foreign associates. Additionally, the determinants of services that were considered "non-core" were judged from a group perspective, not an individual entity perspective.

The criteria for the old administrative practice are set out in the following table, reproduced from the IRD Guidelines.

Criteria for administrative practices for services:[141]

	Services Acquired from Foreign Associated Enterprises		**Services Supplied to Foreign Associated Enterprises**	
	Administrative practice for non-core services	Administrative practice in de minimis cases	Administrative practice for non-core services	Administrative practice in de minimis cases
Applies to all services?	No	Yes	No	Yes
Restrictions on the application of the administrative practices	The total amount charged for the services is not more than 15% of the total accounting expenses of the New Zealand group companies.	The total direct and indirect costs of providing the services is not more than NZ$1,000,000 in the year.	The total amount charged for the services is not more than 15% of the total accounting revenues of the New Zealand group companies.	The total direct and indirect costs of providing the services is not more than NZ$1,000,000 in the year.
Documentation requirement	Adequate documentation is maintained by the taxpayer.	Adequate documentation is maintained by the taxpayer.	Adequate documentation is maintained by the taxpayer.	Adequate documentation is maintained by the taxpayer.
Acceptable transfer prices	Not more than the lesser of: (a) the actual charge, and (b) the cost of providing the services plus a mark-up of 7.5%	Not more than the lesser of: (a) the actual charge, and (b) the cost of providing the services plus a mark-up of 7.5%	Not less than the greater of: (a) the actual charge, and (b) the cost of providing the services plus a mark-up of 7.5%	Not less than the greater of: (a) the actual charge, and (b) the cost of providing the services plus a mark-up of 7.5%

[137] *Id.*

[138] *See* Inland Revenue, Simplification Measures, https://www.ird.govt.nz/international-tax/business/transfer-pricing/simplification-measures.

[139] Inland Revenue Department (2000), "Transfer Pricing Guidelines," Tax Information Bulletin Vol. 12, No. 10 — Appendix, ¶559 (IRD Guidelines), https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/tib/volume-12---2000/tib-vol12-no10-appendix.pdf?la=en.

[140] Originally this was NZ$100,000, as detailed in the IRD Guidelines. However, with effect from July 1, 2010, this was increased to NZ$600,000, and beginning January 1, 2015, it was increased to NZ$1,000,000. *See* Inland Revenue, Service Charges, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/service-charges.

[141] IRD Guidelines, Table 8, page 72, updated for the revised de minimis rule.

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Provided the taxpayer qualified for the administrative practice, a charge of cost plus 7.5% was accepted by the IRD as arm's length. Further, to accommodate the requirements of other jurisdictions and reduce the possibility of double taxation, the IRD allowed inbound services to have a mark-up of up to 10% and outbound services as low as 5%, provided a taxpayer could show the adjusted figure was required by an overseas tax authority.[142]

Under both the old and new administration practices, the IRD expects sufficient documentation to be maintained by the taxpayer relying on the administrative practice to show that the services meet the requirements of either the new OECD Guidelines (for income years from July 1, 2018) or the old IRD Guidelines (for income years commencing prior to July 1, 2018).

5. Special Cases

The IRD has identified a number of areas in tax investigations that do not meet the reasonableness test for chargeable services. In particular, the IRD has highlighted costs related to regulatory costs of the shareholders, global restructuring, global or regional cost allocations, IT applications, captive service providers, and strategic management costs.[143] Accordingly, if these costs are included in service charges, it is recommended that additional analysis be prepared to demonstrate the nature of the services provided, how those services provide more than an incidental benefit to the local subsidiary, and why they are not "shareholder activities" or duplicate services (i.e., services that duplicate services the local subsidiary already receives).

D. Financial Transactions

1. Overview

Financing costs are a common area of focus for the IRD during investigations, including loans, guarantees, fixed-rate shares (i.e., preference shares meeting a specific definition), and other hybrid debt instruments. In general, New Zealand endorses the OECD Guidelines approach to the pricing of financial transactions.[144] From July 1, 2018, new rules were introduced[145] that provide restricted transfer pricing rules for certain inbound financial transactions. These are discussed further at IV.D.2., below. Currently, the IRD's focus is on the following types of arrangements:[146]

- All inbound loans over NZ$10 million;
- All outbound loans, including both loans and guarantee arrangements. In particular, the IRD is focused on low- or no-interest loans to foreign subsidiaries and zero guarantee fees;
- All loans using non-investment grade credit ratings;
- Cash pooling arrangements;
- Guarantees and cross-guarantees; and
- Derivatives.

In reviewing financial arrangements for transfer pricing issues, the IRD also considers the potential application of the thin capitalization rules and, in certain instances, also considers the application of New Zealand's general anti-avoidance provisions for uncommercial financial arrangements.

2. Restricted Transfer Pricing Rules

From July 1, 2018, inbound financing arrangements that involve a nonresident lender and a resident borrower are covered by the new §GC 15–§GC 19, which require specified arrangements to be priced using a restricted transfer pricing approach. These rules specify the credit rating to be applied and remove any "exotic features"[147] when calculating the appropriate interest rate.[148] Section GC 15 sets out how the rules operate and defines what is meant by an insurance or banking person, as the appropriate credit rating differs for insurers and banks. Section GC 16 specifies that inbound financing arrangements are subject to the restricted rules (other than for insurers and banks), when an arrangement is for NZ$10 million or more and either:

- The borrower has a New Zealand group debt percentage of 40% or more or zero and greater than 110% of its group's worldwide debt percentage; and
- The lender has a less than 15% tax rate in its country of residence and that country is different from the tax jurisdiction of its ultimate parent.

Broadly, §GC 16 restricts the credit rating applicable to affected financing arrangements as follows:

- If the financial arrangement falls outside the restricted transfer pricing rules (e.g., outbound financing), then the borrower's credit rating may be used ("default credit rating").[149]
- If the borrower is controlled by a group of persons acting in concert, then the credit rating is the higher of the borrower's credit rating if it had a debt ratio of 40% or less or BBB− ("restricted credit rating").[150]
- If the borrower is controlled by one person, the credit rating is within two notches of the group's credit rating if it is BBB+ or higher, or within one notch of the group's credit rating if it is lower than BBB+ ("group credit rating").[151]
- If the borrower or the New Zealand group has significant third-party debt, then the credit rating for that third-party debt may be used ("optional credit rating").[152]

Section GC 17 specifies the credit ratings applicable for insurers and banks. In broad terms, this section allows for the

[142] *Id.* ¶562 and ¶563.

[143] *See* Inland Revenue, Transfer Pricing, Service Charges, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/service-charges.

[144] *See* Inland Revenue, Financing Costs, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/financing-costs.

[145] Taxation (Neutralising Base Erosion and Profit Shifting) Act 2018.

[146] *See* Inland Revenue, Financing Costs, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/financing-costs.

[147] *Id.*

[148] A detailed description of the new rules is contained in Inland Revenue, Tax Information Bulletin, Vol. 31(3), April 2019.

[149] ITA 2007, §GC 16(8).

[150] ITA 2007, §GC 16(9).

[151] ITA 2007, §GC 16(10).

[152] ITA 2007, §GC 16(11).

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application of either the credit rating of the member of the group with the most third-party debt[153] or the optional credit rating (credit rating of the NZ borrower or NZ group).[154]

In all cases covered by the restricted transfer pricing rules, the credit rating must be applied to the financial arrangement after removing any exotic features — that is, those features not normally seen in third-party financial arrangements. Section GC18 sets out the terms to be disregarded, which include payments other than in money, interest deferrals of more than 12 months, changes in interest rates within the control of the borrower, exclusions of lenders' usual rights of enforcement, contingencies, loan terms greater than five years, and subordinations.

With respect to outbound loans that are not subject to the restricted transfer pricing rules, the IRD has stated that if a New Zealand lender has correctly applied these rules, the IRD will treat the resulting interest rates as arm's length.[155]

Additional disclosure is required to be made in relation to financial transactions falling within the restricted transfer pricing rules.[156]

3. Pricing of Loans and Guarantees

The IRD follows the OECD Guidelines' approach that interest rates should be based on an appropriate base indicator rate plus an arm's-length margin. The IRD's website provides details of the IRD's current approach to auditing these transactions, discussed further below.[157] In general, setting the pricing for loans requires consideration of both the terms and conditions of the particular arrangement, which determines the appropriate base indicator rate, together with an assessment of the credit rating of the borrower, which determines the appropriate arm's-length margin.

a. Base Indicator Rate

The base indicator rate reflects the terms and conditions of the loan (e.g., the loan value), lending currency, borrowing period, frequency of interest payments, and frequency of interest rate reviews. In general, the IRD considers that the following base indicator rates are likely to be appropriate:

- Variable rate loans: bank bill rate; and
- Fixed-rate loans: applicable swap rates.

If a taxpayer uses a different basis for pricing a loan, additional documentation should be used to support the rate as arm's length for the arrangement.

b. Arm's-Length Margin

Subject to the restricted transfer pricing rules discussed in IV.D.2, above, the IRD's view is that the arm's-length margin ("credit spread") added to the base rate is primarily a reflection of credit risk (i.e., the risk of default). Further, the IRD expects this credit spread to be determined using the credit rating of the borrower (e.g., using Standard & Poor's ratings). In particular, the IRD considers that other factors, such as liquidity, debt ranking, and early repayment, only have a limited impact on the credit spread. In this regard, the IRD takes a stand-alone entity approach (i.e., what would be the credit rating of the borrower if it were not part of the multinational group). The IRD notes that a stand-alone subsidiary could have a higher credit rating than the wider group, and this possibility should be considered when determining the credit rating of the borrower.

c. Administrative Practice for Low-Value Loans

In recognition of the high cost of performing a robust analysis of the transfer pricing of loans, particularly in relation to assessing the credit rating of the borrower and identifying an appropriate arm's-length margin, the IRD accepts a simplified calculation basis for low-value loans (less than NZ$10 million principal). Specifically, low-value and other loans are subject to these rules on pricing:[158]

- Loans with less than NZ$10 million principal: 175 basis points (1.75%)[159] over the relevant base indicator rate are regarded by the IRD as arm's length, in the absence of any readily available market rate for a debt instrument with the same terms and conditions.
- Loans with NZ$10 million or more principal: A comprehensive assessment of the base indicator rate and credit rating of the borrower are expected, using the approach outlined in IV.D.3.a. and IV.D.3.b.

This administrative practice is not mandatory, and taxpayers can follow the normal application of appropriate transfer pricing methods for loans (i.e., the approach described above for loans of NZ$10 million or more).

d. Guarantee Fees

The IRD expects to see a written agreement in relation to guarantees before it recognizes these agreements. In particular, it does not accept letters of comfort as sufficient. The pricing of guarantee fees should be based on the interest rate savings that the borrower benefits from by reason of the guarantee — that is, it must be demonstrated that the interest rate paid is less than would be payable in the absence of the guarantee. Further, the IRD's view is that it would not normally expect to see guarantees in relation to associated party debt.[160]

e. Practice Issues

The IRD has highlighted common errors identified during investigations of taxpayers.[161] These include:

- Ignoring internal comparable data;

[153] ITA 2007, §GC 17(a).

[154] ITA 2007, §GC 17(c).

[155] *See* Inland Revenue, Financing Costs, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/financing-costs.

[156] *See* Inland Revenue, Base Erosion and Profit Shifting (BEPS) disclosure, https://www.ird.govt.nz/international-tax/business/beps-disclosure and the BEPS disclosure preparation form (IR1250), https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir1200---ir1299/ir1250/ir1250-2021.pdf?modified=20220411004156&modified=20220411004156.

[157] *See* Inland Revenue, Financing Costs, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/financing-costs.

[158] *Id.* The IRD is scheduled to review these "safe harbor" interest rates by June 30, 2025.

[159] This rate applies for the period from July 1, 2023. For earlier rates refer to Inland Revenue, Simplification Measures, https://www.ird.govt.nz/international-tax/business/transfer-pricing/simplification-measures.

[160] *See,* Inland Revenue, Financing Costs, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/financing-costs.

[161] *Id.*

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• Using the wrong geographic market to select the interest rate (e.g., using New Zealand rates on an Australian dollar loan);

• Using base indicator rates and credit spreads that do not reflect loan terms and conditions;

• Using Reserve Bank rates instead of bank bill rates; and

• Failing to use the credit rating of a less developed country for outbound loans when the country credit rating is lower than that of the stand-alone borrower.

4. Nonresident Withholding Tax and Approved Issuer Levy

Under the nonresident withholding tax (NRWT) rules, interest paid to a nonresident is subject to 15% withholding unless the recipient is a resident of a country with which New Zealand has a double tax agreement, in which case it is reduced to 10%. These rules were modified in 2017 to strengthen the effect of these rules.[162] The 2017 changes apply to arrangements made on or after the first day of the borrower's income year commencing after March 30, 2017, and affect when the NRWT must be paid. Under the changes, NRWT must now be paid at the same time as the interest is deducted by the New Zealand resident borrower if the lender and borrower are associated.[163]

There is also an Approved Issuer Levy (AIL) in New Zealand, which taxpayers can elect to apply to reduce the NRWT to a final tax of 2%. However, AIL does not apply to borrowings between related parties and is therefore not relevant for transfer pricing financial arrangements. The 2017 changes ensure that AIL cannot apply where a third party is interposed between a related ultimate lender and a New Zealand borrower.

E. Commodities

There are no specific rules regarding the pricing of commodities under the New Zealand legislation. Accordingly, transfer prices should be set in accordance with the OECD Guidelines standard approach. In this respect, the IRD is likely to expect taxpayers to give due consideration to the CUP method and the available comparable data provided by quoted prices.

F. Cost Contribution Arrangements

The IRD requires expenditures under a cost contribution arrangement (CCA) to meet both the transfer pricing requirements and the domestic deductibility rules. New Zealand's transfer pricing rules are to be applied to CCAs in accordance with the 2022 OECD Guidelines, Chapter VIII. In practice, the IRD notes that very few CCAs have been entered into by New Zealand taxpayers.[164]

A CCA is contractual in nature and is designed to assign costs to each member of the CCA based on the expected benefits received from the arrangement. There is no standard structure recommended by the IRD for CCAs, and each depends on its own circumstances. The arm's length principle applies, as with all other associated-party cross-border transactions.

The tax treatment of payments made in relation to a CCA depends on the character of the payment. Generally, amounts are deductible, provided the expenditure would be deductible to the taxpayer if incurred outside the CCA and provided the share of the costs incurred by the New Zealand taxpayer reflects a reasonable apportionment of the total costs.

G. Business Restructurings

New Zealand's transfer pricing rules are to be applied to business restructurings in accordance with the 2022 OECD Guidelines, Chapter IX. Given the complexity of restructures, the IRD recommends that taxpayers obtain an advanced pricing agreement.[165] The IRD's current focus is on:

• Restructuring of the supply chain that involves the shifting of major functions, assets, or risks from New Zealand.

• Restructuring arrangements with low or no tax jurisdictions, including the use of central hubs for marketing, logistics, or procurement.

Consistent with the OECD Guidelines, the IRD's focus is on the economic substance of newly created low-risk operations, consistent return of routine profits, and commercial rationale of the restructures. In this regard, the IRD expects to see additional documentation that analyzes the restructure both before, during, and after the restructure takes place. This documentation should include the rationale for the restructure and functional analyses of each step; analyze the consideration; examine the capability of entities to which functions, assets, or risks are transferred; consider whether any permanent establishments have been created in New Zealand; and analyze valuations of assets transferred.[166]

The IRD also scrutinizes any synergistic benefits claimed under a restructure. The IRD's concerns in relation to these are that:

• These benefits are not intangible property; therefore, the IRD would not expect to see charges to New Zealand taxpayers for these benefits;

• The benefits should not be wholly attributed to one entity without consideration of the contributions to the savings made by all associated parties; and

• Material synergistic benefits may require comparability adjustments.

As well as considering the transfer pricing implications of any restructuring arrangements, the IRD also considers the general anti-avoidance rules. This requires consideration of the economic rationale of each step of the restructuring arrangement to identify any unnecessary steps, circularity of fundflows, or artificial elements to the arrangement.

[162] Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017.

[163] *See* Inland Revenue, Tax Information Bulletin, Vol. 29(5), June 2017.

[164] *See* Inland Revenue, Cost Contribution Arrangements, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/cost-contribution-arrangements.

[165] *See* Inland Revenue, Restructuring, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/business-restructuring.

[166] For a complete list of the documentation the IRD expects, *see Id.*

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H. Attribution of Profits to Permanent Establishment

New Zealand rejects the Authorized OECD Approach pertaining to the attribution of profits to a permanent establishment.[167] New Zealand has an explicit reservation against the 2010 OECD Model approach contained in Article 7, with notional mark-ups allowable by New Zealand only for certain internal transfers. In addition, New Zealand recently introduced a new permanent establishment anti-avoidance rule aimed at large MNEs using structures designed to avoid the creation of a permanent establishment in New Zealand. These rules are discussed further at III.A.3.b., above.

[167] ITA 2007, §YD 5.

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V. Documentation and Reporting Requirements

Generally, there are no legislative requirements for taxpayers to maintain transfer pricing documentation. However, the legislation requires New Zealand's transfer pricing rules to be applied in accordance with the 2022 OECD Guidelines, and the IRD's view is that sufficient documentation should be maintained to support a taxpayer's transfer pricing position.

A. Master File and Local File

The IRD has endorsed the revised Chapter V of the OECD Guidelines in relation to the maintenance of a master file and a local file and has not imposed any additional requirements.[168]

In New Zealand, there are no legislative requirements for taxpayers to disclose details of their transfer pricing transactions and/or documentation outside of a specific request from the IRD. For example, there is no requirement for such disclosures when filing a taxpayer's income tax return. If the IRD requests documentation as part of a transfer pricing risk review or audit, generally, taxpayers will have two months to provide the requested documentation.[169]

B. Country-by-Country Reports (CbC Rules)

For income years commencing on or after January 1, 2016, certain large New Zealand taxpayers are required to comply with the country-by-country reporting requirements in the 2022 OECD Guidelines, Chapter V, Annex III.[170] These requirements apply to corporate groups headquartered in New Zealand with annual consolidated group revenue of over EUR750 million. The IRD reports that currently there are approximately 20 New Zealand companies affected by these requirements.[171]

The IRD contacts each affected company required to file CbC reports. These companies must file aggregated financial information for each jurisdiction in which they operate using the IR1032 form.[172] This form is required to be filed within 12 months of the end of the income year.

C. Annual Tax Return Disclosure

1. Statutory Requirement to Maintain Documentation

There is no explicit New Zealand legislative requirement for taxpayers to maintain transfer pricing documentation.[173] However, taxpayers are required to comply with the transfer pricing rules in relation to their cross-border arrangements with associated parties. The maintenance of documentation provides evidence that a taxpayer has applied the legislation in determining its transfer prices. Further, the IRD expects taxpayers to present transfer pricing documentation on request in the event of a risk review or tax investigation.[174]

As discussed in III.B.5., above, the burden of proof in determining the arm's-length consideration lies with the taxpayer. It is unlikely a taxpayer will be able to demonstrate that it has appropriately applied the legislation without documenting the selection and application of the prescribed methods in accordance with the legislation.

The only documentation that is subject to a statutory requirement is the country-by-country (CbC) reporting, as discussed in V.B., above. Any large MNEs subject to these rules are required to file CbC reports annually.

2. Documentation Requirements

Documentation should record both the processes followed and the analysis undertaken by taxpayers in support of their transfer pricing position. This should evidence that taxpayers have selected the most reliable methods and applied appropriate comparable data to determine arm's-length transfer prices. The IRD has provided guidance on the elements that should be included in good transfer pricing documentation, as follows:[175]

- A detailed description of the facts, including an analysis of the taxpayer's functions, risks, and assets — particularly the taxpayer's intangible assets;
- An industry analysis that describes the taxpayer's position in its industry, including the identification of key profit drivers, performance of major competitors, and when value is added by the taxpayer in the supply chain;
- Separate consideration of each category of associated party transactions;
- A discussion of the process undertaken to identify internal comparable data;
- Details of the rationale for the selection of the best pricing method;
- Details of all comparable data searches performed, including the identification of databases used, criteria employed, and the reasons for accepting or rejecting data;
- An analysis of the comparability of uncontrolled companies selected;
- An unadjusted income statement for each comparable company used, with any adjustments explained in detail;
- When using the transactional net margin method, a cross-check of the application of the method using at least a second profit level indicator;
- Conclusions, including reasonableness checks to demonstrate commercial realism of the transfer prices; and
- Copies of all intercompany agreements, together with the local and global corporate structures.

In addition, specific disclosure is required in relation to financing transactions subject to the restricted transfer pricing rules.[176]

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[168] *See* Inland Revenue, Documentation, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/documentation.

[169] *Id.*

[170] Tax Administration Act 1994, §78G.

[171] *See* Inland Revenue, Country-by-Country Reporting, https://www.ird.govt.nz/international-tax/exchange-of-information/country-by-country-reporting-requirements.

[172] Available at https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir1000---ir1099/ir1032/ir1032-2018.pdf.

[173] *See* Inland Revenue, Documentation, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/documentation.

[174] In most cases taxpayers would have up to two months to provide the information requested *see* https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/documentation.

[175] *Id.*

[176] *See* IV.D.2.above.

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3. Practice Issues

The IRD has provided guidance on common errors in transfer pricing documentation that has not been adequately prepared,[177] including an absence of basic information regarding the legal structure of the arrangements and identification of all the parties involved, together with poor analysis of the nature of the relationship between agents and principals. In addition, the IRD has provided guidance on reliance on basic business descriptions without adequate consideration of fundamental business processes and inadequate analysis of where risks are borne. The IRD also recommends that any financial ratios calculated in the transfer pricing documentation should be reconciled to the financial statements. The IRD notes that taxpayers should be wary when relying on earlier documentation that has not been updated or on documentation that was prepared for an overseas tax authority (e.g., parent company transfer pricing documentation used to support the New Zealand transfer pricing position). The IRD emphasizes the importance of ensuring that documentation reflects current practice, New Zealand legislation, and New Zealand market conditions.[178]

D. Penalties and Other Sanctions

The level of transfer pricing analysis and documentation is a factor in determining the extent to which shortfall penalties arise when a transfer pricing reassessment occurs. Adequate transfer pricing documentation most commonly serves to demonstrate that the taxpayer has taken "reasonable care" and consequently prevents the application of shortfall penalties. The interaction of the transfer pricing rules with the penalties regime is discussed further in VIII., below.

[177] *Id.*

[178] *Id.*

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VI. Transfer Pricing Audits

A. Forward Audits

The IRD does not generally undertake forward audits (i.e., an audit prior to the filing of a return). However, there is no statutory restriction preventing the IRD from commencing an audit or issuing an assessment of income tax prior to either the due date for filing an income tax return or the actual date of filing. A forward audit is not likely to occur unless an issue has been identified by the IRD as part of a post-filing audit.

In addition to formal audits, the IRD also conducts risk reviews. A risk review comprises a desk review of a high-level questionnaire detailing the nature of the taxpayer's transactions, internal procedures implemented, and so forth. Following a risk review, the IRD categorizes the taxpayer by risk level and determines the auditing program for that taxpayer.

B. Post-Filing Audits

Post-filing transfer pricing audits are either undertaken as specific transfer pricing audits or as a part of comprehensive income tax audits. The IRD generally aims to undertake comprehensive income tax audits every four years for most large businesses. Transfer pricing-specific audits may be triggered by a variety of IRD audit activities, including industry reviews, transaction reviews (e.g., royalty or interest rate reviews), taxpayer-specific media releases, or other information that has come to the IRD's attention.

An audit is usually based on a review of the taxpayer's most recently filed tax return and its responses to a transfer pricing questionnaire issued by the IRD as part of the audit process. The IRD has drafted three questionnaires targeting New Zealand-owned multinationals, foreign-owned multinationals, and New Zealand branch operations, which the IRD suggests can be used by taxpayers to self-assess their transfer pricing risk.[179]

The number of income tax years typically included in an audit varies based on the issues uncovered during the audit and the materiality and associated risks of these issues as perceived by the IRD. The time frame initially audited does not usually exceed the statutory time bar (statute of limitations) for the amendment of assessments. This period runs for four years from the end of the income tax year in which the taxpayer has furnished the return and may be extended to seven years if the Commissioner has notified the taxpayer that a tax audit or investigation has commenced.[180] Further, the IRD is not restricted by the statutory time bar if the tax return is considered to be fraudulent or willfully misleading or has omitted income from a particular source.

C. IRD's Transfer Pricing Specialists

The IRD has developed a specialist transfer pricing team that performs a number of functions, including:[181]

- Maintaining a multinational enterprises database;
- Monitoring taxpayers using both general and specific surveillance;
- Identifying and scoping taxpayer transfer pricing risks;
- Providing advice and assistance to IRD audit staff, including audit recommendations, advice on functional and comparability analyses, and application of methodologies;
- Preparing industry analyses and special projects;
- Training IRD audit staff;
- Negotiating and approving APAs;
- Dealings regarding mutual agreement cases; and
- Exchanging information from and to treaty partners.

In general, for large transfer pricing issues, one or more of the transfer pricing specialists are involved, particularly if economic analysis is required as part of the audit.

D. IRD's Approach to Transfer Pricing Reviews and Audits

The IRD's enforcement program is based on the perceived risk to the revenue base. Taxpayers with a high perceived risk are more likely to be reviewed or audited than those perceived to have a low risk.[182] On this basis, in enforcing New Zealand's transfer pricing rules, the IRD does not expect taxpayers to incur compliance costs beyond the minimum requirement to reasonably assess whether the transfer prices comply with the arm's length principle.

A taxpayer's transfer pricing risk is just one of a number of tax risks considered by the IRD when organizing its auditing activities. These risks are considered in the context of the taxpayer's industry, commercial practices, history, ownership, and key performance indicators.

E. IRD's Assessment of Risk

The IRD's main transfer pricing focus is on taxpayers in the "significant enterprises segment," which includes companies or groups with turnover in excess of NZ$100 million.[183] In addition, the IRD has a continuing focus on a number of high-risk areas, including:[184]

- Unexplained losses by foreign-owned groups.
- Loans in excess of NZ$10 million in principal and guarantee fees;
- Payments of unsustainable levels of royalties and service fees;
- Material transfer pricing transactions with low- or no-tax jurisdictions;

[179] *See* Inland Revenue, Questionnaires for Transfer Pricing, https://www.ird.govt.nz/international-tax/business/transfer-pricing/questionnaires.

[180] ITA 2007, §GC13(6).

[181] *See* Inland Revenue, Specialists for Transfer Pricing, https://www.ird.govt.nz/international-tax/business/transfer-pricing/specialists.

[182] *See* Inland Revenue, Compliance Programme for Transfer Pricing, https://www.ird.govt.nz/international-tax/business/transfer-pricing/compliance-programme.

[183] *See* Inland Revenue, Significant Enterprises, https://www.ird.govt.nz/about-us/who-we-are/organisation-structure/significant-enterprises.

[184] *See* Inland Revenue, Compliance Programme for Transfer Pricing, https://www.ird.govt.nz/international-tax/business/transfer-pricing/compliance-programme.

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- Income from e-commerce transactions;
- Supply chain restructures involving significant transfers of assets, functions, or risks out of New Zealand;
- Unusual arrangements in controlled foreign companies;
- Profitability of foreign-owned distributors. In particular, small wholesale distributors (less than NZ$30 million turnover) with weighted average profit-before-tax ratios of less than 3%.

F. Burden of Proof Rule

From July 1, 2018, the burden of proof for transfer pricing arrangements has been shifted from the Commissioner to the taxpayer.[185] The taxpayer is now required to demonstrate that the transfer prices used are correct, usually by providing adequate transfer pricing documentation that demonstrates compliance with the transfer pricing rules. The burden of proof rule for transfer pricing is now in line with the general rule for income tax matters.

Prior to July 1, 2018, the burden of proof was with the Commissioner, unless the taxpayer had failed to adequately apply the transfer pricing rules. In assessing a taxpayer's audit risk, the IRD would consider whether the burden of proof could be shifted to the taxpayer. In accordance with §GC 13(4), the burden could be shifted to the taxpayer when either the Commissioner could demonstrate a more reliable measure of the arm's-length amount or the taxpayer did not cooperate with the Commissioner. In this regard, the quality of the taxpayer's documentation and analysis and the taxpayer's cooperativeness were especially important in determining the audit risk.

G. IRD Transfer Pricing Questionnaires

The IRD has three standard questionnaires:[186] (1) a version for foreign-owned multinationals; (2) a version for New Zealand branch operations; and (3) a version for New Zealand-owned multinationals. The IRD uses these questionnaires as part of its audit program to assess transfer pricing risk. The IRD recommends taxpayers use these questionnaires to self-assess their own risk. However, there is currently no statutory requirement to complete these forms, unless required to do so as part of an audit.

The questionnaires typically request some or all of the following information for a particular taxable year:

- A description of the principal activities of the taxpayer, the taxpayer's ultimate parent company, and its consolidated group;
- Financial information for both the taxpayer and the consolidated group;
- Details of all cross-border associated-party transactions;
- Details of the value of transactions that have been confirmed by each of the five transfer pricing methods, including disclosure of the value of "untested transactions;"
- Details of transactions involving the New Zealand taxpayer providing any goods, services, or anything else of value to a nonresident associated person for no consideration;
- The total value of transactions with associated persons tax resident in no- or low-tax jurisdictions or territories;
- Details of any material structural changes (i.e., business restructurings) in the last five years resulting in a reduction of business functions, assets held, and risks borne by the New Zealand taxpayer;
- Details of any partnership, joint venture, or profit or revenue sharing arrangements entered into with a nonresident associated person;
- Confirmation of whether transfer pricing documentation has been prepared in accordance with the 2022 OECD Guidelines;
- Disclosure of the number of staff the company employs and details on the staff who earn more than NZ$150,000 per annum, including benefits;
- Details of the taxpayer's and the group's total debt and assets; and
- Disclosure as to whether any associated-party transactions have been the subject of an APA in another jurisdiction or New Zealand.

In addition, in May 2015 the IRD introduced another international questionnaire for foreign-owned taxpayers requesting selected information regarding MNEs.[187] This questionnaire is generally sent to foreign-owned taxpayers or groups with turnover of over NZ$30 million. The purpose of this questionnaire is to improve IRD risk assessment processes and to assist in meeting the IRD's obligations in relation to the OECD's Base Erosion and Profit Shifting project. The questionnaire[188] requests information regarding the New Zealand group's financial and tax position and contains questions related to tax governance, thin capitalization, transfer pricing arrangements and selected compliance issues, such as whether any material changes to the business structure were made during the income year.

[185] This was enacted through the repeal of ITA 2007, §§GC 13(4) and 13(5), which previously placed the burden of proof on the Commissioner.

[186] *See* Inland Revenue, Questionnaires for Transfer Pricing, https://www.ird.govt.nz/international-tax/business/transfer-pricing/questionnaires.

[187] *See* Inland Revenue, International Questionnaire, https://www.ird.govt.nz/international-tax/business/international-questionnaire.

[188] *Id.*

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VII. Transfer Pricing Adjustments

A. Overview

Generally, the provisions of §GC 6–§GC 14 only apply to increase a taxpayer's taxable income. However, in limited circumstances, a provision is made to allow for a reduction either in the taxable income of the taxpayer or in that of the other party to the transaction. Two types of adjustments may be made to either the New Zealand taxpayer's or other taxpayer's New Zealand tax liability in the event of a transfer pricing adjustment:

- Compensating adjustments: These arise in limited circumstances when the taxable income of a taxpayer may be reduced as a result of a transfer pricing adjustment.
- Adjustments relating to requests for matching treatment: These arise in limited circumstances when the taxable income of the other party to the audited transfer pricing transaction may be reduced as a result of a transfer pricing adjustment to the taxpayer.

B. Compensating Adjustments

Compensating adjustments are available under §GC 9 and §GC 10 when a taxpayer is subject to an adjustment that increases its taxable income in a particular income year and the taxpayer enters into a "compensating adjustment transaction" in the same, previous, or succeeding year. A compensating adjustment transaction is a transaction entered into with the same other party as the original transaction and involving either the supply of the same type of property or the setting of the consideration payable or receivable with regard to the amount payable under the original transaction.

The effect of this provision is that it allows, in limited circumstances, non-arm's-length transactions to be offset, when one increases and the other reduces the taxpayer's taxable income.

The application of §GC 9 and §GC 10 allows for the offset of the excessive consideration paid (or inadequate consideration received) in the original transaction with the inadequate consideration paid (or excessive consideration received) under the compensating adjustment arrangement.

C. Request for Matching Treatment

Generally, if a taxpayer is subject to an adjustment under §GC 6–§GC 14, that adjustment does not affect the calculation of the New Zealand income tax liability of the other party to the transaction. However, a request for matching treatment (sometimes referred to as correlative adjustment) is provided for under §GC 11, which allows the substituted amount to be used by the other taxpayer.

A request for matching treatment is only available when a substitution has been made under either §GC 7 or §GC 8 in relation to an arrangement entered into by a taxpayer and the other party to the arrangement has applied to the Commissioner in writing within six months of the date of the assessment that reflects the substitution. In addition, a substitution is only allowed when the Commissioner considers it fair and reasonable. The substitution applies for all purposes in calculating the New Zealand income tax liability of the other party, except for the determination of a deemed dividend.

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VIII. Penalties

A. Overview

The transfer pricing rules contain no specific penalty or interest provisions. Therefore, the transfer pricing regime is subject to the same compliance and penalty rules that apply to general income tax issues. The New Zealand penalties regime is included in the Tax Administration Act 1994, part 9. The three main types of penalties imposed by the penalties regime are:

- "No fault" civil penalties for late filing or late payments;
- Civil penalties that involve consideration of the conduct of the taxpayer, such as the level of knowledge of the taxpayer and the intention of the taxpayer to breach a tax law; and
- Criminal penalties, for which the taxpayer's state of mind may be relevant.

When a transfer pricing adjustment occurs, a civil penalty known as a shortfall penalty may be imposed. The New Zealand shortfall penalties regime applies when, for example, a transfer pricing adjustment results in a tax shortfall (i.e., additional tax owing). This regime provides a comprehensive, mandatory set of penalties for failure to comply with the law. The penalties imposed depend on the conduct of the taxpayer and are aimed at penalizing taxpayers for conduct from noncompliance to overly aggressive interpretations of tax laws to blatant tax avoidance.

Other civil penalties, such as late payment penalties and interest, may also apply to a transfer pricing adjustment. Further, criminal penalties may also be relevant if the IRD decides to prosecute a taxpayer.

In addition, penalties of up to NZ$100,000 may also apply to large MNEs that fail to comply with the Country-by-Country reporting requirements[189] or fail to provide information when requested by the IRD.[190] Further, from January 1, 2025, a penalty of up to NZ$100,000 may also apply to taxpayers who fail to register or provide information under the Global Anti-Base Erosion rules.[191]

Penalties are nondeductible to the taxpayer and can represent a significant cost.

B. Shortfall Penalties

A shortfall penalty is generally imposed on the understatement of tax that results from an IRD reassessment, including a transfer pricing reassessment, typically as a result of an audit.[192] The level of penalty imposed depends on the conduct of the taxpayer.[193] The categories of fault are summarized in the following table:

[189] Tax Administration Act 1994, §138AAB.

[190] *Id.*, §138AB.

[191] *Id.*, §138ABB.

[192] *See* Inland Revenue, Shortfall Penalties, https://www.ird.govt.nz/managing-my-tax/penalties-and-interest/penalties-and-debt/shortfall-penalties.

[193] There are also "promoter" penalties that can apply to persons involved in planning or promoting arrangements that give rise to an abusive tax position for a taxpayer.

Action Subject to Penalty	Standard Rate	Reduced by 75% or 100% for Disclosure Before Audit	Reduced by 40% for Disclosure After First Notification of Audit, but Before Audit Starts	Reduced by 75% for Disclosure When Filing	Increased by 25% for Obstruction
Not taking reasonable care	20%	0%	12%	N/A*	25%
Unacceptable tax position	20%	0%	12%	5%	25%
Gross carelessness	40%	10%	24%	N/A*	50%
Abusive tax position	100%	25%	60%	25%	125%
Evasion	150%	37.5%	90%	N/A*	187.5%

* This reduction is limited to the unacceptable interpretation and abusive tax position penalties because it specifically relates to the disclosure of the taxpayer's interpretation at the time of filing.

The shortfall penalty may also be reduced by 50% based on the taxpayer's past record of "good behavior" and by 75% when the tax shortfall is a "temporary tax shortfall."[194] In certain circumstances, when a taxpayer makes a voluntary disclosure of a tax shortfall prior to notification of an audit, the Commissioner may reduce any penalty by 100% if it relates to a failure to take reasonable care or the adoption of an unacceptable tax position.

A taxpayer is liable for only one penalty in relation to each tax shortfall. Where a taxpayer could otherwise have been liable for more than one penalty, the highest shortfall penalty is imposed.

[194] A temporary tax shortfall occurs when the taxpayer has reversed or corrected the tax shortfall within four years of the day on which the taxpayer took the tax position giving rise to the tax shortfall. *See* Tax Administration Act 1994, §141I.

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The level of transfer pricing analysis and documentation is a factor in determining the extent to which shortfall penalties arise when a transfer pricing reassessment occurs. Adequate transfer pricing documentation most commonly serves to demonstrate that the taxpayer has "taken reasonable care" or has not demonstrated "gross carelessness" and consequently prevents the application of these shortfall penalties.

Failure to prepare and maintain transfer pricing documentation does not, by itself, give rise to penalties. Shortfall penalties only arise when an adjustment is made to the taxpayer's transfer prices and adequate documentation is not maintained.

1. Not Taking Reasonable Care

A taxpayer who does not take reasonable care in taking a tax position is liable to pay a 20% penalty if that tax position results in a tax shortfall. The standard of reasonable care is based on what a reasonable person in the same circumstances would do. Generally, if a taxpayer relies on the advice of a tax advisor, the taxpayer is regarded as having taken reasonable care.

Similarly, if a taxpayer adopts an acceptable tax position, that taxpayer is treated as having taken reasonable care. In effect, a taxpayer has taken reasonable care if, viewed objectively, the tax position meets the standard of being about as likely as not to be correct. In determining whether the standard of reasonable care has been met, the Commissioner considers the likelihood of a tax shortfall, the quantum of the shortfall, and the difficulty of preventing a tax shortfall.

The shortfall penalty for not taking reasonable care can be reduced for the taxpayer's previous behavior, voluntary disclosure, or when the tax shortfall is temporary.

The transfer pricing rules require a taxpayer to determine the arm's-length amount using the prescribed method (or methods) that produces the most reliable measure of the arm's-length amount.

To demonstrate that these rules have been complied with, a taxpayer is expected to adopt and maintain appropriate documentation. A taxpayer who fails to do this is unlikely to satisfy the standard of reasonable care and is subject to a 20% penalty on any tax shortfall arising from a transfer pricing adjustment. Depending on the taxpayer's actions and the transfer pricing position adopted, the IRD may seek to impose higher penalties if the IRD considers the taxpayer has adopted an "abusive tax position" or if the taxpayer's actions represent "gross carelessness" or "evasion," as discussed further in the following sections.

2. Unacceptable Tax Position

An unacceptable tax position is one that objectively does not meet the standard of being about as likely as not to be correct. The penalty for an unacceptable tax position is 20% of the tax shortfall, provided that the shortfall exceeds both NZ$50,000 and 1% of the taxpayer's total tax figure for the return period.

Whether a tax position is acceptable is considered at the time at which the taxpayer took the relevant tax position.

Section GC 7 and §GC 8 require the taxpayer to determine its transfer prices in accordance with the arm's length principle. Therefore, a taxpayer who cannot demonstrate the application of the arm's length principle in determining a transfer price faces the risk of the IRD applying a penalty for an unacceptable tax position.

3. Gross Carelessness

Gross carelessness is defined as doing or not doing something in a way that suggests or implies a complete or high level of disregard for the consequences. Such behavior is characterized by conduct that creates a high risk of a tax shortfall when this risk and its consequences would have been foreseen by a reasonable person in the circumstances. Gross carelessness is more than a lack of reasonable care but less than evasion in that it does not require the necessary intention to evade tax. A penalty of 40% is imposed when a taxpayer is grossly careless in taking a tax position.

A failure to prepare adequate transfer pricing documentation or acceptance of pricing that is clearly inappropriate could result in the IRD imposing a penalty for gross carelessness if apparent problems involving material-associated party transactions are simply brushed over or ignored.

In the transfer pricing context, the IRD is likely to subject a taxpayer to a gross carelessness penalty when, for example, the taxpayer has engaged in material cross-border dealings with associated parties and has made no effort to determine whether the dealings complied with the arm's length principle prescribed by the transfer pricing regime.

4. Abusive Tax Position

A shortfall penalty of 100% is applied when a taxpayer takes an abusive tax position leading to a tax shortfall. In general, an abusive tax position is one that has been adopted to avoid tax. This penalty applies when the taxpayer has taken an unacceptable tax position and has acted, interpreted, or applied tax laws with a dominant purpose of taking a tax position that reduces or removes tax liabilities or gives tax benefits. An abusive tax position falls short of evasion (discussed below) insofar as the taxpayer has a dominant purpose of avoiding tax but does not knowingly evade tax. As such, no criminal penalties apply to this category of shortfall penalty.

5. Evasion

A penalty of 150% of the tax shortfall applies when the taxpayer commits evasion or a similar act in taking a tax position. Evasion or a similar act is defined in the Tax Administration Act 1994 as occurring when, in taking a tax position, the taxpayer:

- Evades the assessment or payment of tax by the taxpayer or another person;
- Knowingly uses withheld tax for a purpose other than payment to the IRD;
- Knowingly does not make a deduction or withholding of tax or transfer of payroll deduction required to be made;
- Attempts to obtain a refund or payment of tax, knowing that the taxpayer is not lawfully entitled to the refund or payment under a tax law;
- Obtains a refund or payment of tax, knowing the taxpayer is not lawfully entitled to it;

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• Enables another person to obtain a refund or payment of tax, knowing that other person is not legally entitled to it; or

• Attempts to enable another person to obtain a refund or payment of tax, knowing that the other person is not lawfully entitled to the refund or payment under a tax law.[195]

The penalty for evasion or similar act is the highest level of civil penalty and applies when the taxpayer has knowingly attempted to cheat the IRD. For this penalty to apply, it needs to be determined that the taxpayer knew of the existence of a tax law and was knowingly in breach of it. In addition, the IRD can also seek to apply criminal penalties for evasion, which can result in up to five years in prison and/or a fine of up to NZ$50,000.

C. Interest

New Zealand has a "use of money interest" (UOMI) system designed to compensate the Commissioner or the taxpayer for the loss of the use of money. The interest rules are contained in the Tax Administration Act 1994 and require a taxpayer to pay interest when various taxes and duties are not paid by the due date for payment. There is a corresponding requirement for the Commissioner to pay interest to the taxpayer when the taxpayer has overpaid a tax or duty.[196] Technically, UOMI is not a penalty, but when a shortfall arises, it can give rise to a significant additional cost.

The interest payable by the taxpayer or the Commissioner is payable pursuant to a formula applied each day tax is unpaid. The interest is calculated for each day there is a discrepancy with the tax that should have been paid. Interest does not compound. The taxpayer's paying rate and the Commissioner's paying rate are both set by regulation. This is discussed further at I.C.2.b., above.

For transfer pricing purposes, interest is payable on any tax shortfall that arises as a result of a transfer pricing adjustment by the IRD. Accordingly, interest may present a significant cost to taxpayers when a transfer pricing adjustment is made to a transaction that occurred some years in the past.

[195] Tax Administration Act 1994, §141E.

[196] From August 29, 2023, the credit rate payable by the Commissioner on overpaid tax is 4.67% and the debit rate charged by the Commission on unpaid tax is 10.91%.

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IX. Appeals and Litigation Matters

A. Administrative Appeals of Disputed Audit Findings

Transfer pricing disputes are subject to the standard dispute procedures. The purpose of the dispute procedures is to improve the accuracy of assessments, reduce the likelihood of disputes by encouraging open and full communication between the taxpayer and IRD, promote the early identification of the basis of disputes, and enable prompt resolution of disputes. In practice, most transfer pricing issues are fully discussed between the IRD and taxpayer as part of the audit prior to the disputes procedures.

The IRD may issue a taxpayer a notice of proposed adjustment (NOPA) in relation to any disputed audit findings. The NOPA can be issued at any time during the audit process but is usually issued at the end of the audit. Depending on the disputed issue, the NOPA may relate to a specific income year or several income years. If more than one issue is uncovered in a particular income year, the IRD may issue a separate NOPA for each separate issue.

The NOPA document must identify the issue in dispute, the proposed adjustment, and the key facts and legal arguments supporting the proposed adjustment in sufficient detail and in the prescribed form.[197] Consistent with the purpose of the dispute procedures, the intention is for the IRD to provide full disclosure at an early point in the process.

The taxpayer has two months from the date the NOPA is issued to provide a notice of response to the IRD.[198] If the taxpayer does not respond within this timeframe, it is deemed to have accepted the NOPA. The notice of response must identify the key facts and supporting legal arguments contained in the NOPA that the taxpayer considers to be incorrect and any facts and supporting legal arguments relied upon by the taxpayer to support its position. In addition, the notice of response must contain the quantitative adjustments to figures referred to in the NOPA.[199]

If the parties disagree at this stage, a conference is likely to be held, but this is not a legislative requirement. If the issue remains unresolved, the IRD issues its statement of position and a disclosure notice to the taxpayer to inform the taxpayer that it will be required to prepare a statement of position. The statement of position contains more detail than disclosed in either the NOPA or notice of response. In the event that the matter proceeds to court, the facts disclosed in the statements of position are binding on the parties. In addition, the parties are limited to challenging only the facts and evidence raised in the statements of position.

Although not a requirement, in practice if resolution is not met following the exchange of the statements of position, the IRD refers the matter to its Disputes Review Unit. If the matter remains in dispute following a review by this unit, the IRD issues a notice of assessment.

If a taxpayer has been issued a notice of assessment with which it does not agree, and the IRD has not previously issued a NOPA in relation to that assessment, the taxpayer may issue a NOPA.[200] The IRD is entitled to issue a notice of response and follow the general dispute procedures as outlined above.

In relation to transfer pricing disputes, a taxpayer may seek relief through the mutual agreement procedure (MAP) article of a relevant treaty, if applicable, for any double taxation that has arisen or will arise as a consequence of the dispute. In practice, consideration is often given to initiating the MAP procedures prior to issuing a NOPA or notice of assessment in accordance with the dispute procedures.

B. Judicial Appeals of Disputed Audit Findings

Although taxpayers have a right to lodge judicial appeals for transfer pricing matters, no cases involving transfer pricing have been heard since the inception of the 1995 transfer pricing legislation.

A taxpayer may challenge a disputed decision by commencing proceedings in one of two hearing authorities: the Taxation Review Authority (TRA) or the High Court.

The TRA is a lower-level authority, as opposed to the High Court. Disputes that involve significant legal issues of precedent or unclear or disputed facts are generally referred to the High Court. A challenge filed with one of the authorities may be transferred to the other authority if the initial authority considers it more appropriate. The High Court may also transfer initial proceedings to the Court of Appeal.

To ensure a taxpayer retains its right of appeal to these authorities, it is important that it adheres to the requirements and timeframes set out in the dispute proceedings. Proceedings can only be commenced if specific criteria have been met. Generally speaking, proceedings can be commenced once the IRD has issued a notice of assessment or when a taxpayer has proposed an adjustment through the disputes procedures that has been rejected by the IRD.

If the IRD and taxpayer have issued statements of position as part of the dispute procedures, both parties may only raise the facts, evidence, issues, and propositions of law arising from those statements of position unless the relevant hearing authority allows further issues to be raised. Given this constraint, it is important to seek legal advice during the dispute procedures.

C. Litigation

To date, there have not been any cases before the New Zealand courts that pertain to the operation of §GC 6–§GC 14. Further, the application of the previous transfer pricing legislation, contained in §22 of the Income Tax Act 1976,[201] was considered by the courts in only one case: *ER Squibb & Sons (NZ) Ltd v. Commissioner of Inland Revenue.* That case predominantly dealt with administrative issues arising from a reassessment for income tax and related notices issued by the IRD.

The case involved a taxpayer in the business of distributing pharmaceuticals. The IRD issued an amended assessment

[197] Tax Administration Act 1994, §89F.

[198] *Id.* §89AB.

[199] *Id.* §89G.

[200] *Id.* §89D. The taxpayer may file and the IRD may issue an assessment that differs from the return, or the IRD may issue an assessment agreeing with the return, in which case the taxpayer can issue a NOPA to propose an adjustment to the filed return.

[201] Subsequently §GC 1 of the Income Tax Act 1994 before introduction of the current transfer pricing regime.

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for New Zealand income tax based on evidence that profits were being shifted out of New Zealand. This evidence was primarily provided by a former employee of an Australian associated company. The case resulted in three High Court decisions and a Court of Appeal decision.[202] The key decision from these proceedings that is likely to be relevant to the current transfer pricing rules was that the Commissioner was not required to disclose to the taxpayer the information it used to assess the profitability of the taxpayer. The IRD obtained this evidence from a former employee of an Australian associated company, the Australian Taxation Office, and other taxpayers.

[202] *ER Squibb & Sons (NZ) Ltd v. Commissioner of Inland Revenue*, [1991] 13 N.Z.T.C. 8,096 (H.C.); *ER Squibb & Sons (NZ) Ltd v. Commissioner of Inland Revenue (No 2)*, [1991]; 13 N.Z.T.C. 8,131 (H.C.); *ER Squibb & Sons (NZ) Ltd v. Commissioner of Inland Revenue (No 3)*, [1991] 13 N.Z.T.C. 8,174 (H.C.); and *Commissioner of Inland Revenue v. ER Squibb & Sons (NZ) Ltd v. Commissioner of Inland Revenue* [1992] 14 N.Z.T.C. 9,146 (C.A.).

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X. Competent Authority

A. *Conflicts with Countries Covered by Relevant Tax Treaties*

1. *Overview*

Under New Zealand tax law, taxpayers are not permitted to make adjustments to transfer prices unless the adjustments are required by the application of the transfer pricing rules. Therefore, taxpayers cannot include additional income or deductions in their tax returns for transfer pricing adjustments made in foreign jurisdictions.

When a foreign adjustment has been made and the adjustment results in double taxation, taxpayers can seek competent authority assistance under the mutual agreement procedure article of the relevant income tax treaty[203] to obtain a corresponding adjustment in New Zealand. New Zealand currently has income tax treaties with the following 40 countries:[204]

Australia	Indonesia	Singapore
Austria	Ireland	South Africa
Belgium	Italy	Spain
Canada	Japan	Sweden
Chile	Korea	Switzerland
China	Malaysia	Taiwan
Czech Republic	Mexico	Thailand
Denmark	Netherlands	Turkey
Fiji	Norway	United Arab Emirates
Finland	Papua New Guinea	United Kingdom
France	Philippines	United States of America
Germany	Poland	Vietnam
Hong Kong	Russian Federation	
India	Samoa	

Also, New Zealand is currently negotiating agreements or revised agreements with several countries, including a double tax agreement with the Slovak Republic and a revised second protocol with Austria.[205]

In addition, New Zealand's Tax Information Exchange Agreements have limited-scope MAP articles, and a number of more recent agreements (Cayman Islands, Cook Islands, Guernsey, Isle of Man, Jersey, and the Marshall Islands) provide for a MAP to cover transfer pricing arrangements.[206]

New Zealand is also a party to the OECD's Convention on Mutual Administrative Assistance in Tax Matters, in force from March 1, 2014, and the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, in force from October 1, 2018.

Many of New Zealand's income tax treaties include time limits for applying for competent authority assistance. Generally, the IRD applies a three-year time limit in accordance with the OECD's Model Tax Convention. The time limits start from the first notification of the action that results in double taxation. The time limits range from two to five years. However, New Zealand's most recently signed income tax treaties include a time limit of three years (Canada, China, Japan, Papua New Guinea, and Vietnam). In addition, following the ratification of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, New Zealand will apply a three-year limit for any "covered tax agreements" that have a shorter limit in the applicable income tax treaty.[207]

2. *Competent Authority Procedure*

In New Zealand, the relevant competent authority for transfer pricing matters is the Strategic Advisor (International) and the Strategic Policy Advisor at the IRD. They are responsible for negotiations with treaty partners under the applicable tax treaties and for matters related to treaty interpretation. There is no formal procedure for initiating a mutual agreement procedure, with taxpayers advised to send a written request to the New Zealand Competent Authority, c/o Strategic Advisor (International), Inland Revenue Department. The request should include the relevant facts, the article of the relevant tax treaty to which the matter relates, an analysis of the issues supported by relevant evidence, copies of submissions made to foreign competent authorities on the matter, and copies of any APA or settlement agreement related to the matter. The IRD generally follows the three-year time limit in the OECD Model Tax Convention, but this can vary depending on the relevant double tax agreement.[208]

B. *Conflicts with Countries not Covered by Relevant Tax Treaties*

In the event that a transfer pricing adjustment by the IRD or a foreign country gives rise to double taxation and there is no applicable income tax treaty, no process is available to resolve the matter. However, if an adjustment is made by a foreign country, a credit for foreign taxes may be available under the ITA 2007.

C. *Exchange of Information Agreements*

One important reason for tax treaties is that they allow for an exchange of information between countries. Such treaties authorize and facilitate the sharing of information when it may not otherwise be possible due to the laws of a country or the

[203] In New Zealand, income tax treaties are referred to as "double tax agreements."

[204] A list of jurisdictions with which New Zealand has an income tax treaty in force can be found on the Bloomberg Tax platform: https://www.bloombergglaw.com/product/tax/search/results/4e3a03d956b537df9481be3a1a09a8fa/.

[205] *See id.*

[206] *Id.*

[207] For a full list of covered tax agreements *see* http://www.oecd.org/tax/treaties/beps-mli-position-new-zealand-instrument-deposit.pdf.

[208] *See* Inland Revenue, Mutual Agreement Procedure (MAP), https://www.ird.govt.nz/international-tax/double-tax-agreements/mutual-agreement-procedure.

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attitude of the competent authority. The process involves one competent authority requesting information from another for the proper administration of the country's tax laws.[209]

There is an Exchange of Information article in most of New Zealand's income tax treaties. For example, in the New Zealand-U.S. Income Tax Treaty, Article 25 deals with the exchange of information. The article, as replaced by the second protocol to the treaty, provides that the exchange of information should be carried out "as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States." There are exceptions to the article's broad scope — for example, there is no obligation to supply information that would disclose a trade secret.

In addition to the exchange of information articles in New Zealand's network of income tax treaties, New Zealand also has tax information exchange agreements (TIEAs) in force with 19 non-treaty countries, as well as with another two signed but not yet in force.

New Zealand is also a signatory to the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters, which provides for administrative cooperation between signatories in the assessment and collection of taxes. This treaty, together with the work of the OECD to facilitate the automatic exchange of information under the treaty, will significantly increase the IRD's ability to obtain taxpayer information, given that it provides access to a much wider range of countries than are covered by New Zealand's existing network of income tax treaties and TIEAs. In this regard, the Income Tax Act 2007 and the Tax Administration Act 1994 have been modified to provide for the Automatic Exchange of Information in relation to the OECD's Common Reporting Standards.[210] Most recently, the OECD Convention's new rules on reporting for digital platforms have also been incorporated into the Tax Administration Act 1994, effective from January 1, 2024.[211]

Further, although it pertains to individual financial account information and is not directed per se at transfer pricing, New Zealand signed an intergovernmental agreement with the United States to clarify the reporting obligations of New Zealand financial institutions under the U.S. Foreign Account Tax Compliance Act (FATCA). Effective July 3, 2014, the agreement allows New Zealand financial institutions to send disclosures required under FATCA to the IRD for exchange with the Internal Revenue Service. This agreement, together with the Common Reporting Standards, have been enacted in the Tax Administration Act 1994, Part 11B.

Most recently, New Zealand signed on May 18, 2016, the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports, and legislation to implement this agreement is contained in the Tax Administration Act 1994, §78G.

In New Zealand, the relevant competent authority for transfer pricing matters is the Strategic Advisor (International) at the IRD.[212] This person is responsible for information exchanges with treaty partners.

In the context of transfer pricing, the exchange of information article has practical application at the audit stage, including any audit planning activity, in the course of resolving potential double taxation following an adjustment, and in agreeing to an APA. At each of these levels, there is potential for information to be exchanged automatically, under a request, or spontaneously.

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[209] For an overview of the IRD's approach, *see* Inland Revenue, Offshore Tax Transparency, https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir1200---ir1299/ir1246/ir1246-2022.pdf?modified=20220628021500&modified=20220628021500.

[210] Determination AE21/01, sets out the participating jurisdictions for the Common Reporting Standards, effective from 1 April 2021,*see* https://www.taxtechnical.ird.govt.nz/-/media/project/ir/tt/pdfs/determinations/crs-common-reporting-standard/ae-21-01-participating-jurisdictions-for-the-crs-applied-standard.pdf?modified=20210421233220&modified=20210421233220.

[211] Tax Administration Act 1994, §§185S–185T.

[212] *See* Inland Revenue, Mutual Agreement Procedure (MAP), https://www.ird.govt.nz/international-tax/double-tax-agreements/mutual-agreement-procedure.

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XI. Advance Pricing Agreements and Rulings

A. Overview

In New Zealand, advance pricing agreements (APAs) are available upon application by a taxpayer to the IRD and can take one of three forms:

• Unilateral: An agreement in the form of a private binding ruling between the IRD and the taxpayer is provided for under Part 5A of the Tax Administration Act 1994. While a unilateral agreement technically only provides certainty in relation to the New Zealand tax position, the IRD has undertaken to support taxpayers by entering into competent authority negotiations with the other jurisdiction, if necessary.[213] The IRD shares information with tax treaty partners regarding unilateral APAs issued on or after January 1, 2010, that were still in effect from January 1, 2014.[214]

• Bilateral: An agreement between two tax authorities pursuant to the MAP article in the relevant income tax treaty.

• Multilateral: An agreement involving more than two tax authorities made pursuant to the MAP articles in the relevant income tax treaties.

To date, a significant majority of New Zealand's bilateral APAs have been with Australia, but APAs have also been negotiated with Belgium, Canada, China, Japan, Korea, Switzerland, the United Kingdom, and the United States.

B. The APA Process

The IRD has not issued any standardized formal procedures on the process of obtaining an APA and prefers to tailor the process for each applicant. However, the IRD has outlined the initial steps to be undertaken in the APA process for the reference of applicants, as follows:[215]

• A pre-application meeting form[216] is submitted to the IRD, detailing the business background, the transfer pricing transactions for which the APA is sought, and the suggested transfer pricing methodology to be applied;

• A pre-application meeting is arranged between the taxpayer and one of the IRD's transfer pricing specialists to discuss the proposal; and

• The APA request is formalized and submitted for consideration, which includes:

— The identification of the tested party;

— An analysis of the key profit drivers and value added for the tested party;

— A full functional analysis;

— The choice of methodology;

— An analysis of comparable data;

— The application of the proposed methodology and comparable data; and

— Copies of all intercompany agreements.

• If the application is for a unilateral APA, the application should also include a completed Application for a Private Ruling (IR713)[217] and Application for Private Ruling on Transfer Pricing Arrangement — Additional Declaration (IR713A)[218] forms.

In considering the application for the APA, the IRD undertakes all or some of the following actions:

• A site visit to examine the operations of the associated parties, particularly when the transaction in question involves valuable intangibles and a residual profit split methodology is proposed;

• A review of the comparable data provided by the taxpayer, which may involve a new search by the IRD for comparable data; and

• A review of the methodology employed by the taxpayer, including a cross-check of the results from the proposed methodology using another methodology.[219]

After its review, the IRD meets with the taxpayer in the case of a unilateral APA or with the revenue officers from the other jurisdiction(s) in the case of a bilateral or multilateral APA to discuss any issues or differences in opinion. Exchanges of facts and opinions continue until an agreement is reached.

The IRD aims to complete bilateral APAs with Australia and all unilateral APAs within six months of the date of acceptance of a formal application. Negotiations with other foreign tax jurisdictions generally take much longer.[220] The IRD seeks to recover any costs related to an APA if foreign travel is involved, and an estimate of costs is provided prior to undertaking the travel. There is no application fee for bilateral or multilateral APAs, while unilateral APAs have a NZ$322 application fee.[221]

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[213] *See* Inland Revenue, Advance Pricing Agreements, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/advance-pricing-agreements.

[214] *Id.*

[215] *Id.*

[216] *See* Inland Revenue, Advance Pricing Agreement (APA) Pre-application Meeting, https://www.ird.govt.nz/-/media/project/ir/home/documents/international/advance-pricing-agreement/apa-pre-application-meeting.pdf?modified=20200529011643&modified=20200529011643.

[217] https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir700---ir799/ir713/ir713-2022.pdf?modified=20230803035801&modified=20230803035801.

[218] https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir700---ir799/ir713a/ir713a-2023.pdf?modified=20230330224545&modified=20230330224545.

[219] *See* Inland Revenue, Advance Pricing Agreements, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/advance-pricing-agreements.

[220] *Id.*

[221] https://www.ird.govt.nz/-/media/project/ir/home/documents/forms-and-guides/ir700---ir799/ir713/ir713-2022.pdf?modified=20230803035801&modified=20230803035801.

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Once an APA has been issued, the taxpayer is required to file an annual compliance report. The contents depend on the particular APA but are likely to include financial statements, computations of the transfer pricing method(s) reconciled to the financial statements or other underlying financial data, confirmation of adherence to the APA terms, and confirmation that no critical assumptions contained in the APA have been breached.[222]

[222] *See* Inland Revenue, Advance Pricing Agreements, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/advance-pricing-agreements.

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XII. Other Rules Relating to Transfer Pricing

A. Thin Capitalization Rules

In addition to determining whether the cost of the financing arrangement is at arm's length under the transfer pricing regime, it is also necessary to consider the application of New Zealand's thin capitalization rules.[223] Broadly, the thin capitalization rules apply to New Zealand taxpayers that are controlled by:

- A single nonresident;
- A "nonresident owning body" (essentially a group of entities with linked levels of debt in the New Zealand taxpayer); or
- A trustee of a trust, if 50% or more of settlements in the trust are from nonresidents.

Section FE 2 specifies when interest apportionment may be required for inbound investments. This includes nonresidents other than companies, nonresident companies (unless they are 50% or more owned by a New Zealand resident or no nonresident owns 50% or more), and New Zealand companies when a single non-resident or a nonresident owning body or certain foreign-controlled trustees own 50% or more of the New Zealand company or has control by any other means. Ownership interests are calculated by aggregating both direct and indirect interests of the person and any associated persons.[224] Foreign-owned banks are also subject to the rules when the level of equity is below a defined threshold level. Further, the rules may also apply to New Zealand residents with outbound investments in controlled foreign companies and certain foreign investment funds.[225]

The thin capitalization rules restrict the deductibility of interest by New Zealand resident taxpayers when the level of debt is more than the "safe harbor" level. In general, for inbound investment (i.e., loans to New Zealand taxpayers), interest is deductible, provided the New Zealand group's interest-bearing-debt-to-assets percentage is less than or equal to 60% *and* that percentage is less than or equal to 110% of the worldwide group's debt percentage.[226] If the debt level is higher than one or both of these thresholds, then an apportionment of interest deductions may be required if the New Zealand debt percentage is more than the greater of 60% or 110% of the worldwide group debt percentage. For example, if a New Zealand company had a New Zealand group debt percentage of 80% and a worldwide debt percentage of 70%, given an annual interest deduction of $100, the amount of interest disallowed would be calculated as:[227]

$$\$100 \quad \times \quad (0.8 - (1.1 \times 0.7))/0.8 \quad = \quad \$3.75$$

New Zealand's thin capitalization rules also apply to certain outbound investments by New Zealand residents. These rules are primarily aimed at New Zealand taxpayers claiming deductions for interest on funds invested in offshore CFCs and certain foreign investment funds. In general, these rules limit interest deductions for affected New Zealand taxpayers when the New Zealand group debt percentage is more than 75% *and* the New Zealand group debt percentage is more than 110% of the worldwide group debt percentage.[228] Specific disclosure may be required to be made by taxpayers in their annual income tax return in relation to the application of the thin capitalization rules.[229]

B. Coordination with GST and Customs Rules

1. Relationship Between the Transfer Pricing Rules and GST Rules

New Zealand's GST rules apply to all taxable supplies of goods and services made by registered persons in New Zealand. In general, taxable supplies relate to supplies made in New Zealand, but also includes imported goods and certain imported services.[230] For businesses, most transactions are subject to the standard rate of 15%, except exempt supplies (e.g., financial services) and zero-rated supplies, such as exports. A registered person is required to collect GST on taxable supplies made but can claim GST paid on purchases used to make those supplies, including zero-rated supplies but not exempt supplies.[231] The difference between the GST paid and the GST collected is either payable to or refundable from the IRD.

Under the GST rules, the valuation of goods and services is generally based on the price. However, special rules apply to supplies between associated persons. Under §10(3) of the GST Act 1985, when there is no consideration or the consideration is less than an "open market value," the value is deemed to be the open market value.[232] This is defined in §4 as the price that would be paid for similar goods or services supplied under similar conditions in New Zealand when the supply is "freely offered" between parties who are not associated. When similar transactions cannot be identified, §4(4) provides for the Commissioner to approve an alternative method that provides a "sufficiently objective approximation" of the consideration that could be obtained for the supply.

There is limited guidance either from the IRD or from case law discussing the requirements under §4. Nor is there any guidance as to the relationship between "open market value" and the "arm's-length value" under the transfer pricing rules. However, given the Commissioner's power under the GST rules to approve an alternative valuation method, it is like-

[223] ITA 2007, subpart FE.

[224] ITA 2007, §§FE 38–FE 41.

[225] ITA 2007, §FE 2(1).

[226] ITA 2007, §FE 5.

[227] Refer to ITA, §§FE 6 and 6B, for the full formula; note that there are additional adjustments that may apply in relation to certain fixed rate dividends, on-lending concessions, and mismatch adjustments under the hybrid instruments rules.

[228] ITA, §FE 5.

[229] *See* Inland Revenue, Base Erosion and Profit Shifting (BEPS) disclosure, https://www.ird.govt.nz/international-tax/business/beps-disclosure.

[230] Imported services are defined in §5B of the GST Act 1985 and include certain management services, legal and accounting services, and products downloaded from the internet.

[231] In certain cases, primarily related to imported services, the collection of GST may be the responsibility of the recipient of the supply and not the supplier, referred to as "reverse charging" in §5(27) of the GST Act 1985.

[232] There are certain exceptions to this rule when there is no net loss to the tax system (e.g., when the supplier and recipient are both registered or when the supply is zero-rated).

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ly that the IRD would take note of the transfer pricing valuation. In addition, given the similarity of the GST definition of "open market value" to the CUP method, it is likely that an argument could be made that the two approaches should result in similar prices.

An exception to the standard valuation rule described above relates to the import of goods, as the administration of the GST rules for imports is the purview of the New Zealand Customs Service, which has its own valuation rules. In practice, many of the GST issues encountered in relation to transfer pricing relate to imported goods. Accordingly, consideration should be given not to the standard GST valuation approach but to the approach of the New Zealand Customs Service. This is discussed further in XII.B.2., below.

2. *Relationship Between the Transfer Pricing Rules and Customs Rules*

New Zealand's GST system is unusual insofar as the administration of part of the GST system is deemed under §12 of the GST Act 1985 to be part of the Customs and Excise Act 2018[233] and is administered by the New Zealand Customs Service (Customs). Section 12(2) of the GST Act defines the value of all goods imported into New Zealand as the value determined by Customs plus the amount of any duties, excluding GST on import, plus transport costs, plus any amounts payable under the Climate Change Response Act 2002[234] (e.g., synthetic greenhouse gas levies on certain types of goods). Accordingly, the valuation of imports into New Zealand for both customs duty, if any,[235] and GST purposes use the same Customs valuation methods.

The Customs valuation rules are based on the World Trade Organization model, with the primary method of valuation being the "transaction value" of the goods (i.e., the invoice price for the goods).[236] The transaction value requires the price to reflect the price for which goods would be sold for export to New Zealand under free market conditions. Accordingly, when the supply is between related parties, this method is unlikely to be acceptable to Customs, unless the importer can demonstrate, using one of five alternative methods, that the relationship has not affected the transaction value. In this regard, the Customs definition of "related party" is much wider than the income tax definition of "associated person" and includes companies with only 5% or more common shareholding.

If the transaction value is not available, the five alternative methods are:

- The transaction value of identical goods (similar to the CUP method);
- The transaction value of similar goods (similar to the CUP method);
- The deductive value method (similar to the resale price method);
- The computed value method (similar to the cost plus method); or
- The residual method (based on a flexible interpretation of the other methods).

While the Customs valuation methods are broadly similar to some of the transfer pricing methods, there is no direct link between the two regimes, and the Customs valuation methods are transaction based. For this reason, transfer pricing analysis using profit-based methods to calculate transfer prices is unlikely to be acceptable, even under the Customs residual method. Similarly, transfer pricing documentation is unlikely to be acceptable to Customs unless the documentation specifically considers the application of both IRD valuation methods and Customs valuation methods. It is also important to consider the impact on customs values of any post-import adjustments made to transfer prices, such as year-end transfer pricing adjustments under a comparable profits method approach, because customs duty, including GST, is required to be determined at the time of each import.

In some cases, a reasonable estimate can be used by importers under the provisional customs values scheme under the Customs and Excise Act 2018, §102. Under this scheme, an importer with an advanced pricing agreement or that has been granted permission by the New Zealand Customs Service may use a reasonable estimate at the time of entry and then revise that value within 12 months of the end of the importer's financial income year.[237] The New Zealand Customs Service and the IRD consult to determine whether an importer has an acceptable transfer pricing arrangement for the purposes of this scheme.[238]

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[233] Customs and Excise Act 2018, 2018 S.N.Z. No. 4 (C&E Act 2018).

[234] Climate Change Response Act 2002, 2002 S.N.Z. No. 40.

[235] Most New Zealand imports are currently tariff free, with only GST payable on import.

[236] *See* New Zealand Customs, Customs Import Value, https://www.customs.govt.nz/business/import/valuation-for-import/customs-import-value/.

[237] *See* New Zealand Customs Service, Provisional Values, https://www.customs.govt.nz/globalassets/documents/ce-2018/document-library/provisional-values.pdf.

[238] *See* Inland Revenue, Customs New Zealand, https://www.ird.govt.nz/international-tax/business/transfer-pricing/practice-issues/customs-new-zealand.

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XIII. Special Considerations

From July 1, 2018, New Zealand introduced new rules aimed at eliminating hybrid and branch mismatches arising from differences in the tax treatment of instruments, entities, or branches between two or more countries.[239] These rules are designed to eliminate the deferral or reduction of taxation when these mismatches occur. Subpart FH of the Income Tax Act 2007 implements the OECD recommendations in Action 2 of the BEPS Action Plan. The rules apply to related taxpayers who are subject to tax in one or more countries and who use hybrid financial instruments or branch structures to reduce their income tax. The rules also apply to structured arrangements whereby unrelated taxpayers have structured their arrangements to achieve a mismatch.[240]

When the hybrid mismatch rules apply, "mismatch amounts" arise, being deductions that are denied or additional assessable income recognized in the current income year under §FH 5–§FH 6 and §FH 8–§FH 10. These amounts may be offset against "surplus assessable income" under §FH 12. Broadly, surplus assessable income includes surplus assessable income from previous income years that has not been offset against mismatch amounts, plus assessable income related to the mismatch arrangement in the current year that is expected to be taxed in the other country. This term equates to the OECD's concept of dual inclusion income.

[239] *See* Inland Revenue, Tax Information Bulletin, Vol. 31(3), April 2019.

[240] The Inland Revenue has provided a table to assist taxpayers to self-assess whether a disclosure is required to be made, see Inland Revenue, Base Erosion and Profit Shifting (BEPS) disclosure, https://www.ird.govt.nz/international-tax/business/beps-disclosure.

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DETAILED ANALYSIS

CHAPTER 125: TRANSFER PRICING RULES AND PRACTICE IN NORWAY

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I. Introduction

As in most developed countries, transfer pricing is a tax issue of high and increasing concern in Norway. Although the Norwegian transfer pricing legislation is still developing, its roots date back to 1911. Historically, the Norwegian tax authorities have focused their transfer pricing resources on petroleum activities and petroleum-related operations carried out on the Norwegian continental shelf. Since the 1990s, however, the scope has broadened gradually, and the Norwegian tax authorities now utilize a more comprehensive and systematic risk-based approach to evaluate transfer prices in numerous types of transactions and industries.

Although the scope of transfer pricing activity has broadened, certain businesses and types of transactions remain as main focus areas. This is a reflection of the country's industry and business profile, and allocation of audit resources to core industries that are dominated by multinationals. Thus, on specific transactions and industries, the Norwegian Tax Administration has gained much experience, and there exists a substantial amount of jurisprudence. With regard to other types of transactions and industries, the administrative practices are more limited.

Traditionally, a greater amount of resources has been allocated to the control of foreign multinationals doing business in Norway (inbound transactions) than to the control of Norwegian groups doing business abroad (outbound transactions). In recent years, however, there has been a shift toward a more balanced risk assessment and audit focus in respect to this.

This chapter examines Norwegian transfer pricing legislation, case law, and administrative practice on selected types of transactions, as well as administrative issues, such as reporting requirements, penalties, appeals, and litigation. Before the transfer pricing issues are addressed in detail, an overview of the Norwegian tax system and its tax administration will be provided, followed by a somewhat more detailed description of the general corporate tax system and the special tax regimes applicable to specific business sectors.

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II. Overview of the Tax System and the Tax Administration

A. The Tax System

The Norwegian legal system, while rooted in civil law, is also influenced by common law. As in most continental European legal systems, written law governs most areas. But like common law, case law is an important source of law. In particular, the Supreme Court plays an important role by interpreting and developing the law. Tax law is dominated by written law, and most substantive tax rules are laid down in statutes or regulations. However, in the transfer pricing area, written law is scarce, so case law and administrative practice are therefore important sources of law.

There are constitutional restrictions on taxation. Taxes that are levied in the following year must be approved by the Parliament in a plenary decision. Even if the substantive tax rules are laid down in statutes, the Parliament must annually adopt a tax resolution on direct and indirect taxes. Approval from the Parliament is regularly obtained as part of the budgetary process for the forthcoming year.

Since a major tax reform in 1992, Norway has had a two-part system in place for taxation of income. All taxpayers, individuals as well as companies and entities, are subject to tax on their general income. General income is computed on a net basis. The tax base is broad. The tax rate was fixed at 28% from 1992 to 2013 but has since been gradually reduced. Since 2019, the tax rate is 22%. All items of taxable income are included in the general income tax base, such as business income, employment income, interest, capital gains, pensions, etc. Deductions are granted for income-related expenses, interest (including interest not incurred in relation to taxable income), and certain standard and personal allowances. The tax on general income is the only income tax levied on legal entities such as companies and entities. The other tax base is personal income. This is the tax base for surtax and social security contribution payments. These taxes are levied on individuals only. The personal income is computed on a gross basis and encompasses employment and pension income, as well as business income earned through an individual enterprise. The progression in the income tax system allows for certain minimum and standard allowances and for thresholds and progressive rates for the surtax.

In 2024, total taxes — direct and indirect paid to the state, the counties, and the municipalities — were estimated at 2.084 billion Norwegian kroner.[1] Since 1985, total taxes in Norway have been in the range of 38–44% of the Gross National Product (GNP) while the comparable figures for OECD countries in the same period were in the range of 30–35%.[2] Of the total tax revenue collected in 2024, the state received approximately 86%, the municipalities received 12%, and the counties received 2%.

Income tax levied on individuals is the main source of revenue, and the amount of income tax on individuals (including social security tax) estimated for 2024 was 699 billion Norwegian kroner. The value-added tax and excise duties levied on cars, petrol, alcohol, and tobacco, etc., also play an important role in generating revenue. For example, in 2024 the estimated revenue from the value added tax was 392 billion Norwegian kroner. Excise duties and customs duties are estimated to amount to 113 billion Norwegian kroner, of which customs duties are almost insignificant. Of great importance are taxes levied on the petroleum extraction activity on the Norwegian continental shelf. The tax revenue from the petroleum sector is highly sensitive to market prices on oil and gas and is subject to considerable variation. In 2024, the tax revenue from the petroleum sector was estimated to amount to 349 billion Norwegian kroner, while the tax revenue from companies exclusive of the petroleum sector was estimated to amount to 130 billion Norwegian kroner. The relative importance of the petroleum sector can be illustrated by the fact that, except for 2016, 2020 and 2021, the income tax revenue from petroleum companies each year between 2000 and 2024 was substantially higher than the income tax revenue generated from companies in all other sectors combined.

Social contributions paid by employers are another important revenue source in Norway. In 2024, social contributions paid by employers were estimated to amount to 269 billion Norwegian kroner. In the same year, the net wealth tax on individuals was estimated to be 32 billion Norwegian kroner. Property tax has become slightly more important but still plays a rather modest role in generating tax revenue. Estimated property tax revenue in 2024 was 18 billion Norwegian kroner, with a substantial portion having been paid by hydroelectric power plants and energy-intensive industry plants. The inheritance tax was abolished effective January 1, 2014.

B. The Legal Framework

Since 1999, most tax legislation has undergone a substantial technical revision. This work resulted in the adoption of several new statutes and regulations. The revision systemized the legal material and modernized the language. As part of this work, a large number of old fragmentary regulations were replaced by a few comprehensive ones that directly addressed each statute. The numerical references in the statutes and the regulations are now harmonized so that all regulations issued in relation to a single statute paragraph can be easily identified in the supplementary regulations.

The legal basis and the substantive rules regarding income taxes for individuals, companies, and entities that are resident in Norway are laid down in the Tax Act of March 26, 1999 (Tax Act). The regulations related thereto are laid down in regulations no. 1158, November 19, 1999, and no. 1160, November 22, 1999. The Tax Act also provides the legal basis for the net wealth tax levied on individuals and certain types of entities that are resident in Norway,[3] and for taxation of activity and work that is carried out within the Norwegian territory by individuals, companies, and entities that are resident abroad. The substantive rules for taxation of the petroleum activity (extrac-

[1] Prop. 1 LS (2024–2025), Chapter 1.6.

[2] Prop. 1 LS (2024–2025), Chapter 2.2.

[3] The net wealth tax is levied on individuals and on certain types of corporations and entities. Most corporations and entities, including limited companies and partnerships, are not subject to net wealth tax, however, because the value of the ownership parts is taxed in the hands of the shareholders and partners, respectively.

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tion of petroleum and pipeline transportation of such petroleum) on the Norwegian continental shelf, and the legal basis for taxation of non-resident individuals and companies that are carrying out work and activity related to the petroleum activity on the Norwegian continental shelf is laid down in the Petroleum Tax Act of June 13, 1975 (Petroleum Tax Act).

The value added tax is set out in the Value Added Tax Act of June 19, 2009 (VAT Act) and regulation no. 1540, December 15, 2009. Customs duties are contained in the Customs Act of December 21, 2007 (Customs Act) and regulation no. 1502, December 17, 2008.

Legislation concerning tax administration issues, such as reporting requirements, assessments, audits, amendments, administrative appeals, penalties, etc., and the procedures governing these rules are regulated in the Tax Administration Act of May 27, 2016 (Tax Administration Act) and regulation no. 1360, November 23, 2016. This Act and regulation comprise administrative rules concerning both direct and indirect taxes, such as the income tax (including the special petroleum income tax), the net wealth tax, the value added tax, and various excise duties. The regulation concerning the payment of taxes is laid down in the Tax Payment Act of June 17, 2005 (Tax Payment Act) and regulation no. 1766, December 21, 2007.

C. The Tax Administration

Norway is a centralized state, as reflected in the manner by which public administration is organized. The Ministry of Finance is responsible for proposing tax and customs legislation, proposing legislative amendments, interpreting those laws, and organizing and supervising the tax and customs administrations. The Tax Directorate is the supreme agency in the Norwegian Tax Administration, and the Customs Directorate is the supreme agency in the Norwegian customs administration. The Tax Directorate and the Customs Directorate report to the Ministry of Finance. These directorates are responsible for executing legislation and for supervising subordinate administrations.

The tax administration is responsible for handling the taxation of income and capital, value added tax, and excise duties. The customs administration is responsible for customs and for some limited functions related to value added tax and excise duties.

Beginning January 1, 2019, the Norwegian Tax Administration was fundamentally reorganized. In the new organization, a risk-based organization model was implemented, in contrast to the earlier segment-based and geographic-based model. The Tax Directorate continues to be the superior agency, but the regional units and certain tax offices with specialized tasks and responsibilities have been replaced by four divisions with national responsibility for the core activities of the administration. These divisions are: (i) Information Management (*Informasjonsforvaltning*), (ii) User Dialogue (*Brukerdialog*), (iii) Priority (*Innsats*), and (iv) Collection (*Innkreving*). In total, approximately 7,000 people are employed by the Norwegian Tax Administration.

Large Businesses (LB) is a department in the Priority Division, with 330 employees. LB is headquartered in Moss, with sub-units in Oslo, Sandvika, Stavanger, and Bergen. It is responsible for assessing Norwegian-based enterprises and groups with turnover in excess of 1 billion Norwegian kroner. After the 2019 reorganization, the Oil Taxation Office (OTO) is included as a separate unit in LB. The OTO is responsible for assessing companies engaged in the extraction of petroleum on the Norwegian continental shelf and pipeline transportation of such petroleum. Although OTO is part of the tax administration, matters concerning interpretation of the Petroleum Tax Act fall within the direct responsibility of the Ministry of Finance. Thus, the Tax Directorate does not have authority over the OTO in these matters.

In the new organization, LB was assigned national responsibility for transfer pricing issues and for attribution of profit to permanent establishments. All such matters (except for cases which fall within the responsibility of the OTO, which will continue to be handled by the OTO) are handled by the Transfer Pricing Section. The Transfer Pricing Section is divided into four sub-groups located in five different cities and consists of approximately 65 employees. This implies that all transfer pricing and allocation matters concerning taxpayers, whether assessed by the LB or not, will be transferred to and handled by the Transfer Pricing Section in respect to such matters. The MAP APA (Mutual Agreement Procedure/Advance Pricing Agreement) unit is a separate section in the LB and is authorized by the Ministry of Finance to act as competent authority in transfer pricing and allocation MAP cases and to conclude bilateral APAs.

Norway also has an administrative tax appeal system and a judicial system where tax cases ultimately may be heard. The administrative tax appeal system is utilized far more frequently than the judicial system. The Tax Appeal Board, which is part of the administrative tax appeal system, has national responsibility, is organized separately, and operates independently from other parts of the tax administration. It has its own secretariat responsible for preparing the cases. Neither the tax administration nor the Ministry of Finance have authority over the Tax Appeal Board or the secretariat. Members of the Tax Appeal Board are appointed by the Ministry of Finance. A separate body, the Oil Taxation Appeal Board, is responsible for handling appeals from taxpayers that are assessed by the OTO. It operates independently from the government and the tax administration. Its members are also appointed by the Ministry of Finance.

D. Tax Assessment and Income Period

The procedures for assessing income and net wealth tax is laid down in the Tax Administration Act of May 27, 2016. The rules provide that a taxpayer's filing of a tax return (or acceptance of a pre-filed tax return) is regarded as an assessment of the tax base (i.e., self-assessment of the tax base). The tax authorities then levy income tax and net wealth tax against that self-assessed tax base, unless the tax authority amends it. The tax authorities notify the taxpayer of the tax assessed no later than December 1 in the year of assessment.

The corporate income tax is levied on the taxable income generated during the taxable year. In general, the taxable year is the calendar year. Under certain circumstances, a taxpayer may use a different period (which generally must be 12 months) for accounting and tax purposes. This is often the case when the taxpayer is a Norwegian permanent establishment or a Norwegian subsidiary of a foreign group, which elects to use the same accounting year as the foreign company or parent company.

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Companies and self-employed persons file their tax returns in electronic form by May 31 in the year following the taxable year. However, the filing date for companies subject to the special petroleum tax is April 30. As from 2024 (financial year 2023) all enterprises must submit their tax return through an annual report and account system that provides for reporting through a standardized digital format.[4]

E. Amendment of a Tax Assessment

When the tax base is self-assessed by the taxpayer and it has not been amended by the tax authorities nor has a tax audit been initiated, the taxpayer may adjust an earlier-filed self-assessed tax base within a period of three years from the filing date of the tax return.[5]

A taxpayer may not pursue a self-initiated adjustment if the tax authorities have assessed the tax base (typically by disregarding the initial self-assessed tax base) or initiated a tax audit.[6] In such situations, the taxpayer may file a complaint against the tax assessment made. The appeal process, time limits, and other rules governing this process are described in XI-II.A., below.

A tax assessment may be initiated by the tax authorities, typically as a result of a tax audit. The rules governing the audit process, including the time limit for initiating an audit, are described in XI., below.

A taxpayer may also ask the tax authorities for an amendment when the time limit for filing a self-adjustment or a complaint has expired. If the tax assessment is incorrect, the tax authorities have discretion to decide whether to grant the taxpayer's request. The law sets out criteria that the tax authorities must consider in this respect. However, there are situations in which the tax authorities are obligated to amend a tax assessment, such as to respond to the outcome of a court proceeding.[7]

The general time limit for an adjustment, irrespective of whether it is initiated by the tax authorities or the taxpayer, is five years after the close of the relevant income year.[8] A ten-year limit applies when the Tax Administration Act's conditions for levying an increased penalty tax are present or the taxpayer's action is reported as a criminal offense according to certain provisions in the Criminal Act.[9] In certain specified situations, such as where an amendment is required as a consequence of a court proceeding, no time limits apply.[10]

F. Payment of Corporate Income Tax

Companies are obliged to pay the income tax in the year following the taxable year. Normally, corporations make two tax prepayments during the assessment year (i.e., the year in which the return is filed), but in advance of an assessment. The tax to be paid, referred to as preliminary tax, is typically equal to the tax paid in the preceding year.[11] A taxpayer must file an application with the tax office if it is seeking to pay an amount other than the preliminary tax.[12] The preliminary tax must otherwise be paid in two equal instalments on February 15 and April 15 in the year following the taxable year.[13] If the amount of prepaid tax is less or exceeds the final tax payable, the balance (including interest) must be paid or repaid within three weeks after the tax assessment notice is sent to the taxpayer.

Different rules apply to companies carrying out extraction and pipeline transportation of petroleum on the Norwegian continental shelf. Such companies pay their estimated income tax in six installments: three in the autumn of the income year and three during the assessment year (i.e., the year in which the tax return is filed).[14] In general, tax claims must be paid when due, irrespective of whether the lawfulness of the claim is challenged by the taxpayer.[15] Thus, collection is not suspended when the taxpayer decides to file a complaint, a writ, or a MAP request.[16] In exceptional cases, however, and based on an overall judgment of the facts and circumstances of the particular case, the tax collector may accept a deferral of the collection provided that the tax claim is satisfactorily secured. In such an overall judgment, it is not unreasonable to expect that payment of tax on the same income in two states may be regarded as a relevant factor to consider.

[4] More information about the tax return for companies and how to submit the tax return is available in the English Language on Tax return for companies — The Norwegian Tax Administration (skatteetaten.no).

[5] Tax Administration Act §9-4.

[6] *See* II.D., above, for information on taxpayer self-assessment.

[7] Tax Administration Act §12-1(3).

[8] The time limits in the legislation applicable prior to 2017 were different and more nuanced with a potential maximum limit of ten years. Certain transitional rules apply.

[9] Tax Administration Act §12-6(1) and (2).

[10] Tax Administration Act §12-8.

[11] This amount may be altered depending on certain conditions.

[12] Tax Collection Act §6-5.

[13] Tax Collection Act §10-20.

[14] The large petroleum tax payments to the state (as well as repayments to taxpayers in cases where the estimated tax is overstated) may potentially influence the effectiveness of the Norwegian money market. As a response, the Government has proposed to increase the number of instalments for payment of petroleum tax from six to ten. *See* Prop. 1 LS (2024–2025). It is proposed that the changes shall take effect for payment of petroleum tax for the income year 2005.

[15] Tax Collection Act §10-1(1).

[16] An exemption applies with regard to additional tax (i.e., penalty tax). Collection of additional tax is postponed until a decision has been rendered by the Tax Appeal Board, and (if requested by the taxpayer) until a binding court decision has been rendered, *cf.* Tax Collection Act §10-1(1) and Tax Administration Act §14-10(2).

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III. Overview of the Corporate Taxation System

A. General Principles

Companies and entities resident in Norway are taxable in Norway on their world-wide income at the general rate of 22%.[17] The net income principle is applied. There is full tax consolidation within a taxable company or entity, meaning that losses from one business sector are consolidated with profit from other business sectors. Losses are carried forward indefinitely and are set off against future profit from the same company or entity. Expenses incurred abroad are also deductible except when they are incurred in connection with a foreign-sourced item of income that is exempt from Norwegian taxation by way of a tax treaty.[18]

The rules determining the residence of companies and entities (i.e., the country in which they have global tax liability) were changed in 2019. According to the new rules, a company or entity is deemed to be resident in Norway if it is: (i) incorporated according to Norwegian law, or (ii) effectively managed in Norway. In considering whether effective management is in Norway, there must be due regard for where management at the level of the Board of Directors takes place and where the day-to-day management takes place but also for other circumstances concerning the company or entity's business and organization. An exemption applies if a company or entity, which fulfills the criteria under (i) or (ii) above, is resident in another country according to a tax treaty with that other country. In such a case, the company or entity is not regarded as resident in Norway according to Norwegian domestic legislation.[19]

Companies and entities are taxable only by the national government. No income tax is levied by a county or municipality. Companies are not subject to net wealth tax. Instead, net wealth tax is levied on individual shareholders based on the value of their shares. No special rules apply for closely held companies.

B. Type of Corporate Tax System

Individuals residing in Norway have a general tax liability on income from dividends and capital gains on shares. The Norwegian Allowance for Shareholder Equity system (ASE) applies to individuals and prevents double taxation of the normal return (i.e., the risk-free return) on equity by providing a tax relief (i.e., a reduction of taxable income) of such amount at the shareholder level. The allowance is referred to as the "rate of return allowance" (RRA) and is calculated by multiplying the shareholder's cost of acquiring the shares and a risk-free interest rate. If dividends paid by the company are lower than the RRA, unused RRA is added to the base used for calculating the RRA for subsequent periods. Thus, under the ASE the normal return on equity is taxed at the corporate level but is shielded from taxation at the shareholder level.

For individuals, dividends and capital gains on shares in excess of the normal return, multiplied by a factor of 1.72[20] are taxed at the shareholder level at a rate of 22%.[21] The combined marginal tax rate (at the company and the shareholder level) is 51.51%.[22] Since the base used for calculating the RRA is stepped up with unused RRA, shareholders are indifferent as to whether the normal return on equity investments is received as dividends or as capital gains. The system also ensures that equity-financed and debt-financed investments are treated neutrally, in the sense that the normal rate of return is taxed at 22% for both types of investments. The (combined) tax rate of 51.51% on dividends and capital gains on shares is close to the marginal tax imposed on labor income. The minor rate differential between labor and share income significantly reduces the tax incentive to convert labor income into dividend income or capital gain — a problem that often is relevant for closely held companies.

The ASE applies to shares in Norwegian as well as foreign companies. In order to facilitate the system, Norwegian shareholders must register the acquisition costs of shares, dividends received, and sales prices in a national "shareholder register." Such a register was implemented in 2004.

C. Exemption Method on Intercompany Dividends and Capital Gains

Like many other European countries, Norway replaced its former imputation system with an exemption system for dividends distributed to certain qualifying entities.[23] Likewise, capital gains on shares realized by qualifying entities are exempted, and losses are not deductible.[24]

Qualifying entities are both private and public limited companies resident in Norway. Share funds; associations; municipalities; companies with tax residence abroad that are comparable to qualified companies resident in Norway; and certain entities that, for tax purposes, are treated as limited companies

[17] Tax Act § 2-2, *cf.* The Parliamentary resolution on taxes on income and capital for the income year 2024, §3-3. An exception applies to income from extraction of petroleum abroad (i.e., outside the geographic area covered by §1 in the Petroleum Tax Act). Such income and related costs are exempted from taxation in Norway, cf. Tax Act §2-39. Another divergence from the general principle is that the tax rate for financial enterprises is 25%; *see* IV.E., below.

[18] Tax Act §6-3 (5).

[19] Tax Act §2-2 (7) and (8).

[20] The rate 1.72 applies to dividends determined and gains realized on October 6, 2022, and later. The rate was 1.6 on dividends determined and gains realized from January 1, 2022, until October 5, 2022.

[21] For corporations, chain taxation is avoided through an exemption method for dividends and gains on shares, *see* III.C., below. However, when this income flows to individual shareholders, the income is taxed. The shielded income, when computing the tax base at the hand of the individual, is RRA allowance, and the idea is to shield from taxation a normal return on the shareholder's equity investment but not more. The gross-up of dividends and gains by 1.72 is simply a technical step required to reach the intended tax level/percentage. The rule is that dividend or gain is multiplied by 1.72 and taxed with the general tax rate (applicable to corporations and individuals) of 22% (i.e., in economic terms, the tax rate at the hand of the individual recipient is higher than 22%). Alternatively, the gross-up could have been skipped and the tax rate for dividends and gains set higher, but it is regarded as a better system and technical solution to apply the general tax rate on these types of income. Due to the factor of 1.72 and tax rate of 22%, the combined effective tax rate on an individual's share income (corporation and shareholder level) is 51.51%, which is very close to the marginal tax imposed on labor income.

[22] 0.22 (corporate level) + ((1 − 0.22) × 1.72) × 0.22 (shareholder level) = 51.51%.

[23] Except where dividends are paid to a qualifying entity that holds more than 90% of the shares and the voting power in the distributing company, 3% of the dividends are regarded as taxable income for the recipient, *cf.* Tax Act §2-38 (6). This is to compensate for the fact that the shareholder may fully deduct its expenses, including shareholder costs.

[24] Unlike the treatment of dividends, there is no exception applying a 3% taxation.

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are also treated as qualifying entities.[25] Importantly, qualifying companies etc. with tax residence abroad are only exempted from the domestic rules on withholding tax on dividends,[26] if they are genuinely established and conduct real economic activity in the European Economic Area (EEA).[27]

The system avoids double or chain taxation of corporate income in multi-tier corporate structures, but only as long as the corporate income is kept within the sphere of qualifying entities. As described in III.B., above, dividends and capital gains on shares (in excess of a normal rate of return) multiplied by a factor of 1.72 are taxed at a rate of 22% when distributed to or realized by individuals.

Exempted income means dividends and capital gains from the realization of shares in private and public limited companies and certain comparable entities. As a main rule, the exemption applies to income from resident as well as (comparable) non-resident companies and entities.[28]

Exemption of income from companies resident in Norway and other countries in the European Economic Area (EEA) are not subject to any ownership interest or holding period requirements. However, income from companies resident in countries outside the EEA is exempted only if there is a 10% continuous participation over a two-year period.

From a tax policy point of view, a fundamental premise for exempting intercompany income is that the distributed or realized income has been properly taxed at the corporate level. The exemption is, therefore, not applicable to income from a company or entity resident in a low-tax jurisdiction, unless that low-tax jurisdiction is within the EEA and the entity that is resident in it has economic substance. A low-tax jurisdiction is defined as a country where the income tax levied on corporate profit is less than two-thirds compared to Norwegian tax.

Effective in taxable year 2016, a measure was introduced to counteract international hybrid mismatch arrangements. Received dividends are not tax-exempt to the extent that the distributing company has been granted a deduction for the payment, typically where the payment is treated as an interest payment in the subsidiary's state of residence.

D. Withholding Tax

Non-resident shareholders in Norwegian companies are subject to a 25% withholding tax on dividends under domestic law. The rate may be reduced in an applicable tax treaty.[29] However, from the intercompany dividend rules described in III.C. above, it follows that qualifying entities that are genuinely established and conduct real economic activity in the European Economic Area (EEA) are not subject to withholding tax on dividends distributed from Norwegian companies.

There is no general domestic legal basis for levying withholding tax on payments, other than dividends, to foreign companies or entities. However, for payments and charges earned after July 1, 2021, a 15% withholding tax, or a reduced rate available under an applicable tax treaty, is levied on certain interest and royalty payments, and on lease charges paid in respect of ships, vessels, rigs, and such; aircraft; and helicopters. The legislative objectives are to counteract profit shifting and double non-taxation. Therefore, the scope is limited to interest, royalty, and lease charges paid from a Norwegian entity or Norwegian permanent establishment to a related entity resident in a low-tax jurisdiction. Furthermore, the withholding tax is not imposed if the recipient is genuinely established and conducts real economic activity in the EEA.[30]

E. Group Taxation

Companies and entities are taxed on their income on an unconsolidated basis. Two special tax measures are applicable to companies that belong to a group of companies. These special tax measures constitute what may be called the Norwegian "group taxation rules." A group of companies, in relation to these measures, consists of a parent company and one or more subsidiaries of which the parent company owns more than 90% of the capital and controls more than 90% of the voting rights. The parent company may be a foreign company. The favorable tax rules are, with certain exceptions, reserved for group companies that are resident in Norway.

The first measure enables one company within the group to make a tax-deductible contribution to another group company (*konsernbidrag*).[31] The contribution may consist of cash or any other asset. It does not have to be transferred right away, but the transferring company must establish a legally binding obligation to make a contribution to the recipient company at some point in time. Often the group contribution is just posted as a claim outstanding between the parties in the year-end balance sheet. Group contributions can be made between all companies or entities within the group, provided that they are resident in Norway.[32] The contribution is treated as deductible by the contributing company (subject to a limit) and as taxable in-

[25] Qualified entities are listed in the Tax Act §2-38(1).

[26] Tax Act § 10-13.

[27] Tax Act §2-38 (5).

[28] The exempted income is listed in the Tax Act §2-38(2).

[29] Tax Act §2-3(1)c, *cf.* §10-13, *cf.* The Parliamentary resolution on taxes on income and capital for the income year 2024, §3-5.

[30] Tax Act §10-80 and §10-81.

[31] Tax Act §10-2–§10-5.

[32] In some situations, group contribution can be made to non-resident companies. They fall in four categories:

(1) The group contribution rules apply to a Norwegian branch of a foreign company resident in another EEA state, cf. Tax Act § 10-4 (2). The conditions are:

(a) the foreign company must be equal, i.e., have the same legal characteristics, as a Norwegian Limited Liability Company,

(b) the profit of the branch must be taxable in Norway, and

(c) the received group contribution must be taxable for the branch in Norway.

(2) A tax-deductible group contribution can be made to a foreign company that is resident in another EEA state and has a loss carry-forward from its former Norwegian business operations, cf. Tax Act 10-4 (3).

(3) A tax-deductible group contribution can, under certain conditions, be made to cover a final loss in a subsidiary resident in another EEA state, cf. Tax Act §10-5.

(4) A Norwegian permanent establishment of a company resident outside EEA can make a tax-deductible contribution to a Norwegian resident company, provided there is a tax treaty in place that prohibits discrimination of permanent establishments in the other state, *see* Skatte-ABC 2024 A-8-2.5. The statement in Skatte-ABC reflects current administrative practice. After revision of the commentaries to article 24 of the OECD Model Tax Treaty in 2008 it is clarified that the non-discrimination clause of the OECD Model Tax Convention does not require deduction to be granted for group contribution made by a Norwegian permanent establishment to a Norwegian resident company. Thus, there might be some uncertainty with respect to whether this administrative practice will be upheld in the future.

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come for the receiving company to the extent of the contributing company's deduction. In large part, this measure ensures that it is possible to balance out taxable profits within a qualifying group. Since the contribution will reduce the taxable income of the distributing company, there are certain limitations to the scheme. Most importantly, the contribution cannot exceed the taxable income of the distributing company (i.e., the contribution cannot create a loss for the distributing company), and the contribution must be lawful under the company dividend distribution rules provided in the company legislation.

The second measure is the option to transfer assets between group companies without taxation of unrealized gains, based on the principle of continuity.[33]

F. Exit Taxation

Exit taxation applies to a number of situations. These rules imply that unrealized gains (or losses) are taxable (or deductible) in certain situations where a taxpayer changes residency or where an asset or liability is transferred in such a way that it is no longer taxable in Norway.[34]

G. Controlled Foreign Companies

Legislation addressing the treatment of Controlled Foreign Companies (CFCs) was introduced in 1992. In Norway, CFC rules are referred to as NOKUS-rules (*Norsk Kontrollert Utenlandsk Selskap*).[35] The CFC rules apply to Norwegian taxpayers with ownership interests in a Norwegian-controlled company resident in a low-tax jurisdiction. They also apply to Norwegian taxpayers who, alone or together with other Norwegian taxpayers, directly or indirectly control an entity or estate established in a low-tax jurisdiction from which the taxpayer directly or indirectly derives benefits. The CFC rules may therefore be applicable to beneficiaries of a trust.[36]

A foreign company or entity is regarded as being controlled by a Norwegian taxpayer if 50% or more of its interests or capital are directly or indirectly owned or otherwise controlled by a Norwegian taxpayer. The CFC rules apply to any Norwegian taxpayer who has an interest in such a foreign entity, irrespective of the size of the interest.

A low-tax jurisdiction is defined as a jurisdiction in which the ordinary income tax levied on total profit is less than 2/3 of the income tax that would have been levied if the company or entity had been resident in Norway. It is the actual tax level that is relevant, not the formal tax rates. Although the statute refers to a comparison between the general income tax levels in the two countries, it is clear from the legislative preparatory work that it is the (actual) tax levels for the relevant type of business that must be compared.[37]

The application of the CFC rules is somewhat limited in relation to companies and entities established in a low-tax jurisdiction within the European Economic Area (EEA). The CFC rules do not apply if:

1. the taxpayer documents that the foreign company or entity carries on a real economic business activity in the low-tax EEA jurisdiction, and

2. Norway has the ability to obtain tax information from the low-tax jurisdiction according to a treaty request (or, if such a treaty request is not available, that the tax administration of the low-tax jurisdiction confirms the information provided by the taxpayer).

The Norwegian tax authorities have prepared a white list and black list of jurisdictions related to the application of the CFC rules. The lists are laid down in §10-63-2 of the regulations of November 22, 1999, no. 1160. As a starting point, the lists are binding. However, the white list is not binding if the foreign company or entity is tax exempt or subject to reduced tax under tax-incentive schemes in the foreign jurisdiction or if its income mainly consists of dividends or capital gains from a low-tax jurisdiction.

The CFC rules apply to all types of business activities (i.e., they are not limited to passive income only). However, if the foreign company or entity is covered by a double tax treaty between Norway and the low-tax jurisdiction, the CFC rules only apply where the income of the foreign company or entity is mostly passive.

H. Global anti-Base Erosion Rules (GloBE Rules)

The Global Minimum Tax of 15% (GloBE rules — Pillar two) was adopted by the Parliament in a separate law in January 2024.[38] The legislation is based on the OECD Model rules, and the OECD commentary and administrative guidance to the GloBE rules.[39] In scope for the Income Inclusion Rule (IRR) and Top-up tax will be groups with annual turnover 750 million euro or more.[40] Pure Norwegian groups also shall be in scope. Qualifying Domestic Minimum Top-Up Tax (QDMTT) is introduced. A safe harbor rule of simplified reporting requirements in the introductory phase applies for accounting periods beginning before January 1, 2027, and ending before July 1, 2028. The Ministry of Finance has instituted a reporting deadline of June 2026 for applicable groups.

The Income Inclusion Rule (IRR) and the Qualifying Domestic Minimum Top-Up Tax (QDMTT) is effective as from fiscal year 2024. The Undertaxed Payment Rule (UTPR) is not yet adopted, but will be introduced as from the fiscal year 2025.[41]

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[33] Tax Act §11-21 and Reg. no 1158, November 19, 1999, §11-21. This measure is restricted to the transfer of assets between companies, *etc.* resident in Norway. Under certain conditions it applies to the transfer of assets from a Norwegian branch of a foreign company to a group company resident in Norway and between two Norwegian branches of a foreign company. It does not allow for the transfer of assets to non-resident companies resident within the EEA. In such cases the transfer is subject to exit taxation according to § 9-14 of the Tax Act.

[34] Tax Act §9-14, §10-70, §10-71.

[35] The NOKUS-rules are laid down in the Tax Act §10-60–§10-68. The Government has signaled evaluation of the NOKUS-rules, *cf.* Meld. St. 4 (2015–16).

[36] Rt. 2002, p. 747, *Ptarmigan.*

[37] Ot. prp. no. 16 (1991–92) p. 79.

[38] Law January 14, 2024, no 1. *See* Prop. 29 LS (2023–2024).

[39] Tax Challenges Arising from the Digitalization of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two) - OECD

[40] The proposed turnover threshold is 750 million euro, not the equivalent amount in Norwegian kroner.

[41] *See* Government Proposal in Prop. 1 LS (2024–2025).

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I. Partnerships

Partnerships may be established in the legal form of a General Partnership *(Ansvarlig selskap, ANS)* or Limited Partnership *(Kommandittselskap, KS).*[42] In the ANS, all partners are either fully liable for the partnership's debt or each partner is liable for a portion of the partnership's debt (pro-rata ANS). In the KS, there is at least one general partner with unlimited liability for the partnership's debt *(komplementar)* and at least one partner whose liability is restricted to his or her investment (*kommandittist*). Silent partners may participate in either ANS or KS and have limited liability for the debt of the partnership.

ANS and KS are legal entities and governed by statute of June 21, 1985, no. 83, *Selskapsloven.* They are regarded as transparent for tax purposes and not subject to tax as entities. Instead, the partnership's net profit is determined under the ordinary rules in the Tax Act, as if the partnership were a taxable entity, and then allocated to the partners. Tax is assessed against each partner, at the general income tax rate of 22% on that partner's share of the partnership's net profits. Partners are taxed on a partnership's annual profits, even if profits are not distributed to them currently.

In general, profits and losses from participation in a partnership can be offset against profits and losses from other sources in calculating the general income tax in the hands of the partner. However, the right to offset losses from a partnership against profits from other sources does not apply to partners that have a limited liability for the partnership's debt.[43]

Individuals are, in addition, taxed at a rate of 22% on distributions from the partnership and on capital gains derived from the realization of shares in a partnership. The tax base is computed in such a way that the taxation of distributions and capital gains for individuals who are partners in a partnership is economically neutral compared with the taxation of profits and capital gains from participation in a Public or Private Limited Liability Company.[44]

[42] Another type of partnership is the "Partrederi", which is used in the shipping sector and regulated by the Sea Act, 1994.

[43] Such partners are required to carry losses forward. Losses may be deducted against future income from the partnership or against capital gains from the realization of shares in the partnership.

[44] Corporate/legal entity partners resident in Norway are not subject to tax on distributions from the partnership or capital gains from the realization of shares in the partnership. The rationale for this is to avoid chain taxation and to harmonize with the exemption system applicable to limited liability companies, *see* II.C., above. Corporate/legal entity partners resident abroad are, however, subject to 3% taxation on distributions from the partnership, cf. Tax Act § 2-38 (6) second and third sentences.

J. Non-Resident Enterprises

Non-resident enterprises may be subject to source-based taxation of business profits under Norway's domestic tax laws. Tax liability is established according to the Tax Act if a non-resident taxpayer is conducting business or participates in business that is either carried on in Norway or managed from Norway.[45] The Petroleum Tax Act provides legal basis for taxation of non-resident enterprises that are performing petroleum extraction activity, or activities related thereto, on the Norwegian continental shelf.[46] Beginning fiscal year 2024, non-resident enterprises are subject to tax on income from extraction of minerals on the Norwegian continental shelf and activities related thereto, on income from exploitation of renewable energy (e.g., offshore wind and solar energy) and activities related thereto within the Norwegian economic zone, and on exercise of CO2 handling activity and activities related thereto within the Norwegian economic zone.[47]

When the activity of a foreign enterprise is covered by a tax treaty, Norwegian taxation requires that a permanent establishment, as defined in the relevant treaty, is established.

Non-resident enterprises are taxed on a net profit basis and at a rate of 22%. The net income is computed on the basis of the same rules as for enterprises resident in Norway.

Special rules apply with regard to depreciation of assets that are used temporarily in Norway (or on the Norwegian continental shelf). Although these are general rules, they may be particularly relevant to foreign companies that carry out temporary activities on the Norwegian continental shelf.[48]

Non-resident enterprises that incur losses from activities in Norway are entitled to carry forward such losses indefinitely for Norwegian tax purposes.

Repatriation of profit from a Norwegian permanent establishment does not trigger withholding tax in Norway. Also, there is no equivalent to the U.S. branch profits tax. As stated in III.F., above, however, exit taxation of gains occurs when a permanent establishment ceases or when assets or liabilities belonging to it are removed from Norwegian tax jurisdiction.

[45] Tax Act §2-3(1)(b).

[46] Petroleum Tax Act §2, *cf.* §1.

[47] Tax Act §2-3(1) (k), (l), (m). Furthermore, the Government has proposed to introduce tax liability for non-resident enterprises on income from exploration and production of aquaculture, and activities related thereto, within the Norwegian economic zone, as well as on income from exploration and production of sedentary species on the Norwegian continental shelf, and activities related thereto. *See* Prop. 1 LS (2024–2025). The tax liability will begin fiscal year 2025.

[48] Tax Act §14-60–§14-66.

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IV. Tax Regimes Applicable to Special Business Sectors

A. Extraction and Pipeline Transportation of Petroleum

Special tax rules are applicable to the extraction and pipeline transportation of petroleum on the Norwegian continental shelf and certain adjacent geographical areas. The legal basis is the Petroleum Tax Act of June 13, 1975. In §8 of the Act, there is a reference to the Tax Act that makes the general tax rules applicable, to the extent that special rules are not provided for in the Petroleum Tax Act.[49] Thus, the tax regime governing the extraction and pipeline transportation of petroleum on the Norwegian continental shelf is based on the fundamental principles in the Tax Act. Although there are deviations provided for in the Petroleum Tax Act, the system provides for a net-income-based tax system.

Extraction of petroleum at the continental shelf is a high-margin business viewed as generating a considerable excess return (resource rent). Therefore, a special tax is levied on income from extraction and pipeline transportation of petroleum within the geographic area described in §1 of the Petroleum Tax Act.[50] The special tax is levied in addition to the general income tax of 22%. The blended tax rate (general income tax plus special tax) has been constant at 78% since 1992.[51]

Beginning January 1, 2022, fundamental amendments became effective in the Petroleum Tax System.[52] Most impactful is the change of the special tax into a cash flow-based tax, meaning that costs incurred from investments in pipelines and production facilities are fully deductible (in the tax base of the special tax) the year in which the investments are made. As part of the new cash-flow based tax system for petroleum resource rent, the state will reimburse companies for the special tax value of the losses (i.e., the loss incurred from the computation of the special tax multiplied with the special tax rate) as part of the annual tax settlement with the petroleum companies.[53]

The investment-based deductions granted under the previous rules are not granted under the new rules applicable from January 1, 2022, but they are still applicable for relevant costs incurred until 2021 in the computation of the special tax. These are fixed straight line depreciation for tax purposes over six years of expenses incurred in the acquisition of fixed production facilities and pipelines (i.e., 16.67% annually) from the year in which the investment was made, an increased asset-cost recovery (uplift) of 5.2% of the cost of fixed production facilities and pipelines, which is granted annually for four years (i.e., for a total of 20.8%), and deduction of finance costs.

Moreover, as of January 1, 2022, the general income tax of 22% is deductible in the tax base of the special tax.[54] Thus, to keep the total tax rate (i.e., the tax rate on the general income tax plus the tax rate on the special tax) unchanged at the effective rate of 78%, the tax rate on the special tax is technically adjusted to 71.8%.[55]

The reasoning underlying the changes to the deduction system is to make the special tax neutral in the sense that it should not influence taxpayers' investment behavior (i.e., the profitability of a project will, under the new system, be equal irrespective of whether the calculations are made on a pre-tax or on post-tax basis). This change was based on the government's recognition that under the prior rules, the various investment-based deductions, when viewed in total, were too generous and could give taxpayers an incentive to carry out investments that were not profitable from a socio-economic perspective.

Furthermore, in June 2020, temporary targeted changes were made in the petroleum tax system to help the oil and gas industry maintain activities during the COVID-19 crisis, including measures allowing for increased and immediate deduction for expenses incurred to acquire fixed production facilities and pipelines in the tax base for the special tax.[56] These temporary rules are not affected or limited in scope by the new set of rules introduced as of 2022. In sum, this means that for some years ahead, three different sets of rules may be applicable for petroleum companies on the Norwegian continental shelf: (i) the prior general set of rules, (ii) the temporary rules introduced in 2020, and (iii) the new set of rules applicable as of 2022.

Sales prices of crude-oil are determined administratively for taxation purposes by way of norm-prices. Norm-prices are set retroactively and reflect the prices in transactions entered into between independent parties in the relevant period.[57]

Net financial costs incurred on interest-bearing debt are deductible. However, there are important limitations with re-

[49] Petroleum Tax Act §8.

[50] Petroleum Tax Act §5.

[51] Since 1992, the blended tax rate has been fixed at 78%. Until the taxable income year 2013, the general tax rate was set at 28% and the special tax rate was set at 50%. Since the taxable income year 2014, the general income tax rate has been gradually reduced to 22% and the special tax rate has increased to 56%.

[52] Prop. 88 LS (2021–2022).

[53] The right to immediate deduction of investment costs the year the investment is made means that the various investment-based deductions granted under the prior rules, such as depreciation of investment costs, the increased asset-cost recovery (uplift), and deductions for finance costs, are no longer granted in the computation of the special tax as of January 1, 2022. Immediate deductions under the new deduction rules apply to investment costs incurred on or after January 1, 2022.

[54] The tax of 22%, which is deductible in the tax base of the special tax, is computed according to special rules that differ slightly from the rules applicable in the computation of the general income tax of 22%.

[55] $22\% + (1-22\%) \times 71.8\% = 78\%$.

[56] *See* Innst. 351 L (2019–2020) and Prop. 113 L (2019–2020). The package of tax measures adopted by the Parliament (the *Storting*) is more generous to the industry and will have an effect over a longer period than the measures proposed by the Government. The tax measures are laid down in the temporary provision §11 of the Petroleum Tax Act. The main elements are that expenses incurred in the acquisition of fixed production facilities and pipelines, plus an asset-cost recovery (uplift) are immediately deductible in the tax base for the special tax the year they are incurred (while the general rules previously applicable provides for a straight-line depreciation of such expenses over six years, plus an asset-cost recovery (uplift) of 5.2% annually over four years). The asset-cost-recovery (uplift) in the temporary rules was set at 24% in 2020–2021. The uplift was technically reduced to 17.69% in 2022 because of a change in the tax rate due to introduction of cash flow-based taxation, and further reduced to 12.4% on expenses incurred as from January 1, 2023.

These measures apply to investment costs incurred in the income years 2020 and 2021. They also apply to investment costs that are included in plans for new developments (PDOs/PIOs) that are submitted to the authorities by the end of 2023 and approved by the end of 2024, to the extent such costs are actually incurred before the production starts. Furthermore, taxpayers are entitled to reimbursement from the state for the tax value of losses and unused asset-cost recovery (uplift) incurred in the income years 2020 and 2021.

[57] *See* VI.D.1., below.

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spect to the amount of net financial costs that may be allocated to, and deducted from, income subject to the special tax on petroleum.[58] The remaining net financial costs are attributed to, and deductible from, onshore income, which is taxed at 22%.

Dividends paid by a Norwegian resident company subject to the special tax are not also subject to tax when paid to a foreign company that holds at least 25% of the capital of the distributing company. However, when the Norwegian resident company is not subject to the special tax for a portion of its income, a corresponding portion of the dividends distributed are subject to taxation according to the general rules.[59]

B. Tonnage-Tax Scheme Applicable to Shipping Income

Effective from 1996, a tonnage-tax scheme was introduced for shipping companies. The scheme was substantially amended beginning in 2007 to be more similar to tonnage-tax schemes in other European countries. Until 2007, the Norwegian scheme was a tax-deferral scheme and not a tax-exemption scheme. Under the former scheme, the qualifying shipping income was not taxed on a current basis. Instead, the untaxed income was deferred and was subjected to the general income tax when it was distributed to the owners or by exit from the special regime.

Beginning with fiscal year 2007, the qualifying income under the tonnage-tax scheme is fully exempt from general income taxation.[60] However, the shipping companies subject to the special regime remain liable for a modest tonnage-tax determined on the basis of the net tonnage of the qualifying vessels. Taxation under the tonnage-tax system is optional for qualifying companies. If selected, there is a requirement that all qualifying companies in a group (as defined in §1-3 of the Limited Liability Company Acts) be taxed under the special regime. There is also a 10-year holding period requirement, but a shipping company may exercise the option to exit from the regime before the expiration of the 10-year period and the departure will have no tax consequences other than excluding the company from re-entering into the special regime before the expiration of the 10-year period. The entrance into the tonnage-tax scheme triggers taxation of unrealized gains or losses on such assets from which the income is exempt from taxation under the tonnage-tax scheme.

The tonnage-tax regime is strongly ring-fenced to avoid spill-over effects into the ordinary tax regime. Permitted assets and activities of a tonnage-taxed company are regulated in the Tax Act and in secondary regulations. Income that is exempt from taxation under the tonnage-tax regime is income from ownership, operation, and disposition of qualifying vessels, as well as closely related income such as, for example, income from strategic and commercial management of vessels. Financial income and expenses, including gains and losses on foreign currency, are exempt from the tonnage-tax regime and subject to ordinary taxation.

Only Norwegian limited liability companies and comparable companies established within the European Economic Area (EEA) qualify for the tonnage-tax regime.[61] Such companies may, however, derive qualifying income from a partnership or from a company subject to CFC taxation in Norway insofar as these companies satisfy the requirements of the scheme. Qualifying vessels may therefore be owned or leased by such underlying companies.

C. Production of Hydroelectric Power

Special rules apply to the taxation of enterprises engaged in the production, distribution, and sale of hydroelectric power.[62] These enterprises are subject to the general income tax of 22% and the tax base is computed in accordance with the general rules with some important deviations. Most notably, assets such as power plants, dams, tunnels, etc., are subject to a straight-line 1.5% depreciation over a period of 67 years while equipment, etc., in the power plants is subject to a straight-line 2.5% depreciation over 40 years.

Furthermore, a special resource rent tax *(grunnrenteskatt)* is levied on the owners of power plants with a rated power capacity of 10 MVA or more. The tax is levied on the value of the production minus operational costs, investment costs, etc. The deduction scheme for investment costs related to power plants is changed for costs incurred as from January 1, 2021. Such costs, whether incurred in relation to new constructions, reinvestments, or extensions of existing plants, are immediately deductible in the computation of the resource rent tax (*grunnrenteskatt*); i.e., the resource rent tax is altered into a cash flow-based tax.[63] As from 2021, the (separately computed) general income tax of 22% is deductible in the computation of the resource rent income tax base (*grunnrenteinntekt*).The effective resource rent tax is 45%. Resource rent-related corporate tax is deducted from the basis for resource rent tax. An effective resource rent tax of 45% therefore means that the formal resource rent tax rate is set at 57.7 %. Hence, the total income tax levied is 67%.[64]

[58] *See* VI.D.3., below.

[59] The Parliamentary resolution on taxes on income and capital for the income year 2024, §4-4.

[60] Tax Act, §8-10–§8-20.

[61] However, a company established in an EEA state other than Norway qualifies for the tonnage tax-regime only if it solely carries out permitted activities that are subject to tax in Norway according to Norwegian domestic legislation. *See* Tax Act § 8-10 (2). To the knowledge of the author, basically all companies being taxed under the tonnage-tax regime are established in Norway.

[62] Most of the hydroelectric power in Norway is produced by plants owned by the government, counties, or municipalities, or by publicly owned enterprises.

[63] The reason for the shift to a cash flow tax is to make the resource rent tax (*grunnrenteskatt*) neutral in the sense that the tax itself will not influence the profitability of an investment, i.e., an investment in a power plant will have equal profitability irrespective of whether the calculation is made on a pre-tax or on a post-tax basis. *See* Prop. 1 LS (2020–2021) Chapter 7. Investments in power plants made before January 1, 2021, are computed according to the rules applicable for the computation of the resource rent tax (*grunnrenteskatt*) until and including 2020, with a straight-line annual depreciation of investment cost of 1.5%/2.5% and a special uplift meant to compensate for the fact that such costs are capitalized and depreciated over a period of time subsequent to the year the investment is made.

[64] 22% + (1−22%) × 57.7% = 67%. Beginning 2022, the effective resource rent tax rate is increased from 37% to 45%. Thus, the total income tax levied increased from 59% (2021) to 67% (2022 and 2023). Moreover, a high-price contribution was introduced as from September 28, 2022, with the rate set at 23% of the electricity price more than NOK 0.70 per kWh. The contribution is designed as an excise duty payable to the treasury.

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D. Aquaculture and Onshore Wind Power

New rules for taxation of aquaculture were adopted by the Parliament (*the Storting*) on May 31, 2023. The new legislation covers the production of salmon, trout, and rainbow trout and involves the taxation of resource rent (*grunnrenteskatt*) at an effective rate of 25%.[65] Including corporate tax of 22%, the total income tax is 47%.[66] The rules apply from January 1, 2023.

The resource rent tax is designed as a cash flow tax. A standard deduction of 70 million Norwegian kroner applies, which means that only the largest operators will pay the resource rent tax. The excess return (resource rent) in the Norwegian aquaculture business relates to the sea phase of the production.[67] Thus, the resource rent tax aims to capture the value of the fish when it is removed from the pen, not the value created further down the value chain.

Market prices are generally not observed when the fish is removed from the pen because sales to external parties often take place after slaughter, transport, or processing. Aquaculture businesses are often organized as integrated companies or groups. Thus, where production is subject to an effective tax rate of 47% (corporate tax of 22% plus resource rent tax of 25%) and value creating activities further down the value chain (such as e.g., slaughter, processing, and marketing) are subject to corporate tax of 22% only, there is a risk for tax-motivated price manipulation aimed at reducing the tax burden of the company or group. In response, the legislation provides for the establishment of an independent price board that will set market prices for tax purposes, i.e., the price that could have been agreed to between independent parties in a free market. The objective is that the price set for tax purposes (the norm price) will be equivalent to the market value of the fish when the fish is removed from the pen, irrespective of the point in the value chain at which the sale takes place. Detailed provisions concerning the organization of a price board and the setting of prices for tax purposes are laid down in regulatory provisions.[68]

New legislation for onshore wind power was adopted by the Parliament on December 19, 2023.[69] The new rules include resource rent taxation at an effective rate of 25%, applicable to wind farms that are subject to licensing (that is, wind farms that have more than five turbines or installed capacity of 1 MW or more). The resource rent tax is designed as a cash flow tax. Corporate tax is deducted from the basis for resource rent tax. The effective resource rent tax rate of 25% therefore means that the formal resource rent tax rate will be set at 32.1%. Including corporate tax, the proposed total income tax levied is 47%.[70] Certain transitional rules apply. The resource rent tax on wind power is in effect from January 1, 2024.

E. The Financial Sector

Effective January 1, 2017, the financial sector is subject to additional taxation compared to businesses in general. The additional tax in the financial sector is referred to as the "Financial Activity Tax" and is comprised of two elements: (i) a payroll tax of 5% on gross salaries in the financial sector, and (ii) the general income tax for financial undertakings of 25%, which implies that financial enterprises are not eligible for the general income tax rate of 22%.[71]

The scope of the Financial Activity Tax comprises activities covered by section "K" of the Norwegian Standard for Classification of Economic Activities (SN2007) — that is, Financial and Insurance Activities (code 64–66), which is based on the corresponding Statistical Classification of Economic Activities in the European Union (NACE rev 2).[72] Certain thresholds and limitations apply with respect to the Financial Activity Tax. The Financial Activity Tax is intended to tax the value added in the provision of financial services that is currently exempted from the value added tax (VAT).

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[65] The Government had proposed a resource tax rent rate of 35%, cf. Prop. 78 LS (2022–2023), but the final decision by the Parliament (the *Storting*) was a rate of 25%. A summary of Prop. 78 LS (2022–2023) is available in English: prp202220230078000engpdfs.pdf (regjeringen.no).

[66] Resource rent-related corporate tax is deducted from the basis for the resource rent tax. The proposed effective resource rent tax rate of 25% therefore means that the formal resource rent tax rate must be set at 32.1%. The total tax levied is 47% (22% + (1−22%) × 32.1%).

[67] Prop. 78 LS (2022–2023).

[68] Regulations no. 1158, November 19, 1999, §19-5. Prices set by the board will apply from fiscal year 2024. For fiscal year 2023 the companies must themselves determine the tax price at the edge of the pen.

[69] Prop. 2 LS (2023–2024). A summary in English is available at prp202320240002000engpdfs.pdf (regjeringen.no), Innst. 131 S (2023–2024).

[70] 22% + (1−22%) × 32.1% = 47%.

[71] The scope of the Financial Activity Tax is regulated in §23-2(a) of the Social Security Act, February 28, 1997, and the Parliamentary Resolution on the Financial Activity Tax (which is enacted on an annual basis). The government is considering amending the structure of the Financial Activity Tax, see Prop. 1 LS (2018–2019), Chapter 32, and Prop. 1 LS (2019–2020), Chapter 22.

[72] *See* the Statistical classification of economic activities in the European Community (NACE rev 2): http://ec.europa.eu/eurostat/documents/3859598/5902521/KS-RA-07-015-EN.PDF.

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V. General Principles Relevant to Intra-Group Transactions

A. *The Arm's Length Principle*

The arm's length principle is a fundamental principle in Norwegian tax law, implying that associated taxpayers for tax purposes must transact with each other on terms and conditions as if they were not associated. The arm's length principle is anchored in §13-1 of the Tax Act. It is an important principle governing the taxation of associated enterprises, and it works in conjunction with and supplements other general tax principles and rules — some of them being of particular importance in intra-group relations where the close relationship between the taxpayers means that there is an inherent risk of profit shifting and tax evasion. Four of these general tax principles are briefly described below.

B. *General Rules of Attribution of Items of Income and Costs*

It is a fundamental principle in Norwegian tax law that any item of income and cost must be taxed and deducted in the hands of the taxpayer who is entitled to the income or obligated to bear the cost according to private or public law. Thus, an item of income earned by an enterprise may ordinarily not be transferred to another enterprise without causing a taxable event. And likewise, an item of cost incurred by an enterprise may ordinarily not be transferred to and deducted from taxable income of another enterprise.[73]

This principle of income attribution is the starting point to determine which taxpayer will be attributed a specific item of income or cost for tax purposes. It may establish a legal basis for not recognizing arrangements of income shifting between associated companies. An old case from the Supreme Court, *Greie Hjem* (1930), is illustrative on this matter. In *Greie Hjem* (1930), two associated companies had entered into an agreement whereby the total profits earned by both companies were to be split between them based on a pre-fixed formula. Based on this agreement, company A transferred part of its profit to company B and claimed a deduction for the transferred amount. The Court found that the transferred amount was not deductible in the hands of the transferor. It was regarded as a transfer of company A's taxable income and not as an expense deductible for company A. Thus, the Court regarded the transfer from company A to company B as a shifting of income that was not accepted for tax purposes and ruled in favor of the taxing authorities.[74]

The arm's length principle in §13-1 of the Tax Act may be regarded as supplementing the principle of income attribution. In the absence of a specific arm's length provision in the Tax Act, in some cases, it would often be possible to arrive at the same result by applying the basic income attribution principle. For example, basic principles of cost attribution imply that overhead costs incurred by a parent company may be partially attributed to (and deducted by) other associated companies, based on the premise that these costs were not incurred for the purpose of the parent but, rather, for the purpose of the associated companies.

The considerations under the basic attribution principle and the arm's length principle are somewhat different, however. When applying the basic income attribution principle, the main concern seems to be attributing an item of income or cost to a particular taxpayer, without necessarily questioning the amount of that particular income or cost. The main concern when applying the arm's length provision in §13-1 of the Tax Act is whether the amount of the particular income or cost is appropriate (i.e., whether the amount is at arm's length). In the example above, while considerations under the basic cost-attribution principle can be similar to the determination of whether an intra-group service has resulted in profit shifting, the issue of whether a mark-up should be added onto the profit derived from the provision of such services should be viewed under the arm's length principle and not under the general cost attribution rules.

C. *Substance Over Form Doctrine*

A substance over form doctrine applies in Norway. The substance over form doctrine implies that the tax consequences of an economic transaction must be determined on the basis of its actual economic substance and its actual legal effect on the parties. At least two implications can be drawn from this principle. First, as a general rule, taxation must be based on a correct determination of the facts. This also implies that pro forma arrangements are not accepted for tax purposes. A pro forma arrangement is one in which the legal form of a contract or transaction is not binding on the parties because the parties are actually acting as if they were governed by a different, underlying agreement. In such cases, the legal form is disregarded, and the tax consequences are determined on the basis of the underlying agreement.

The second implication of the substance over form doctrine is that the tax consequences of an agreement or transaction must be deduced from its actual legal content and the legal effects on the parties, irrespective of the characterization (form) given to the transaction by the parties. For instance, if the parties have entered into a sales contract, which, when further scrutinized, is more correctly characterized as a leasing contract, then the tax consequences will be determined in accordance with the provisions governing leasing contracts.[75] Another example is whether an advance of money to an entity, properly characterized, is a loan or equity.[76] Hence, under Norwegian law, taxation is based on a proper, substantive characterization of the transaction and its consequences. In this respect, there are significant similarities with the substance over form principles under Norwegian law and the requirement to accurately delineate the transaction under the OECD's Base Erosion and Profit Shifting (BEPS) Actions and the 2017 version of the OECD Transfer Pricing Guidelines. Application of the arm's length principle requires a second step after the transaction in question is properly characterized — namely, adequately pricing the transaction. The following fact-pattern illustrates how

[73] The fundamental principle of income and cost attribution is reflected, for instance, in the Tax Act §5-1, §6-1.

[74] Rt. 1930, p. 939, *Greie Hjem.*

[75] Rt. 2009, p. 441, *Nordkraft.*

[76] Rt. 2010, p. 790, *Telecomputing.*

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the application of this doctrine applies to the arm's length principle.

> *Example:* A Norwegian subsidiary entered into a franchise contract with its foreign principal. The subsidiary paid a franchise fee to the principal based on the economic results achieved by the subsidiary. The Norwegian tax authorities took the position that the foreign principal furnished services to the subsidiary, but not intangibles, and regarded the transaction as a pure service contract and not a franchise. As a result, the tax authorities concluded that the services rendered should be remunerated on a cost plus-basis and not by paying a franchise fee based on turnover.[77]

D. Taxation at Market Value

Transfer of property or goods and rendering of services constitute taxable events. The agreed-upon contract price will constitute taxable income for the transferor or service provider. When such transactions represent a gift or contain a gift element (i.e., the transaction is priced below the market value), §5-2 of the Tax Act ensures that the transferor or service provider is taxable for an amount of income equivalent to the market value of the property transferred or services rendered.[78] Such taxation is generally applicable where the transferor of property or service provider is a company, and with certain limitations in other cases. The rule applies to goods, assets, and the rendering of services. The underlying motivation is twofold. First, a transfer or withdrawal of goods and services from a company represents consumption and consumption must take place with taxed money. Second, the rule ensures effective company taxation bearing in mind that dividends, to a large extent, are tax-exempt at the hands of the recipient.

Where a service is provided or goods are transferred from a Norwegian company to a related foreign company, this taxation rule ensures taxation at fair market value. In such cases, the arm's length principle in §13-1 of the Tax Act supplements this general taxation rule.

E. General Anti-Avoidance Rule

A general anti-avoidance rule applies in Norwegian tax law. Although not fixed by law before 2019, it has been developed by case law and juridical theory since the 1960s. Tax authorities have invoked the anti-avoidance rule in numerous cases. Beginning January 1, 2020, a general anti-avoidance rule was established in §13-2 of the Tax Act.[79] By cross reference, law §13-2 of the Tax Act also applies to Value Added Tax.[80]

The anti-avoidance rule statutory provision builds on a similar two-part structure as formulated by the Supreme Court in 2006 and applied in administrative practice since then.[81] This structure means that: (i) there is a basic condition requiring the obtainment of a tax benefit to be the main purpose of the transaction(s), and (ii) an overall assessment must be made where various elements are considered. The basic condition is necessary, but it is not sufficient for applying the anti-avoidance rule on its own. The tax benefit condition in the statutory provision is a completely objective test (i.e., what would typically be the purpose of a fictional rational party carrying out such a transaction). This represents a change compared to the standard developed by the Supreme Court from 2006 onwards, where the subjective purpose of the taxpayer was the center of importance.

In the overall assessment, different factors must be considered when judging whether a transaction is a tax avoidance transaction. The statutory provision lists a number of factors that must be considered. These are, inter alia:[82]

— The commercial intrinsic value and effects of the transaction other than tax effects in Norway and abroad;

— The size of the tax benefit and the degree of tax purpose;

— Whether the transaction is an inappropriate way to achieve the economic purpose of the transaction;

— Whether the same result could have been achieved in a manner not impacted by the anti-avoidance rule;

— The relevant tax rule's technical construction, including whether it is sharply restricted in time, quantity, or any other manner; and

— Whether the tax rules are applied in contradiction with their objectives or with fundamental objectives of the tax law.

The legislative preparatory work states that the threshold for applying the statutory anti-avoidance provision is, in principle, the same as the previous non-statutory rule. However, there are differences in three distinct areas:[83]

— A tax benefit obtained abroad must no longer be recognized as a commercial effect, but must, in principle, be left out when considering the commercial intrinsic value of the transaction;

— The taxpayer's individual subjective motive for the transaction must not be decisive. Instead, an objective purpose test is made, based on what purpose a fictional rational party typically would have had with such a transaction; and

— In principle, it must no longer weigh in favor of the taxpayer that an abuse situation has been identified and mentioned in the legislative preparatory work without being targeted by a specific anti-avoidance rule.

The ordinary effect of applying the anti-avoidance rule is that taxation must be based upon a re-characterized legal arrangement that reflects the economic content of the transaction(s).

Although anti-avoidance terminology and considerations are occasionally used in the application of §13-1 of the Tax Act (arm's length principle), there are distinctive differences between the general anti-avoidance rule and the arm's length principle in §13-1 of the Tax Act. The most important differ-

[77] Utv. 2009, p. 363 (2003-067SKN).

[78] Tax Act §5-2.

[79] Prop. 98 L (2018–2019), Innst. 24 L (2019–2020), NOU 2016:5.

[80] Value Added Tax Act §12-1.

[81] *See e.g.*, Rt. 2006, p. 1232, *Telenor*; Rt. 2007, p. 2009, *Hex*; Rt. 201, p. 1888, *Dyvi.*

[82] Tax Act, §13-2 (3) (author's translation).

[83] Prop. 98 L (2018–2019).

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ences are the conditions for applying the two sets of rules. Application of §13-1 of the Tax Act does not require the transaction(s) to be tax motivated or in conflict with the object and purpose of the tax law, which is required under the general anti-avoidance rule. Furthermore, the normal outcome of applying the general anti-avoidance rule would be re-characterization of one or more transactions, whereas the usual outcome of applying §13-1 of the Tax Act would be adjustment of the price. There is some uncertainty with regard to the scope and delimitation of the arm's length rule in §13-1 in the Tax Act as compared to the general anti-avoidance rule. A decision relevant in this respect was rendered by the Supreme Court in its decision in *IKEA Handel og Eiendom AS (2016)*.[84]

As part of their work in establishing the general statutory anti-avoidance tax rule, the lawmakers endorsed the reasoning and result reached by the Supreme Court in *IKEA* and concluded that this judgment sufficiently clarified the demarcation between the two sets of rules. Thus, they found no need to amend §13-1 in the Tax Act to clarify the scope of this provision.

[84] HR-2016-2165-A-Utv-2016-1678. *Ikea Handel og Eiendom AS*.). In this case, the issue was whether IKEA Handel og Eiendom AS ("IKEA") was entitled to a deduction for interest paid on an internal loan issued in connection with a re-structuring of the company's property portfolio in 2007. Prior to the re-structuring, IKEA directly owned property with a market value of 2.1 billion Norwegian kroner and a book value of 1 billion Norwegian kroner. Through demergers, the properties were transferred from IKEA to seven newly established single-purpose companies held by IKEA's parent company, Pro Holding BV in the Netherlands. A few months later, Pro Holding BV transferred its shares in the seven property-owning companies to a newly established Norwegian holding company as a contribution in kind. The value of the shares was set to 2.1 billion Norwegian kroner, which reflected the market value of the properties. Then the shares in the Norwegian holding company were sold back to IKEA for the market value of the shares/property and this purchase was financed by a loan from the group's Belgian financing entity. Thus, after the re-structuring, IKEA ended up owning the same property, only indirectly, and with substantial amount of intra-group debt. The Supreme Court considered two legal grounds for denial of the interest deduction; the arm's length principle in §13-1 of the Tax Act and the general anti-avoidance rule. The Court concluded that §13-1 of the Tax Law was not applicable to genuine equity transactions (in this case reduction of capital and distribution of equity due to demergers) carried out in conformity with Norwegian company legislation. On the other hand, the Court concluded, after careful consideration of the conditions, that the general anti-avoidance rule was applicable, and ruled against the taxpayer.

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VI. Transfer Pricing Legislation

A. Overview

1. Transfer Pricing Legislation

Norwegian transfer pricing legislation is limited. The general statutory provision is in §13-1 of the Tax Act, 1999. It establishes the arm's length principle under domestic law. It reads as follows:

> (1) Discretionary assessment may take place if the wealth or income of the taxpayer has been reduced as the result of a direct or indirect community of interest with another individual, company or entity.
>
> (2) If the other individual, company or entity mentioned in Sub-section 1 is resident in a state outside the EEA, and there is reason to believe that the wealth or income has been reduced, such reduction shall be deemed to have resulted from a community of interest unless the taxpayer documents that such is not the case. The preceding sentence shall apply correspondingly if the other individual, company or entity is resident or domiciled in a state within the EEA, provided that Norway does not have the right to demand information concerning the wealth and income of such person pursuant to an international law agreement.
>
> (3) Wealth or income shall be assessed discretionarily as if there had been no community of interest.
>
> (4) If there is a community of interest between enterprises resident in Norway and abroad, and their commercial or financial relations are subject to arm's length terms as provided in a tax treaty between respective states, the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations adopted by the Organisation for Economic Co-operation and Development (OECD) shall be taken into consideration for purposes of determining whether wealth or income has been reduced as stipulated in Sub-section 1 and for purposes of the discretionary assessment of wealth or income pursuant to Sub-section 3. These Guidelines should, to the extent applicable, be correspondingly taken into consideration in other cases than those mentioned above. The above shall only apply to the extent that Norway has acceded to the Guidelines, and provided that the Ministry has not decided otherwise.

Paragraph 8 of the Petroleum Tax Act, 1975, refers to the general tax legislation. This means that the arm's length provision in §13-1 of the Tax Act is also applicable to taxpayers subject to tax according to the Petroleum Tax Act.

There are no domestic regulations or domestic guidelines on the application of the arm's length provision in §13-1 of the Tax Act.[85] Domestic guidance is mainly developed by interaction and mutual influence between administrative practices and case laws. Consequently, the OECD Transfer Pricing Guidelines are an important source of guidance in the application of the arm's length principle under domestic law.

The Petroleum Tax Act, 1975, contains specific legislation that is relevant from a transfer pricing perspective. These rules are described in VI.D., below.

Special transfer pricing reporting and documentation rules were enacted in 2007,[86] and are provided in §8-11 of the Tax Administration Act and its secondary regulations. These are discussed in X.B., below. There is no specific regulation covering intra-group services or cost sharing arrangements, and such transactions and arrangements are subject to the general rules.

2. Domestic and Cross-Border Transactions

The arm's length principle in §13-1 of the Tax Act is applicable to domestic transactions, as well as to cross-border transactions. The provision is not restricted to intra-group transactions but also covers transactions between other related persons such as a shareholder and a closely held company. Although there still is a need for §13-1 outside the sphere of intra-group transactions, the main area of application today (and the topic of this chapter) relates to intra-group transactions.

Transfer pricing is primarily an issue in cross-border transactions. In domestic transactions, transfer pricing is generally not a risk area as companies are subject to the same tax regime and the group contribution rules to a large extent allow for consolidation of the tax base within a group of domestic companies. Thus, where all entities in a group of domestic companies are subject to the ordinary tax regime, the tax burden may normally not be reduced by mispricing internal transactions. However, if one of the companies in a domestic group is subject to one of the special tax regimes (i.e., the petroleum tax regime, the tonnage tax regime, the regime applicable to hydroelectric power-producing companies, or the regime applicable to aquaculture), there is a huge incentive to shift profit by way of internal transactions. In such cases, transfer pricing is an important risk area also in domestic transactions.

Although not important for the overall tax burden of a group of (ordinarily taxed) domestic companies, transfer pricing could have an influence on the division of tax revenue between local tax creditors. Until 1998, the general income tax on companies and entities was credited partly to the state and partly to the county and municipality in which the company was located or carried out its activities. Beginning in 1998, however, the general income tax levied on companies and entities is credited only to the state. Thus, the pricing of intra-group transactions no longer influences the division of tax revenue between counties and municipalities. Hence, transfer pricing is an issue which, for all practical purposes, is of relevance only in cross-border-transactions and in domestic transactions which involve companies subject to one of the special tax regimes.

[85] The tax Administration aims to provide more guidance on its website. This work is ongoing, and guidance and information will be released step by step. Some basic information about transfer pricing, transfer pricing audits and documentation rules etc. are available at Om internprising - Skatteetaten (for the most part Norwegian language only).

[86] The special transfer pricing documentation rules became effective as of the income year 2008.

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3. Thin Capitalization

There is no specific thin capitalization legislation in Norway. The arm's length provision in §13-1 of the Tax Act is applicable to thin capitalization. An interest deduction limitation rule (fixed ratio rule) also applies.[87]

4. Simplification Measures

Taxpayers are not exempt from the arm's length provision in §13-1 of the Tax Act under any safe harbor measures. Generally, there are no domestic regulations or administrative guidance with respect to any type of transaction where pre-denominated margins or prices are accepted as being entered into on an arm's length basis (i.e., no safe harbor rules are established in domestic legislation). However, the norm-price system in the Petroleum Tax Act may be characterized as a simplification measure aiming to lighten the administrative burden with regard to the pricing of crude oil extracted on the Norwegian continental shelf.

Norway has accepted its application of the simplified approach to low-value-added services that is introduced in Chapter VII.D of the 2017 version of the OECD Guidelines and has not indicated that its application of the simplified approach will be restricted to any thresholds, although it has not ruled out considering it in the future. Despite its general endorsement of this simplified approach, the Norwegian Ministry of Finance has informed the Norwegian Tax Administration and the OECD Centre for Tax Policy and Administration that the Norwegian oil taxation authorities are not prevented from conducting a thorough transfer pricing analysis with regard to service costs charged or allocated to Norwegian upstream companies that are subject to the Norwegian petroleum tax and a total combined tax rate of 78%. Thus, the simplified approach for low-value-added services is not elective in Norway for oil and gas companies operating on the Norwegian continental shelf.

No separate implementation procedure is required for the safe harbor mechanism on low-value-added services to apply in Norway since sub-paragraph (4) of §13-1 of the Tax Act makes the substantive provisions of the OECD Guidelines directly applicable in the determination of arm's length prices.

Certain simplification measures apply with regard to the scope of the special transfer pricing documentation rules.[88] No other simplification measures have been introduced in Norwegian transfer pricing regulations or practice.

5. Relationship Between Domestic Law and Tax Treaty Provisions

Under the Norwegian dualistic legal system, a tax treaty must be incorporated into domestic law before a treaty provision can be applied directly. The incorporation process of tax treaties is somewhat simplified in the sense that a special Incorporation Act ensures that a tax treaty, which has been approved by the Parliament and entered into by the King in Council, is regarded as being incorporated into domestic law.[89] A tax treaty provision has the same legal status as a statutory provision but generally prevails on the basis of the *lex-specialis* principle. The jurisdiction to impose tax must be established in domestic law. Thus, a treaty provision based on Article 9 of the OECD Model Tax Convention does not by itself establish a legal basis for making an income adjustment. Instead, the basis to do so must be established by the domestic law provisions (i.e., §13-1 of the Tax Act).[90] However, where a transaction is covered by a tax treaty, an adjustment made according to domestic law must be in conformity with Article 9 of the tax treaty.

6. Status of the OECD Guidelines

The OECD Transfer Pricing Guidelines (OECD Guidelines) represent internationally agreed-upon principles and provide guidelines for the application of the arm's length principle of which Article 9(1) of the OECD Model Tax Convention is the authoritative statement.[91] The OECD Guidelines are not binding upon the OECD Member States in their application of tax treaties based on the Model Tax Convention, but the OECD Council has recommended that they be applied by tax administrations in the Member States, and Norway does so. The OECD Guidelines are an important source for interpreting and applying Article 9(1) in the Model Tax Convention and the domestic arm's length provision in §13-1 of the Tax Act.

In the *Agip* case (2001), the Supreme Court gave an important clarification with regard to the status of the OECD Guidelines in relation to Norwegian domestic law.[92] The case concerned the pricing of insurance premiums paid by a Norwegian company to a related captive insurance company in Bermuda. There was no tax treaty between Norway and Bermuda, and the pricing of the premiums was therefore solely tested and assessed based on the provision in §13-1 of the Tax Act.

The Supreme Court explained that the OECD Guidelines are relevant and should be taken into account when interpreting and applying §13-1 of the Tax Act. The Court went on to state that it "considers that §13-1, supplemented by the brief remarks to the arm's length principle in the legislative preparatory work, in principle reflects the same as the OECD Guidelines."[93] Further, the Court stated: "[I]t's therefore not a restrictive or a liberal interpretation of §13-1 of the Tax Act when great importance is attached to the OECD Guidelines. The OECD Guidelines more precisely express the substance of §13-1 of the Tax Act."[94] Hence, it is clear that the OECD Guidelines are highly relevant in the interpretation and application of §13-1 of the Tax Act and that the OECD Guidelines are an important source of law.

In 2007, an explicit reference to the OECD Guidelines was inserted in a new sub-paragraph 4 of §13-1 of the Tax Act. The sub-paragraph states that the OECD Guidelines "shall be taken into account" in the application of §13-1 when "there is a community of interest between enterprises resident in Norway and abroad, and their commercial or financial relations are sub-

[87] *See* VI.C., below.

[88] *See* X.B., below.

[89] Act July 28, 1949, no. 15.

[90] Article 9 of the OECD Model Treaty addresses the allocation of profits in multinational enterprises.

[91] *See* Para. 1 in the OECD Commentaries, Art. 9. The current and previous editions of the OECD Guidelines are available on the Bloomberg Tax platform: https://www.bloomberglaw.com/product/tax/page/oecd_guidelines_2022.

[92] Rt. 2001, p. 1265, *Agip*.

[93] Rt. 2001, p. 1265, *Agip* (unofficial English translation).

[94] Rt. 2001, p. 1265, *Agip* (unofficial English translation).

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ject to arm's length terms laid down in a tax treaty between the respective states."[95] It further states that the OECD Guidelines "should, to the extent applicable, be correspondingly taken into account in other cases than those mentioned above." The last part refers to the situation in which the intra-group transaction is not covered by a tax treaty. In such a case, where the arm's length conditions are to be determined on the basis of domestic law, the lawmakers did not find it logical to establish a "strong" formalized connection to the OECD Guidelines.

It is clear that the OECD Guidelines are only used as persuasive guidelines and not binding authority under domestic law. It appears from the legislative preparatory work that the reference to the OECD Guidelines ("shall be taken into account") is only relevant in relation to the substantive guidance concerning the arm's length principle, and not in relation to the administrative issues dealt with in Chapter IV and the documentation issues dealt with in Chapter V of the OECD Guidelines. The fact that the reference to the OECD Guidelines is anchored in §13-1 of the Tax Act substantiates this view.

However, the explicit reference to the OECD Guidelines applies only to the extent that Norway has acceded to the Guidelines and provided that the Ministry of Finance has not decided otherwise. Therefore, the Ministry of Finance has been delegated the competence to deviate from the Guidelines in secondary regulations. From the legislative preparatory work it appears, however, that it is not very likely that the Ministry of Finance will issue regulations that deviate from the OECD Guidelines. It may be more likely that more precise guidance could be provided on some selected topics in conformity with the OECD Guidelines.

Tax literature has since pointed out that sub-paragraph 4 of §13-1 of the Tax Act is rather unique, and it could be questioned as to whether the explicit reference to the OECD Guidelines ("shall be taken into account") implies anything else or more compared with what already followed from the decision by the Supreme Court in the *Agip* case.[96] However, from the legislative preparatory work, it follows that the Ministry of Finance assumed that a formalized connection to the OECD Guidelines to some extent would lead to a more harmonized practice, in line with the intentions of the Guidelines, and a more systematic use of the OECD Guidelines in the practical work with transfer pricing issues.[97] In retrospect, one can conclude that the introduction of an explicit reference to the OECD Guidelines has led to a more systematic use of the OECD Guidelines in Norwegian administrative practice. While the Guidelines were rarely referred to in administrative practice and by the Courts before 2008, they are nowadays generally extensively discussed and referred to in Norwegian administrative practice and by Norwegian Courts dealing with transfer pricing cases.

7. *Historical Development*

The first transfer pricing regulation in Norwegian statutes dates back to 1911. That year, two tax acts (the Tax Acts) were adopted: one was applicable to persons in the countryside and the other was applicable to persons in the cities. Both Tax Acts contained the same identical provision that gave the tax authorities the power and discretion to stipulate the wealth or income of a person who "appeared to be a supplier, lender or guarantor, but where the facts indicated that he should be regarded as being interested in another person's business in essentially the same way as a participant."[98] In 1975, the two Tax Acts were merged, and the provisions were enacted in §54(1) of the (renamed) General Tax Act of 1911. At the time the provision was originally introduced (i.e., in the year 1911), domestic transactions were scrutinized in most countries. It is therefore quite interesting that the provision was motivated by the potential loss of revenue resulting from cross-border transactions. From the legislative preparatory work, it appears that the introduction of the provision was directly inspired by actual cases. In one of the cases, a foreign wholesaler had carried out transactions with its related Norwegian distributing company and the net profit of the Norwegian distributor appeared to be relatively low as compared to its turnover. In the legislative preparatory work, it was assumed that, in such a case, it would be difficult to disregard the local incorporated company for tax purposes and levy tax directly on the foreign enterprise. Instead, an income adjustment provision was proposed to ensure taxation at arm's length.[99]

In 1918, a second sentence was added to §54(1) of the General Tax Act, 1911. The additional sentence made it clear that the tax authorities could make a discretionary stipulation of a taxpayer's wealth or income when a taxpayer "purchases or sells goods or hires out power at a price which, by reason of a community in interests, is assumed to be different from which it would have been in the absence of such a community of interests."[100] The second sentence that was added in 1918 uses the wording "community of interests" and differs from the first sentence, which used the wording "interested . . . in essentially the same way as a participant." According to the legislative preparatory work, the diverging wording was deliberately chosen, and the intention was to lower the threshold for applying the provision in the latter instance.[101] One motivating factor for adding this sentence was the comprehensive foreign investments in Norwegian power stations at the time.

Although the provision was primarily motivated by protecting domestic tax revenue in international transactions, it was hardly used for that purpose during the first decades. At that time, it was mainly applied to domestic transactions. The main area of use was transactions between a sole and managing-owner and "his" company, where classification of payments from the company as salary or dividend could substantially affect the amount of tax levied.

Later, the focus on transfer pricing increased rapidly in the mid-1970s as a result of the petroleum activity on the Norwe-

[95] Unofficial English translation.

[96] Frederik Zimmer, *Internasjonal inntektsskatterett*, 4, utgave, 2009, p. 149.

[97] Ot. prp., no. 62 (2006–07), available at https://www.regjeringen.no/contentassets/6e4a4c447d5749afbb98d518f5af19d7/no/pdfs/otp200620070062000dddpdfs.pdf.

[98] Norwegian Tax Acts (August 8, 1911) (unofficial English translation).

[99] Ot. prp. no. 43 — 1910, p. 25–27.

[100] General Tax Act, §54(1), 1911 (unofficial English translation).

[101] Indst. O I, 1918, p. 48.

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gian continental shelf. Multinational enterprises were engaged in the petroleum business from the start as either petroleum companies or as companies that were carrying out activities auxiliary to, and related to, the exploration and extraction of petroleum. In 1975, the Petroleum Tax Act was adopted. It introduced a norm-price system in which the prices of crude oil for taxation purposes are determined administratively by a board appointed by the government. The norm-price system is a special feature of the Norwegian transfer pricing regulations, and it is still in operation.

The next step was the amendments to §54(1) of the General Tax Act, 1911, which came into place in 1981. The provision was restructured, and the language was modernized. A new provision was enacted describing the conditions that must be satisfied to adjust a taxpayer's wealth or income. The first sentence read: "[D]iscretionary assessment may take place if the wealth or income of the taxpayer has been reduced as the result of a direct or indirect community of interest with another individual, company, or entity." Elsewhere, guidance explained how to perform the discretionary assessment in such a case. The new law provided: "[W]ealth or income shall be assessed with discretion as if there had been no community of interest."[102]

In the legislative preparatory work to the 1981 amendments, it was underlined that the main purpose of the provision was to shield the Norwegian tax base from tax erosion.[103] International transactions were the apparent focus and, in particular, possible tax erosion as a result of intra-group mispricing in the petroleum industry. In the legislative preparatory work, it was stated that the burden of proof could be particularly difficult to overcome in cross-border situations where it might be difficult for the tax authorities to obtain the relevant information. Thus, the 1981 revision relaxed the rules concerning the burden of proof in cases where the associated party was resident outside Norway.

The next important event occurred in 1994 with the introduction of thin capitalization rules in the Petroleum Tax Act. The background was that the tax reform in 1992 and contemporaneous new accounting legislation made it possible to transfer substantial amounts of released equity to foreign principals. As a result, it was observed that the debt-to-equity ratio of many Norwegian subsidiaries rose substantially. These reforms were general in nature, but thin capitalization was a particular concern in relation to companies that were subject to a combined tax rate of 78%. As a response, thin capitalization rules were introduced for enterprises that carried out petroleum extraction and pipeline transport activity on the Norwegian continental shelf. According to these rules, such companies would be assessed as if a minimum 20% of the total capital recorded in the balance sheet of the financial accounts was equity. The thin capitalization rules in the Petroleum Tax Act were abolished in 2007 and replaced with rules that limit the net financial costs that can be allocated to, and deducted from, the income subject to 78% taxation.

In 1999, the current Tax Act was adopted. It was inspired as a technical revision and the general intention was not to make any substantive amendments. Section 54(1) of the General Tax Act, 1911, was incorporated in §13-1 of the Tax Act, 1999. Some minor technical amendments were made; the provision had been divided into three paragraphs (instead of three sentences). The legal content of the provision was not changed, however, and older case law and administrative practices related to §54(1) of the General Tax Act, 1911, are still relevant to the interpretation and application of §13-1 of the Tax Act, 1999.

In 2007, special transfer pricing documentation rules were adopted.[104] In addition, an explicit reference to the OECD Guidelines was inserted in a new sub paragraph 4 in §13-1 of the Tax Act. Also, some minor adjustments were made with regard to the rules concerning the burden of proof in §13-1(2).[105]

Although not a transfer pricing rule, it is worth mentioning that an interest deduction limitation rule (Fixed Ratio Rule) was introduced with effect from 2014.[106]

B. The Arm's Length Provision in §13-1 of the Tax Act

1. Introduction

The arm's length provision in §13-1 of the Tax Act has a general applicability. Additionally, in some respects, it has a broader scope than Article 9(1) of the OECD Model Tax Convention in that it applies both to cross-border transactions and domestic transactions. It also applies to all taxpayers who transact with another person, company, or entity by which there exists a community of interests. The provision states that a discretionary assessment may take place if the wealth or income of the taxpayer has been reduced as the result of a direct or indirect community of interest with another individual, company, or entity. Hence, three cumulative conditions must be met before an adjustment of a taxpayer's income or wealth can be made:

— First, there must be a direct or indirect community of interest between the taxpayer and some other person, company, or entity.

— Second, a reduction of the taxpayer's wealth or income must have taken place.

— Third, there must be a causal link between the community of interest and the income or wealth reduction incurred.

If all three conditions are met, under §13-1(1) of the Tax Act, it is stipulated that the taxpayer's income or wealth may be adjusted by the tax authorities. The wording indicates that the tax authorities are not obliged to make an adjustment; they may exercise discretion and omit to do so even if the requirements for making an adjustment are fulfilled. There are, however, some limitations in this respect due to principles of equal treatment and prohibition of unjustifiable difference in the treatment of taxpayers.

Generally, when all three conditions are satisfied and an adjustment is made, the taxpayer's income or wealth must be assessed "as if there had been no community of interest" be-

[102] General Tax Act, 1911, §54(1), as amended (1981) (unofficial English translation).

[103] Ot. prp., no. 26 (1980–81).

[104] *See* X.B., below.

[105] Ot. prp., no. 62 (2006–07).

[106] Tax Act, §6-41, *see* VI.C., below.

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tween the parties (i.e., at arm's length).[107] There is a close connection between the conditions that must be met in order to make a discretionary adjustment and the discretionary assessment to be made. In either instance, there must be a comparison between the transfer price and other conditions in the controlled transaction to the transfer price and other conditions that are or would have been agreed upon between unrelated parties engaged in a similar transaction under comparable circumstances (arm's length price and conditions). The arm's length price and conditions are on the one hand the "standard" against which the agreed price and conditions must be measured when determining whether there has been a reduction of the taxpayer's income or wealth. The arm's length price and conditions are also determinative for the discretionary assessment since the income or wealth must be determined as if the community of interest does not exist.

2. Authority to Make Adjustments

The Tax Act §13-1 authorizes an adjustment of the taxable income or wealth when the taxpayer's income or wealth has been reduced due to a community of interest. In line with the wording of the provision, it is a common understanding that the provision does not in itself establish a legal basis for taxing an item of income. An income or wealth adjustment based on §13-1 therefore requires that the "reduced" income or wealth is in fact taxable according to another provision in the tax legislation. However, due to the broad scope of items defined as income in Norwegian tax law, this is generally not an issue of consideration in practice.

3. Authority to Make Valuation and Structural Adjustments

The main scope of §13-1 of the Tax Act is to provide for an adjustment of the price of one or several aggregated controlled transaction(s) if the price agreed upon in the controlled transaction(s) is not at arm's length.[108] Adjustment of the price may be referred to as a valuation adjustment.

Section 13-1 of the Tax Act also constitutes a legal basis for adjusting a taxpayer's income (or wealth) if it is reduced due to one or several aggregated controlled transactions which contain terms, other than price, that are not commercial, natural, or reasonable and can only be explained by the community of interest. In this respect, an *obiter dictum* made by the Supreme Court as far back as 1940 in the *Fornebo* case is influential.[109] The case concerned thin capitalization, and one of the questions was whether §54(1) of the Tax Act, 1911 (now §13-1 of the Tax Act, 1999), constituted a legal basis for the recharacterization of a loan. Although the capital structure in the *Fornebo* case was in fact accepted, the Supreme Court stated in general terms that the provision would be applicable "if the community of interest has resulted in an arrangement with respect to the enterprise's funds or income which is not commercial, natural or reasonable, but may only be explained by the community of interest and which may have resulted in an alteration of the tax bases."[110]

Subsequently, the courts have generally accepted that §13-1 of the Tax Act is applicable to thin capitalization structures. It has also been clarified that the provision may be used as a basis for restructuring a particular element of a contractual arrangement between related parties.[111] Thus, the provision is, in principle, also applicable as a basis for restructuring a transaction or certain elements or terms of a transaction (i.e., it is applicable to so-called "structural adjustments").[112]

4. The Community of Interest Condition

Application of the community of interest condition under §13-1 of the Tax Act requires that there exist a "direct or indirect community of interest between the taxpayer and some other person, company or entity." In practice, in the vast majority of transfer pricing cases, the "community of interest" condition is not disputed.

As in Article 9(1) of the OECD Model Tax Convention, the community of interest between the taxpayer and the other (related) party can be either direct or indirect. When the factors that establish a community of interest exist in the relation between the taxpayer and the related party, the community of interest is direct in nature.[113] The typical example is the parent-subsidiary relationship.

When the facts establish separate relations between two parties and one or more other person(s), the community of interest is of an indirect nature. One example is a parent company and two wholly-owned subsidiaries. In such a case, there is a community of interest between the two subsidiaries based on the ownership interest and control that the parent company exercises in relation to both entities. In such a case, the parent company is the link that "connects" the two subsidiaries (the connecting party). Another example is a parent company and its second-tier subsidiary. A community of interest exists between the two companies based on the ownership and control that the parent company exercises in the subsidiary (the connecting party) combined with the ownership and control that the subsidiary exercises in the second-tier subsidiary.

Whether direct or indirect, §13-1 of the Tax Act requires a community of interest to exist between the "taxpayer" and some "other person, company or entity." The term "taxpayer" refers to the person whose income (or wealth) is reduced and therefore is subject to adjustment (the adjusted party). The term implies that the "adjusted party" must be subject to tax in Norway. The term "taxpayer" does not require, however, that the adjusted party be a Norwegian resident. The adjusted party might be resident abroad and subject to limited source taxation in Norway. Hence, the adjusted party could be a Norwegian permanent establishment of a foreign enterprise (which does businesses with a related person, company, or entity).

Except for the requirement of being subject to tax, the term "taxpayer" does not limit the scope of the provision in any way. The provision is applicable to individuals as well as to legal persons.

[107] Tax Act §13-1(3).

[108] Rt. 2010, p. 790, *Telecomputing.*

[109] Rt. 1940, p. 598, *Fornebo.*

[110] Rt. 1940, p. 598, *Fornebo* (unofficial English translation).

[111] *See e.g.,* the *Agip* (2001) case, discussed in IX.I., below.

[112] Andreas Bullen, "Arm's Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing," 2010, §1.6.3.

[113] For example, an ownership interest may establish a community of interest.

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Section 13-1 requires that a community of interest exist between the taxpayer and "some other person, company and entity" (the related party). The term "person, company or entity," encompasses individuals and different types of legal entities. A municipality, for example, is regarded as being an "entity" in relation to the provision.[114] It is not a requirement that the related party is a "taxpayer" (i.e., subject to tax in Norway or elsewhere).

The statute's scope is not restricted to situations where the community of interest exists between two companies or entities. It also applies where a community of interest exists between an individual and a company or entity, and even where a community of interest exists between two individuals. It is not a requirement that any of the parties are carrying on business.[115] Hence, §13-1 of the Tax Act has a broader area of application than Article 9 of the OECD Model Tax Convention, which is restricted to situations where there is a community of interest between enterprises resident in the two states.

The community of interest must, however, exist with some "other" person, company, or entity. The wording, therefore, clearly presupposes that the provision is not directly applicable as a basis for adjusting the profit of a permanent establishment (or a head office) due to incorrect attribution of profit between different parts of an enterprise.

The provision does not state which factors could constitute a "community of interest." The criteria are not defined or exemplified in the Act. The wording indicates that different factors may be relevant. The core elements would be the factors that are explicitly mentioned in Article 9(1) of the OECD Model Tax Convention, namely that one party participates in the management, capital, and control of the other party, or that one or more persons participate in the management, capital, and control of both parties. Community of interest based on ownership interests (capital) is the most frequent in practice. It is not possible to stipulate exactly what ownership interest would be required. However, one might assume that an ownership interest of 50% or more normally would be enough, whereas an ownership interest of less than 33% would normally not be enough.[116] A variety of factors might be relevant to consider, and the overall decisive criterion seems to be if one party is in a position to influence decisions made by the other party. Therefore, in combination with factors such as controlling a majority of the votes or having the right to appoint a majority of the members of the board, an ownership interest of less than 50% could be enough to establish a community of interest. On the contrary, an ownership interest of 50% or more does not necessarily establish a community of interest if the majority owner only controls a minority of the voting power in a company.

Under certain circumstances, a community of interest may be established on the basis of factors other than ownership. Examples might be a dominant creditor or supplier position. As a general rule, a mere contractual relationship (e.g., as a creditor or supplier) with another party would not imply that a community of interest exists between the parties, but there are exceptions to this rule. For instance, where one party is more or less totally dependent on the other, such a contractual relationship could establish a community of interest between the parties. The decisive criterion would be whether the creditor or supplier has such a dominant position that it might materially influence the decision made by the other party.[117]

Between individuals, a community of interest cannot be based on ownership. Possible connecting factors are family and economic relations. It is quite clear that family relations alone will not make the provision applicable. In such cases, there must be a substantial economic relation between the persons, but a family relation may be a relevant element in the overall judgment.

5. The Wealth or Income Reduction Condition

For an adjustment to be made under §13-1 of the Tax Act, tax authorities must demonstrate that either the taxpayer's wealth or income has been reduced. The term "income" is broader than the term "profits," which is used in Article 9 of the OECD Model Tax Convention. The term "income" encompasses business profits (including profits from performance of professional services and other activities of an independent character), as well as other types of income such as, for example, salaries, pensions, and financial income not considered as business income. The use of the term "income" reflects that the scope of the provision extends beyond the scope of Article 9 of the OECD Model Tax Convention, which is limited to situations where the profit of an enterprise has been reduced. On the other hand, the aim of §13-1 of the Tax Act implies that the term "income" only includes income types that are taxable according to Norwegian law.

The "wealth reduction" condition has no parallel in the OECD Model Tax Convention. Again, the aim of this provision implies that the term "wealth" refers to assets and liabilities that are taxable and deductible, respectively, in the computation of the taxable net wealth base according to Norwegian tax law. In practice, the wealth reduction condition is of very limited importance. One reason is that this condition is only relevant to taxpayers who are in fact subject to the net wealth tax (i.e., individuals and a limited number of entities). Another explanation is that a reduction in wealth normally does not occur unless there has been a simultaneous reduction of income. Hence, the independent importance of the wealth reduction condition is limited to situations in which a person subject to net wealth tax (individuals and some entities) has experienced wealth reduction without having experienced income reduction. Because of the limited importance of the wealth reduction condition, only the income reduction condition is referred to below.

The income reduction condition implies that there is a particular standard under which the taxpayer's reported income must be measured in order to decide whether it has been "reduced." In doing so, the facts and circumstances leading to the reported income would have to be compared with some "normal" situation assumed to prevail in an uncontrolled market.

[114] Utv. 2000/613 (701).

[115] This distinguishes §13-1 of the Tax Act from domestic transfer pricing legislation in many other countries, including the United States, which authorize adjustments to transactions only between businesses or only in business transactions.

[116] Arvid Aage Skaar m fl., Wiersholm, Norsk Skatteavtalerett, p. 348, 1st ed., 2006.

[117] Rt. 1939, p. 699, *Brœkken.*

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Whether the income reduction must be substantial cannot be deduced from the wording of §13-1. Some old decisions by the Supreme Court concerning the size of a management salary in a privately held stock company stated that the difference had to be substantial.[118] Tax literature issued after these holdings set forth that overly strict implications should not be drawn from these old judgments, arguing that substantiality is not a requirement under the Act but that it may be addressed from the perspective of assessment of evidence.[119] The Supreme Court has later stated that adjustment according to §13-1 does not require, per se, that the income reduction must be substantial.[120] However, the concept of arm's length ranges are generally accepted under Norwegian administrative practice and case law. Thus, it is recognized that application of the most appropriate transfer pricing method in many cases will generate a range of equally reliable prices (the arm's length range). In such cases the "income reduction" condition requires that the price (or margin) in the controlled transaction fall outside the range.[121]

There is no limitation with respect to the manner in which an income reduction may occur. Normally, an income reduction will occur as a result of one or more transactions with a related party. An income reduction may result from a single transaction such as a sale or from a long-term contract such as a license agreement. It is, however, not required by the statute that the income reduction results from a "transaction." The statute simply requires that the income "has been reduced," and this may potentially be caused by other circumstances as well.

The income reduction test is an objective test. The question, according to the wording of §13-1, is simply whether there has been an income reduction. Tax authorities are not required to show that an income adjustment based on §13-1 of the Tax Act is being sought because the income reduction was intentional or tax motivated.[122]

One might reasonably argue that whether an income reduction has occurred in principle should be determined on a year-by-year basis. This is a natural extension of the general principle in Norwegian law that taxable income cannot be transferred from one period to another. Therefore, under this line of reasoning, if the taxpayer's income is too low compared to the arm's length income in year one, an income reduction will exist and the income may be adjusted, even if the taxpayer's income in year two is higher than the arm's length income. This question was put before Supreme Court in *Baker Hughes Oilfield Operations Inc.* (1999).[123] The Court did not make any definite or general statement but concluded that it seemed right in the particular case to consider the pricing on a year-by-year basis. However, in the determination of the arm's length price in any particular year, in some cases it could be useful to consider multiple-year data to get a better understanding of the controlled transaction, and in the identification of reliable comparables.[124]

In practice, whether the income reduction condition is satisfied or not is essential to evaluate in all transfer pricing cases.

6. *The Causal Connection Condition*

Section 13-1 of the Tax Act requires a causal link between the income reduction and the community of interest. Both the Act and the legislative preparatory work clearly presuppose that there could be cases in which an income reduction in a related-party transaction may be caused by other reasons than the community of interests. Answering which event has triggered an income reduction is a matter of proof.

In practice, however, the causal link requirement is of minor importance. In almost all cases, it is quite clear, and the taxpayer and tax authorities agree, that if an income reduction has been shown to occur, it is caused by the related-party situation. Furthermore, the income reduction condition and the causal link condition are very closely linked, and it can be difficult to distinguish between the two conditions. There are examples in case law where the court has found it inappropriate to discuss these two conditions separately.[125]

However, in *Statoil Angola* (2007), the Supreme Court annulled an income adjustment explicitly on the basis of the causal link condition.[126] The Supreme Court concluded:

> [Although] Statoil ASA [a Norwegian company] had issued an interest free loan to Statoil Angola (Statoil ASA's subsidiary) that exceeded the subsidiary's loan-capacity, so that Statoil ASA thereby had its income reduced, . . . the interest free loan [was] not a result of the community of interest between Statoil ASA and Statoil Angola but rather founded on commercial business reasons.[127]

7. *Burden and Level of Proof*

An assessment is based on the facts that appear to be most likely. According to the Tax Administration Act, the main responsibility for providing the factual information lies with the taxpayer.[128] When establishing the facts of the case, the tax authorities must take into consideration the facts stated by the taxpayer, as well as other factual information of which they are aware.

In general, an income adjustment under §13-1 of the Tax Act requires the tax authorities to demonstrate that the taxpayer's income has been "reduced." The tax authorities must also demonstrate that there is a community of interest between the transacting parties.[129] It is not entirely clear, however, whether the tax authorities must also prove the existence of a causal connection or whether there is a presumption that a causal connection exists when the tax authorities have demonstrated that there is an income reduction and a community of interest. The law does not impose a heavy burden of proof on the tax author-

[118] Rt. 1925, p. 363; Rt. 1926, p. 392; Rt. 1928, p. 540.

[119] Jan Syversen, Skatt paa petroleumsutvinning, p. 393, Oslo, 1991; Joachim M. Bjerke, Internprissetting, p. 135, Oslo, 1997.

[120] Rt. 1999, p. 187, *Baker Hughes Oilfield Operations Inc.*, Rt. 2001, p. 1265, *Agip.*

[121] Gulating Court of Appeals, LG-2021-38180, *ConocoPhillips Scandinavia AS*, Borgarting Court of Appeals, LB-2022-052192, *Pgnig Upstream Norway AS.*

[122] Utv. 2009, p. 210, *Lyse Energi AS.*

[123] *See* IX.C., below.

[124] OECD Guidelines (2022), at paragraph 3.75–3.79.

[125] Utv. 2004, s. 685, *Scribona.*

[126] Rt. 2007, p. 1025, *Statoil Angola. See* IX.F.2, below.

[127] Rt. 2007, p. 1025, *Statoil Angola. See also* the Supreme Court's decision in *Telecomputing*, Rt. 2010, p. 790 (author's translation).

[128] Tax Administration Act, §8-1.

[129] Ot. prp. no. 62 (2006–2007) p. 16.

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ities, however. It merely requires that they, based on the facts of the case, are able to demonstrate that income reduction and the existence of community of interest between the parties are more likely than other alternatives.

In 1981, a special "burden of proof rule" was introduced in relation to cross-border transactions. The purpose was to relax the burden of proof requirements in situations where the other party to the transaction is resident abroad. The motivation for implementing the change was the increasing foreign activity on the Norwegian continental shelf in the 1970s, and the assumption that it would be more difficult for the tax authorities to establish the facts of a case in situations where the other party to the transaction is resident outside Norway. This "burden of proof rule" is currently set forth in §13-1(2) of the Tax Act. It stipulates that if "there is reason to believe that the wealth or income has been reduced, such reduction must be deemed to have resulted from a community of interest unless the taxpayer documents that such is not the case."

Until 2007 the special "burden of proof rule" applied in all cases where the other party to the transaction was resident outside of Norway. As of 2007, however, the rule is applicable only where the other party is resident in a state outside the European Economic Area (EEA). The special rule also applies if the other party is resident in a state within the EEA, if Norway does not have the right to require tax information from that other state according to a treaty.

The special burden of proof rule set forth in §13-1(2) of the Tax Act relaxes the tax authorities' burden of proof with respect to cross-border transactions in the following ways:

- First, from the legislative preparatory work, it appears that it was intended to slightly relax the level of proof that is required to demonstrate that an income reduction has occurred.[130] As a consequence, the phrase "reason to believe that the wealth or income has been reduced" was inserted in the Tax Act. In *Baker Hughes Oilfield Operations Inc.* (1999) the Supreme Court discussed the meaning of the phrase "reason to believe" in the context of the legislative preparatory work. The Court found that the weight of evidence must prove that the income has been reduced (also) in cross-border transactions where the special rule applies. However, the Court further stated that "in such cases, the factual information [on] which the tax authorities may base its decision can be somewhat less comprehensive than in cases where the main rule applies."[131]

- Second, when the tax authorities demonstrate that the income has been reduced, the "burden of proof rule" presumes that the income reduction has been caused by a community of interest. Hence, in such cases the burden of proof is shifted to the taxpayer. To rebut the presumption, the taxpayer must either prove that there is no community of interest or that there is no causal link between the income reduction and the community of interest.

The Supreme Court's decision in *Dowell Schlumberger (Eastern)* (1995) is interesting in the context of burden of proof.[132] The case concerned deductibility of captive insurance premiums. An essential issue in the case was whether the captive arrangement constituted a real transfer of risks from the Norwegian taxpayer to the intra-group captive. Entitlement to the deduction would require the taxpayer to prove, among other things, that the captive company had the financial capacity to bear the risks insured. The Court found the taxpayer's evidence unclear. It pointed out that the taxpayer is responsible for documenting that the conditions for tax deduction are fulfilled, and that the taxpayer had not arranged for clarification of the uncertainty. The Court held that the taxpayer was not relieved from of its duty to document the foundation for the deduction simply because the necessary information required to support the taxpayer's claim concerned another legal entity (which was resident in another jurisdiction and not controlled by the taxpayer). The Supreme Court concluded that when claiming a deduction for an intra-group payment, the taxpayer is required to provide the information necessary to assess whether the transaction is real. If this is not the case, the consequence is denial of the deduction.

8. The Discretionary Adjustment to Arm's Length

The legal consequence of being able to demonstrate that all three conditions in §13-1 of the Tax Act are fulfilled is that the tax authorities may make a discretionary assessment of the taxpayer's income. A prerequisite is, of course, that the time limit for making a retroactive adjustment has not expired.

Paragraph 3 of §13-1 of the Tax Act clearly indicates that where an income reduction has occurred, the relevant standard for a discretionary adjustment to be made is a question of what income would have been derived if the transaction had occurred at arm's length. There is a legal link between the income reduction requirement (legal condition) and the discretionary income assessment (legal effect). In both cases, the arm's length income is the relevant reference point. Hence, the same legal transfer pricing framework and the same transfer pricing analysis are relevant in both instances. In principle, consideration of the income reduction and the discretionary assessment can be carried out in one single operation. In practice, however, they are normally carried out in two separate operations, and dealt with in separate parts of the administrative process. Generally, as a first step, the tax authorities confine themselves to demonstrating that the legal condition of income reduction is fulfilled, without stipulating or making any assumption of the size of the reduction. When a legal foundation for making an income adjustment has been established, the remaining part of the transfer pricing analysis must be carried out as part of the discretionary assessment in the second step. When making the discretionary adjustment to arm's length, however, a transfer pricing analysis must be carried out in full detail and one particular price (or margin or profit split) has to be determined.

There are no domestic regulations or guidance with respect to the carrying out of the discretionary assessment. Subparagraph (4) of §13-1 of the Tax Act refers to the OECD Guidelines and explicitly states that the Guidelines must be taken into consideration when making the discretionary adjustment of the taxpayer's income. Thus, the methodologies and the vari-

[130] Ot. prp., no. 26 (1980–81).

[131] Rt. 1999, p. 187, *Baker Hughes Oildfield Operations Inc.* (unofficial English translation).

[132] Rt. 1995, p. 124. The decision is described in IX.I., below.

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ous elements of the comparability analysis recommended in the OECD Guidelines are of particular relevance when determining the arm's length price. Administrative practice and case law on the application of transfer pricing methodologies and certain comparability issues are described in VII., below.

9. Court's Authority to Judge a Transfer Pricing Adjustment Made by the Tax Authorities

The courts' authority to review and judge the decision made by the tax authorities is different in relation to the two steps described in VI.B.8, above. While the courts have full authority to judge whether the adjustment is based on correct facts and whether the legal conditions required for adjusting the income are fulfilled, (i.e., whether there is community of interest between the taxpayer and some other person, company or entity; whether such community of interest have resulted in the taxpayer's income being reduced; and whether there is a causal link between the community of interest and the wealth or income reduction), they have limited authority to judge the discretionary assessment actually made by the tax authorities. In respect of discretionary assessment made by the tax authority, the general principle of administrative discretion applies. Thus, when the court finds the reassessment itself is based on correct facts and legally justified, the discretionary assessment made by the tax authority may only be annulled if legal standards for conducting a discretionary assessment are not met, if the discretional assessment is not sufficiently broad and unbiased, or if its outcome is evidently unreasonable.[133] Hence, the discretionary assessment made by the tax authority is not subject to thorough control by the courts. The result is that courts have limited influence on certain parts of a transfer pricing analysis, such as the detailed application of acceptable methodologies or the selection of a specific price in a range of acceptable prices.

10. Exception to the Scope of the Provision

In one particular situation, the Tax Directorate has issued instructions not to make adjustments based on §13-1. It concerns the situation where a (typically predominant) shareholder is working for a company and receives a salary that is less than the market value for his or her work. Such a situation can often be explained by the community of interest between the shareholder and the company, and an upward adjustment of the taxable salary may, in principle, be allowed under §13-1 of the Tax Act. However, in a statement on March 24, 2009, the Tax Directorate stated that salaries should normally not be adjusted in these situations.[134]

The statement made by the Tax Directorate is linked to the tax reform during the years 2004–2006 and views expressed by the Ministry of Finance in the legislative preparatory work therein. The tax reform introduced a system in which it is more or less economically immaterial (looking at an individual shareholder and the company over a period of time) whether disbursements to the shareholder take the form of salary or dividend. Under these circumstances, it was regarded as inappropriate to adjust the salary income of the shareholder for taxation purposes.

C. Interest Deduction Limitation Rule (Fixed Ratio Rule)

Beginning in the taxable income year 2014, an interest limitation rule is in effect. This rule, known as the fixed ratio rule, is found in §6-41 of the Tax Act. The rule limits the tax deduction of an entity's net interest expenses to a maximum of 25% of its earnings before interest, taxes, depreciation, and amortization (EBITDA) based on tax numbers.[135] The main purpose for this rule is to counter base erosion and profit shifting through the use of excessive debt financing and to strengthen (equalizing) conditions for domestic corporations, which cannot utilize such techniques in the same manner as multinationals. Even though §13-1 in the Tax Act applies to intra-group debt financing and thin capitalization situations, Norway's tax policy makers recognized that arm's length provisions are hard to administer in practice for debt financing transactions and, thus, they are not effective in tackling base erosion and profit shifting in respect to debt financing.

Effective from taxable income year 2019, the fixed ratio rule was substantially amended by introducing a new set of fixed ratio rules applicable to "companies, *etc.*, in a group."[136] The pre-2019 rules, are still applicable to companies *etc.*, that are not part of a group.

The effect of these amendments is that the Norwegian interest limitation legislation as from the taxable income year 2019 consists of two parallel sets of rules. One set of rules is applicable to companies *etc.*, in a group (group rules), and a different set of rules is applicable to companies *etc.*, not being part of a group (pre-2019 stand-alone company rules).

The group rules disallow deductions for both internal and external interest if total net interest expenses exceed 25% of EBITDA. This set of rules includes an escape clause, which allows for full deduction of interest if the equity ratio of the company equals or exceeds the equity ratio in the consolidated financial statements of the group as a whole.[137] Further, this set

[133] Rt. 2012, p. 1025, *Norland*, Borgarting Court of Appeals, 2019-03-19. LB-2017-202539, *Normet Norway AS*.

[134] *See* Utv. 2009, p. 1284 (March 24, 2009, statement of the Directorate of Taxes).

[135] The rate was 30% for 2014 and 2015 and lowered to 25% as of the income year 2016.

[136] The amendments applicable to "companies, *etc.*, in a group," involved three major changes compared to the pre-2019 rules: (1) external interest became subject to limitation, (2) introduction of an escape clause, and (3) introduction of a de minimis threshold of 25 million Norwegian kroner. The term "companies *etc.*, in a group" is defined in § 6-41 (5) of the Tax Act. First, the fixed-ratio rule applicable to companies etc. in a group was tightened in the sense that deduction of both interest paid to unrelated parties (external interest) and interest paid to related parties (internal interest) is disallowed if the taxpayer's net interest payments exceed 25% of EBITDA. In contrast, the rule generally applicable up to and including 2018 only disallowed interest paid to related parties, although external interest was also taken into account when measuring the net interest/EBITDA ratio. This tightening of the rule was motivated by the fact that multinationals can also shift profit by placing excessive amounts of external debt in countries with high or normal tax levels, like Norway. The second amendment was the introduction of an escape clause, which allows for full deduction of interest if the equity ratio of the company equals or exceeds the equity ratio in the group's consolidated financial statements. Finally, the new set of rules also introduced a *de minimis* threshold of 25 million Norwegian kroner, meaning that an entity is excluded from the rule if net interest expenses of all Norwegian entities in the group in a given year do not exceed 25 million Norwegian kroner.

[137] The purpose of the escape clause is to shield ordinary business loans that are not part of a profit shifting strategy from being affected by the limitation. The application of the escape clause requires that the Norwegian entity applies

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of rules is subject to a *de minimis* threshold of 25 million Norwegian kroner, meaning that an entity can therefore take a full deduction if the net interest expenses of all Norwegian entities in the group in a given year do not exceed 25 million Norwegian kroner. However, the pre-2019 stand-alone company rules also apply to companies, *etc.*, in a group that, on the basis of the escape clause or the *de minimis* threshold of 25 million Norwegian kroner, are not affected by the group rules.[138]

The pre-2019 stand-alone company rules disallow only interest paid to related parties.[139] There is no escape clause, and it is subject to a *de minimis* threshold of 5 million Norwegian kroner at the entity level, meaning that an entity can take a full deduction if its net interest expense in a given year does not exceed 5 million Norwegian kroner.

The fixed ratio rule applies to limited companies and certain other types of entities that are liable to taxation, as well as partnerships and entities subject to the CFC rules, and foreign enterprises with a limited tax liability to Norway (permanent establishments). The fixed ratio rule is applied at the entity level, not the group level. However, two modifications apply, both of them relevant under the group rules:

- First, while the escape clause may be applied at the entity level, it could alternatively (with certain exemptions) be applied at the level of all Norwegian entities in the group. Thus, purely Norwegian groups automatically fulfill the conditions of the escape clause and therefore are always able to deduct interest paid to unrelated parties.

- Second, the *de minimis* threshold of 25 million Norwegian kroner is measured at the level of all Norwegian entities in the group.

The term "interest" used in the fixed ratio rule is based on the general understanding of the term in Norwegian tax legislation. Foreign exchange gains and losses are not covered by the term. To take account of volatility in earnings and timing issues, disallowed interest expenses may be carried forward for a period of 10 years. Carryback is not allowed, and unused interest capacity may not be carried forward. Where applicable, the general group contribution rules[140] provide a means for balancing out taxable profits, such as EBITDA, within a (Norwegian) group of companies.

On June 26, 2024, the Supreme Court rendered a decision where it found the fixed ratio rule applicable in 2014 and 2015 to conflict with the obligation to grant free establishment on equal terms under Article 31 and Article 34 of the EEA agreement. The Supreme Court decided in accordance with the EFTA Court's advisory opinion laid down in a decision of June 1, 2022, in case E-3/21, *PRA Group Europe AS*. The fixed ratio rule represented a "restriction" of the right of free establishment on equal terms since only Norwegian groups had the possibility to utilize group contribution (see III.E., above) and thereby increase a company's EBITDA and threshold for interest deduction under the fixed ratio rule. The "restriction" was not justified since the taxpayer (the borrowing company) had not been given the chance to demonstrate that the loan provided by its parent Luxembourg company was founded on sound business principles and arm's length. Moreover, in *PRA Group Europe AS*, the Supreme Court rejected both a justification based on the need to preserve balanced allocation of taxing powers as well as a justification based on combatting tax avoidance and evasion.[141] The decision concerned the pre-2019 fixed ratio rules, and it is unclear whether the Supreme Court's reasoning in *PRA Group Europe AS* will have any bearing on the prevailing fixed ratio rule applicable as from the income year 2019.

The fixed ratio rule is not applicable to financial institutions. Additionally, the fixed ratio rule is not applicable to taxpayers that are subject to the specific interest deductibility rules in the Petroleum Tax Act, §3(d).

The Norwegian fixed ratio rule is well aligned with the best-practice approach recommended by the OECD in BEPS Action 4 (Limitation on Interest Deductions) and the interest limitation rule in Article 4 of EU's Anti-tax Avoidance Directive.[142]

D. Special Regulations in the Petroleum Tax Act

1. The Norm-Price System for Sales of Crude Oil

When the Petroleum Tax Act was prepared in the early 1970s, it was a major concern to secure an acceptable arm's length basis for the taxation of petroleum extraction income. At the time, it had become evident that the Norwegian continental shelf contained large petroleum resources. Production licenses were assigned to multinational oil companies, and since the petroleum extraction income would be subject to resource rent taxation (combined tax rate of 78%), there would be a strong tax incentive to transfer extracted petroleum at below-market prices to associated sales companies subject to ordinary taxation.

In the legislative preparatory work, it was assumed that it would be extremely challenging for the tax authorities to control whether sales prices were set at arm's length conditions. It was also assumed that it would often be difficult for the tax authorities to determine whether there was a community of interest between the selling company and the purchasing company. As a response to these challenges, Norway's lawmakers decided to adopt a system of norm-prices in which the sales prices recognized for tax purposes are determined administratively by an expert board (the Petroleum Price Board) appointed by the government. The aim of the norm-price system is to obtain prices for tax purposes that correspond to prices that could have been achieved in sales between independent parties (arm's length prices).[143]

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the same accounting principles as used in the group's consolidated financial statement. Certain adjustments must be made to the accounting figures when calculating the equity ratios.

[138] Tax Act, §6-41 (9). This means that deduction may be disallowed for interest paid to related parties "outside the group", cf. regs. no. 1158, November 19, 1999, § 6-41-4.

[139] The term "related party" is defined in §6-41 (5) of the Tax Act and covers in broad terms any person, company, or entity owned or controlled, directly or indirectly, by 50%.

[140] *See* III.E., above.

[141] *See* HR-2024-01168, PRA Group Europe AS.

[142] Council Directive (EU) 2016/1164.

[143] The norm-price system is based on §4 of the Petroleum Tax Act, and supplemented by regulations of June 25, 1976, no. 5 (The Norm Price Regulations), and of December 17, 1976, no. 7 (The Norm Price Tax Regulations).

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Norm-prices may be determined for petroleum extracted in Norwegian waters, in Norwegian territorial seas, and on the Norwegian continental shelf. Norm-prices may also be determined for petroleum extracted in adjacent seas, insofar as it concerns petroleum deposits beyond the median line in relation to another state, to the extent that the right to extraction has been conferred to Norway by agreement with the other state. However, since its introduction in 1975, norm-prices have been determined for crude oil only, not for natural gas.[144]

Guidance for the determination of the norm-price is found in §4(2) of the Petroleum Tax Act. The norm-price is to correspond to the price that the petroleum could have been traded for between independent parties in a free market. In principle, the Petroleum Price Board may take into account any piece of information that is relevant when estimating the free market price for any specific type of oil. However, the Petroleum Tax Act provides that norm-prices must be determined by a non-exclusive list of factors, including achieved and quoted prices for petroleum of the same or a corresponding type with adjustment for differences in quality, transportation costs, etc. to the North Sea area or other relevant markets; delivery date; payment date; and other terms and conditions. Further, the Petroleum Tax Act refers to achieved and quoted prices for petroleum products, with necessary adjustment for refining, etc., and other comparable prices or valuations that may be available.

A norm-price is to be used for tax purposes not only when crude oil is sold to a related party but also when crude oil is sold to an unrelated party. Thus, actual sales income is tax exempt to the extent it exceeds the determined norm-price. On the other hand, there is taxation of income that is not realized if the actual sales price is lower than the determined norm-price. Norm-prices are determined separately for different qualities. For the time being, norm-prices are set for approximately 15 different qualities of crude oil (oil from 15 different fields). Norm-prices are published on the web site of the Ministry of Petroleum and Energy.[145]

The norm-prices are set retrospectively. For many years, norm-prices were determined on a monthly basis as an average of the observed market prices during one month. However, beginning October 1, 2010, norm-prices are, as the main rule, determined on a daily basis. The rationale underlying this amendment is to better fulfill the purpose of price setting, namely, to reflect market prices. Use of monthly average prices may be well suited when a majority of the production companies are lifting oil frequently throughout the month. On the Norwegian continental shelf, however, there has been a development towards lower production of crude oil, more and smaller fields, and an increased number of market participants. In a market with more volatile oil prices and an increased number of smaller market participants that are lifting smaller volumes, the determination of norm-prices on a daily basis normally better reflects the market price. The change was also motivated by the fact that monthly average norm-prices might lead to abusive behavior such as postponement of sales when the oil prices were expected to decrease the following month. Determination of daily norm-prices is not an absolute rule, and it could be deviated from in cases where it is appropriate and reasonable. Despite the fact that the sales prices recognized for tax purposes are set administratively, there is reason to believe that the norm-prices generally reflect the market prices quite accurately.

2. *Sale of Natural Gas*

The norm-price system has only been applied for crude oil and not for sales of natural gas. Historically, the sales of natural gas did not raise transfer pricing compliance problems. This is due to the fact that until 2002 all sales contracts for natural gas from the Norwegian continental shelf were negotiated between unrelated parties so that the sellers had business incentives to maximize the sales prices. In fact, all sales contracts had to be negotiated by a committee through which all the main gas-producing companies on the Norwegian continental shelf were represented. Under this system, the negotiated contractual terms had to be approved by the Norwegian government, and the government further decided from which field the gas sold in any particular contract should be delivered. If a gas-producing company was involved on the buyer-side, the company was excluded from the committee during the negotiation of that particular contract. Hence, under this system all the gas-producing companies had a clear incentive to maximize the sales prices, and the prices were, therefore, accepted for tax purposes.

This system was abolished on January 1, 2002, as a consequence of the liberalization and deregulation of the European gas market. Since then, gas-producing companies on the Norwegian continental shelf have been responsible for selling their own gas. Many of these companies are carrying out downstream activities as well, and a large part of the natural gas produced on the Norwegian continental shelf is sold to group companies. In addition, the production value of natural gas has gradually become more important compared to crude oil. Since upstream activities are taxed at a combined rate of 78% (ordinary corporate tax plus the special tax) and downstream activities at ordinary corporate tax rates, there is a strong incentive to sell natural gas below market prices. Taking into account the large volumes involved, the pricing of natural gas is a matter of great importance and a big challenge for the Norwegian tax authorities.

Norwegian lawmakers have responded differently to the challenges related to internal sales of natural gas compared to the challenges related to internal sales of crude oil. A norm-price system for natural gas was considered in 2004–2005 but was not proposed. It was assumed that norm-prices would be less suitable to natural gas than to crude oil since the terms of the contracts vary considerably and since the gas market in Europe at the time was not transparent. Instead, two other measures have been introduced to alleviate the challenges. The first, introduced in 2006, is a system of advance binding rulings on the pricing of intra-group gas sales. Then, effective July 1, 2012, special reporting requirements were introduced in relation to sales of natural gas. These two schemes are described below in XVI.D. and X.C., respectively.

3. *Deductibility of Interest and Other Financial Costs*

A general deductibility of interest and a total tax rate of 78% on income from petroleum extraction and pipeline trans-

[144] *See* VI.D.2. below.

[145] For more on norm-prices, *see* Petroleum Price Board and the norm prices — https://www.regjeringen.no/en/topics/energy/oil-and-gas/petroleum-price-board-and-the-norm-price/id661459/.

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port activity give a strong incentive to finance such activities with debt. As a consequence, various measures have been adopted in the Petroleum Tax Act over the years to counteract thin capitalization and to ensure a proper allocation of financial costs between upstream activities that are taxed at the combined tax rate of 78% (the offshore activities) and the other activities that are taxed at the general tax rate of 22% (the onshore activities). As such, the rules in the Petroleum Tax Act concerning the deductibility of net financial costs have been amended several times during the last couple of decades.

Prior to 2022, the rules in the Petroleum Tax Act concerning deduction of interest and other financial costs had been adopted in 2007.[146] Net financial costs are fully deductible. However, the portion of net financial costs that is deductible in the offshore tax base and subject to the combined tax rate of 78% tax (i.e., the general tax and the special petroleum tax)[147] is determined on the basis of a formula. The formula is technical, but the general principle is that 50% of the tax-value of the assets used in the upstream activities on the continental shelf may be financed by interest-bearing debt for tax purposes. Any excess net financial costs are deductible against income earned onshore, which is taxed at the general tax rate of 22%. Any remaining net financial costs that cannot be effectively deducted onshore may be deducted from the offshore tax base subject to the general tax rate of 22%.

Beginning in 2022, the special petroleum tax is changed into a cash-flow based tax, meaning that costs incurred from investments in pipelines and production facilities are fully deductible in the year in which the investments are made (*see* IV.A., above). This implies that the investment costs of relevant assets, including those financed with debt, are fully deductible against offshore income in the year of acquisition. Thus, according to the government, an additional deduction for finance costs in the offshore tax base is not justified from an academic point of view.[148]

As described above, in the offshore tax base, 50% of the tax-value of assets used in the upstream activities may be financed by interest-bearing debt. Thus, as investments made in 2022 and subsequent years are fully deductible in the year in which the investments are made and the tax-value of a taxpayer's earlier acquired assets gradually declines as they are written-off for tax purposes, the deduction for finance costs in the offshore tax base will gradually be phased out. The government estimates that tax deductions for finance costs in the offshore tax base will fully phase out by 2025.[149] However, such costs will still be effectively deductible in the computation of the general tax (either the onshore tax base or the offshore tax base subject to the general tax) and taxed at 22%.

E. Special Regulations in the Tonnage Tax Scheme

Under the tonnage tax scheme, shipping income is exempt from income taxation. The tax exemption does not cover net financial income, however. Net financial income earned by tonnage-taxed companies is subject to the general income tax of 22%. Since tonnage-taxed companies cannot utilize net interest costs, there is an incentive to fund such companies with equity. Thus, from a tax-planning perspective it would generally be favorable to let the parent company, which is subject to ordinary taxation, raise external loans and then fund the tonnage-taxed subsidiary with equity. With the aim of counteracting such tax-planning schemes, a specific anti-abuse measure has been adopted in §8-15(7) of the Tax Act. The special rule stipulates that if more than 70% of total capital in the (tonnage-taxed) company's balance sheet consists of equity, the excess amount multiplied by a normative rate of interest is regarded as taxable income. Thus, this measure is enacted to counteract "thick capitalization" of companies that are subject to tonnage-taxation.

[146] The Petroleum Tax Act, §3(d).

[147] I.e., 22% general tax + (1−22%) × 71.8% special petroleum tax= 78%.

[148] Prop. 88 LS (2021–2022).

[149] Prop. 88 LS (2021–2022).

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VII. Transfer Pricing Regulations and Tax Conventions

A. *Overview*

Norway has an extensive network of double taxation tax treaties (tax treaties). As of 2022, Norway has comprehensive tax treaties with approximately 85 countries.[150] The tax treaty between Norway and the United States was signed in 1971 and supplemented by an amending protocol signed in 1980. It is one of the oldest Norwegian tax treaties still in force,[151] and it is one of very few U.S. tax treaties that do not contain a Limitation of Benefit (LOB) clause.

Norway's treaty policy is based on the OECD Model Tax Convention, with certain modifications and additions. In general, Norway does not enter into tax treaties with tax havens. However, that policy has not been completely consistent in this respect as, for example, for historical reasons tax treaties were concluded with Barbados[152] and the Dutch Antilles in the late 1980s. Those treaties do contain an LOB clause.

Norway does not impose withholding tax on interest and royalties in general.[153] Thus, in its tax treaties, Norway has preferred exclusive residence-taxation of such income to limit withholding taxation to the extent possible.

An article identical or very similar to paragraph 1 of Article 9 in the OECD Model Tax Convention has been included in all of Norway's tax treaties.

Norway uses the credit method for elimination of double taxation in all tax treaties concluded after 1992. In treaties before 1992, the exemption method is used (combined with a credit method for certain types of income). Some of the treaties that were concluded in the late 1980s contain a "switch over clause" in the protocol, which allowed Norway to switch to a credit method by notifying the treaty partner. Such notification has been sent to a number of countries. In the treaty with the United States, Norway applies the credit method for certain types of income and the exemption method for other types of income.

B. *Corresponding Adjustment*

Norway has gradually changed its treaty policy with regard to the corresponding adjustment provision in paragraph 2 of Article 9 of the OECD Model Tax Convention. This paragraph is not included in the vast majority of Norwegian tax treaties concluded before the mid-1990s and, in fact, Norway had made a reservation to the paragraph until the 2003 update of the OECD Model Tax Convention. As a result, in its treaties with a large number of countries, paragraph 2 of Article 9 is not included.[154] However, the Norwegian tax authorities are authorized by domestic legislation to make a corresponding adjustment if they find the assessment of the taxpayer incorrect and the primary adjustment justified, provided that the taxpayer so requests and domestic time limits have not expired.[155] The tax authorities exercise discretionary power in this respect and take into account, among other things, factors such as the behavior of the taxpayer, the time elapsed, the importance of the issue, and the taxpayer's documentation of the case facts.[156]

Like most other OECD countries, Norway acknowledges that economic double taxation resulting from transfer pricing adjustments is not in accordance with, or at least not within the spirit of tax treaties, and matters involving potential double taxation fall within the scope of the Mutual Agreement Procedure (MAP) provision in Article 25 of the OECD Model Tax Convention. Norway would not prevent access to the MAP procedure on the basis that the tax treaty does not contain a provision similar to paragraph 2 of Article 9. In some treaties not containing this provision, such as the treaty with the United States, it is specifically stated that cases of economic double taxation are covered by the consultation procedure provided for in the MAP.[157]

More recent tax treaties generally contain an Article 9, paragraph 2. In a limited number of treaties, however, the phrase "shall make an appropriate adjustment," as used in the OECD Model Tax Convention, is substituted with the phrase "may make an appropriate adjustment." Although not clear, arguably the latter wording gives the tax authorities freedom to refrain from making a corresponding adjustment and, as a result, the treaty provision adds little to what follows from Norwegian domestic legislation. On the other hand, one could assume that the inclusion of such a provision in a treaty represents a policy statement implying that a corresponding adjustment should generally be accepted under such circumstances, at least in bona fide cases.

The current treaty policy is to use the OECD Model Tax Convention's wording of Article 9, paragraph 2, and it is included in Norway's tax treaties with a number of states. Such wording imposes a treaty obligation on the tax authorities to make a corresponding adjustment if it agrees in principle that an adjustment is warranted and if it also agrees to the amount of the primary adjustment made in the other state. In practice, the vast majority of transfer pricing cases are dealt with under the MAP.

In new tax treaties with OECD member states, Norway prefers to include the "new" version of Article 7 (i.e., the version first adopted in the 2010 OECD Model Tax Convention), including the corresponding relief provision provided for in paragraph 3 of that article.

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[150] A list of Norway's tax treaties is available on the Bloomberg Tax platform: https://www.bloomberglaw.com/product/tax/search/results/816565b0c7e5850d90ae330a07274352/?bc=W10-27454fc992cc3b0548731555b1daed545c19a695.

[151] The Norway-United States Income Tax Treaty (1971).

[152] The tax treaties with Sierra Leone, Barbados, Curacao, Jamaica, and Trinidad and Tobago were decided terminated by Royal Decree dated June 9, 2023. Diplomatic notes have been sent and the terminations will have effect from January 1, 2024.

[153] As from July 1, 2021, a withholding tax on certain interest, royalty, and lease payments has been introduced, *see* III.D., above. The scope of this tax is limited, though. It is targeted to capture certain intra group payments to related parties resident in low tax jurisdictions. The introduction of these rules is therefore not expected to alter Norwegian treaty policy with respect to taxation of interest and royalty payments.

[154] E.g., treaties with the United States, France, Italy, Canada, Singapore, and South Korea.

[155] Tax Administration Act, §12-1(1).

[156] Tax Administration Act, §12-1(2).

[157] *See* Norway-United States Tax Treaty, Art. 27(2)b.

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C. Mutual Agreement Procedure

A MAP article is included in all effective tax treaties. Those treaties generally reflect paragraphs 1 to 3 of Article 25 of the 2014 update of the OECD Model Tax Convention.[158]

The time limit for requesting MAP assistance in the vast majority of Norwegian tax treaties follows the OECD Model Tax Convention, Article 25(1). It stipulates that the case must be presented to the competent authority within three years from the first notification of the action resulting in taxation not in accordance with the provision of the tax treaty. Some tax treaties, including the one with the United States, do not include a time limit, while others contain time limits other than three years. In the Nordic tax treaty, the time limit is five years.

In Norway's domestic MAP Guidelines, the following principles are stated with regard to the starting point of the time limit in the tax treaties for applying for MAP in individual cases:[159]

- Where a tax treaty does not include a time limit for applying for a MAP, no time limit applies.
- The time limit is calculated from the time the taxpayer becomes aware that the income in question has been taxed in a manner that is not in accordance with the tax treaty. This is normally when the taxpayer receives notification of the tax assessment in Norway or receives similar information from another state.
- If the tax assessment is conducted at a later point than the regular tax assessment (e.g., as a result of an amendment case), the time limit is calculated from the date on which the taxpayer is made aware of the decision.
- If the taxpayer has appealed the tax assessment or initiated legal proceedings, the time limit is calculated from the time the assessing tax office renders a decision (i.e., the handling of the case in an administrative appeals process or in legal proceedings does not provide any deferment of the time limit).
- In cases concerning taxes deducted at source on dividends, etc., the time limit is calculated from the time the payer deducted the tax.

The treaties with a few countries, including the United States, do not contain the second sentence of paragraph 3 of Article 25. This sentence authorizes the competent authorities to resolve issues of double taxation that are not provided for in the treaty; its absence limits the possibility of solving through the MAP unanticipated situations of double taxation. However, Norway's Covered Tax Agreements with regard to the MLI are modified to include a sentence allowing for the competent authorities to resolve issues of double taxation not provided for in the treaty.[160]

A MAP provision is included in Tax Information Exchange Agreements (TIEAs), to allow the competent authorities to discuss issues related to the interpretation and implementation of the treaty. Norway entered into limited double taxation agreements with some countries as separate agreements in conjunction with concluded TIEAs. Thus, the limited tax treaties with Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, Jersey, and the Isle of Man contain a provision that authorizes transfer pricing cases to be dealt with under MAP.

With regard to arbitration, as provided for in paragraph 5 of Article 25 in the OECD Model Tax Convention, the rules are discussed in XV.B., below.

D. Excessive Interests and Royalties

Most Norwegian tax treaties reproduce paragraph 6 of Article 11 and paragraph 4 of Article 12 of the OECD Model Tax Convention concerning, respectively, excessive interest and royalty (in both cases, permitting the article's tax rate benefit only to the arm's length amount, leaving the excess to the two countries' domestic laws). A similar provision on technical services is concluded in the tax treaties with some developing countries.

E. Permanent Establishment

Norway includes special provisions for services in its treaty policy on permanent establishment (PE). Many older Norwegian tax treaties include a 183-day rule for professional services, which is based on Article 14 of the UN Model Tax Convention. In more recent treaties, Norway has included a specific services-permanent establishment rule based on the suggested provision in paragraph 144 of the commentaries to Article 5 of the OECD Model Tax Convention (2017).

Since first including it in an amending protocol with the United Kingdom in March 1978, Norway has included a special provision for activities carried out offshore in connection with the exploration or exploitation of the seabed or subsoil or its natural resources. This provision substantially lowers the threshold for source-taxation of business and labor income earned in connection with natural resource exploration and exploitation activities on the Norwegian continental shelf. Such a provision was included in the treaty with the United States in the amending protocol that entered into force in 1981.[161] In some tax treaties the continental shelf has been excluded from the scope of the treaty, and the taxation is left to the domestic law of the two states.

In the Multilateral Instrument to implement BEPS measures (MLI), Norway opted for including all the changes to the definition of Article 5 of the OECD Model Convention identified in BEPS Action 7 (Preventing Artificial Avoidance of

[158] Upon entry into force of the OECD Multilateral Agreement (MLI), a treaty that is considered a Covered Tax Agreement (i.e., a treaty for which both Norway and the contracting jurisdiction have made notification to the Secretary-General of the OECD listing the treaty as one which they both intend to be covered by the MLI) will generally be updated to be fully compatible with the minimum standards of BEPS Action 14 (Making Dispute Resolution More Effective).

[159] Guide for Mutual Agreement Procedure pursuant to Tax Treaties (MAP), paragraph 5, available at https://www.regjeringen.no/contentassets/a91a5dd41bde46c88ed4dfc2bf724252/guide_for_the_mutual_agreementprocedure.pdf.

[160] The Norway-United States tax treaty is not a Covered Tax Agreement and, as such, has not been updated to incorporate the second sentence of paragraph 3 of Article 25.

[161] *See* Norway-United States Income Tax Treaty, Art. 4A.

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Permanent Establishment Status).[162] Norway prefers to include these provisions in new tax treaties with other states, as well.

Norway has concluded a number of treaties with the "new" version of Article 7 (i.e., the version first adopted in the 2010 OECD Model Tax Convention).

F. Exchange of Information

Norway has a strong treaty policy with regard to exchange of tax information. Virtually all Norwegian tax treaties contain a provision for the exchange of information for the purpose of carrying out the provisions of the treaty and domestic tax legislation. Tax Information Exchange Agreements (TIEAs) are signed with a large number of jurisdictions. Norway also prefers to include an extensive assistance-in-collection article in its tax treaties.

Norway is a party to the Convention on Mutual Administrative Assistance in Tax Matters, the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country reports, and the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information.

Norway and the United States also have concluded a bilateral agreement for the implementation of the Foreign Account Tax Compliance Act (FATCA), a Competent Authority Agreement on Automatic Exchange of Financial Account Information, and a Competent Authority Agreement on administrative Exchange of Country-by-Country (CbC) reports.

[162] Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). Norway signed the MLI on June 7, 2017, and the instrument of ratification was deposited on July 17, 2019. The MLI entered into force for Norway on November 1, 2019.

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VIII. Methods and Comparability Issues

A. Transfer Pricing Methods

The arm's length provision in §13-1 of the Tax Act does not refer to the use of any particular transfer pricing methods. Additionally, secondary regulations and administrative guidelines do not refer to any particular methods. In its guidelines to the transfer pricing documentation rules, the Tax Directorate describes the five transfer pricing methods that are acknowledged by and in line with the OECD Guidelines and describes situations in which each method may be useful. The Tax Directorate has also published guidance for conducting reliable benchmark analyses for the use of the transactional net margin method (TNMM). There is no other domestic guidance for the application of any other particular method.

A wide spectrum of transfer pricing methods is possible under Norway's domestic law as long as all provide for an arm's length outcome.[163] However, in 2007 an explicit reference to the OECD Guidelines was inserted into sub-paragraph 4 of §13-1 of the Tax Act, suggesting that the domestic law provision now endorses the most appropriate method principle, introduced by the 2010 version of the Guidelines, and has a strong preference for the five pricing methods acknowledged by the OECD Guidelines.

While the Norwegian tax authorities have historically been skeptical of the profit-based methods, their position on transactional profit methods changed gradually in the period between 2005 and 2010. During this time frame, the tax authorities' own use and acceptance of such methods increased.[164] Nowadays, transactional profit methods are generally accepted if they are the most appropriate method, in alignment with the most appropriate method approach introduced in the 2010 version of the OECD Guidelines. TNMM is commonly used by the tax authorities as a justification for making income adjustments. Examples are found in the low court decision by Oslo Tingrett in *Goodyear Dunlop Tires Norge AS* (2017)[165] and the decision by the Borgarting Court of Appeals in *Stanley Black & Decker Norway AS*.[166] In *VingCard Elsafe AS* (2012) the Borgarting Court of Appeals accepted the taxpayers' use of the TNMM and year-end adjustments to the boundaries of the interquartile range for remuneration of a distributor/marketing company.[167] Thus, over some time Norwegian administrative practice has changed from a hierarchy of methods endorsed by the 1995 OECD Guidelines to the most appropriate method approach, which is endorsed by the 2010 OECD Guidelines. Further, the discounted cash flow (DCF) method is commonly used for the pricing of certain intra-group transactions, such as sales of shares, highly specialized tangible assets, and intangible assets where lack of comparables is predominant.

B. Availability of Data and Data Sources Commonly Used

The financial statement, annual report, and auditor's report of enterprises that are obligated to keep accounts under Norwegian legislation are publicly available.[168] Such information must be submitted to the National Register of Company Accounts within one month after adoption.[169] If enterprises with a fiscal year-end on December 31 do not submit the required information by August 1 of the following year, a daily fee (for which all members of the board may be held responsible) accrues until all required information has been submitted. For enterprises with fiscal year-end between January 1 and June 30, a daily fee accrues if the required information is not submitted by 1 February the following year. Private limited companies *(aksjeselskap)* and public limited companies *(allmennaksjeselskap)* will ultimately be dissolved if the information is not submitted.

The financial information held by the Norwegian National Register of Company Accounts is not electronically searchable, but it can be made available to commercial databases, etc. Therefore, databases containing financial information about Norwegian companies exist and may be used in searches for comparables.

The Norwegian tax authorities have access to databases containing market information on interest rates and raw material prices, credit rating software, and certain royalty databases. The commercial databases AMADEUS (Europe) and Orbis (Worldwide) are also available to and used by the Norwegian tax authorities. In addition, the Norwegian tax authorities are using the software TP-Catalyst to perform TNMM-analyses. The administrative guidance to the transfer pricing documentation rules issued by the Tax Directorate states that it is a prerequisite for a database analysis to be provided such that the tax authorities may study and review the application of the analysis.

C. Foreign Comparables

Pan-European comparables are not rejected automatically solely because they are non-domestic but are considered on a case-by-case basis in relation to the comparability factors described in the OECD Guidelines. In many cases, a pan-European approach is respected by Norwegian tax authorities but, since financial data are available in Norway at the company level, the tax authorities have a preference for Norwegian com-

[163] Rt. 2001, p. 1265, *Agip*.

[164] The skepticism was in particular directed toward taxpayers' use of the TNMM or the comparable profit method (CPM), supported by database analyses and use of statistical tools for substantiating transfer prices. Until 2005, administrative practice hardly existed in which the tax authorities openly accepted the use of the TNMM or relied on the TNMM as a basis for making an income adjustment. Thus, the tax authorities' own practice and attitude were in line with the guidance in the 1995 OECD Guidelines, which recognized the TNMM and the transactional profit-split method, but only as methods of last resort, limited to exceptional cases. Although the tax authorities historically expressed a strong preference for the traditional methods, they inevitably had to "stretch" the guidance in the OECD Guidelines from time to time. One explanation is the difficulties in obtaining data on transactional gross margins to support the application of the resale minus and the cost-plus methods. The Norwegian courts have accepted deviations from the OECD Guidelines in cases where the tax authorities argue that it has been hard or impossible to apply any of the traditional transaction methods properly. Examples are the decisions by the Supreme Court in *Baker Hughes Oilfield Operations Inc.* (Rt. 1999, p. 187) (cost-plus, but no comparison with market data), and *Agip* (Rt. 2001, p. 1265) (comparable uncontrolled price (CUP), but primarily comparisons with controlled transactions).

[165] 2017-06-19. TOSLO-2014-160055.

[166] Utv. 2019, p. 37, *Stanley Black & Decker Norway AS*.

[167] Utv. 2012, p. 1191, *Vingcard Elsafe AS*.

[168] The Accounting Act, 1998, §8-1.

[169] Under Norwegian company law, the financial statements and reports are adopted as a mandatory agenda item at the shareholders' annual general meeting.

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parables, provided that the sample is not too limited or does not reflect large comparability defects. Certain characteristics of the Norwegian market may raise comparability issues related to the use of foreign comparables, however. As an example, economic macro figures demonstrate that Norway was not affected by the 2008 financial crisis to the same extent as most other European countries. Thus, the use of pan-European financial company data (which often includes a large number of southern European companies) for the financial year 2008 and subsequent years may contain severe comparability defects as a benchmark for businesses operating solely in the Norwegian market in the same period. Similar considerations may be relevant for the years affected by the COVID-19 crisis (2020–2021), where substantial parts of the Norwegian commodity trade business in fact experienced a positive development in sales and profitability. Other aspects of the Norwegian market that might be of relevance in some businesses are less competition compared to large economies (e.g., due to features of being a relatively small and geographically widespread market) and a wealthy customer base.

In audit situations where a broad pan-European benchmark is rejected, the Norwegian tax authorities may suggest a narrower geographic scope compared to the comparable set presented by the taxpayer. One approach is to exclude comparables originating from southern European countries and potentially those from certain northern European countries with diverging market characteristics compared to Norway. If the Norwegian tax authorities prepare their own benchmark analysis as a basis for making an adjustment, the starting point is often to consider whether a reliable analysis may be based on Norwegian comparables alone. If not, the tax authorities tend to broaden the geographical scope of the analysis to include comparables from neighboring countries operating in the same business segment before including Norwegian comparables from other business segments.

D. Comparability Adjustments and Use of Ranges

The concept of arm's length ranges is recognized in administrative practice and case law where one cannot determine an arm's length result that clearly is more precise than others.[170] Thus, the concept of arm's length ranges is most relevant when applying the TNMM and other methods that rely on a sample of market data extracted from databases, etc.

There is no administrative guidance on the use of ranges and how to compute an arm's length price. The use of interquartile ranges to narrow down or improve the range is not mandatory but is commonly used by taxpayers, as well as the Norwegian tax authorities. The Norwegian tax authorities are normally highly skeptical of the use of extremely broad searches (industry wide, region wide), and they attempted to improve them with the use of statistical tools. The Norwegian tax authorities tend to focus on a narrower set of comparables with a higher degree of comparability.

The Norwegian tax authorities generally start their audit from the comparability benchmark analysis provided by the taxpayer. It is not a general requirement that working capital adjustments be made. In some audit cases, the Norwegian tax authorities prepare their own benchmark analysis and use it as basis for an adjustment. In such cases, standard working capital adjustments (accounts receivable, accounts payable, inventory) are generally made. Plant, Property, and Equipment (PPE) adjustments are made where appropriate.

With regard to determining a point in the range, it is generally expected that the Norwegian tax authorities will select the median point. However, in cases where the tested party has a high- or low-risk profile, conducts high-value functions, or employs certain valuable assets, the Norwegian tax authorities may select a different point in the range instead of carrying out sophisticated comparability adjustments.

E. Secret Comparables

The term "secret comparables" is commonly used to describe information available to the tax authorities from their examination of other taxpayers or from other sources of information that may not be disclosed to the taxpayer.

Although not often used, Norway is among the countries that have not, by law or administrative guidance, explicitly ruled out the possibility of using secret comparables as a basis for substantiating a transfer pricing adjustment. The tax authorities have taken the position that secret comparables may be used and relied on under certain circumstances and under certain precautions. Until recently, case law was limited to a low court decision from 1997 in which the court upheld the assessment but in a general remark stated that "an assessment, which too heavily is based on information which may not be disclosed to the taxpayer, may be annulled."[171]

In 2015, the Norwegian Supreme Court (Høyesterett) clarified the issue in *Total E&P Norge AS*, a case of first impression, which dealt with the issue of secret comparables.[172] *Total E&P Norge AS* ("Total") carried out oil and gas production on the Norwegian continental shelf. Liquefied petroleum gas ("LPG") was sold to foreign trading companies within the Total group, which resold the gas to unrelated parties. Total was subject to the combined total tax rate of 78%, while the foreign trading companies were subject to ordinary corporate tax rates. In its reassessment, the oil taxation authorities applied the comparable uncontrolled pricing (CUP) method and compared Total's prices with prices in contracts between independent parties on which only the oil tax authorities had information.

During the administrative procedure leading up to the reassessment, Total requested access to the contracts that actually had been used as comparables, as well as all other contracts that the oil taxation authorities potentially could have used as comparables. To that end, Total wanted to review whether the selection of comparables was representative and whether the contracts actually used as comparables, in fact, were comparable with the controlled transaction. The request was rejected due to confidentiality restrictions. Instead, Total was given an explanation of the procedure to select the independent contacts used as comparables and information about their price formulas, mark-ups, and certain other contractual elements to the ex-

[170] E.g., Borgarting Court of Appeals, Utv. 2018, p. 210, *ExxonMobil Production Norway Inc.* and Gulating Court of Appeals, LG-2021-038180, *ConocoPhillips Scandinavia AS*; *see* overview of both cases in IX.F.4., below.

[171] Utv. 1997, p. 1216 *Agip* (unofficial English translation).

[172] Rt. 2015, p. 353, *Total E&P Norge AS*.

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tent possible without infringing with the confidentiality obligations. In order to check its own evaluations, the oil taxation authorities ordered Total to submit resale prices that the trading companies had agreed to with independent third-party buyers. Total did not comply. In this respect, Total stated that it did not have access to the information, it could not provide the information without disclosing business secrets between the trading companies and the independent buyers, and the information was not relevant for the pricing of the intra-group sales transaction. Total argued that it had otherwise documented that its internal sales were priced at arm's length.

Two procedural issues were submitted to the Supreme Court. The first was whether it was procedural error under domestic administrative law not to give Total access to the contracts that were actually used and that could have potentially been used as comparables. If so, this would lead to an annulment of the assessment. Second, the Court examined whether the oil taxation authorities could justify a reassessment under domestic law and under the OECD Guidelines by relying on these comparables and preventing Total from obtaining full access to the data as part of the administrative procedure.

With regard to the first issue, as a preliminary matter, a taxpayer under Norwegian domestic law has an extensive right to review documents concerning an assessment.[173] The reasoning is that the taxpayer must be given an opportunity to correct mistakes that otherwise could lead to an incorrect assessment. As such, the third-party contracts constitute documents to which Total should have been given access because they were documents that had been used in the assessment. However, in this case, these third-party contracts had been submitted by other taxpayers to the Norwegian tax authorities and were subject to strict confidentiality restrictions that prevented tax authorities from disclosing taxpayer assets, income, or other information related to the taxpayer's affairs, business, or person. The third-party contracts were, in fact, submitted by Total's competitors and contained confidential business information. Thus, the question before the Court was which set of rules should prevail — Total's right to be given access to the third-party contracts that had been used as basis for an income adjustment or the confidentiality protection of business secrets contained in documents submitted by other taxpayers. The Court concluded that Total would not have the right to fully access the third-party contracts. It referred to the legislative preparatory work which stated that the taxpayer's right to access to documents in its own case would be restricted by confidentiality rules in certain circumstances.[174] The Court acknowledged that a taxpayer could agree to be bound by the same strict confidentiality restrictions imposed upon the tax authorities before gaining access to secret comparables but opined that this would not be meaningful when a taxpayer who is requesting access to the contracts is the same party that the confidentiality rules are meant to provide protection against.

The Court then considered whether the oil taxation authorities could rely on the third-party contracts as a basis for an adjustment when Total had not been given access to the contracts. The Court initially stated that fundamental requirements apply with regard to due and proper administrative procedures. When evaluating whether these requirements were satisfied, the Court explained that one would have to take into consideration that Total had not been given access to — and therefore did not have an opportunity to comment on — the third-party contracts that constituted an important basis for the assessment. As a starting point for its analysis, the Court referred to the legislative preparatory work of an amendment to the Tax Administration Act, which introduced stricter reporting obligations on oil and gas companies.[175] Although these rules were not proposed until after the period of reassessment, the Court was of the view that these statements gave "perspective" on the need for being able to have an effective control of the tax revenue from the petroleum industry. The Court found that it could not have been the intention of the legislators to limit the information that the tax authorities could utilize when assessing a particular company. On this basis, the Court went on to consider the principles that would have to apply if nondisclosed information became the basis used by the tax authorities in their assessment.

In this respect, the Court accentuated the relevance of the OECD Guidelines and quoted paragraph 3.36 of the 2010 Guidelines:

> [T]ax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective juridical control by the courts.[176]

In its consideration as to whether Total had been given an "adequate opportunity to defend its own position," the Court referred to the following summary of the administrative process described by the Court of Appeals:

> [I]n this case the tax authorities have provided extensive and precise information about the criteria used for selection of third-party contracts and in addition provided key information about the third-party comparable contracts' content to the extent possible due to the prevailing confidentiality requirements. By this approach, the basis for the decision had been made visible to the taxpayer before the final assessment was made.[177]

The Supreme Court found this to represent a due and proper administrative procedural approach in the present case. The Court referred to the particular challenging control aspects that were present and stated that by providing Total with key elements of information, the tax authorities had sought to provide information "within the limits of its domestic confidentiality requirements,"[178] which met the standard required both under the OECD Guidelines and under domestic legislation.

[173] Tax Administration Act 1980, §3-4, no. 1 (Tax Administration Act 2016 §5-4(1)).

[174] To. prp., no 29 (1978–79); Ot. prp., no 32 (1998–99).

[175] *See* X.C., below.

[176] OECD Guidelines (2010), paragraph 3.36.

[177] Utv. 2014, p. 780, *Total E&P Norge AS* (unofficial English translation).

[178] Utv. 2014, p. 780, *Total E&P Norge AS* (unofficial English translation).

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The Court also emphasized the fact that Total had not complied with the request to submit information about the resale prices obtained by the trading companies. The Court referred to an earlier Supreme Court decision and concluded that the information requested was information that the tax authorities were allowed to request from a taxpayer as part of an assessment.[179] The Court stated that it clearly was the tax authorities — not the taxpayer — which were to assess whether resale prices could give a proper basis for verifying the prices used under the CUP method or whether a different pricing method would be more suitable. The Court further stated that, by the tax authorities' requests, Total had been given "an adequate opportunity … to defend its position."[180] Finally, the Court found that as long as the courts had been given the possibility to test the approach utilized by the tax authorities, the procedural approach satisfied the requirement under the OECD Guidelines "to safeguard effective juridical control by the courts."[181]

The Court concluded that the oil taxation authorities had not made a procedural error, and the assessment was upheld. The decision clarifies that under Norwegian law, secret comparables may be used by the tax authorities as basis for a transfer pricing adjustment under certain circumstances and with certain precautions.[182]

[179] Rt. 1999, p. 1087, *Baker Hughes Oilfield Operations Inc.*

[180] Utv. 2014, p. 780, *Total E&P Norge AS* (unofficial English translation).

[181] OECD Guidelines (2010), paragraph 3.36.

[182] For additional analysis on *Total E&P Norge AS*, *see* Bjerke and Sørgaard, International Transfer Pricing Journal, Aug. 12, 2015, Vol. 22, No. 5.

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IX. Transfer Pricing Case Law and Administrative Practice

A. *Overview*

In the late 1970s and throughout the 1980s, transfer pricing in Norway was primarily the concern of the oil taxation authorities. Their main focus in that period was on issues related to intra-group debt financing, with the single most important transfer pricing issue (in terms of tax revenue) probably being the instances of thin capitalization addressed in that period by the oil taxation authorities. Loan pricing has also been a priority for the oil taxation authorities since the 1970s' and other financing issues, such as the pricing of captive insurance premiums, have also been addressed.

Service charges and royalties paid to foreign principals have been another priority risk area for the tax authorities. The same applies to inbound leasing arrangements, such as bareboat charters of specialized vessels and drilling rigs, as well as other pricing and profit allocation issues related to the offshore petroleum service industry.

From the 1990s, as the transfer pricing focus areas gradually became broader, transfer pricing issues began to be addressed by various tax administration units outside the oil taxation authorities as well. Financing issues, such as cash pooling arrangements, thin capitalization, and guarantees have been addressed by several tax offices. Business restructuring issues, such as risk stripping arrangements, foreign acquisitions, and the subsequent transfer of intangibles, have been other issues to which the tax authorities have paid a great deal of attention. Additional attention has also been devoted to local distributors and the sale of goods, as well as restructuring cases. In recent years, control with respect to the pricing of the sale of natural gas has become a priority for the oil taxation authorities.

Over the past decade or so, there has been a noticeable shift, in general and with respect to transfer pricing, towards a risk-based approach and focus of the Norwegian Tax Administration. This is reflected in the 2019 reorganization of the Tax Administration, during which responsibility for transfer pricing issues was consolidated in the Priority Division, Large Business Department.[183]

Transfer Pricing Annual Reports, as well as biennial reports, are published identifying risk areas and the volume of various intra group transactions addressed through audit, the Tax Appeal Board, Mutual Agreement Procedures (MAPs), Advanced Pricing Arrangements (APAs), and the judicial system. Based on identified risks, the following projects and particular focus areas (exclusive of the petroleum sector) were established in 2019/2020 and are still operative in 2023:[184]

— Intangible assets and business restructuring;

— Low profitability companies, including multi-year loss-making companies;

— Profit attribution to permanent establishments;

— Pricing of financial transactions;

— Leasing of large assets;

There are many lower court decisions regarding §13-1 of the Tax Act and the arm's length principle. However, there has not been a substantial number of transfer pricing cases tried before the Supreme Court.

B. *Sale of Natural Gas (Dry Gas)*

The production of gas on the Norwegian continental shelf started in the late 1970s. Originally, the pricing formulae in most long-term agreements for sales of gas from the Norwegian continental shelf were indexed to oil products, as gas increasingly competed with heavy fuel oil and heating oil. Subsequently, marketplaces, or "hubs," where buyers and sellers of gas can meet and transact in an efficient and transparent manner, developed all around Europe. Today, both oil and spot (hub) prices may be observed in the pricing formulae under existing long-term contracts. However, the since the financial crisis in 2008–2010 the spot proportion has been rising every year due to renegotiations of old long-term oil-indexed contracts. New Gas Sales Agreements (GSAs) from the Norwegian continental shelf are based on spot gas market prices. Currently, Norway sells most of its gas on indices linked to traded prices at market hubs across Europe.

Norwegian gas is transported through an integrated gas transportation grid and processing facilities from the production fields to the European continent and the United Kingdom. The transportation system is owned by the Gassled joint venture, and the gas grid is based on an entry-exit system and a number of zones (A to I). Area D is the dry gas zone. Currently, there is no hub or market mechanism for buying or selling gas in an efficient manner inside Area D. In Area D, gas transactions are exclusively facilitated through bilateral agreements.

Generally, all internal gas contracts are based on a reference price. This reference price is usually a hub price/index, but could also be a resale price, or a CUP (i.e., the contract price in GSAs between unrelated parties). Usually, an adjustment (addition or deduction) is made to the reference price to reflect differences in delivery terms between the reference contract (hub price/resale price/CUP) and the internal gas contract. A large part of the oil taxation authorities' audit work therefore involves assessing the reference price and the adjustments.

Norwegian gas inside Area D can travel via different exit points to reach several hubs across the European continent (THE,[185] TTF, Zeebrugge and PegN) and in the United Kingdom (NBP). The pricing formula in spot-based GSAs is often linked to a hub price connected to the agreed delivery point(s). The hub price may be a day-ahead price, a month-ahead price, a quarter-ahead price, etc., and the applied reference price may derive from a combination of different pricing periods based on different market locations. The assessment of the hub price typ-

[183] *See* II.C., above.

[184] The Annual Transfer Pricing Report, 2023, issued by the Norwegian Tax Administration (Norwegian language only). Annual Transfer Pricing Reports back to 2009 are available on the Skatteetaten A˚rsrapporter om transfer pricing webpage:. https://www.skatteetaten.no/bedrift-og-organisasjon/rapportering-og-bransjer/bransjer-med-egne-regler/internprising/arsrapporter/ Shortened English versions of the Annual Transfer Pricing Reports are available for the years 2018, 2019 and 2020: https://www.skatteetaten.no/en/business-and-organisation/reporting-and-industries/industries-special-regulations/transfer-pricing---internal-pricing/annual-report-of-transfer-pricing/.

[185] Substitute the former hub's Gaspool and NCG, which were merged on October 1, 2021.

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ically includes an evaluation of the applied pricing periods and the market location on which the price is based.

Adjustment factors may be added to or deducted from the reference price. Adjustments can be related to flexibility, transportation costs, management fees, sales costs, service fees, and balancing costs. Some adjustments, for instance deductions for costs related to resale, may be relevant when the resale price method is used. Conversely, the oil taxation authorities generally do not accept deductions other than those for relevant transportation — and balancing costs if the reference price is based on the CUP. Adjustments that may be relevant when a CUP method is used are deductions or additions related to flexibility. For example, if the buyer in the reference contract has the ability to vary its daily offtake but the buyer in the internal contract does not, a deduction from the reference price (CUP) is made to adjust for the lack of flexibility in the internal contract.

In some contracts, where the delivery point is inside Area D, the buyer is granted an option to take and resell the gas in several possible markets while the reference price is based on quotations at one hub (or an average of several hubs). In this case, flexibility is granted to the buyer since it can resell the gas to whichever market has the highest price. The assessment of such a contract includes not only an evaluation of the reference prices but also an evaluation of the flexibility value granted to the buyer. Similarly, a buyer-nominated contract with multiple delivery points also includes a flexibility value.

The oil taxation authorities' audit also involves assessments of clauses relating to delivery obligation, such as over- and under-deliveries (excess gas and default gas), delays, and nomination deadlines. In addition, the oil taxation authorities look into cases involving offshore and onshore allocations of gas income and costs, which include assessments of trading activities and portfolio optimization.

Although there is substantial administrative practice regarding taxation of sale of dry gas from the Norwegian Continental Shelf, there is little jurisprudence. The first decision by the Court of Appeals concerning adjustment of a hub price was rendered on March 6, 2023 and is illustrative for several issues often dealt with by the oil taxation authorities and described above:

PGNiG Upstream Norway AS (PGNiG) (2023).[186] PGNiG Upstream Norway AS (PUN) extracts oil and gas from the Norwegian continental shelf. In 2013 and 2014 PUN held an 11.92% share in the Skarv field. The year before, PUN had entered a long-term contract for the sale of all its gas from the Skarv field to a German related company, PGNiG Sales & Trading GmbH (PST). PUN and PST belong to the Polish PGNiG group, which is a major player in the Polish gas market. The contractual term was 10 years, but the parties intended to extend it to the lifetime of the field (i.e., 20–25 years). PUN was obliged to deliver the gas at the pipeline's landing point ("beach") in either Emden or Dornum in Germany. From these landing points the buyer (PST) could take the gas to three European marketplaces (hub's); TTF in the Netherlands, Gaspool in Northern Germany, and NCG in Southern Germany. The price in the contract was based on a reference price and several deduction elements. The reference price was the spot price for gas sold on "day ahead" terms. In advance of any year, the buyer (PST) had the right to decide which of the three market's price (day ahead) indexes should be used as reference price.

The Oil Taxation Appeal Board concluded that PUNs income had been "reduced" due to the community of interest between PUN and PST. In particular, the Appeal Board was of the opinion that two of the deductions stipulated in the internal contract would not have been accepted in an arrangement between unrelated parties. One deduction not accepted was "Market Access Costs." This deduction was supposed to cover infrastructure costs such as IT-systems, trading equipment for marketing gas, and membership on trading hubs as well as costs incurred in respect of services such as management of market and counterparty risk, regulatory issues, confirmation, and invoicing. The other deduction not accepted was "Daily Operations Fee." This deduction was supposed to compensate the buyer for its variable costs of nominations, transportation, and selling of the gas, as well as market access costs like exchange fees, broker fees, clearing fees, and virtual trading point-fees. The deductions not accepted were, in the view of the Oil Taxation Appeal Board, costs related to PSTs resale of the gas on the European market. A portion of the "Daily Operation Fee" was accepted, however, as it represented compensation to the buyer for saved downstream costs.

The Appeal Court remarked that the price in the controlled transaction could be evaluated in two ways. One way is evaluating whether the price is based on a balanced adjustment of the selected index price, having regard to rights and obligations otherwise following from the contract. The other way is to make comparisons with other contracts made in a comparable market. The Court noted that the latter approach reflects each party's negotiation power. Further, it remarked that if the price doesn't appear to be balanced when the contractual arrangement is viewed in isolation, it could still be regarded as being "arm's length" if it corresponds to terms and conditions agreed on between unrelated parties in a comparable market.

The Appeal Court referred to paragraph 2.18 and 2.19 of the 2017 version of the OECD Guidelines and noted that, as a starting point, there is nothing wrong in using a price index as a comparable. The Court stated that this must be valid irrespective of the fact that these paragraphs were not included in the OECD Guidelines at the time the internal contract was entered.

The Appeal Court noted there were several deviations between the index price (hub price) and the price in the internal contract. Amongst others, the internal contract made several deductions in favor of the buyer (PST), and PST could single-handedly decide which hub price to apply for the upcoming year. While the hub price relates to a stipulated volume for delivery the day ahead, the internal contract regulates indefinite gas volumes over many years. And further, the internal contract was entered into on take-or-pay terms, meaning that PST had to receive and pay for the volumes anytime delivered under the contract. The Court noted that in accordance with the general application of the CUP method reasonable adjustments must be made, and the issue at stake was whether the price in the internal contract was arm's length or not.

The Court believed there was a non-neglectable profit potential at the hands of the buyer (PST) which was not reflected in the internal contract. It noted that it seems unbalanced to in-

[186] Borgarting Court of Appeals, LB-2022-052192. *PGNiG Upstream Norway AS.*

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clude a right for PST to single handedly decide upfront which of three European hub indexes to apply for the upcoming year. Further, it agreed with the tax authorities that the landing points for the gas and the contractual arrangement provided for flexibility and a certain profit potential for PST as they could sell the gas on several hubs while the price was fixed up-front at one of them. It also noted that PST could potentially earn a profit by reselling the gas at different price concepts, such as month ahead, year ahead etc.

The taxpayer argued that certain deductions in the internal contract, including the "Market Access Cost" and "Daily Operations Fee", reflected the additional risks and costs of PST due to the unpredictable deliveries from the Skarv-field from which they had contractual obligations to take deliveries even if the volumes were significantly changed on short notice. Further, according to the taxpayer, the cost elements also reflect that the seller (PUN) does not themselves have in-house resources to handle gas sales activities on a daily basis.

The Appeals Court didn't agree that the buyer (PST) incurred any price- or volume risk related to the resale of the gas which PUN should reasonably pay compensation for without taking part in any potential upside from the resale of the gas. The Court found that price/volume risk was related to PST's resale of the gas at different terms (other than day ahead), which, only mirrors the fact that the profit potential is transferred to PST under the internal contract. In respect of volume risk, the Court also noted that the internal contract provided for compensation of balancing costs and that estimated volatility in deliveries from the Skarv-field didn't justify a separate deduction in the hub price.

The Court further noted that PST was not restricted to resell the gas at the hub. The gas could also be sold directly to end users or by entering bilateral contracts. Evidence showed that PST in fact had entered many such contracts. The Court also noted that PST acquires gas from the European market for deliveries to the Polish parent company and that a large portion of the gas acquired in 2013 and 2014 was in fact sold to the parent company. The taxpayer, on the other hand, stated that all the gas purchased from PUN in fact had been resold at the hub at day ahead terms. The Court didn't find this statement evidenced, and noted that even if this was the case, it was not decisive since PST was not obligated to sell the gas at the hub at day ahead Gaspool index prices.

The taxpayer argued that the seller (PUN), in an alternative scenario, would have to sell the gas to the market themselves. In such case PUN would have realized similar costs as reflected in the "Market Access Cost" and "Daily Operations Fee" and therefore such deductions (i.e., the saved costs) should be accepted in the price formula. The Court, however, agreed with the tax authorities that in such an alternative scenario the seller (PUN) would also retain the profit potential related to the resale of the gas at different terms and in different markets.

The taxpayer also referred to tenders from independent buyers and to several contracts entered between independent parties. The Court noted that the OECD Guidelines requires comparison with "transactions" and didn't put weight to the tenders presented. It reviewed in detail the uncontrolled contracts presented but found none of them to be comparable with the controlled transaction (amongst others; none of them were long-term gas sales contracts involving any substantial volume). In summary, the Appeal Court regarded the controlled transaction under review as not balanced in the sense that the seller (PUN) was indirectly partly charged for the buyer's (PST's) potential downside (i.e., resale costs) without taking part in the potential upside. Thus, the Court upheld the assessment made by the Oil Taxation Appeal Board.

C. Leasing of Drilling Rigs and Highly Specialized Equipment

Cross-border intra-group leasing of movable property represents one of the major challenges in the taxation of petroleum-related activities on the Norwegian continental shelf. Such activities include drilling, heavy lifting, the laying of pipelines, and sub-sea and diving operations. It is not unusual for a company that performs activities on the shelf to rent drilling rigs, specialized vessels, or equipment from a related asset-owning company that typically is resident in a low-tax jurisdiction or otherwise subject to a favorable tax regime. Mispricing of bareboat charter leases therefore lends itself to tax planning or tax avoidance, since the lease fees are deductible for the lessee and usually constitutes a substantial part of its operating costs whereas, on the other hand, the lease income is often subject to no, or very little, taxation in the hands of the asset-owning company. For these reasons, the Norwegian tax authorities have been thoroughly scrutinizing bareboat charter arrangements for many years. Further, the potential for using such arrangements for profit shifting and base erosion is an important ground for the introduction of a withholding tax on certain intragroup lease charges.[187]

There is considerable administrative practice in this area, and a few cases have been tested before the courts. An ongoing problem in these cases is that it is difficult to find acceptable comparables since the vessels or equipment in question are often highly specialized or unique and seldom leased to independent parties. Because of the difficulty of finding acceptable comparables, the CUP method is rarely applicable. In their early practice, the tax authorities tended to use a cost-plus method, which was applied to the asset-owning company.

Baker Hughes Oilfield Operations Inc. (*Baker Hughes*), decided by the Supreme Court in 1999, exemplifies the tax authorities' application of the cost-plus method to the equipment-operating company. The case raised a number of questions, including the pricing of the leasing fee for specialized equipment.[188] Baker Hughes leased equipment from its U.S. parent company and performed petroleum services on the Norwegian continental shelf, primarily based on the leased equipment. An audit was performed by the tax authorities for the years 1986–90, but the leasing fees were only disregarded for the years 1986–88, as they were accepted as being at arm's length for the 1989–90 period. When testing the arm's length nature of the leasing fees, the Appeal Board used a cost-plus method, which was the same method that the group used as the basis for its pricing policy. However, the Appeal Board adjusted some of the parameters. The group used standard cost as the

[187] *See* III.D., above and Prop. LS 1 (2020–2021), Chapter 6, for further details.

[188] Rt. 1999, p. 187, *Baker Hughes Oilfied Operations Inc.*

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cost-base, on the assumption that all costs should be recovered within a period of five years. An audit revealed that there was a substantial deviation between standard costs and the depreciation actually claimed. Therefore, in the Appeal Board's decision, the standard costs were replaced by estimated depreciation based on historical cost, which was regarded as the appropriate cost-base. The group had added interest costs to the cost-base, which the Appeal Board accepted subject to a number of adjustments. The mark-up was considered by the group on a year-to-year basis. In reaction to changed market conditions, the group had reduced the mark-up from 150% in 1984 to 25% in the period 1986–88.

The Appeal Board calculated the leasing fee by applying depreciation based on historical cost, plus a 25% mark-up and added interest costs of 6% based on average historical cost and the mark-up. Finally, a 3% mark-up was added.

The Supreme Court upheld the Appeal Board's assessment. Baker Hughes had argued that an income adjustment under §13-1 of the Tax Act could only be made if the income reduction was substantial. The Supreme Court rejected this argument, stating that there was no basis for it. Baker Hughes had further argued that the Appeal Board had incorrectly applied the law when it adjusted the rental prices for 1986–88 only, without taking into consideration the leasing fees paid for 1989 and 1990 (which Baker Hughes argued had been below market prices). With regard to this issue, the Court simply noted that the Appeal Board was correct to test the rental prices on a year-to-year basis.

Baker Hughes had also argued that the Appeal Board had not substantiated its contention that the leasing fee was not at arm's length since it had not documented market prices or otherwise made any references to market information, and that the cost-plus method was incorrectly applied by the Appeal Board with regard to the depreciation period and the interest applied. The Supreme Court found that the leased equipment was unique and that Baker Hughes was, in fact, in a monopoly situation. The court explained that it was possible neither to find comparable market prices (CUPs) directly nor to apply the cost-plus method as required by the OECD Guidelines by referring to market information (in particular in the determination of the profit element). With regard to the parameters actually applied in the cost-plus method, the Court had diverging views. A majority of four judges decided this issue by reference to burden of proof considerations, indicating that their decision was based on information provided by the taxpayer during the assessment process, and the fact that the Appeal Board, based on the information provided by the taxpayer, had reason to believe that Baker Hughes's income had been reduced. In these circumstances, Baker Hughes was under an obligation to provide information to substantiate its contention that the position taken by the tax authorities was incorrect. Such information had not been provided.[189]

Trig & Trag (1997) also illustrates the application of these rules.[190] The Supreme Court decision in this case is of particular importance in relation to foreign enterprises' liability to tax in Norway. In addition, the case addressed issues relating to the bareboat charter pricing of a drilling rig.

Trigon Contracting AG (Trag), a Swiss-registered company, conducted drilling operations on the Norwegian continental shelf in 1989–90 and was liable for tax in Norway on its income from these operations. During this time, Trag used a drilling rig that was leased on bareboat terms from an associated Liberian-registered company, Trigon Inc. (Trig). Trig's sole business purpose was to own and lease out the rig. The bareboat charter contract was entered into back-to-back with the contract that Trag had entered into with the oil company. Trag received US $53,500 per day from the oil company for carrying out the services and paid Trig a daily charter rate of US $29,000 for the charter of the rig.

The main issue addressed by the Supreme Court was whether the rig-owning company, Trig, was subject to tax in Norway. It was clear that a foreign enterprise in general would not be regarded as carrying on business on the continental shelf (and therefore as being subject to tax in Norway) merely as a result of leasing out a rig on bareboat terms to another enterprise for use on the Norwegian continental shelf. However, the tax authorities argued that the rig-owning company (Trig) and the operating company (Trag) in fact carried on a joint business on the shelf. They argued that the two companies were closely connected and mutually interdependent: Trag was dependent on Trig's sole business, which was to lease the rig to Trag; Trig, on the other hand, was totally dependent on Trag's ability to engage the rig, since the rig was leased solely to Trag, and on short-term contracts entered into every time the rig was engaged. The tax authorities, therefore, argued that the businesses of the two companies were highly integrated, practically and economically, and that they shared the risks and the prospects for profit.

In line with the lower courts, the Supreme Court decided in favor of the taxpayer, concluding that Trig was not subject to tax in Norway. The Court initially pointed out that splitting functions between separate companies may be commercially rational and that each company should be taxed on its own merits. It explained that a close relationship between the entities could not lead to the conclusion that a joint business had been carried on. The Supreme Court further pointed out that the two companies bore separate risks and that Trag would earn gain or suffer loss based on how well it performed its own operations.

The tax authorities had also challenged the bareboat charter rate. This issue was finally settled by the decision of the Gulating Court of Appeals,[191] which agreed with the tax authorities that the bareboat charter rate was not at arm's length and resulted in an income reduction for the lessee (Trag). The appellate court recognized that neither the tax authorities nor the company had been able to identify comparable transactions. In these circumstances, the Court of Appeals found that the cost-plus method used by the tax authorities was applicable to the rig-owning company (Trig). The company argued that a resale minus method would be more appropriate, but the Court was unpersuaded by the evidence.

[189] There was one dissenting opinion to the effect that the assessment should be annulled. The dissenting judge was of the opinion that the Appeal Board had not tested the various elements in the cost-plus model thoroughly, based on the information provided by Baker Hughes in the complaint.

[190] Rt. 1997, p. 1646, *Trig & Trag*.

[191] Utv. 1996, p. 1038, *Trig & Trag*.

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The tax authorities had applied a methodology similar to that used in *Baker Hughes*. The cost base consisted of two elements: (i) an estimated depreciation charge (representing the costs of obtaining the rig); and (ii) an estimated finance cost. The depreciation was based on the actual cost of building the rig and a 5% straight-line rate of depreciation (i.e., an estimated 20-year life for the rig). The finance cost was stipulated as 10%, calculated on 50% of invested capital. On top of this, a margin of 30% was added. The method was accepted by the Court.

In its more recent practice concerning bareboat leases of drilling rigs, the Norwegian tax authorities have taken different approaches when stipulating the arm's length bareboat charter rate. A cost-plus method applied to the rig-owning company (lessor) seems no longer to be applied in cases where the charter period is relatively short. Where the bareboat charter contract is concluded "back-to-back" with the contracts entered into between the rig-operating company and the oil company, the predominant market risk lies with the rig-owning company.[192] The tax authorities have, in some cases, applied a modified resale minus method. The starting point for pricing the intra-group bareboat charter rate has been the payment from the oil company to the rig-operating company. This represents an arm's length charter rate by definition, and the rate is often calculated on a daily basis. From this amount, deductions have been made for budgeted daily operating costs incurred by the rig-operating company and an appropriate net margin. The residual amount constitutes the daily bareboat charter rate. The net margins applied by the tax authorities in two cases referred to in *Kolter* (2006) were 10% and 15%, respectively. The difference in margin reflected differences in the risks assumed by the rig-operating company.[193] In a third case referred to in *Kolter*, the related parties had entered into a long-term bareboat charter contract. In that case, the tax authorities found that the predominant risks were shared, and a profit-split method was applied.

In recent years, the Norwegian tax authorities have in some cases accepted that a residual profit-split method may be considered the most appropriate method for the pricing of bareboat leasing arrangements. The method described by the Norwegian tax authorities is based on a two-sided analysis in which the rate of anticipated return for both the operating company and the rig-owning company is deducted from the agreed drilling rate, and the remaining residual is split between the parties based on the underlying value of their contributions. The 2022 update to the OECD Guidelines appears to indicate that the pricing of bareboat leasing arrangements should be in line with the actual conduct of the parties and based on the functions performed and risks assumed. For rig-owning entities without any risk-control functions, and thus no risk assumption, the maximum remuneration, according to the OECD Guidelines, seems to be a risk-free return for their funding.

D. Intra-Group Service Charges

Management service fees, including fees for general administrative, technical, or commercial services, have for several decades been an area of priority for the Norwegian tax authorities. The main focus has been on inbound transactions and whether payments for intra-group services are deductible for Norwegian subsidiaries. Historically, the Norwegian tax authorities seem to have been somewhat less concerned with whether Norwegian-based groups have properly charged their foreign subsidiaries for services rendered. This picture may be changing, however.

In the context of transfer pricing, intra-group services raise two important questions. The first question is whether intra-group services have been rendered and to what extent they have been rendered. The second question is how an arm's length price should be determined for intra-group services rendered.

Regarding the first question, the substantive issue is whether the service rendered provides the respective group member with economic or commercial value that enhances its position and whether an independent enterprise would have been willing to pay an independent party for performing the service or alternatively would have performed the service in-house for itself. In practice, controversies in this area tend to revolve around documentation issues.

The rendering of specific intra-group services seldom raises problems, and, in such cases, it is normally required for the services to be charged directly. In more complex cases, which typically occur where a parent company or a centralized service company provides a variety of services to the group as a whole, it can be a challenge to determine the types and extent of the services actually received by a local subsidiary, and whether the services provide any benefit to the subsidiary. In such cases, an indirect charge method is typically applied by the taxpayer.[194] Although the tax authorities have (not surprisingly) signaled a clear preference for direct charge methods, indirect charge methods are generally accepted in line with the considerations outlined in paragraph 7.24 of the OECD Guidelines. That being said, the use of indirect charge methods is challenged from time to time. In particular, the Oil Taxation Office (OTO) pays considerable attention to the type and extent of the costs that multinationals allocate to a subsidiary, which is hardly surprising given that the OTO regards inbound fees as deductible in computing the 78% tax base.

The use of indirect charge methods for intra-group management services (sometimes in conjunction with use of intangible property) has been challenged by the tax authorities on several occasions. Two decisions rendered by the Court of Appeals are described below.

In *3M Norge* (2002),[195] 3M Norge was the Norwegian subsidiary of a U.S.-based multinational group and a distributor of 6,000–7,000 products from a broad range of products produced

[192] Such arrangements may require an analysis of whether risks contractually allocated to the rig owning company must be respected, or whether such risks may be allocated to another entity in the group for transfer pricing purposes. This will involve an analysis of whether the rig owning company exercises control over market (utilization) and investment risks, and whether it has financial capacity to assume such risk, cf. OECD Guidelines Chapter 1.D.1.

[193] Helene Kolter, *Internprising — praksis ved Sentralskattekontoret for utenlandssaker*, Skatterett Tidsskrift for skatt og avgift, Feb. 2006, at 155.

[194] An indirect charge method relies on the allocation or apportionment of costs, for example, when the value of services provided cannot be easily quantified or when the administrative burden of identifying the cost of each specific service would be disproportionate. In a direct charge method, services are charged for directly. It is used when services performed and associated costs are clearly identifiable.

[195] Utv. 2002 p. 1393 *3M Norge.*

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by the 3M group. For several years, the parent company had charged 3M Norge a license fee equal to 5% of 3M Norge's net sales as compensation for "patents, know-how, trademarks, marketing information, and management expertise." In 1994, the fee was changed, and a Technical Service Agreement (TSA) was substituted for the prior agreement. Under the TSA, 3M Norge was required to pay 5% of its turnover up to 140 million Norwegian kroner, and 2% of its turnover in excess of 140 million Norwegian kroner up to 840 million Norwegian kroner in consideration for technical services, know-how, management systems, etc. For the years 1992 through 1994, the Tax Appeal Board allowed deductions for only a portion of the license fee, as 3M Norge had no documentation to the effect that it received services that could justify a larger payment.

The core issue before the Court was whether 3M Norge had provided adequate documentation to the tax authorities for the services rendered by its U.S. parent. In response to the tax authorities' request for specific detailed documentation regarding the extent of services rendered and benefits received, the taxpayer provided a combined non-itemized accounting of services and benefits. The 3M group had not kept time reports or other records that could document and substantiate the volume of services rendered in any detail.

The Court recognized that 3M Norge had not responded to all of the questions raised by the tax authorities, partly because the documentation requested did not exist in the books of either 3M Norge or the U.S. parent company. However, the Court found that: (i) it was likely that 3M Norge had received substantial contributions from the parent company and that 3M Norge had properly demonstrated that it had received such contributions; and (ii) an independent party would have been willing to pay a comparable fee in a comparable situation.

Referring to paragraph 7.24 of the OECD Guidelines, the Court accepted that it was appropriate to use an indirect charge method in this case. The Court stated that it would be very difficult — at least without incurring disproportionate administrative costs — to quantify in detail the services and know-how received. It recognized that 3M Norge had provided estimates and stated that it would be inconsistent with the application and recognition of an indirect charge method to ask for such detailed documentation as had been requested by the tax authorities. The Court also found that a charge of 5% and 2% of the subsidiary's turnover was reasonable and annulled the reassessment that had been made by the tax authorities.

At the time of the decision in *3M Norge*, Norway had not introduced any specific transfer pricing documentation rules. From the perspective of the state, the outcome of this particular case clearly underlined the need for stricter documentation rules, or at least, rules that clarified to a greater degree what kind of documentation a taxpayer was expected to prepare and could submit on request. The specific transfer pricing documentation rules introduced in 2008 contain a special clause concerning centralized administrative, technical, or financial services. Specifically, they stipulate that the benefit of services received must be documented and that, for purposes of a cost-based allocation, the cost basis, the allocation key, and any profit margin must be properly documented and explained.

A few years later, the Court of Appeals rendered another decision in *Enterprise Oil Norge AS* (2010), a similar case that also concerned income earned in years prior to the introduction of the specific transfer pricing documentation rules.[196] Enterprise was a U.K.-based petroleum company with approximately 300 employees. Its main activity was to furnish services of various kinds to a number of operating subsidiaries, including Enterprise Oil Norge AS (ENOL). ENOL was engaged in exploration for, and the extraction of, oil in the Norwegian sector of the North Sea. A 1991 Service Agreement between Enterprise and ENOL provided that services "shall be rendered at cost or on such other basis as the parties from time to time agree." On this basis, costs incurred by Enterprise plus a 5% mark-up were allocated among the subsidiaries and the operating units. Enterprise grouped its costs into three categories: category 1 and 2 costs consisting of general service costs relating to the London office, human resources, group finance, group management, and group services; and category 3 costs relating to services of a technical, legal, or administrative nature, such as exploratory and marketing activities carried out for specific subsidiaries and operating units. Category 1 and 2 costs were allocated based on the number of employees in the units and subsidiaries but adjusted in such a way that an employee in a subsidiary was allocated only 50% of the costs allocated to an employee in an operating unit within the parent company. Beginning in 1998 and over subsequent years, there was a substantial increase in the categories 1 and 2 costs allocated to ENOL. This was partly due to the fact that in 1999 ENOL was allocated costs related to the restructuring of the parent company. The units in the parent company that carried out category 3 service activities had been allocated category 1 and category 2 costs up front, and such costs were included in the category 3 cost base. The category 3 cost base was allocated among the subsidiaries based on registered time-lists.

The Oil Taxation Appeal Board adjusted ENOL's taxable income for the years 1998 through 2001. For 1998, only a minor adjustment was made for shareholder costs that had been allocated to ENOL. However, for the years 1999 through 2001, the Appeal Board made substantial adjustments and disallowed deductions for service fees totaling approximately 142 million Norwegian kroner.

The Appeal Board was of the opinion that the general costs allocated from categories 1 and 2 were not at arm's length and found that ENOL had not produced proper documentation to the effect that it had received, and benefited from, these services to the extent ENOL claimed. In its discretionary assessment, the Appeal Board concluded that the amount charged for category 1 and 2 costs in 1998 also represented arm's length charges for the years 1999 through 2001.

With regard to the category 3 costs, the Appeal Board accepted the registered time-lists as a basis for allocation. However, the charge that had been allocated to ENOL for the category 3 services implied a pay rate of 3000 Norwegian kroner per hour, which was far higher than the price independent parties would have charged for comparable technical and marketing services, according to the Appeal Board. Hence, in its discretionary assessment, the Appeal Board applied a CUP-method and compared fees charged by other enterprises for comparable services.

[196] Utv. 2010, p. 207, *Enterprise Oil Norge AS*.

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The Court of Appeals upheld the assessment. The Court initially remarked that the service fee must be based on the arm's length principle and that in principle whether or not the parent company would fully recover its costs was irrelevant. ENOL's principal argument before the court was that the service charges should be accepted as arm's length since the same cost allocation (except for some corporate costs and the addition of a profit margin) had been accepted by independent licensees that, together with Enterprise, were participants in a Joint Operating Agreement (JOA) on a field in the U.K.-sector where Enterprise acted as the operating company. The Court, however, was of the opinion that a community of interest existed between the participants in a JOA, as they agreed to share the costs, risks, and profit related to the operations. Thus, the fact that other participants in the JOA had accepted the cost allocation system as an element of a broader joint operation was not decisive with respect to determining the true arm's length character of the service fees.

One of the main issues before the Court was whether ENOL had sufficiently substantiated the extent to which it had received, and benefited from, the general services in categories 1 and 2. The tax authorities had requested detailed information in this respect, but the answers provided by ENOL were rather vague and referred in general to the types of services that were provided by the parent company. The Court initially invoked burden of proof considerations and stated that although it is the responsibility of the tax authorities to demonstrate that the conditions for making an income adjustment are satisfied, a tax deduction may be disregarded or reduced where the taxpayer has submitted imperfect or unclear information.[197] ENOL had argued that *3M Norge* implied that there were limitations on the level of documentation that the tax authorities could require, but the Court disagreed, stating that *3M Norge* did not have such far-reaching consequences and indicating that the level of documentation required should be considered on a case-by-case basis. The Court further remarked that the Court in *3M Norge* had actually found that the taxpayer documented its receipt of the disputed services. The Court noted that the situation in *3M Norge* could be distinguished from the case before it here, finding the cost allocation system applied by Enterprise to be complicated and lacking in transparency. In such circumstances, ENOL would have to bear the consequences of not being able to provide the appropriate and required level of documentation.

The Court also discussed the treatment of restructuring costs. In 1999, ENOL had been allocated 9 million Norwegian kroner for the restructuring and reduction of staff — costs that were incurred in the parent company (London office). The Court concluded that such costs, if the transaction had been an independent party transaction, would not have been immediately allocated with a mark-up but would have had to be recovered through pricing mechanisms over a longer period of time, having regard to what would be acceptable under the prevailing market conditions. The Court also emphasized that Enterprise's use of headcount as the allocation key was not particularly logical in this situation because reducing the staff at the London office (which otherwise implied a reduction in the volume of services rendered), in fact, lead to ENOL charging an increased service fee.

In relation to the category 3 costs, ENOL argued that the parent company had furnished man-hour services in excess of what had been registered in the time-lists (which would imply that the hourly charge rate was lower than assumed by the Appeal Board). The Court held that ENOL had failed to substantiate this contention.

Based on the above, the Court concluded that ENOL's income had been reduced because of intra-group service fees paid to Enterprise and affirmed the discretionary service fee that had been assessed by the Appeal Board.[198]

E. Business Restructurings/Intangibles

In the past couple of decades, business restructurings have been an important transfer pricing topic in many countries, including Norway. A large number of business restructurings have been carried out in Norway, often involving the conversion of a local Norwegian company into a low-risk/low-profit entity (limited risk distributor/commissionaire or contract researcher/manufacturer) combined with a transfer of intangibles to a foreign related company. Typically, the situations in which such restructurings occur are connected with foreign acquisitions of Norwegian groups. These acquisitions are often heavily financed by intra-group debt, giving rise to additional transfer pricing financing issues.[199]

In recent years, the Norwegian tax authorities have become more vigilant with respect to business restructurings and the related transfer pricing issues. Typically, business restructurings qualify as high-risk areas in the tax authorities' risk assessments and the authorities will scrutinize the events leading up to such restructurings.[200]

In *Dell* (2011), for example, the Norwegian tax authorities challenged a commissionaire structure established by the Dell group.[201] Rather than challenging the profit earned by the Norwegian commissionaire, the tax authorities contended that the Irish principal that sold through the commissionaire had a dependent-agent permanent establishment (PE) in Norway to which the authorities attributed a certain amount of profit.

The case was finally decided by the Supreme Court, which was tasked with interpreting the phrases "acting on behalf of an enterprise" and "authority to conclude contracts in the name of the enterprise" in Article 5(5) of the Ireland-Norway tax treaty. The Court concluded that for a PE to exist, these provisions required the principal company to be legally bound by contracts entered into by the Norwegian company. Thus, since a principal is not legally bound by contracts entered into by a "commissionaire company" under Norwegian law (and civil law, generally), the Court concluded that the Irish principal company did not have a Norwegian PE and was not taxable in Norway.

A group restructuring may involve intended or unintended transfers of intangible property from one company to other related companies within the group concerned. *Cytec KS* (2007),

[197] Rt. 1995, p. 124, *Dowell Schlumberger (Eastern).*

[198] Two other decisions rendered by the Court of Appeals concerning the indirect allocation of centralized service costs are referred in Utv. 2010, p. 1541, *Scientific Drilling*, and Utv. 2016, p. 25, *Total.*

[199] *See* IX.F.1., below.

[200] *See* X.B.3., below.

[201] Rt. 2011, p. 1581, *Dell.*

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which was decided by the Eidsivating Court of Appeals, is a good example of how restructuring can result in unintended transfers between related companies.

Cytec KS was a limited partnership established in Norway and wholly owned by entities in a group ultimately controlled by a U.S. multinational group, Cytec Industries.[202] For many years, Cytec KS had been a 50/50 joint venture established by the U.S.-based Cytec group and the Norwegian-based Dyno group. The joint venture ceased to exist in 1998, when the Cytec group acquired Dyno's 50% share of Cytec KS for 305 million Norwegian kroner. The acquisition was followed by a major business restructuring in 1999, in which Cytec KS was converted from a fully-fledged manufacturer to a toll manufacturer. Before the restructuring, Cytec KS produced branded chemical products in its own name and at its own risk, which were distributed by a Dutch sales agent. After Cytec KS had been restructured, its functions and risks were reduced to those of a toll manufacturer, and its former wider functions were taken over by a Dutch group entity. As a result of the restructuring, the profit of the Cytec KS, which had been 48 million and 45 million Norwegian kroner in 1997 and 1998, respectively, dropped to 3 million and 6 million Norwegian kroner in 2001 and 2002, respectively.

Under the contracts entered into for purposes of the reorganization, Cytec KS was paid a certain amount for the transfer of inventory, but it received no consideration for the transfer of intangible property. Nevertheless, the Tax Assessment Board was of the opinion that, before the reorganization, Cytec KS had owned intangible property in the form of a customer base, an exclusive right to technology, trademarks, and goodwill. It asserted that these assets had been transferred from Cytec KS for no consideration. The Tax Assessment Board's conclusion was, in large part, based on two independent valuation reports that had been prepared in connection with Cytec KS's acquisition of Dyno's 50% share one year before the reorganization. The valuation reports estimated the total value of Cytec KS to be approximately 720 million Norwegian kroner, of which the value of intangibles amounted to approximately 490 million Norwegian kroner.

Based on the valuation reports and the acquisition agreement entered into between Cytec KS and Dyno, the Tax Assessment Board concluded that intangible assets with value in the range of 302–388 million Norwegian kroner had been transferred to the Dutch principal entity.[203] In its discretionary assessment, the Tax Assessment Board estimated the value of the transferred assets to be 300 million Norwegian kroner and imposed tax accordingly.

The Court of Appeals upheld the Board's assessment. The Court thoroughly examined the assets that Cytec KS held before the restructuring, and a majority of two judges concluded that the restructuring resulted in a transfer of business with Cytec KS only retaining the assets required to carry out the more limited functions of a toll manufacturer. As such, the majority found the discretionary assessment acceptable.[204]

Another case concerning business restructuring and transfer of intangibles was dealt with by Borgarting Court of Appeals in *Normet Norway AS* (2019).[205] As opposed to *Cytec KS* (2007), this case concerned an explicit transfer of intellectual property to a related enterprise. A main issue concerned the accurate determination of which assets had been transferred; particularly whether goodwill was comprised. Another main issue concerned which pricing method to apply, either "relief from royalty" as used by the taxpayer, or a CUP ("Comparable Uncontrolled Price") based on a foregoing third party acquisition of the shares in the company as used by the tax authority. Other issues concerned the aggregation of transactions, and whether reasonably accurate adjustments could be made to eliminate the differences between the third-party share acquisition and the transferred intellectual property.

The Norwegian company Dynamic Rock Support (DRS) had developed a rock bolt (D-bolt) to be used in deep underground mining. The company itself had no other operating assets or activities but owned two subsidiary companies in Australia and Canada. Each subsidiary had two employees who marketed the D-bolt to potential customers in their markets, but no contracts had been concluded at the time. On January 30, 2013, the Swiss company Normet International Ltd. acquired all the shares in DRS for 10.5 million Euro. The following day, DRS's intellectual property was transferred to the acquiring company for 493,590 euro. Nine months later, the two subsidiaries were transferred to the same company for 10.125 million euro. While the transfer of intellectual property was taxable in Norway, the transfer of subsidiaries was tax exempt. DRS was merged into Normet Norway AS and thereafter dissolved.

The Court of Appeals found it evidenced that no excess value was left in DRS after its sale of intellectual property and subsidiaries and that no values had disappeared in the reorganization. Thus, DRS's total value had been transferred through the two transactions. The Court noted that the two transfers appeared to be part of an overall and planned reorganization, which the Court found was intended when the shares in DRS were acquired. Under these circumstances and with references to §13-1 in the Tax Act, case law[206] and paragraph 3.9 of the OECD Guidelines, the Court found it appropriate to aggregate the two intragroup transactions and view them jointly when judging the tax authority's assessment of the first transaction, i.e., the sale of intellectual property. This implied that it became essential to determine how to distribute the value transferred in the two transactions.

In doing so it was required to determine with precision which assets were covered by the first transaction. It was undisputed that it covered the D-bolt patent and trademark, but it was disputed whether it comprised any remaining intellectual property, including goodwill. The Court of Appeals started with an analysis of the wording of the sales agreement and found that

[202] Utv. 2007, p. 1440, *Cytec KS*.

[203] The two reports had somewhat diverging estimates with regard to the allocation of these values between the Norwegian manufacturing unit and the distribution unit located in the Netherlands.

[204] The sole dissenting judge indicated that, before the restructuring, Cytec KS only had the right to use some of the intangible assets (i.e., it was not in the position of an owner) and opined that the assessment should be annulled, since it was based on an incorrect understanding of the facts, which had influenced the outcome of the assessment.

[205] Borgarting Court of Appeals, 2019-03-19, LB-2017-202539, *Normet Norway AS*.

[206] Rt. 2007, p. 1025, *Statoil Angola*.

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it indicated that not only patent and trademark were covered but also all the technology related to the D-bolt. The Court also found the sales agreement evidenced that DCS, at the time of the first sale, had no intention to continue any activity after the completion of the reorganization. Thus, the parties' consecutive conduct supported the understanding that all related technology were transferred in the first transaction. In respect of goodwill, the Court remarked that although goodwill generally does not relate to specific assets, if specific assets are sold and no operating activity remains left, the goodwill is also transferred.

The Court evaluated and found it evident that the "relief from royalty" method with parameters used by the taxpayer did not produce an arm's length price. The Court then considered whether the acquisition price of all shares in DRS could be applied as a CUP ("Comparable Uncontrolled Price"), which was the method applied by the tax authority. In this respect, the Court referred to paragraph 6.147 of the OECD Guidelines and examples 22, 23, and 26 in the Annex to chapter 6 in the OECD Guidelines and found the method applicable, provided that reasonable accurate adjustments had been made. Therefore, the essential question was whether the tax authority had made "reasonable accurate adjustments" to account for the value of the subsidiaries not transferred in the first transaction. In doing so, the Court first evaluated and concluded that the value of the subsidiaries had not changed during the nine months between the share acquisition and the date the subsidiaries were sold, i.e., there were no timing differences. Based on these facts, the Court evaluated the valuation of the subsidiaries made by the tax authority. It noted that the DCF ("Discounted Cash Flow") method used is a recognized method and concluded that the different parameters applied by the tax authority, viewed in totality, was reasonable. As a result of this a majority of four (out of five) judges concluded that the adjustment of income made by the tax authority was justified, and the adjustment was upheld.

F. Intra-Group Debt Financing

1. Thin Capitalization

Under Norwegian law, thin capitalization issues may be addressed under the general arm's length provision in §13-1 of the Tax Act. The Supreme Court's 1940 decision in *Fornebo* is often cited in this context. That case concerned a thin capitalization situation and, although the tax adjustment was annulled, the Court in *obiter dictum* (incidental remark) clearly presupposed that the statute authorized the recharacterization of loans when the "debt financing was not founded on sound business principles, but could only be explained by the community of interests."[207] In addition, the legislative preparatory work to §54(1) of the General Tax Act 1911 (continued in §13-1 of the Tax Act 1999) states that the provision may be used in cases of "unnatural[ly] high debt financing."[208]

There is extensive administrative practice relevant to the treatment of thin capitalization issues under the arm's length provision in the Tax Act. An important reason for this is that Norway has never had specific thin capitalization rules, except for those that applied to oil companies from the early 1990s through 2007.

The key issue is whether the debtor is financed through internal loans in excess of what it could have obtained from unrelated parties in comparable circumstances (i.e., whether the company is financed with debt in excess of the debtor's "loan capacity"). No predetermined debt-to-equity ratio or other financial ratio, such as a leverage ratio, can be stipulated under the general arm's length provision. The factors that must be taken into account when considering the amount of debt a taxpayer could have obtained from unrelated parties (i.e., the loan-capacity of the debtor) requires a high degree of discretionary judgment on a case-by-case basis. In a 2004 decision, the Borgarting Court of Appeals stated that the essential problem to be addressed is "what the taxpayer's situation would have been in an independent loan arrangement."[209] The Court also suggested that "a broad consideration is needed where the equity, debt, and earnings are important elements."[210]

The development of Norwegian administrative practice relating to thin capitalization can broadly be divided into two phases. The first phase stretched from the late 1970s to the early 1990s. During that period, multinational oil companies made large investments on the Norwegian Continental Shelf, and thin capitalization became an extremely important focus area for the oil taxation authorities. In the absence of specific thin capitalization rules, the authorities successfully utilized the arm's length provision of the Act to counteract financing structures involving thin capitalization.

From the early 1990s onward, various measures were introduced in the Petroleum Tax Act to prevent undercapitalization and erosion of the tax base in the high tax regime applicable to oil companies, with the result that the oil taxation authorities have been able to focus on other issues and risk areas.

Although application of the arm's length principle requires an individual judgment of the facts and circumstances in each case, it also requires that the administrative practice be reasonably consistent. To facilitate its work with these challenges, in the mid-1980s, the oil taxation authorities developed a set of guidelines that established approximate norms for acceptable levels of debt financing for companies engaged in various stages of petroleum activity on the Norwegian continental shelf.[211] The guidelines were not binding and could be deviated from in individual cases. When stipulating the need for equity-financing, the guidelines distinguished between various types of costs and activities, to reflect the diverging levels of risk assumed at various stages of the business. In short, the guidelines indicated that costs incurred in relation to exploration activities must be wholly financed by equity because of the high risk involved. Development costs, on the other hand, may be financed with a debt-to-capital ratio of 80%. The guidelines were rather lengthy and nuanced, and the basic points described above were adjustable to take into account other factors that were expected to influence the company's ability to obtain external loan financing, such as whether the company had income from other fields, whether it had surplus income from previous years, and the amount of the company's operating costs.

[207] Rt. 1940, p. 598, *Fornebo* (author's English translation).
[208] Ot. prp., no. 26 (1980–81), p. 66.
[209] Utv. 2004, p. 685, *Scribona* (author's English translation).
[210] Utv. 2004, p. 685, *Scribona* (author's English translation).
[211] The guidelines are summarized in PSK 19861 110 A, 4.3.

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Based on these guidelines, the capital structures of a number of oil companies operating on the Norwegian continental shelf were adjusted for tax purposes. While taxpayers filed cases challenging the resulting assessments, all assessments were upheld in the lower courts.

In *Amoco Norway Oil Company (Amoco)* (1989),[212] Amoco was a Delaware-registered company that operated through a branch in Norway. The company participated in several licenses on the Norwegian continental shelf. Amoco was wholly owned by Amoco Production Company and ultimately owned by Standard Oil Company. As of December 31, 1982, Amoco had equity of 57.3 million Norwegian kroner. The remaining capital consisted of a loan from the parent company and external bank loans that were guaranteed by Standard Oil Company. Amoco's equity percentage was 1.7%. Based on the guidelines referred to above, the Appeal Board reclassified a loan amount of 225 million Norwegian kroner as equity and denied deductions for the corresponding interest and exchange losses. The Court found that §54(1) of the Tax Act, 1911 (corresponding to §13-1 of the Tax Act, 1999), could be applied to adjust a company's taxable income if the company was financed with less equity than would be required in the absence of a community of interest. It made no difference whether the loan concerned was granted by a related company or by a third party based on a guarantee from a related company.

Given the uncertainty surrounding the issue, the Court indicated that the tax authorities must exercise caution when considering the appropriate arm's length capital structure, both in determining whether an income reduction has occurred and in determining the discretionary assessments to be made. The Court considered that the guidelines were both prudent and within reason. At the same time, it emphasized that, while the Appeal Board had referred to the guidelines, it had also not neglected to make a genuine discretionary assessment in the particular case concerned, as is required by the arm's length provision in the Tax Act. When Amoco's capacity to obtain third-party loans was examined, a question that arose was what type of external loan would be appropriate to compare with Amoco's related-party loans. While Amoco had been able to demonstrate that it could have borrowed the same amount of money from an external party without guarantees from related parties, the Court characterized the external loan invoked by Amoco in this context as a "project loan," which was less flexible and issued on stricter terms than the loans Amoco actually had. The Court stated that when considering Amoco's loan-capacity, the comparison that had to be made was with loans that were comparable to the loans that Amoco had actually been granted. The Court concluded that Amoco's income had been "reduced" as a result of the extensive loan financing and that the discretionary income adjustment made by the Appeal Board was reasonable.

A second phase of thin capitalization practice was initiated around 2010 and lasted until Norway introduced an interest limitation rule (fixed ratio rule) with effect from 2014. The catalyst for this renewed focus around 2010 was the volume of activity involving debt-financed acquisitions of Norwegian businesses and, in particular, the prevalence of debt push-down structures. Sometimes these structures included the debt financing of several layers of companies above the acquired company. Because of Norway's group taxation rules, there were instances in which the operating profits of the acquired company (which typically had been converted into a low risk/low profit entity) were not sufficient to absorb all of the internal financing costs incurred by the Norwegian company or companies established for purposes of the acquisition. A limited amount of material has been published illustrating the administrative practice of recent years, which has resulted in the settlement of some of these cases. In these cases, the focus of the tax authorities primarily has been on: (i) a combined "loan capacity" (i.e., borrowing capacity) assessment made on the Norwegian arm of the group (both holding and subsidiary companies) where the loan capacity of both companies is supported by the same underlying cash flow; and (ii) in the comparability analysis, the placing of considerable weight on cash flow based key financial ratios such as the leverage ratio (debt to EBITDA) and the interest coverage ratio (EBITDA to net interest) as compared to balance sheet ratios (for example, debt to equity).[213]

In its more recent administrative practice, the oil taxation authorities also tend to rely more on cash flow financials and less on balance sheet figures (which was at the center in the administrative guidelines developed in the mid-1980s and referred to above) when considering loan capacity of a borrower.

2. Interest-free Loans

In the early 1990s, the tax authorities began to review cases in which Norwegian parent companies financed foreign subsidiaries with interest-free loans or contributions. The key issue was whether, and if so to what extent, the capital provided ought to generate deemed interest income for the parent company, based on the assumption that external lenders would require interest compensation in comparable circumstances. The fundamental issue in this context is the correct characterization of the transaction actually carried out (i.e., whether it is debt or equity that is actually contributed to the subsidiary). The starting point for the analysis is to determine the character of the transaction, starting with its form. That form may, however, be disregarded for tax purposes if it is not in conformity with the substance of the transaction. Various factors must be considered in this respect, such as the existence of a repayment obligation and a repayment due date, the remedies available to the creditor, and whether the parties are actually doing what the documents say they are doing.

The Ministry of Finance has issued three statements on the subject, and several lower court decisions have been rendered concerning this issue. These have made it clear that where the capital provided is properly characterized as a loan, the arm's length provision in §13-1 of the Tax Act may constitute a legal basis for attributing deemed interest income to the lending company, which must be taxed accordingly. A requirement for making such an attribution, however, is that the foreign subsidiary financed by its Norwegian parent would be able to obtain external debt financing (i.e., that it has loan capacity). To the extent the foreign subsidiary does not have loan capacity, the arm's length provision of the Tax Act does not authorize the tax authorities to tax the Norwegian parent company on any

[212] Utv. 1989, p. 304, *Amoco.*

[213] Published extracts from one case are found in Utv. 2015, p. 399, item 2.3.18.

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deemed interest income. The loan capacity of a foreign subsidiary is to be tested based on the same principles as applicable when the loan capacity of a Norwegian subsidiary is tested in relation to an inbound loan.

Four of the assessments made by the tax authorities in the 1990s were brought before the courts. In *Nycomed*, which was decided by the Borgarting Court of Appeals in 1998,[214] the Court concluded that the tax authorities were entitled to impose a deemed interest charge on a part of the non-interest-bearing funds provided to a subsidiary, but it did not accept the discretionary assessment made by the tax authorities as to how much of the funds should be regarded as a loan subject to interest payments. Thus, the tax authorities were ordered to provide a new assessment.

The three other cases were decided by the court of first instance.[215] In all three cases, the assessments were annulled because the court opined that the tax authorities, in its discretionary assessment, had not properly assessed the extent to which the borrowing company had loan capacity. In all cases, the tax authorities were ordered to provide a new assessment.

A related issue was dealt with by the Supreme Court in *Statoil Angola* (2007).[216] The issue was whether under §13-1 of the Tax Act the tax authorities were allowed to disregard the actual allocation of interest-bearing and interest-free loans within a group. Statoil Angola was a 100%-owned subsidiary of a Norwegian company, Statoil ASA. Statoil Angola was funded by two internal loans. The main loan was interest-bearing and issued by Statoil Belgium, which was a group financing company controlled by the parent company, Statoil ASA. The second, and much smaller, loan was an interest-free loan issued by Statoil ASA. The taxpayer and the tax authorities agreed that if Statoil Angola had borrowed money from an external party, it would only have been granted a loan in an amount equal to the amount of the loan issued by Statoil Belgium. Hence, Statoil Angola had received internal loan financing in excess of its loan capacity in an amount equal to the amount of the loan granted by the parent company, Statoil ASA. In these circumstances, the Oil Taxation Appeal Board disregarded the group's allocation of the interest-free loan and attributed a proportional part of the interest-free loan to both internal lenders, implying that a proportional part of the interest income should be attributed to Statoil ASA. The prevailing argument was that neither of the lenders, if they had been independent lenders, would have granted Statoil Angola an interest-free loan in excess of that company's loan capacity. The Appeal Board was of the opinion that, in such circumstances, the disadvantage of not receiving interest should be proportionally allocated between the two internal lenders.

Noting that no comparable transactions could be identified, since no external party would issue an interest-free loan in excess of the debtor's loan capacity, the Supreme Court annulled the assessment. The Court stated that in these circumstances, the non-interest-bearing loan should be allocated between the lenders based on the "interest each of them had in the transaction."[217] This statement was directly rooted in a Private Limited Company Act provision and the preparatory work to that provision, which stipulated that income, costs, etc., that cannot be allocated to any particular group company should be allocated among the group companies based on their respective business interests in the transaction concerned.[218] The Court concluded that the only interest the group's financing company, Statoil Belgium, had in the transaction at hand was to earn interest income. On the other hand, the predominant interest of Statoil ASA, as the parent company, was related to the future return on Statoil Angola's business operations and not to interest income on the loan issued. Thus, the way the group had structured the debt financing had to be respected.

3. *Subordinated Loans*

Another issue that has attracted attention is the debt-financing debt of hydroelectric power production and distribution companies owned by municipalities and counties (a common phenomenon in Norway). In such cases, the asymmetric tax treatment of the corresponding interest creates a strong incentive to fund such companies with debt. While interest paid is deductible for the production company, interest received is tax exempt in the hands of its public owners. Thin capitalization has not been an issue in these cases, but the tax authorities have challenged the agreed interest rates and other terms of the relevant loan agreements that potentially influence the interest rate. A number of the loans concerned contain terms that are not usually observed in the market, such as long or indefinite maturity and the absence of termination rights for the debtor. Many of the loans are structured as subordinated loans and are subject to higher interest rates than loans with ordinary priority. In some cases, the tax authorities have restructured the loan terms for tax purposes by disregarding the subordination aspect. The following case brought forth before the Borgarting Court of Appeals is illustrative.

Lyse Energi AS (2009) concerned a subordinated loan of 3 billion Norwegian kroner, proportionally provided from the shareholders (tax-free municipalities) to a hydroelectric power production company, Lyse Energi AS.[219] The loan had been established by a corresponding write-down of the company's premium fund capital. In addition to the subordination condition, the loan documents contained a number of unusual conditions — for example, the maturity of the loan was 67 years, and the loan could not be terminated by the debtor. The interest rate agreed was the three-month Norwegian Interbank Offered Rate (NIBOR) plus a margin of 2%.[220]

The main issue before the Court was whether Lyse Energi AS, if contracting with an independent party, would at all have raised a 3 billion Norwegian kroner, subordinated loan (and thereby paid a premium for the low priority of the loan), and whether §13-1 of the Tax Act could provide for a re-structuring of the "subordination condition" and a corresponding adjustment of the interest rate.

[214] Utv. 1999, p. 540, *Nycomed*.

[215] Utv. 1997, p. 816, *Freia*; Utv. 1999, p. 849, *Dyno*; Utv. 1999, p. 1291, *Elkem*.

[216] Rt. 2007, p. 1025, *Statoil Angola*.

[217] Rt. 2007, p. 1025, *Statoil Angola* (unofficial English translation).

[218] Private Limited Company Act, §3-9; NOU: 1996:3, p. 192–193.

[219] Utv. 2009, p. 210, *Lyse Energi AS*.

[220] The parties agreed that such an extreme long-term, non-terminable loan would not be found in uncontrolled transactions, but the Court did not examine these conditions because it was evidenced that the interest rate was lower than the rate independent lenders would have agreed to on a subordinated loan with maturity of 15–20 years.

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The Court initially pointed out that Lyse Energi AS was sufficiently capitalized and that it could see no justification for reassessing or disregarding the company's decision to raise a 3 billion Norwegian kroner loan. With regard to the subordination condition, the Court referred to paragraph 1.36 of the 1995 OECD Guidelines and the Supreme Court's decision in *Fornebo*, stating that the issue was whether the term was "commercially natural and reasonable."[221] The Court was satisfied with the taxpayer's documentary evidence, which showed that the loan arrangement resulted from a deliberately chosen business strategy that was in line with the interests of the company. Among other factors, the Court emphasized that the entire industry was in a restructuring phase and that Lyse Energi AS was planning to carry out acquisitions and was going into new areas of business. In this environment, it was of vital importance for the company to have stable, long-term financing and, at the same time, wide flexibility with respect to obtaining future external loan financing at short notice. Given these circumstances, it was considered commercially rational for Lyse Energi AS to receive a long-term, subordinated loan from its shareholders, and the reassessment was annulled.

4. Pricing of Loans

While the oil taxation authorities had focused primarily on thin capitalization issues in the late 1970s and early 1980s, in the late 1980s, they turned their attention to loan pricing, which continues to be a major concern today. There exists comprehensive administrative practice relating to the pricing of inbound loans to Norwegian group companies engaged in upstream petroleum activity on the Norwegian continental shelf. However, to date, only a handful of cases have been brought before the courts. More recently, the tax authorities have increasingly focused on the pricing of outbound loans made by Norwegian parent companies to their foreign subsidiaries.

While Norway has never had any safe harbor rules with respect to the pricing of loans, the administrative practice indicates that adjustments are generally not made where there is minor divergence between the rate of interest actually paid and the rate that the tax authorities have determined as being at arm's length. For example, in one case, the Oil Taxation Appeal Board declined to adjust an internal interest rate that was 25 basis points (bps) higher than the rate that the Appeal Board regarded as the arm's length rate.[222]

In general, the interest rate of a loan would include a base rate and a margin. In addition, other fees or expenses may apply (e.g., establishment costs or commitment fees). The assessment of most intra-group loan transactions primarily concerns the interest rate margin or the credit spread on the loan. In most cases, the applied base rate (or reference rate) is a money market rate such as SOFR (Secured Overnight Financing Rate) (for floating rate loans in USD) or NOWA (Norwegian Overnight Average) (for floating rate loans in Norwegian kroner) or a swap rate (for fixed rate loans), which are mostly accepted as arm's length. Establishment costs and other fees and expenses may also be subject to scrutiny in the Norwegian administrative practice.

The CUP method is most often used by the tax authorities in their pricing of intra-group loan transactions. Loan pricing seems to be approached by the Norwegian tax authorities in a quite uniform way, involving two steps:

> (i) First, it is necessary to determine the borrower's creditworthiness, adjusted for any implicit group support. It is a long-standing administrative practice in Norway that the effect of group affiliation or passive association is taken into account when determining the interest rate to be paid on intra-group loans, a practice that has been recognized by the Appeals Court since 1992.[223] Thus, any implicit support of improved creditworthiness resulting from being part of a group must be taken into account when determining the interest rate paid by a group member on a related-party loan;[224] and
>
> (ii) Second, it is necessary to identify market data with respect to comparable loans. Various sources have been used to assess this metric (e.g., Bloomberg and Thompson Reuters), and the suppliers' index estimates are generally recognized as representing data derived from comparable third-party transactions.

The issue of identifying comparable loan data, as well as certain other issues related to loan pricing and the application of the CUP method have been dealt with by the Court of Appeals in two recent decisions.

In *ExxonMobil Production Norway Inc. (EPNI)* (2018), the Court considered whether a credit facility (a revolving line of credit) of 20 billion Norwegian kroner issued in November 2009 by the Norwegian entity EPNI to a related U.S. entity borrower was priced at arm's length.[225] The contractual terms of the loan agreement included a maturity of approximately nine years, a floating interest rate at 3M NIBOR plus 30 bps, and a revision clause, which provided EPNI with the sole right to adjust the interest rate if there had been a material change in the borrower's creditworthiness (step up clause).

The Oil Taxation Appeal Board adjusted the interest margin up from 30 bps to 75 bps. It determined the arm's length range of interest margins using a set of index estimates. This analysis involved the pricing of bond issues in the secondary market, issued around the time of the origin of EPNI's intercompany loan, with similar remaining maturity and credit rating as in the case at hand. The index estimates were derived from several commercial databases, including Bloomberg, Reuters, J.P. Morgan, and Barclays Capital.[226] Index estimates do not reflect a specific transaction. Rather, index estimates are determined based on calculations and adjustments of data representing underlying transactions to form normalizations of credit curves.

EPNI argued that (i) it was an incorrect application of the arm's length principle to rely on index estimates, and (ii) it was incorrect to determine a range of interest margins from a set

[221] Rt. 1940, p. 598, *Fornebo*.

[222] PSK 19 890 206 B.

[223] Eidsivating Court of Appeals, September 28, 1992, *Conoco Norway Inc.* (unpublished).

[224] This is in line with the principle reflected in paragraph 7.13, as well as example 1 in Chapter 1 of the OECD Guidelines (2017).

[225] Borgarting Court of Appeals, Utv. 2018, p. 210, *ExxonMobil Production Norway Inc.*

[226] The index estimates were converted to Norwegian kroner by use of basis swap adjustments.

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of index estimates using midpoints, rather than applying a statistical range. In other words, in the view of the taxpayer, the arm's length principle requires comparisons to be made with specific third-party transactions, not index estimates. However, if the index estimates should still be accepted, a statistical range needs to be considered for each of the index estimates, rather than a midpoint for each index. While the Court agreed that the arm's length principle is initially based on a comparison with specific, third-party transactions, it concluded that, in the case at hand, such comparisons provided little guidance.[227] The Court further discussed whether a statistical range (specifically, standard deviation) should be taken into account for each of the indexes rather than using midpoints, but it concluded that such an approach would lead to acceptance of almost all data. Instead, the Court considered the Oil Taxation Appeal Board's calculation, which was based on the midpoints of each of the respective index estimates provided for the case, to represent an expression of a reliable arm's length range.

Another issue discussed during the proceedings was the value of the step-up clause, i.e., the contract clause that gave the lender, at its sole discretion, the right to adjust the interest rate if there was a material change in the creditworthiness of the borrower. The term "material change" in creditworthiness was defined in the loan agreement as an increase or decrease of the borrower's credit rating of two or more rating grades (a change of two rating grades being, for example, from AAA to A or from BBB to AA). If the lender adjusted the interest rate, the borrower would be entitled to elect to pay off the loan immediately. The Court recognized that statements and valuations provided by expert witnesses regarding the step-up clause diverged substantially from each other, and, as such, the Court concluded that they gave little guidance as to the value of the step-up clause in the marketplace. The Court summed up that it is unclear how similar clauses are priced in the market, and that the facts and circumstances of the arrangement indicated that the parties regarded the clause as having no or very limited value.[228] Thus, the Court of Appeal upheld the decision made by the Oil Taxation Appeal Board.

ConocoPhillips Scandinavia AS (COPSAS) (2022).[229] In 2013 the Norwegian company COPSAS entered into a credit facility as borrower of 20 billion Norwegian kroner, with a maturity of five years. Until maturity, COPSAS was free to draw down or make repayments on the loan facility, i.e., the loan amount was flexible (revolving credit facility). The contractually agreed interest rate was 6M NIBOR plus 125 bps. The Oil Taxation Office adjusted the interest margin down from 125 bps to 75 bps.[230] Similar to the approach used in the Exxon case (above), the Oil Taxation Office calculated the arm's length range of interest margins using a set of index estimates derived from a number of commercial databases (Reuters Industrials, Bloomberg Industrials, Bloomberg Energy, Moody's Implied Ratings), two reports made by a Norwegian Bank (DnB), and a consultancy firm (Rann).

The taxpayer, COPSAS, argued that Oil Taxation Office should, when conducting the comparability analysis, rely on specific third-party loans issued to other companies operating on the Norwegian continental shelf. The Court of Appeals concluded, however, as the courts did in the Exxon case, that the Oil Taxation Office, by establishing the arm's length interest range based on the set of index estimates, had applied the CUP method in accordance with the OECD Guidelines. The Court further stated that, under the circumstances of the case, it was not contrary to the OECD Guidelines for the Oil Taxation Office to make comparisons without specific, identifiable loans.[231] COPSAS further argued that the Oil Taxation Office should have adjusted for certain economic characteristics of the disputed loan (e.g., flexible loan, issued in Norwegian currency, issued to subsidiary), and, had it done so, the contractually agreed interest margin of 125 bps would have fallen within the arm's length range established by the Oil Taxation Office. The taxpayer argued that the interest rate in the loan agreement should be considered to include payment for a commitment fee, i.e., a fee to the lender for making available to the borrower an amount equal to the contractual borrowing limit under the credit facility. The Court, on the other hand, opined that the Oil Taxation Office was not required to take into consideration costs, such as a commitment fee, which the parties had not considered at the time the contract was entered into but which they could have considered at that time. The Court further noted that it would produce adverse economic effects if a compensation for commitment fee were to be included in the interest payment for the drawn amount of the facility. This is because a commitment fee is generally tied to the amount of the credit facility that is not drawn down by the borrower, while the interest payment is tied to the amount drawn on the credit facility. The Court also put weight on the fact that the taxpayer's actual

[227] An overview of nine loans had been presented by the taxpayer.

[228] The case also concerned other issues than the application of the CUP method. In particular, it was discussed whether there was a basis — for tax purposes — to aggregate the outbound loan at dispute with an inbound loan, which the same taxpayer had received from another foreign group company. The inbound loan concerned a loan facility of 20 billion Norwegian kroner, issued some months prior to the disputed outbound loan, containing (almost) identical terms (e.g., the same loan amount, interest rate, maturity, and revision clause). Both loans were priced based on the group's general transfer pricing policy (e.g., based on a maturity of five years). However, the agreed maturity of the two loans was approximately nine to ten years. The taxpayer's argument was that if the interest rate of the disputed outbound loan was below the market rate, the same must apply for the inbound loan, as both loans were priced based on a maturity of five years, in accordance with group policy. Thus, if the two loans were aggregated, there would be no basis to regard the taxpayer's income as being reduced. The Court concluded, based on the facts of the case, that there was not such a commercial or legal connection between the two loans (entered into between different parties) that an aggregation for tax purposes could be justified.

[229] Gulating Court of Appeals, 2022-03-15. LG-2021-038180, *ConocoPhillips Scandinavia AS.*

[230] The parties in the loan agreement determined the interest rate based on an assumption that the credit rating of the borrower was in the category BBB (BBB+/BBB/BBB-). However, at the hearing before the Court of Appeals, the taxpayer accepted the assumption, made by the Oil Taxation Office in its assessment, that the credit rating of the borrower, adjusted for group affiliation, was A-. Therefore, since there is a clear relation between the credit rating and the pricing of the loan, the Court stated, as an introductory remark, that there existed a presumption that the loan was not priced at arm's length in the loan agreement since it was based on an incorrect credit rating of the borrower.

[231] The court did not accept a number of individual loans presented by the taxpayer as being sufficiently comparable to the loan at dispute. Twelve out of 14 loans presented were issued to the same two companies that were involved in a different business (separate from the exploration and production business) with a different risk profile. Also, one of the loans was a related party loan, and one loan was issued a few years later (2015) than the intercompany loan at dispute (2013).

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draw-down had turned out to be far from the full limit of the facility (an average draw-down of approximately 50%). According to the Court, a third-party borrower would not be expected to enter into a credit facility of a very high amount if only a limited amount was expected to be used. Further, according to the Court, the taxpayer had not been able to substantiate that the lender had financial capacity corresponding to its obligation to provide the full credit facility to COPSAS.

Another argument put forward by COPSAS was that if it had to establish an equivalent large credit facility in the market, the borrowing would need to have been made in USD, and thereafter converted to Norwegian kroner. Such a currency exchange would have resulted in currency swap costs for COPSAS, and such costs would need to be taken into account when considering the arm's length price of the intra group loan. The Court, on the other hand, opined that since the loan in the current case had been issued in Norwegian kroner and was to be repaid in Norwegian kroner, it would not be correct to price the loan as if it were issued in USD, then converted to Norwegian kroner and repaid in Norwegian kroner. In the view of the Court, such an approach would mean that a hypothetical transaction would be priced, not the transaction that the parties had actually undertaken. The Court also put some weight on the fact that the taxpayer had not been able to document that the lender had incurred any currency swap costs.

Finally, COPSAS argued that, in its capacity of being a subsidiary, it would need to pay a premium, compared to other borrowers in the market. This argument was not accepted, and, thus, the Oil Taxation Office's decision was upheld.

Currently, the most common approach used by the Norwegian Tax Administration seems to be to determine the Stand-Alone Credit Profile of the borrowing company and to make an upward adjustment to capture the effect of group affiliation and implicit support (the "bottom-up approach"). Since official ratings are usually not available for subsidiaries, commercial credit rating tools are used in the first step to determine a Stand-Alone Credit Profile. This analysis is based on financial data and is potentially adjusted for certain subjective elements (qualitative analysis). Alternatively, an official credit rating of the parent company may be identified, and a downward adjustment of the implicit support may be made, to arrive at the credit rating to be applied in pricing the loan (the "top-down approach"). A 2012 lower court decision (*Bayerngas*)[232] recognized that both the "bottom up" and "top down" approaches are acceptable in certain circumstances.

A qualitative analysis must be carried out for purposes of adjusting the credit rating for the effect of group affiliation/passive association. Key elements in this respect include the parent company's willingness and financial ability to provide support to the subsidiary during a period of financial stress. Additionally, the analysis should take into account other significant elements, such as the strategic importance of the subsidiary (core business or non-core business), the degree of integration, the reputational effect of a potential default, and the parent's credit rating and track record. In practice, an adjustment for group affiliation is made by adjusting the Stand-Alone-Credit Profile up by one or more notches ("notching up") or by adjusting the parent's official credit rating down by a determined number of notches ("notching down").

The administrative practice encompasses cases in which a Norwegian parent company is the group financial hub, raising all external loans and funding its subsidiaries with a combination of loans and equity. In its earlier practice, when determining the interest rate on the intra-group loans in such cases, the tax authorities had primarily followed a standardized methodology.[233] The starting point was the interest rate margin of the parent company on its external loans for the same period. The parent company's interest rate margin could be subject to change depending on changes of its loan portfolio. The margin required by the external lenders reflects an independent consideration of the creditworthiness of the group as a whole, including effects from synergies, etc. The external margin(s) paid by the parent was (were) then adjusted to reflect the weaker credit rating of the subsidiary concerned. This exercise involved elements of subjective judgment and was based on factors such as the subsidiary's solidity and cash flow (e.g., EBIT margin or EBITDA margin). It was sometimes appropriate to adjust for country-risk in the case of subsidiaries operating in parts of the world with high risk (high sovereign risk). Further adjustment could be required to cover administrative costs incurred and to provide the lender with an appropriate expected profit for the transaction. This approach had elements of a cost-plus methodology, as well as an internal CUP. The approach entailed more subjective adjustments than are entailed in the CUP approach that is primarily used today.

G. Financial Loan Guarantees

Since approximately the year 2000, the tax authorities have been paying attention to the pricing of financial loan guarantees. The administrative practice primarily concerns situations in which a Norwegian parent company has guaranteed an external loan raised by its foreign subsidiary. From the administrative practice, it can be deduced that legally binding loan guarantees should normally be remunerated on an arm's length basis.[234] On the other hand, no compensation will be recognized for non-binding, implicit guarantees such as comfort letters or the mere fact that an external creditor might expect the parent company to intervene should a subsidiary default.

The tax authorities' approach to financial guarantee pricing in the context of the fact pattern described above is similar to the approach they use in relation to loan pricing. The expected benefit approach (yield approach, saved interest approach) is normally used and accepted. Thus, the loan guarantee fee should reflect the amount of interest saved by the borrower on its external loan as a consequence of the parent company issuing an explicit guarantee. Current administrative practice is for the creditworthiness of the subsidiary to normally be determined on a stand-alone basis by applying credit rating tools. As in the case of a loan, the influence of group affiliation (implicit guarantee) on the credit scoring is not priced so that the subsidiary's stand-alone credit score must be adjusted ("notched up") in order to capture the implicit guarantee (for which no

[232] Utv. 2012, p. 1411, *Bayerngas.*

[233] Olsen and Magnussen, *Internprising — erfaringer fra Sentralskattekontoret for storbedrifter,* Praktisk Økonomi & Finans, Jan. 2010, at 56.

[234] 2002-021 OLN.

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consideration will be paid). The guarantee fee is determined based on the market data spread with respect to comparable loans.[235]

In their earlier practice, the tax authorities applied a more subjective approach.[236] The starting point was an observed guarantee fee or margin on loans paid by the parent to external lenders. Such a fee or margin reflected the creditworthiness of the group as a whole. The guarantee fee or margin paid by the parent was then adjusted to reflect the (normally lower) creditworthiness of the subsidiary in question. In making this adjustment, several factors were evaluated, such as the subsidiary's debt-to-equity ratio, cash flow (e.g., EBIT margin or EBITDA margin), and its country risk. Further adjustments were made to account for the fact that long-term guarantees normally are more expensive than short-term guarantees. In the overall assessment of the creditworthiness of the subsidiary, it was recognized that the subsidiary, if it carried on the core activities of the group of which it was a part, would enjoy a higher creditworthiness as a member of the group than it would have enjoyed on a stand-alone basis.

H. Cash Pooling

For more than a decade, the Norwegian tax authorities have been focusing on transfer pricing issues related to cash pooling arrangements. Such arrangements are common within groups but are rarely, if ever, entered into among unrelated parties. Cash pooling arrangements are instruments for pooling the financial positions of group members, with a view to facilitating cash management for individual group companies, reducing transaction costs, and benefiting from economies of scale when the combined group cash balance is deposited in an external bank.

In *ConocoPhillips Scandinavia AS (2010)*,[237] which was decided by the Borgarting Court of Appeals, two Norwegian upstream petroleum companies, COPSAS and NCOPAS, were participants in a cash pool established within the ConocoPhillips group. The participants established separate currency accounts with an external bank, and each group company could make individual deposits in or borrowings on their respective accounts. The balance of all the participants' deposits with and borrowings from the bank constituted a "top account" that was assumed to be positive at all times. The top account was administered by ConocoPhillips Treasury Ltd., a U.K. group-based company. The parent company, ConocoPhillips Inc., was a participant in the arrangement and was in reality a guarantor for the external bank, even though all participants were jointly and severally responsible. The bank paid interest at the London InterBank Bid rate (LIBID) minus 25 bps on positive balances on the top account and charged interest at the LIBOR plus 25 bps on negative balances. In general, LIBOR was 12.5 bps higher than LIBID, resulting in a 62.5 bps difference between the deposit rate and the borrowing rate with the bank. Within the pool, each participant received LIBID minus 25 bps on its balance, irrespective of whether its balance was positive or negative (i.e., the deposit rate and the borrowing rate were identical). The Norwegian entities, COPSAS and NCOPAS, had substantial deposits in the cash pool in the relevant period, on average amounting to 3.8 billion Norwegian kroner combined. At the same time, NCOPAS had long-term debt, outside of the cash pooling arrangement.

The Oil Taxation Appeal Board adjusted the income of the Norwegian participants, concluding that an interest rate of LIBID minus 25 bps on both deposits and borrowings represented an asymmetrical allocation of the "coordination benefit"[238] obtained by the participants through the cash pool arrangement. In the view of the Appeal Board, an interest rate of LIBID minus 25 bps was highly favorable for the borrowers in the pool at the expense of the depositors. In its discretionary assessment, the Oil Taxation Appeal Board did not disturb the identical deposit and borrowing rate feature but adjusted both rates by 50 bps to LIBID plus 25 basis points.

The Court of Appeal upheld the assessment and concluded that the Norwegian taxpayers' income in the cash pool had been "reduced" and that there was a basis for the discretionary assessment of income. The Court acknowledged that the cash pool arrangement was commercially plausible, reduced costs for the entire group, and enabled the individual participants to obtain a more favorable interest rate than they could have obtained individually. Nevertheless, the Court held that this should not prevent the tax authorities from adjusting the income of one of the participants in accordance with the arm's length principle.[239]

The Court was not convinced by the taxpayers' reliance on the fact that the deposit rate individual participants earned in the pool was the same as what the group earned on its deposits with the external bank.[240] The Court stated that there was no direct link between the deposit rate that the group earned on its "top account" with the external bank and the deposit rate within the cash pool arrangement. The Court explained that if the comparison to be made was with ordinary bank deposits, it would simply disregard both the cash pool framework of the actual transactions and the issue of allocating the coordination benefit between the participants. In the view of the Court, the decisive criterion was whether the deposit rate agreed upon in the cash pool was lower than what it would have been if the participants in the pool had been independent parties.

Another argument of the taxpayers was that the interest earned in the pool should be compared with the interest independent parties would have earned had they entered into a comparable arrangement, taking into account the transaction costs that would have been incurred in such circumstances: the result would have been a net income lower than what was actually earned. The state countered that it would not be correct to take into account transaction costs that had not been incurred in the actual cash pool, as this would entail completely disregarding the coordination benefit derived from the arrangement. The Court stated that it understood the OECD Guidelines and

[235] Example 2 in Chapter 1 of the 2017 OECD Guidelines is in line with the Norwegian administrative practice.

[236] 2002-021 OLN, 2005-010 LN.

[237] Utv. 2010, p. 199, *ConocoPhillips Scandinavia AS*.

[238] The "coordination benefit" was the term used by the Court for the total benefit that the cash pool arrangement generated for the group as a whole.

[239] §13-1 of the Tax Act.

[240] The taxpayers also emphasized (citing a memo prepared by Ernst & Young) that they would not have obtained a higher interest rate had they deposited their funds directly in an external bank, and that the participation in the pool in fact had increased their interest income compared to their best alternative available option.

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Norwegian case law to mean that "when determining the arm's length price one shall take into account all the characteristics of the controlled transaction, except the parties' relationship with each other."[241] The Court went on to state that if it was accepted that the coordination benefit was offset by the additional transaction costs that independent parties would have incurred, the driving economic rationale for the establishment of the whole cash pool arrangement would be lost, which would render irrelevant the question of what interest rate independent parties in a comparable cash pool would have agreed on.

The Court concluded that an interest rate of LIBID minus 25 bps represented an asymmetrical allocation of the coordination benefit that too heavily favored those companies with borrowing needs at the expense of those with a cash surplus.[242] The Court therefore found that the income of the Norwegian taxpayers in the cash pool had been "reduced" and that there was a basis for discretionary assessment of their income.

With regard to the interest rate established by the discretionary assessment (i.e., LIBID plus 25 basis points), the Court observed that the oil taxation authorities had taken the right approach being that the coordination benefit should be allocated based on the respective participants' contributions.[243] The Court therefore upheld the discretionary assessment, finding it to be neither arbitrary nor excessively unreasonable.

I. Captive Insurance

Many of the oil companies operating on the Norwegian continental shelf have insured their installations and other risks with a related-party insurance company within the group (a "captive"). The captive is typically located abroad and subject to favorable tax rules. Premiums paid by the oil company to ensure assets used in its extraction business are deductible in computing both the general income tax and the special petroleum tax. As such, there is a strong incentive for oil companies operating on the Norwegian shelf to use such arrangements for tax-planning purposes. Although focusing their efforts on oil companies, the tax authorities have challenged captive insurance arrangements in other industries as well.

Captive insurance arrangements give rise to two main issues:

(i) whether the premiums paid under the arrangement are deductible at all; and

(ii) whether the pricing of the premiums charged is at arm's length.

The first issue arises because self-insurance is not recognized under Norwegian tax law, implying that deductions are not given if the taxpayer sets aside reserves for the insurance of its own property or business. Thus, in considering whether premiums paid to a captive insurance company are deductible, the decisive question is whether there has been a real transfer of risk from the taxpayer to the captive.

This issue has been addressed by the Supreme Court on two occasions. In *Dowell Schlumberger (Eastern) (DSE)* (1995),[244] DSE carried out service activities on the Norwegian continental shelf. In 1983 and 1984, the company claimed deductions for insurance premiums paid to Tower Assurance Company Ltd., Bermuda (Tower), a captive insurance company that insured risks solely for members of the group. The Appeal Board denied deductions for the premiums paid for non-property risk insurance. According to the Appeal Board, no real insurance arrangement had been established (i.e., the risk had not been transferred to Tower).

On appeal, the Supreme Court stated that the premiums would be deductible if "real insurance" coverage had been purchased. The legal point at issue, which had both a formal and a substantive aspect, was whether risk had been transferred from DSE to Tower. Since the requirement that there be a formal agreement under which the risk was transferred to Tower was met, the real issue was one of substance-over-form (i.e., whether Tower had the capacity to cover claims under the policy). The Court observed that such capacity could be achieved by reinsuring the risks, by building up funds within the captive, or by a combination of the two. The Court went on to state that assessing the captive's solidity and risk exposure required a comparison with what independent insurance companies regarded as necessary when insuring comparable types of risks. For the insurance premiums to be deductible for the paying company, it was also necessary that the captive should be subject to regulations, supervision, and control with respect to the safeguarding of policyholder rights in the same manner as other insurance companies: otherwise, there would be no real transfer of risk.

The Supreme Court upheld the assessment, finding that it was unclear whether Tower had the financial capacity to bear the risks insured. Neither the policies in question nor any other policies concerning non-property risk had been reinsured, and DSE had failed to provide adequate evidence to substantiate the proposition that Tower had sufficient financial solidity to bear the insured risks.[245] In reaching its decision, the Court pointed out that the tax authorities were clearly entitled to require the provision of the requested information. The taxpayer is responsible for providing documentation to establish that the conditions for the granting of a tax deduction are fulfilled, a responsibility with which DSE had failed to comply. The Court stated that the fact that the requested information concerned another legal entity (i.e., Tower), which was resident in another juris-

[241] Author's translation.

[242] In reaching this conclusion, the Court observed that: (i) LIBID minus 25 bps was closer to a CUP for isolated deposits than to a CUP for isolated borrowings; (ii) adjustments had to be made for differences in terms of creditworthiness between an investment in the cash pool and an investment in an external bank; (iii) capital was the scarce commodity in the pool and that it was deposits that made favorable borrowing within the pool possible; and (iv) it would be reasonable to allocate the coordination benefit in proportion to the contribution made by each participant.

[243] The Court noted in this context that the discretionarily assessed interest rate seemed to allocate a substantial portion of the coordination benefit to the net depositors. It was not convinced by the taxpayers' argument that depositors and borrowers in fee negotiations tend to divide a benefit in equal shares, which the Court characterized as a "theoretical assertion" that could not prevail over a legally derived principle that a coordination benefit is allocated between participants based on their respective contribution to the creation of the benefit.

[244] Rt. 1995, p. 124, *Dowell Schlumberger (Eastern).*

[245] The Oil Taxation Office had asked DSE for detailed information to enable it to evaluate whether Tower had sufficient financial solidity. DSE's response was generally somewhat vague, and in some instances no response was given at all, with DSE citing confidentiality considerations and internal restrictions. For instance, Tower did not present its financial accounts and failed to provide information about the total amount insured and the premiums received.

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diction and not controlled by DSE, could not exempt DSE from its duty to document the basis for the deduction. In summing up, the Court stated that, where a deduction is claimed with respect to an intra-group transaction, the taxpayer must provide the information necessary to establish that the transaction is a genuine transaction. When the taxpayer fails to do so, the consequence will be the denial of the deduction.

In *Amoco Norway* (2002),[246] the facts were somewhat different, with Amoco Norway having placed its insurance with two independent insurance companies: Riunione Adriatica Di Sicurta (RAS) and American International Reinsurance Company Ltd. (AIRCO). All the risks that RAS and AIRCO had assumed from Amoco Norway were reinsured with Northern Resources Assurance Inc. (Northern), a pure captive in the Amoco group. Northern had reinsured a part of the risks in the international insurance market and had retained a part of the risks on its own account. The parent company, Amoco Corp., made declarations in which it committed to taking the necessary action to ensure that Northern would be capable of fulfilling its obligations to RAS and AIRCO. The Court regarded these declarations as legally binding guarantees. Furthermore, any payment made to Amoco Norway under the insurance policies was subject to the prior acceptance of Northern, which was to make a contemporaneous payment to RAS and AIRCO under the reinsurance agreement. Under this arrangement, RAS and AIRCO acted as fronting companies, which administered the policies and had no economic risk, besides acting as guarantor for the solvency of Northern and the parent company, Amoco Corp. As consideration for these services, RAS and AIRCO received a flat fee of approximately 1% of the insured amount.

The question before the court was whether Amoco Norway was entitled to deductions for that part of the premiums that related to the risks Northern had not reinsured but had retained on its own account. The state argued that, considering the arrangement as a whole, Amoco Norway had insured its risks with Northern. The fact that the insurance was formally placed with RAS and AIRCO was irrelevant since these companies had no real insurance function. The state further argued that Northern did not have the financial capacity to bear the risks it had assumed. In this respect the Oil Taxation Appeal Board had focused particularly on the exposure ratio (maximum pay-out for one accident/the captive's solvency capital). Northern had an exposure ratio of more than 100% (i.e., the captive would not be able to cover even one maximum loss).[247] The economic reality of the arrangement was that reserves had been set aside within the group and no real purchase of insurance had been made.

The Supreme Court overturned the assessment, with the majority of the judges concluding that the Amoco captive insurance arrangement qualified as performing a genuine insurance function. The decisive point was that risk had been shifted from Amoco Norway to another enterprise, which had the financial capacity to bear that risk.[248] The fronting companies were legally obligated to cover claims and had the financial capacity to do so, irrespective of the financial strength of the captive. The underlying economic risk allocation between the fronting companies and the captive was irrelevant as long as Amoco Norway was released from the risk.

In other cases, where the captive was regarded as having a real insurance function and the premiums were deductible, the tax authorities have challenged the pricing of the premiums and have successfully argued that such pricing was set too high.

In *Norsk Agip AS (Agip)* (2001),[249] Agip held a license in the Ekofisk oil field together with several other companies (companies B, C, D, and E). Each licensee had entered into an insurance arrangement to cover physical damage to the installations. Agip was part of an insurance arrangement with an independent insurance company that acted as a fronting company and reinsured 100% of the risks with Finas, a Bermuda-registered, tax-exempt insurance captive owned by the group which Agip belonged to. Finas had partly reinsured the risks with an insurance pool, Oil Insurance Ltd. (OIL), using "wrap-around" insurance in the market. For the tax years in question (1986 and 1987), the insurance coverage was based on the written values of the installations (Actual Cash Value or ACV). In prior years, the insurance coverage had been based on replacement cost (Full Replacement Value or FRV). The reason for the insurance arrangements being based on ACV for the years in question rather than FRV (which was commonly used) was that the reinsurance with OIL was based on ACV.[250]

The Appeal Board concluded that Agip had entered into an insurance arrangement with Finas (the fronting company was regarded as supplying a fronting service only) and that the arrangement was a genuine insurance arrangement.

Agip claimed deductions for insurance premiums of US $11.1 million and US $9.5 million for 1986 and 1987. Based on FRV (which was known at the time) this represented a premium percentage of 1.15% and 0.94% for 1986 and 1987, respectively. However, Agip's insurance coverage was based on ACV, not FRV, and since the Appeal Board had not been provided with information about the ACV,[251] it was necessary for the Appeal Board to estimate the ACV in order to calculate Agip's premium rates (which was the key indicator used by the Appeal Board in the comparison with premiums paid by other companies). The Appeal Board estimated ACV to constitute 70% of FRV, implying that the premium percentage used by Agip was 1.64% for 1986 and 1.35% for 1987.

Based on a comparison with the premium rates paid by the other major licensees in the Ekofisk oil field (companies B, C, D, and E), the Appeal Board found that the premium rates

[246] Rt. 2002, p. 1247, *Amoco Norway*.

[247] Although not decisive for the outcome, the Supreme Court agreed with the Oil Taxation Appeal Board that the exposure ratio is a key factor when testing the solvency of a captive and that Northern clearly did not have the financial capacity that would be required by a valid insurance company.

[248] When the captive's financial capacity to cover the claims was considered, a question also arose as to how much weight should be given to the guarantees provided by a parent company. Citing *Dowell Schlumberger (Eastern)* (1995), the Court found the guarantees immaterial in this respect. A condition for claiming tax deductions required that the real insurer be subject to the control and supervision (in respect of safeguarding the policyholder's rights) generally applicable to insurance companies. This was not the case with the parent company, Amoco Corp.

[249] Rt. 2001 p. 1265 *Norsk Agip AS*.

[250] Another feature of the insurance was the particularly low own-risk assumed by Agip (US $3,260 for 1986 and US $32,600 for 1987). Also, unlike the other licensees, Agip had arranged for insurance coverage for wave damage.

[251] Agip claimed before the court that the ACV would not be stipulated until after an accident had occurred and therefore was not known.

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actually paid by Agip were excessive as compared to market rates and should be determined based on discretion.[252] When assessing what would be the appropriate premiums to be paid by Agip, the Appeal Board restructured two elements in the controlled transaction because it did not regard these elements as commercially justified from a commercial point of view and did not believe that Agip should have paid additional premiums for them.[253] When assessing what premiums should have been paid, the Appeal Board did not restrict the comparison to the premium rates paid by the four other licensees but took a broader approach and included, among other things, general market information as provided by an expert witness. Accordingly, the Appeal Board accepted deductions for premium rates corresponding to 1.11% for 1986 and 1.05% for 1987, and disallowed deductions for the excess amounts on the grounds that they were excessive as compared to market premiums.

The Supreme Court upheld the Appeal Board's decision. The Court relied on the OECD Transfer Pricing Guidelines when reviewing the Board's interpretation and application of the arm's length principle in domestic law provision, indicating that the OECD Guidelines "more precisely express the substance of §13-1 of the Tax Act," an important clarification of the status of the OECD Guidelines in Norwegian domestic law.[254] The Court remarked that the relevant comparison is with "market conditions" but opined that in this particular case a comparison with the other major licensees in the Ekofisk oil field would provide the best available indications of market conditions since comparable transactions between independent parties were not available. The OECD Guidelines were adapted to the situation of the case at hand because they allowed the use of "other methods."[255] In this case, the Court accepted that the premiums paid by Agip could be compared to the premiums paid by three other licensees in the field, which had also used captive insurance arrangements.

The Court therefore went on to consider whether the Appeal Board's determination (and adjustment) of Agip's insurance terms was acceptable and whether the estimated premium rates for Agip were comparable to the premium rates paid by the other licensees. The Court reached three conclusions:

> (i) The Appeal Board estimate that the ACV constituted 70% of the FRV was reasonable and acceptable,[256] in view of Agip's failure to provide documentation as requested at the assessment stage and its admissions made in relation to earlier income years (when the insurance was based not on ACV but on FRV), and statements from third parties;
>
> (ii) The substantial low own-risk that Agip had assumed could be disregarded; and
>
> (iii) It was not commercially irrational for Agip to arrange for wave damage insurance.

The Supreme Court accepted the Appeal Board's estimate of Agip's premium rates[257] and therefore that Agip's income had been "reduced." The Appeal Board was entitled to exercise its discretion to assess accordingly, and the Court found no reason to annul the discretionary assessment it had made.

In *Agip*, the tax authorities' primary approach had been to compare premiums paid by the taxpayer with premiums paid by other policy holders (direct price comparisons). In other cases, intra-group insurance premiums were priced indirectly, by way of a mark-up on the costs incurred by the captive on its re-insurance of the risks in the market. One example of this is provided by *Fina* (2003), which was decided by the Borgarting Court of Appeals.[258] In *Fina*, one of the main questions was whether the cost-plus method used by the Oil Taxation Appeal Board represented an acceptable approach. The two insured (and reinsured) risks in question were physical damage to installations on the Ekofisk oil field and production shutdown. The focus was on the terms of the reinsurance and the (adjusted) reinsurance costs incurred by the captive, to which a mark-up had been added by the Appeal Board. The Court referred to paragraph 2.7 of the 1995 OECD Guidelines and stated that if "reasonably accurate adjustments can be made," the "CUP method is the most direct and reliable way to apply the arm's length principle." However, the Court was of the opinion that in this case the cost-plus method required fewer and less complex adjustments compared to the adjustments that would be required if direct price comparisons were to be made. The cost-plus method used by the Appeal Board was accepted by the Court, since it regarded that method as being more suitable to the case concerned than a CUP method.

The current administrative practice of the Norwegian oil taxation authorities is to use cost-plus approaches more often than direct price comparisons when testing and pricing captive insurance premiums.

Another issue in *Fina* was whether the pricing of Fina's insurance premium should be considered on a stand-alone basis or whether it would be relevant to take into account the fact that it was a coordinated strategy for other group companies also to place their insurance with the captive. The coordinated strategy and the consequent pooling of the insurance of the group companies gave the captive access to cheaper reinsurance premiums than it would have had if only Fina's risks had been reinsured. The Court agreed with the tax authorities that such coordinated action on the part of the group companies, which gave rise to economies of scale and cost savings for the captive, should be taken into account in determining the insurance premium to be paid by Fina. The Court endorsed a statement from the city court's decision to the effect that "in the determination of the arm's length price, it is Fina's association with the captive that should be ruled out, not Fina's coordinated behavior with other group companies."[259] The Court noted that if the captive had been an unrelated enterprise, such coordinated

[252] Three of the other licensees had, like Agip, insured the physical installations with a captive insurance company. One licensee had entered into a group insurance arrangement with an independent party under which the assets were insured jointly on a worldwide basis.

[253] The insurance of the wave damage risk and the particularly low "own-risk" taken on by Agip.

[254] *See* VI.A.6., above.

[255] In this case, the comparisons were made with transactions between related parties.

[256] Agip had argued that the ACV was higher than 70% of the FRV, in which case Agip's premium rates would have been lower.

[257] Except for the Appeal Board's disregarding of the wave damage insurance (which was of minor importance and could not result in the assessment being annulled).

[258] Utv. 2003, p. 531, *Fina*.

[259] Author's translation.

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behavior would lead to an improved bargaining position over the position where Fina acted on a stand-alone basis. It therefore concluded that the "group discount" deriving from the coordinated behavior of the group companies should be attributed proportionally to Fina and the other operating sister entities in the group. While not finding it necessary to decide whether the group discount should be fully attributed to Fina and its sister companies or whether the captive should also be attributed a portion, the Court pointed out that a portion to be attributed to the captive would, in any case, be modest. As noted above, the Court upheld the assessment made by the Appeal Board.

J. Synergies

The 2017 update to the OECD Guidelines introduced new guidance on synergies,[260] which provides that synergic benefits arising from deliberate, concerted group actions that provide a group member with material advantages not typical for comparable independent companies generally should be shared by the members of the group in proportion to their creation of the synergy.

There are examples in Norwegian administrative practice and case law that align well with this new guidance on synergies. The case *Fina (2003)*[261] stands for the proposition that a "group discount" arising from the collective behavior of the group members should be allocated proportionally between the group members. In *Fina,* the synergic benefit (the group discount) was allocated directly to Fina and the other policy holders in the group using a methodology based on a mark-up on the captive's reinsurance costs to price the insurance premiums.

Another example is provided by *ConocoPhillips Scandinavia AS* (2010),[262] in which the Court concluded that the "coordination benefit" arising from the cash pool arrangement should be allocated to the members of the cash pool in proportion to the contributions made by each participant. The Norwegian tax authorities had not attempted to measure the "coordination" benefit because of the challenges involved, in particular for a tax authority that is only assessing one outer company in the group. Instead, a portion of the "coordination" benefit was allocated to the Norwegian entity by adjusting the internal deposit rate applied in the cash pool.

[260] *See* OECD Guidelines, 1.157–1.162.

[261] *See* IX.I., above.

[262] *See* IX.H., above.

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X. Reporting and Documentation Requirements

A. General Reporting Requirements

The taxpayer's obligation to submit information to the tax authorities is contained in Chapter 8 of the Tax Administration Act. The law requires that a taxpayer must provide correct and complete information and must act loyally and in good faith so that his or her tax liability may be timely clarified and fulfilled.[263] Such information must be submitted in the tax return and the business statement in connection therewith. The tax return must contain the taxpayer's total net wealth, as well as the gross income and deductible expenses for the taxable year. As from 2024 (financial year 2023) enterprises must submit the tax return through an annual report and account system.[264] Taxpayers who carry on a business must submit a statement containing the enterprise's gross income (operating income, financial income, etc.) and deductible expenses as an integrated part of the tax return. Depending on the facts and circumstances of the case, the taxpayer may be obliged to provide more detailed information than what is generally provided.

The obligation to submit a tax return rests with all taxpayers who are liable to pay taxes, according to Norwegian domestic law.

Fundamental statements concerning the extent of the information requirement were provided by the Supreme Court in *Loffland* (1992).[265] The Court stated that a taxpayer has fulfilled his or her obligation if the taxpayer "submitted all the information one could objectively expect." It further stated that the obligation would normally be satisfied if the submitted information provides the tax authorities with "a sufficient basis to further examine the particular tax matter in question — for example, by requesting additional information from the taxpayer." The *Elf* case (1997) illustrates that figures given in the financial accounts may need to be accompanied with further explanations.[266] Hence, the statement in the *Loffland* case which put a duty on the tax authorities to investigate the matter on the basis of the information provided by the taxpayer, needs to be balanced with the taxpayer's obligation to submit the relevant information required for a timely clarification of the tax liability with due care.[267]

Generally, taxpayers who are not subject to the special transfer pricing documentation requirements[268] may in many cases be subject to the general rules described above and be required to submit information about transactions actually carried out with related parties. The comprehensiveness of this obligation in a particular case may be unclear, however. The Ministry of Finance has stated that the taxpayer is required to inform the tax authorities that controlled transactions have been carried out. The extent to which these general rules require the taxpayer to account for more detailed information about such transactions and how prices are determined is less clear.[269]

Upon request from the tax authorities, the taxpayer is required to submit any information that may be of importance for the taxpayer's bookkeeping, its tax liability, and the control thereto. This includes, among other things, information related to accounting books, vouchers, contracts, correspondence, minutes of board meetings, electronic programs, and systems.[270]

B. Special Transfer Pricing Reporting and Documentation Requirements

1. Introduction

Special transfer pricing reporting and documentation requirements were introduced in December 2007. The reporting requirements took effect in 2007, and the documentation rules became effective as of January 1, 2008. The special rules continued and are now anchored in §8-11 of the Tax Administration Act and supplemented by §8-11 in regulation no. 1360, issued on November 23, 2016. These rules supplement and expand the general reporting and documentation rules set forth under §8-1 of the Tax Administration Act. They apply to cross-border, as well as domestic transactions. Cross-border dealings between a permanent establishment and other parts of the enterprise are also covered by the rules.

Although the documentation requirements are chiefly aligned with international standards, they are not adapted to the recommendations from the first and second pillar of the BEPS Action 13 outcome (Master File and Local File), now included in Chapter V of the OECD Transfer Pricing Guidelines (2022).

The reporting requirements are less burdensome than the documentation requirements but apply to a broader range of entities. Failure to comply with the reporting requirements will subject the taxpayer to sanctions in accordance with the general penalty rules in the Tax Administration Act.[271]

More detailed guidance is provided in the Transfer Pricing Documentation Guidelines, issued by the Tax Directorate on December 7, 2007.[272], and on the Tax Administration's website.[273]

2. Persons Subject to the Special Requirements

Provided that certain thresholds are surpassed, the special reporting and documentation rules apply to companies and entities obliged to file a tax return or a "company return" in Norway.[274] Hence, the rules apply to private and public limited companies, various types of partnerships, and associations and other types of taxable entities.

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[263] Tax Administration Act, §8-1.

[264] The previous electronic submission of the tax return and appendixes through Altinn (web portal for digital communication between citizens, business, and public administration) has been substituted by submission through an annual report and account system that provides for reporting through a standardized digital format.

[265] Rt. 1992, p. 1588, *Loffland.*

[266] Rt. 1997, p. 1430, *Elf.*

[267] *See e.g.,* Supreme Court in Rt. 1995, p. 1883, *Slørdahl.*

[268] *See* X.B., below.

[269] Ot. prp., no. 62 (2006–07), p. 32.

[270] Tax Administration Act, §10-1.

[271] *See* XI., below.

[272] Norwegian Tax Directorate, Guidelines for transfer pricing (Norwegian text only), https://www.skatteetaten.no/contentassets/a756fabd4bd44060a8cbdc7dac52e8d7/skattedirektoratets-retningslinjer-.

[273] Tax Administration's web site (information available in the English language) Report and document transfer pricing information — The Norwegian Tax Administration (skatteetaten.no).

[274] Partnerships shall file a company return (a specification of its income and expenses).

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In order to strike a balance between the compliance burdens levied on taxpayers and the benefit for the tax authorities, the special reporting and documentation requirements apply if certain thresholds are met. The rules generally do not apply if the taxpayer has:

- during the income year, controlled transactions with an aggregate fair value of less than 10 million Norwegian kroner, and
- as per the end of the income year, accounts outstanding with associated companies or entities in an amount of less than 25 million Norwegian kroner.[275]

The taxpayer must be below both thresholds if it is to be exempt from the duty to comply with the special rules. In the calculation of the 10 million Norwegian kroner threshold, the taxpayer's total controlled transactions with all associated enterprises are taken into account. The valuation standard relevant to the 10 million Norwegian kroner threshold is the fair market value. In relation to the 25 million Norwegian kroner threshold, the term "accounts outstanding" is defined in the regulations as "all types of accounts receivable and accounts payable, as well as guarantees." Hence, in the calculation of the 25 million Norwegian kroner threshold at the end of the income year, total accounts receivable and all types of debt and all guarantees, operational as well as financial, are taken into account.

Transactions that must be reported and documented under the special reporting and documentation rules are transactions carried out between the taxpayer and "associated companies or entities." The term associated companies or entities" is defined in §8-11, no. 4, of the Tax Administration Act, as:

> (a) any company or entity that, directly or indirectly, is at least 50% owned or controlled by the entity obliged to specify or document;
>
> (b) any individual, company or entity that, directly or indirectly, has at least 50% ownership of, or control over, the entity obliged to specify or document;
>
> (c) any company or entity that, directly or indirectly, is at least 50% owned or controlled by any entity that is deemed to be an associated party pursuant to (b) above; and
>
> (d) any parent, sibling, child, grandchild, spouse, cohabitant, parent of a spouse, and parent of a cohabitant of any individual who is deemed to be an associated party pursuant to (b) above, as well as any company or entity that, directly or indirectly, is at least 50% owned or controlled by such individuals.

In short, companies or entities are associated if one directly or indirectly owns or controls the other by at least 50%, or both are under common ownership or control by an individual or entity that controls at least 50% of the company. Individuals, who are not themselves subject to the special reporting and documentation requirements, may be deemed to own associated entities through common ownership.

In addition, the reporting and documentation requirements apply to dispositions between a foreign company or entity and its Norwegian permanent establishments, and between a Norwegian company or entity and its foreign permanent establishments. In relation to these rules, the term "permanent establishment" has the same meaning as under the applicable tax treaty. Where no tax treaty applies, the term "permanent establishment" has the same meaning as defined in Article 5 of the OECD Model Tax Convention.

Companies and entities subject to the special reporting and documentation rules, but that belong to a small- or medium-sized group are exempt from the documentation requirements (but not from the reporting requirements). Companies and entities are exempt from documentation requirements if the company or entity has less than 250 employees and either:

- a turnover not exceeding 400 million Norwegian kroner, or
- assets (as valued in the financial statements) not exceeding 350 million Norwegian kroner.

These thresholds are measured at the group level.[276] This implies that a small Norwegian subsidiary of a large multinational group will be covered by the documentation rules. Companies and entities that are part of a small- or medium-sized group that are not generally covered by the special documentation rules are obliged, however, to prepare documentation under the special rules for specific transactions undertaken with associated companies or entities resident in a state from which Norway may not require tax information according to a treaty. Furthermore, the documentation exemption for small- and medium-sized groups does not apply to companies that are subject to the special petroleum tax in the Petroleum Tax Act.

3. The Reporting Requirement

Taxpayers subject to the specific transfer pricing reporting requirement must file the required information as an integrated part of the tax return and the business statement that must be filed in connection therewith.[277] It provides the tax authorities with a basis for identifying taxpayers and transactions that should be further investigated. The following information is required:[278]

- the taxpayer's legal relationship with associated entities;
- name and domicile of the ultimate parent company of the group;
- the number of associated entities with which the taxpayer has conducted transactions in Norway and abroad, respectively;
- the taxpayer's EBIT (amount and percent of turnover) and its profit before tax;

[275] Regulation no. 1360, November 23, 2016, §8-11-1.

[276] The group level consists of the taxpayer and its associated companies and entities according to §8-11, no. 4, in the Tax Administration Act.

[277] Beginning 2024 (financial year 2023) the required information constitute an integrated part of the tax return and the business statement that must be submitted in connection therewith. Thus, the transfer pricing form (Form RF 1123) that had to be filed until 2023 (fiscal year 2022) as attachment to the tax return is no longer in operation. However, the information taxpayers are obliged to file in 2024 for fiscal year 2023 is materially the same as before.

[278] In the case of partnerships, which are transparent for tax purposes and not obliged to file a tax return, if a tax return is filed, it must be attached to the partnership return.

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- the group's consolidated EBIT as percent of turnover (data from last preceding year may be used);
- the taxpayer's main business activities and risk profile (e.g., fully fledged distributor, limited risk distributor, commissionaire, agent);
- the taxpayer's costs incurred in relation to self-development of intangibles;
- numbers of patents, trademarks, etc., registered;
- whether the taxpayer has been subject to any acquisitions or any other form of reorganization; and
- whether there have been material changes in the functions carried out, risks assumed, and assets used.

In addition, information about a number of specific listed categories of controlled transactions and inter-company "dealings" carried out during the income year is required. The gross amount in each category must be specified. In relation to each category of transactions, the taxpayer must indicate whether the share of controlled transactions constitutes more or less than 50% or 100% of the total transactions in that category. Further, in relation to each category of transactions, the country code of the related-party or parties must be listed. Likewise, and in the same manner, the taxpayer must specify the amount of intra-group debt and intra-group accounts outstanding at the year-end, as well as the amount of intra-group guarantees.

4. Documentation Requirements

Transfer pricing documentation must be submitted upon request from the tax authorities but is not otherwise filed. The time limit is 45 days after the request is made. The documentation must provide a basis for evaluating whether the terms of controlled transactions have been determined in conformity with the arm's length principle. The documentation must contain the information, explanations, and analyses outlined in §8-11-4 through §8-11-13 in regulations no. 1360. A principle of proportionality applies, implying that the scope of the information, explanations, and analyses must be adapted to the economic size and complexity of the controlled transactions and provide information enabling the tax authorities to evaluate whether the terms of a transaction are at arm's length. The documentation must be organized in a readily understandable manner. If it is extensive, it must contain a summary.

It is optional to prepare and submit the documentation in the format recommended in Chapter V of the OECD Guidelines (2022) (i.e., as a Master-file and a Local-file) as long as all of the information required by Norwegian law is included.

The documentation must include a company analysis. The purpose is to provide the tax authorities with a general overview of the taxpayer and the group, their business, and the market(s) in which they operate. The documentation must contain a description of the legal ownership structure and the operational structure of the group, as well as a description of the most important business areas and the geographical affiliation of the various entities. A brief historical description of the group must be provided, including previous reorganizations. In addition, a brief description of the industry in which the taxpayer operates is required. The documentation must also include financial information concerning the turnover and operating profits and losses for the last three years of the taxpayer and other enterprises in the group with which the taxpayer has had controlled transactions during the income year.

As stated above, the documentation must include a description of the controlled transactions that the enterprise has been involved in during the income year. Similar or closely related transactions may be described jointly but must contain a summary of the transactions in aggregate. Furthermore, the transactions must be described in relation to the five economically relevant characteristics and comparability factors described in Chapter I of the OECD Guidelines that may influence price setting. The five relevant factors are:

- characteristics of the property or services,
- functional analysis,
- contractual terms,
- economic circumstances (market analysis), and
- business strategies.

A functional analysis must be included in the documentation to provide the tax authorities with the factual and economic information governing the controlled transactions, and thereby provide a basis for identifying comparable uncontrolled transactions. The functional analysis is important for the understanding of the business model of the group and for the selection of the most appropriate transfer pricing method. The functional analysis must describe what functions each of the parties participating in the controlled transactions perform, what assets they use, and what risks they assume. The economic significance of various functions, assets, and risks must be addressed, as this influences the profit or loss normally attributed to them.

In the regulations, particular attention is paid to centralized services and intangibles. If centralized services are provided, including services of an administrative, technical, and financial nature, a taxpayer receiving such services must explain its expected benefit from the services. In case of cost-based allocation or price setting, the taxpayer must explain the cost base, the allocation key, and any mark-up. Furthermore, intangible property that is of relevance to the evaluation of the controlled transactions must be described. The description must include specification of the ownership, utilization, development, and maintenance of the intangible property.

The documentation must also include an explanation of the price-setting used in the controlled transactions, the rationale for the method chosen, and an explanation as to how the price resulting from the use of such a method is deemed to be in conformity with the arm's length principle. Furthermore, it must specify the extent to which the price-setting method is compatible with the methods described in Chapters II and III of the OECD Guidelines.

As a principal rule, the documentation must contain a comparability analysis in which the prices and terms in the controlled transactions are considered in relation to comparable transactions entered into between independent parties. However, if no internal comparable transactions exist, and it would be unreasonably difficult or costly to gather and process information concerning external comparable transactions, the documentation obligation is deemed to have been met without a comparability analysis. In such cases, the taxpayer must explain the absence of an analysis and provide an explanation of

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the financial evaluations that were the basis for the price-setting that took place and the rationale for conformity with the arm's length principle. Based on an evaluation of the information in the documentation provided, the tax authorities may request, however, that the taxpayer prepare and submit a comparability analysis (including a database analysis). In such a case, the taxpayer must be given a 60–90-day timeframe in which to comply with the request.

It is not necessary to document the pricing of immaterial transactions. Transactions are deemed to be immaterial if they are entered into independent of a larger purpose, of limited economic significance, and not a part of the core business of the enterprise. It must be specified in the documentation what type of controlled transactions the taxpayer has regarded as being immaterial, however.

The documentation may be prepared in Norwegian, Swedish, Danish, or English.

C. Reporting Requirements Regarding Sale of Natural Gas

Effective July 1, 2012, special reporting requirements apply in relation to the sale of natural gas. The requirement is anchored in §8-10 of the Tax Administration Act and §8-10 of the regulation no. 1360, issued on November 23, 2016.

The reporting requirements apply to all sales of natural gas from the Norwegian continental shelf that are subject to the special tax in the Petroleum Tax Act (and a combined, total tax of 78%).[279] Sales of natural gas liquids (NGL) and condensate are exempt. The Oil Taxation Office (OTO) has been delegated authority to exempt a taxpayer wholly (provided that sales volumes are small) or partly from the reporting requirements.

The reporting requirements apply to sales between unrelated parties, related parties, and from a Norwegian permanent establishment to another part of the enterprise. The sales must be electronically reported to the OTO on a quarterly basis. Noncompliance with the obligation is penalized with a daily enforcement fee.

The information required includes the names of the parties to the agreement, date of signing, and terms of the contract (e.g., the period and place of delivery, quantity, price formulas, allocation of risks, termination conditions). Actual sales prices and sales volumes must be specifically reported since such information often does not appear directly in the sales agreements. The OTO may, on request, require that the gas sales agreement be enclosed.

All information reported is stored in a database. The intention underlying the reporting requirement is that the oil taxation authorities should have access to substantial and updated factual information on terms and conditions actually used in gas sales contracts. The information is expected to be useful in the control of sales prices for tax purposes. It is stated in the legislative preparatory work that control of natural gas pricing is extremely resource-demanding and that having access to broad-based market information is of vital importance to the tax authorities. It is further stated that the information obtained through the general reporting and documentation requirements would not be sufficient in this respect.[280]

The industry has argued that the reporting requirements and the storage of the information in a database could lead to a systematic use of secret comparables. However, in the legislative preparatory work, it is stated that the proposed regulations do not alter the way information about other taxpayers may be used by the tax authorities in actual cases. It is emphasized that any income adjustments — as before — would have to be justified under §13-1 of the Tax Act and the general principles governing Norwegian tax law and tax administration law, including the recommendations in the OECD Guidelines.

It is no doubt that the collection of market information rendered possible through this reporting requirement has improved the oil taxation authorities' knowledge of terms and conditions generally prevailing in the natural gas industry on the Norwegian continental shelf.

D. Country-by-Country Reporting

Domestic legislation for the implementation of the third pillar of BEPS Action Plan Item 13 (the administrative Country-by-Country reporting) was approved by Parliament in November 2016. The domestic legislation is provided in §8-12 of the Tax Administration Act and supplemented by §8-12 in regulation no. 1360, issued on November 23, 2016. The domestic legislation is based on the model legislation prepared by the OECD. The Country-by-Country (CbC) report must be filed by multinational enterprises (MNEs) with consolidated income of more than 6.5 billion Norwegian kroner in the year prior to the relevant accounting year. The CbC report contains aggregate group information, including distribution of revenue and tax in the countries in which they do business, as well as a description of the economic activity in each country and the businesses of each entity of the MNE.[281]

The requirement to file a CbC report in Norway applies to entities that are resident for tax purposes in Norway and that are the ultimate parent entity of an MNE group. A Norwegian group entity (other than the parent company) is subject to local filing requirements in Norway if:

- the ultimate parent entity of the MNE group is not obligated to file a CbC report in its jurisdiction of tax residence; or
- the jurisdiction in which the ultimate parent entity is resident for tax purposes does not have an agreement for automatic exchange of the CbC report in effect with Norway by the end of the year that the CbC report is to be filed; or
- the Norwegian Tax Administration has notified the Norwegian entity that the jurisdiction of tax residence of the ultimate parent entity does not comply with its obligation to exchange CbC reports with Norway.[282]

The deadline for filing the CbC report with Norwegian tax authorities is December 31 of the year after the accounting year, provided that the accounting period is the calendar year. For companies with a deviating annual accounting period start-

[279] *See* VI.D.2., above.

[280] Prop. 126 LS (2009–10).

[281] The Tax Administration's guidance to CbC reporting (English language), available at https://www.skatteetaten.no/en/business-and-organisation/reporting-and-industries/industries-special-regulations/transfer-pricing---internal-pricing/country-by-country-reporting.

[282] Author's English translation.

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ing, for example, July 1 and expiring on June 30 the year after, the deadline is 12 months after the expiry of the fiscal year.

Any Norwegian entity of an MNE group subject to a CbC reporting obligation must notify the Norwegian Tax Administration of the identity and tax residence of the reporting entity. This notification is to be a part of the tax return, which must be filed before May 31 in the year after completion of the accounts.

The primary reporting requirement for Norwegian ultimate parent entities is effective as from the accounting year 2016 and had to be submitted by December 31, 2017. CbC reports submitted to the Norwegian Tax Authorities are subject to confidentiality.

The CbC report is to be submitted as an attachment in XML format to the form RF-1352 via the Altinn Portal.

On January 27, 2016, Norway signed the Multilateral Competent Authority Agreement on the Exchange of CbC Reports based on the OECD Council of Europe's Convention on Mutual Administrative Assistance in Tax Matters. On April 26, 2017, Norway and the United States signed a Competent Authority Agreement on the Exchange of CbC Reports under the Norway-United States Tax Treaty.

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XI. Transfer Pricing Audits

A. Selecting Companies

Very generally, there has been a shift in the way the tax administration directs its effort towards transfer pricing and other high-risk transactions. The tax administration now has a quite consistent and comprehensive risk-based approach, even though the risk aspect was predominant also in prior years when the focus was on certain industries and types of transactions. Transfer pricing is regarded as a high-risk area. Beginning on January 1, 2019, the foundation of a separate Transfer Pricing Section in the Priority Division, Large Business Department, reflects this position. Since then, all Norwegian transfer pricing audits (except for those that falls under the responsibility of the Oil Taxation Office (OTO)) are carried out by this dedicated unit.

All available information is used in carrying out risk analysis and identification of important transfer pricing risks. In 2022 a new automatic analysis platform was launched. It builds on the latest available data (from various sources) and produces risk assessment analysis at the group-, entity- and transactional level. The analysis platform aims to increase the efficiency and quality of mechanical analysis used for prioritizing among transfer pricing risks.

Outputs from the analysis platform provide a basis for further manual examination and selection of transactions for audit. The tax authorities do not follow any pre-fixed procedures or patterns in this regard. Compared to earlier years, audits nowadays are to a larger extent directed towards more complex transactions, such as financial transactions, business restructuring and intangibles. Although difficult to measure precisely, there is also a tendency that transfer pricing audits carried out by the Norwegian Tax Administration nowadays are fewer in numbers but results in higher monetary adjustments compared to earlier years.[283] These shifts in audit selection practice may have several reasons, but the high focus on a risk-based approach in recent years seems to be one reasonable explanation. Beginning 2024, this approach will be even further strengthened as the prioritizing of transactions for transfer pricing audit will be made centrally on a coordinated basis among the top management of the Transfer Pricing Section.[284]

The Oil Taxation Office (OTO) assesses a relatively small number of taxpayers, several of which have been present in Norway for many years. Due to sound knowledge of its taxpayers' activities, difficult tax issues tend to arise during an ordinary assessment and regular audits are relatively rare.

B. The Tax Audit Process

An audit may be initiated in different ways. The most common way is to ask the taxpayer to submit information beyond what was filed in the tax return, and which is of relevance in determining the tax liability. This is often the result of issues being identified in the tax return, manually or by a screening process on pre-determined risk factors. In most cases, an audit is carried out at the tax office entirely. In some cases, the tax authorities may want to conduct a control audit at the site of a business. As such, the general rule is that the taxpayer must be given "reasonable notice" and has a right to be present during the investigation. If it would undermine the purpose of the investigation, advance notification is not required, and the taxpayer may be asked to be absent. There is a threshold for limiting a taxpayer's rights in this respect; the typical example is a clear indication that the taxpayer may otherwise destroy archive material.

Normally, site visits are carried out by a team of two or three auditors. They are obliged to prepare an audit report in which they express their views on the investigated issues. The report must be submitted to the taxpayer.

The tax authorities must notify the taxpayer before adjusting the filed tax return or reassessing earlier tax years, and the taxpayer must be given a proper time period for submitting comments.[285] The content of such a notice must be specific enough for the taxpayer to have a chance to provide relevant comments. The final reassessment is based on the views expressed in the audit report, the notice with the proposed adjustment, and the comments submitted by the taxpayer.

There are no regulations or procedures for settlement under an audit process. However, the taxpayer and the tax office may come to an agreement during an ongoing audit on the disputed issue(s) and decide to settle the case. In such a case, the tax office may issue a reassessment decision in which content is *de facto* approved in advance by the taxpayer. Typically, as part of the agreement, the parties give up their right to appeal or further litigate the issues that have been resolved by the settlement.

C. Time Limits

The general time limit for the tax authorities to initiate an adjustment is five years after the expiration of the relevant income tax year. The time limit is 10 years in cases where increased additional (penalty) tax has been levied or where the taxpayer's action has been reported as a criminal tax offence.[286]

[283] *See* Norwegian Tax Administration — Annual Report Transfer Pricing 2023 (Norwegian language only).

[284] *See* Norwegian Tax Administration — Annual Report Transfer Pricing 2023 (Norwegian language only).

[285] Tax Administration Act, §5-6.

[286] Tax Administration Act, §12-6 (1) and (2).

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XII. Penalties

There are two administrative reactions that are relevant in the context of this chapter — namely, the enforcement fee and the additional tax.

The enforcement fee is the main reaction toward taxpayers that do not timely submit compulsory information and forms. The tax authorities are provided with an authority to levy an enforcement fee in all situations where a taxpayer has not timely submitted information and forms that are required by law. The fee is stipulated per day, and the purpose is to encourage compliance. Hence, an enforcement fee is a potential reaction toward taxpayers who do not submit a tax return, and mandatory information thereto, such as the special transfer pricing reporting requirements, Country-by-Country (CbC) report, or special transfer pricing documentation. The size of the enforcement fee is regulated in the Tax Administration Act and is rather modest.[287]

Additional tax is an administrative sanction levied in connection with an assessment or a reassessment. Additional tax will be levied if the taxpayer has provided the tax authorities with incorrect or incomplete information, or neglected to provide information required by law, if such failure may lead to a tax advantage for the taxpayer.[288] Additional tax may not be levied, however, if the taxpayer's conduct is regarded as "excusable."[289] Some examples of what may be regarded as excusable conduct are mentioned in the legislative preparatory work.[290] The standard by which business and professional taxpayers are assessed may be stricter than for other taxpayers.

The additional tax amounts to 20% of the tax that has, or could have, escaped from taxation (the tax advantage) due to the incorrect or incomplete information provided by the taxpayer. If the taxpayer has acted willfully, was grossly negligent, or did not submit information that the taxpayer understands, or should understand, may lead to a tax advantage, an increased additional tax of 20% or 40% will be levied on top of the general rate of 20% (i.e., the total additional tax will be 40% or 60%). Regarding increased additional tax, the conditions for imposing it and the burden of proof are the same as for tax fraud in the Criminal Code.

Both the ordinary additional tax and the increased additional tax are regarded as a criminal charge according to the European Convention on Human Rights. As a result, several procedural and other rules have been adopted, with specific application for the levying of additional tax only.[291] For example, in contrast to what applies in relation to a reassessment of the income tax, the Courts, in relation to the additional tax, have unlimited authority to test all elements of the tax authorities' decision, including the discretionary assessment of the price adjustment. Because the additional tax is treated as a criminal charge, where the tax authorities have levied additional tax, criminal proceedings cannot be opened later in relation to the same offense.[292]

The basis for considering whether a taxpayer has provided incorrect or incomplete information is whether the taxpayer has fulfilled the information requirements generally or specifically required by the law.[293] Although most of the case law developed in this respect directly relates to the former rules concerning time limits for making a reassessment (the time limit was longer if the taxpayer had provided incorrect or incomplete information), such administrative practice and case law are still regarded as relevant in relation to the identical criteria that are conditions for imposing additional tax.

Two Supreme Court decisions, *Baker Hughes Oilfield Operations Inc.* (1999) and *Statoil* (2012), are illustrative in a transfer pricing context with respect to the former time limits for making a reassessment. In *Baker Hughes Oilfield Operations Inc.* (1999), although the information provided by the taxpayer was factually correct, the Court concluded that the information provided was incorrect since the rental fee actually reported was 40% higher than the arm's length rental fee determined by the Tax Appeal Board.[294] In a later decision, *Statoil* (2012), the Supreme Court concluded that the reporting of an intra-group captive insurance premium that was 19.8% higher than the arm's length premium determined by the Oil Taxation Appeal Board did not represent filing of incorrect information.[295]

[287] The daily enforcement fee is 1,243 Norwegian kroner (from January 1, 2023), with an upper total limitation of Norwegian kroner 62,500 Norwegian kroner (50 × 1,243), cf. Tax Administration Act §14-1 and accompanying Secondary Regulations.

[288] Tax Administration Act, §14-3 (1).

[289] Tax Administration Act, §14-3 (2).

[290] Examples include the taxpayer's failure to deliver the tax return due to mistakes of a technical nature in connection with the submission of the return through the electronic Altinn Portal or failure to correct minor errors in third-party data that were reported to the tax administration and prerecorded in the tax return. *See* Prop. 38 L (2015–16).

[291] Tax Administration Act, §14-8–§14-11.

[292] European Convention on Human Rights, Protocol No. 7, Art. 4.

[293] *See* X., above.

[294] Rt. 1999, p. 187, *Baker Hughes Oilfield Operations Inc.*

[295] Rt. 2012, p. 1648, *Statoil.*

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XIII. Administrative Appeals and Litigation

A. Administrative Appeals

Tax disputes are addressed by an administrative appeal system and by juridical courts. While it may be possible in some cases to contest a decision regarding an income assessment directly before the courts, the usual and predominant practice is to first utilize the administrative appeal system. After the Tax Appeal Board's decision has been rendered, the taxpayer may decide to bring its decision to juridical review in the ordinary court system.

In general, any decision made by the tax office as part of an assessment may be administratively appealed by the taxpayer. A decision made by the Tax Appeal Board regarding the complaint cannot be appealed to any superior administrative body (but can be appealed to the juridical courts). The time limit for filing an administrative complaint is six weeks from the date the notification of the decision has reached the taxpayer. At the discretion of the Tax Appeal Board and based on a consideration of certain circumstances listed in the law, a complaint may be dealt with even if the time limit has expired. In making that decision, among other things, consideration must be given to the conditions on the taxpayer's side, the time that has elapsed, the importance of the issue, and how well documented the facts of the case are. The maximum extension, however, is one year from the date of the decision.[296] The complaint must be in writing and contain specific assertions of the facts at issue.

A complaint must be filed with the administrative body that rendered the decision for which an appeal is filed. That body has authority to amend its decision in line with the claims of the complaint. In the wake of such an amendment, a complaint regarding the assessment must be dealt with by the Tax Appeal Board. As described in II.C., above, since July 1, 2016, a Tax Appeal Board has been established with nationwide responsibility in tax matters (except from cases concerning the petroleum income tax, which continues to be dealt with by the Oil Taxation Appeal Board). The Tax Appeal Board and the Oil Taxation Appeal Board operate independently from the tax administration and thus cannot be instructed to act by either the tax administration or the Ministry of Finance.

A separate secretariat is responsible for preparing the appeal case handled by the Tax Appeal Board and, in most cases, this implies an obligation to prepare a justified recommendation to the Tax Appeal Board. The recommendation from the Appeal Board Secretariat to the Tax Appeal Board must also be submitted to the taxpayer for comments. Cases that are handled by the Oil Taxation Appeal Board are forwarded by the Oil Taxation Office, and its recommendation is, by way of administrative practice, submitted to the taxpayer for comments.

The Tax Appeal Board and the Oil Taxation Appeal Board may consider all aspects of the decision that has been appealed. This means that they may consider elements of the same decision other than the one that was appealed.

B. Litigation

A taxpayer may challenge a tax assessment by legal proceedings. Tax cases are dealt with by ordinary courts. The general rule is that a taxpayer may initiate legal proceedings irrespective of whether the administrative appeal system was utilized. However, effective 2017, on a case-by-case basis, the tax office has authority to decide whether legal proceedings can only be initiated after the administrative appeal system is exhausted with respect to all types of tax cases.[297] Direct litigation is allowed if the appeal decision has not been rendered within one year after the complaint was submitted and the delay is not due to circumstances caused by the taxpayer. In practice, the vast majority of cases are dealt with in the administrative appeals system before court proceedings are initiated.

The time limit for initiating legal proceedings is six months from the date the initial tax assessment or the reassessment decision was sent to the taxpayer. Certain extensions are possible.[298]

The courts may review the facts on which an assessment is based, as well as the tax authorities' interpretation of the law and whether procedural rules have been complied with. However, the tax authorities' administrative discretion in the determination of an arm's length price (provided that the legal conditions for making an adjustment are satisfied) can only be disregarded by the court if it is based on incorrect facts or the court finds the outcome arbitrary or highly unreasonable.[299]

[296] Tax Administration Act, §13-4.

[297] Tax Administration Act, §15-5.

[298] The Dispute Act, §16-12–§16-14.

[299] Rt. 2012, p. 1065, *Norland.*

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XIV. Adjustments to Be Made in the Wake of a Transfer Pricing Adjustment

A. Corresponding Adjustments

The legal framework related to corresponding adjustments depends on the relevant tax treaty and whether the request is treated as part of a Mutual Agreement Procedure ("MAP"). In practice, when a transaction is covered by a tax treaty, a request for corresponding adjustment is most often handled under the MAP. Under MAP, the Norwegian Competent Authority may enter into and implement a corresponding adjustment, regardless of the domestic time limits in §12-6 of the Tax Administration Act.[300]

In some cases, a request for a corresponding adjustment is not treated under the MAP. Examples include situations where the transaction is not covered by a tax treaty, the three-year time limit in the MAP article has expired, or the taxpayer simply does not invoke the MAP. In such cases, a request for corresponding adjustment may be submitted to the tax authorities in the responsible Tax Office.

In such a case, where the transaction is covered by a tax treaty and the relevant tax treaty contains a provision that corresponds to Article 9(2) of the OECD Model Tax Convention, the tax authorities are required to make a corresponding adjustment that falls within the treaty provisions.[301]

If, however, the transaction is not covered by a provision similar to Article 9(2) of the OECD Model Tax Convention, the tax authorities are not legally required to assess the arm's length nature of the primary adjustment or make a corresponding adjustment. In such a case, the tax authorities have discretionary power to assess the request. Their decision should take into account certain criteria, however, which are stipulated in §12-1(2) of the Tax Administration Act, such as, among other things, the taxpayer's conduct, the time that has elapsed, the importance of the issue (e.g., the amount involved), and how well facts of the case are documented.

Further, effective as of 2017, and due to the rules of self-assessment of the tax base, the taxpayer may adjust an earlier filed self-assessed tax base within a period of three years from the filing date of the tax return.[302]

Article 9(2) of the OECD Model Tax Convention does not stipulate a maximum number of years in which a state is obliged to make a corresponding adjustment. Nor is this issue specifically regulated in any of Norway's tax treaties. Therefore, irrespective of whether the transaction is covered by a tax treaty, unless the case is handled through the MAP, the domestic time limit of five years constitutes a restriction with respect to the tax authorities' ability to implement a retroactive corresponding adjustment.[303]

B. Secondary Adjustments

A secondary adjustment is an adjustment arising from imposing tax on a secondary transaction (i.e., a constructive transaction asserted in order to make the actual allocation of profits consistent with the primary adjustment). For example, assume that the taxable income of a local company is primarily adjusted from 100 to 120 due to a reduction of the recognized arm's length price of the goods it has purchased from a sister-company located abroad. The local company's books only recognize a taxable profit of 100, however. The remaining 20 are not recognized in the financial statements, since the related sister-company has been compensated for the goods in conformity with the pre-adjustment transfer pricing policy. In such a case, the country that made the primary adjustment may consider the 20 actually paid as a secondary transaction and tax it accordingly. (In the example, the excess amount of 20 could be viewed as a loan with deemed interest to the related seller (and deemed borrower). It could also be viewed as a capital contribution, which would not usually have as much secondary income tax effect.)

Article 9 of the OECD Model Tax Convention does not provide for secondary adjustments. Secondary adjustments are therefore neither required nor prohibited by tax treaties following the OECD Model. No Norwegian domestic regulations exist, and no administrative guidance has been issued concerning secondary adjustments. There are examples in administrative practice where secondary adjustments have been made, and it can be concluded that Norwegian domestic law does not prohibit secondary adjustments as long as they are in conformity with the primary adjustment and the facts of the case. On the other hand, domestic law does not require a secondary adjustment to follow a primary adjustment.

To the author's knowledge, Norwegian tax authorities have only asserted secondary adjustments in a few cases, all taking the form of constructive dividends (i.e., secondary adjustments have not been asserted in the form of constructive loan arrangements or constructive equity contributions).[304] However, secondary adjustments and constructive dividends have become an issue of less importance after the tax reform in 2004–2006, when intercompany dividends (including cross-border dividends within the European Economic Area) to a large extent were exempted from taxation.

C. Repatriation

As an alternative to asserting secondary transactions and adjustments, the accounts of the taxpayer can be brought in line with the primary adjustment by arranging for a repatriation of the excess profits to the adjusted taxpayer. This alternative can be discussed under the MAP, but normally it is not an issue.

[300] *See* Art. 25(2) of the OECD Model Tax Convention.

[301] In this respect, it follows from paragraph 6 of the commentary to Article 9 of the OECD Model Tax Convention (2017) that a state is committed to make an adjustment of the profits of the affiliated company only if it considers that the primary adjustment made in the other state is justified, both in principle and as regards the amount.

[302] Tax Administration Act, §9-4.

[303] *See* II.E., above, and Tax Administration Act, §12-6.

[304] *See e.g.,* Utv. 2006, p. 195, Utv. 2008, p. 306, Utv. 2009, p. 363.

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XV. Resolving Conflicts with Other Countries

A. *Mutual Agreement Procedure*

1. *Competent Authority*

The Norwegian Competent Authority under tax treaties is the Minister of Finance or the Minister's authorized representative. In general, the authority is exercised by the Ministry of Finance (Tax Law Department). However, the Ministry has further delegated to the Tax Administration the authority to act as competent authority in certain MAP proceedings.

First, the Directorate of Taxes has been delegated the authority with respect to individual MAP cases, except for cases concerning transfer pricing and for cases that raise principal issues or have substantial effect on revenue. Interpretive MAPs are handled by the Ministry.

Second, the authority to act as competent authority in transfer pricing cases and cases of attribution of profits to permanent establishments (i.e., Article 9 and Article 7 cases) has been delegated to a separate unit in the Tax Administration — Large Business: the MAP/APA Section. This reorganization of responsibilities is followed by an increase in the staff dedicated to working with transfer pricing MAPs and bilateral APAs and is a response to the increased number of such cases.

However, the Ministry has retained the authority to act as competent authority in transfer pricing cases that involve taxpayers subject to the special tax on petroleum income (i.e., taxpayers engaged in the extraction or pipeline transportation of petroleum on the Norwegian Continental Shelf). In dealing with such cases, the Ministry works in close cooperation with the MAP/APA Section.

2. *Administrative MAP Practices*

The prevailing domestic guidance on MAP was issued in February 2019.[305] A MAP request must be filed in writing and must contain an explanation as to the basis for the request. Procedures for filing a MAP request and submitting the supporting documentation are provided for in paragraphs 3 and 4 of the MAP Guidelines. Taxpayers have wide access to MAP, and there is a high threshold to deny a taxpayer access.

A protective MAP request can be made when a taxpayer considers it probable that taxation which is not in line with a provision in the treaty would occur. The Norwegian Competent Authority generally waits until the tax authorities have issued a formal decision (typically by deviating from the tax return or issuing a reassessment decision) before a case is actually handled under MAP. Where the same issue is challenged by the tax authorities with respect to several income years, the Norwegian Competent Authority generally permits a multiyear-based resolution through MAP.

3. *Domestic Remedies and the MAP*

It is not a condition for requiring MAP assistance that domestic remedies such as administrative appeal or a court proceeding must be exhausted. Further, requesting MAP assistance does not exclude the taxpayer from invoking domestic remedies at the same time. However, in such cases, MAP and the domestic remedy process must be coordinated since parallel treatment is inappropriate and should be avoided. In this respect, the starting point is that the choice of remedies remains with the taxpayer, but the competent authorities determine the appropriate MAP process, including when the MAP should start. Where the taxpayer wants to reserve the right to potentially use both MAP and domestic remedies, protective claims must be taken to cut off relevant time limits.

If the taxpayer has appealed against a Norwegian tax assessment, the taxpayer may choose whether to pursue the appeal process or the MAP first.[306] In practice, taxpayers often prefer to initiate a "MAP track" before reviewing other options under domestic law, while making a protective filing to reserve the right to exercise domestic remedies in case MAP fails. In such a case, it is common practice for the taxpayer to request for domestic remedies to be suspended until the MAP process is finalized. In general, such a request will be accepted by the Tax Appeal Board and the courts. The legal basis for suspension by the courts is the Dispute Act.[307]

When a taxpayer wishes to first pursue domestic remedies, the MAP is temporarily placed on hold. The MAP can be reactivated after the Tax Appeal Board (or a court) has rendered its decision. Where it is the domestic appeals system that has been utilized by the taxpayer, the Competent Authority bases the bilateral discussions on the Appeal Board's decision. The Norwegian Competent Authority is not bound by the Appeal Board's decision and may deviate from it in the MAP.

However, as a matter of administrative policy, the Norwegian Competent Authority does not deviate from a juridical court decision in subsequent MAP discussions.[308] Hence, if the case is discussed in the MAP after the Norwegian court decision has been rendered on the issue, the Norwegian Competent Authority generally restricts itself to assist the taxpayer to obtain a corresponding relief in the other contracting state.

4. *Collection, Interest, Penalties, and the MAP*

The general rule is that claims must be paid in due time, irrespective of whether the lawfulness of the claim is challenged by the taxpayer. Thus, tax collection is not suspended during the period where a MAP case is pending.

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[305] *See* Guide for Mutual Agreement Procedure pursuant to Tax Treaties (MAP), available at https://www.regjeringen.no/contentassets/a91a5dd41bde46c88ed4dfc2bf724252/guide_for_the_mutual_agreementprocedure.pdf. *See* OECD, Norway Dispute Resolution Profile, available at http://www.oecd.org/tax/dispute/norway-dispute-resolution-profile.pdf (last updated February 20, 2019).

[306] An exemption applies in cases where the taxpayer is subject to the petroleum tax and the Oil Taxation Appeal Board is the Appeals Body. In such cases, if the taxpayer has filed a complaint, the Norwegian Competent Authority will normally require that the appeal proceedings is completed before the MAP commences. In exceptional circumstances, the Norwegian Competent Authority may also in other cases determine that appeal proceedings are completed before MAP commences.

[307] *See* Dispute Act, June 17, 2005, no. 90 Chapter, 16.IV. A court proceeding may be suspended for two years pending resolution under MAP. On request, the suspension period may be extended at the discretion of the judge.

[308] *See* Guide for Mutual Agreement Procedure pursuant to Tax Treaties (MAP), paragraph 10.8.

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The ordinary domestic rules apply in respect to interest when a mutual agreement is implemented. Therefore, if the result of the MAP implies that a downward adjustment must be made from the initial Norwegian assessment, interest is paid to the taxpayer in accordance with the general rules governing the reassessment in order to implement the mutual agreement, unless the MAP provides otherwise.

The additional (penalty) tax in Norway is linked to the amount of tax that potentially could have escaped from Norwegian taxation.[309] The general rules apply with respect to additional tax once a mutual agreement is implemented. Hence, if the mutual agreement implies that a Norwegian adjustment should be scaled down, the additional tax is scaled down proportionally.

5. Implementation of a Mutual Agreement

Immediately after a case is resolved in the MAP, the Norwegian Competent Authority asks the tax office to implement the mutual agreement, and they are required to do so.[310] The technicalities of the implementation depend on the content of the mutual agreement. Unless otherwise stated, the mutual agreement is implemented by way of issuing a reassessment decision for each of the income years covered by the mutual agreement. In some cases, typically where the adjustments reverts back and where the general approach is highly complex to carry out in practice, the mutual agreement may explicitly state that the economic result of the agreed solution may be implemented by issuing a reassessment for a limited number of income years.

It is general practice in Norway to present the terms of a mutual agreement to the taxpayer for acceptance.[311] The mutual agreement is not implemented unless the taxpayer or taxpayers accept the underlying terms.

[309] *See* XII., above.

[310] Tax Administration Act, §12-1, no. 3(c).

[311] Guide for Mutual Agreement Procedure pursuant to Tax Treaties (MAP), paragraph 9.1.

B. Arbitration

Norway is not a member of the European Union and therefore not a party to the European Arbitration Convention or the Council Directive on Tax Dispute Resolution Mechanisms in the European Union.[312] However, in the tax treaty with the United Kingdom and in an amending protocol to the tax treaties with the Netherlands, Switzerland, and Belgium, Norway included an arbitration clause in the MAP provision based on paragraph 5 of Article 25 of the OECD Model Tax Convention.[313] The arbitration clauses concluded in the tax treaties with these countries are based on the OECD Model Tax Convention, but some modifications and limitations apply.

General applicable procedural rules for arbitration have only been made in respect of the tax treaty with Switzerland[314]. Therefore, in respect of the tax treaties with the United Kingdom, the Netherlands and Belgium, the competent authorities would have to establish procedural rules on a case-by-case basis. However, as of 2024 no cases have been submitted to arbitration.

Norway has not made reservations to the inclusion of paragraph 5 of Article 25 in the OECD Model Tax Convention, nor made observations to the commentaries thereto. Thus, it could be expected that an arbitration clause will be included in more treaties. However, whether arbitration shall be part of a tax treaty will be determined bilaterally on a case-by-case basis. This position is reflected in Norway's position under the Multilateral Instrument (MLI) where Norway did not opt for arbitration in any of the covered agreements.

[312] Council Directive (EU) 2017/1852 of October 10, 2017, on Tax Dispute Resolution Mechanisms in the European Union.

[313] The amending protocol with Belgium signed on September 8, 2001, has not entered into force as of September 2024.

[314] *See* agreement-switzerland-2019-11-01.pdf (regjeringen.no).

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XVI. Advance Pricing Agreements and Advance Rulings

A. Overview

Norway has entered bilateral Advance Pricing Agreements (APAs) since 2010. The competent authority for APA cases concerning companies subject to the specific petroleum tax is the Ministry of Finance. For all other APA cases, the competent authority is the MAP/APA Section within the Large Business Department of the Tax Administration. There is no domestic APA legislation and the sole legal basis for Bilateral APAs is article 25 (3) in tax treaties.[315] Norway has not yet entered any multilateral APA but has legal basis for doing so provided there is a tax treaty in place between all relevant countries. Since 2010, approximately 30 bilateral APAs have been established, including a few highly complex cases. The demand for bilateral APAs in Norway is increasing, and the tax administration has gradually allocated more resources to task with APAs.

A general scheme on binding rulings exists. However, this scheme does not generally apply to transfer pricing cases. Therefore, as a general rule, unilateral APAs (i.e., advance pricing agreements entered into between the taxpayer of one contracting state and its tax authorities) are not available under Norwegian law. Further, the Norwegian tax authorities are generally reluctant to issue non-binding rulings with respect to the pricing of intra-group transactions. However, for sales of natural gas extracted from the Norwegian continental shelf, taxpayers may ask for an advance binding ruling on the transfer price intended to be used in a controlled transaction.[316]

Domestic guidance on bilateral APAs is expected to be issued in 2025. To the extent relevant, this guide will also be applicable to multilateral APAs.

B. Bilateral Advance Pricing Agreements

At the onset, APAs are typically established for a period of five years. An APA application must be submitted in writing and must identify the taxpayers involved, provide a description of the transactions to be covered, and contain a functional and comparability analysis. The taxpayer must provide a suggested pricing methodology and pricing terms and propose the length of the APA period.

An APA application must be submitted to the competent authority. The competent authority is not obliged to enter bilateral proceeding in all cases. Every APA application will be considered based on certain criteria such as the risk of double taxation if an APA is not concluded, and whether there are real doubts as to how the arm's length standard shall be applied. Whether the case is suitable for an APA and whether initiation of bilateral proceedings constitute proper use of public resources are also factors considered. There is no minimum requirement with respect to monetary volume or complexity of the transaction.

Taxpayers are encouraged to reach out to the competent authorities in both countries before submitting an APA application (initial contact). In most cases it is useful that a pre-filing meeting is held with the competent authority of both states. At a pre-filing meeting, which occurs before a final application is submitted, the taxpayer broadly presents its case, and the taxpayer and the competent authority may discuss whether the case is suitable for an APA. Pre-filing meetings on an anonymous basis are not accepted.

To the extent that the facts are materially the same, it is possible to ask for a rollback (i.e., that the pricing terms agreed to in the APA for future income years are applied retroactively on earlier income years). The rollback period may include prior income years where an assessment is not yet issued, as well as income years where a final assessment has been issued. In certain circumstances, where sound tax policy makes it justified, the Norwegian Competent Authority may require that a rollback be applied as a prerequisite for moving forward with the APA application.

The competent authority routinely informs the relevant tax office that an APA application has been received. The competent authority may consult with the tax office, but it must and in practice does examine the APA case itself. Bilateral discussions are conducted by the competent authority. In Norway, a bilateral APA entered in accordance with article 25 (3) of a tax treaty is binding on the tax administration. In cases that require highly specialized competence, such as the sale of dry gas, a close interaction with and involvement of the tax office may be required.

In practice, the APA terms agreed upon with the other contracting state under MAP provisions of the tax treaty are forwarded by the Norwegian Competent Authority to the Norwegian taxpayer for acceptance. Hence, a mutual agreement is concluded between the two competent authorities, and a corresponding agreement is concluded between the Norwegian Competent Authority and the Norwegian taxpayer. Beyond that, no separate act of implementation is required under Norwegian law unless the APA itself requires changes to be made to the assessed amount for any preceding income year.

If an APA application concern matters that are covered by or may be affected by an audit, either notified or initiated for previous income years, the Norwegian Competent Authority generally will not start an APA process until the audit is completed. However, in special cases, where required to ensure efficient tax administration, the competent authorities may, in consultation with the tax office, nevertheless decide to start an APA process before the audit is completed.

Norway charges no fee for applying or being accepted into the APA program. The Norwegian Competent Authority generally endorses the renewal of an APA where facts and circumstances are materially unchanged.

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[315] Article 25(3) (first sentence) is the legal basis for entering into bilateral APAs, and this provision is included in all of Norway's tax treaties. As seen in the 2018 Stage 2, MAP Peer Report for Norway, four treaties had wording slightly diverging from to the OECD Model, but Norway stated that also in such cases Norway would endeavor to resolve any difficulties or doubts regarding the interpretation or application of the treaty. Thus, the provision establishes a legal basis for entering into bilateral APAs (The one treaty referred to that did not contain a MAP provision has been terminated).

[316] *See* XVI.D., below.

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C. Advance Binding Rulings

A general scheme on binding rulings is anchored in the Tax Administration Act and regulations thereto.[317] Binding rulings under the general scheme are limited to concrete, planned transactions that are not yet entered into. There is a threshold for binding rulings in the sense that they are only issued in cases where it is of major importance for the taxpayer to clarify the tax consequences of a forthcoming transaction or where the tax authorities find that the legal issue at stake is of general interest. A small fee is required. Binding rulings are issued by the tax office, or by the Tax Directorate when fundamental questions are raised.[318] An application for a binding ruling under the general scheme must contain information about certain defined related persons, which will ensure that the Norwegian Tax Administration can fulfill its potential obligation to spontaneously exchange information about a given binding ruling.

A ruling is binding on the tax authorities only to the extent that the transaction is carried out exactly as described by the taxpayer, and provided that the facts have been correctly presented by the taxpayer. A binding ruling under the general scheme may be administratively appealed by the taxpayer. It cannot be subject to legal proceedings, however.

Binding rulings can only be issued with regard to the interpretation or application of the law. They cannot be issued in cases involving consideration of evidence, valuation, and other discretionary judgments. Therefore, binding rulings cannot generally be obtained in transfer pricing cases. In addition, it should be noted that several legal issues are not covered by the scheme, including domestic law questions of tax residence and whether a foreign enterprise is subject to tax liability in Norway, as well as questions related to the interpretation and application of any tax treaty provision. Thus, a binding ruling is an option that is generally unavailable for related international tax questions.

D. Unilateral APA Scheme on the Sales of Natural Gas

Taxpayers may ask for an advance binding ruling on the transfer price to be used in a controlled transaction involving sales of natural gas extracted from the Norwegian continental shelf.[319] The scheme was introduced in 2005, and the authority to render binding rulings was given to the Oil Taxation Office. It is applicable only to intra-group transactions. The intention was to offer a way for the taxpayers to alleviate uncertainty but also to increase the tax authorities' understanding of such contracts and the factors that are of importance to establish market prices.[320] To achieve a binding ruling, the taxpayer must submit a draft sales contract and provide other information that is relevant for the tax authorities when considering the arm's length nature of the suggested price. The taxpayer must provide information about other factors that may influence the price, such as the place and time for delivery, risk and functions undertaken by each party, allocation of costs, rebates, etc. Relevant documentation might be comparable prices obtained in the market and resale prices obtained in sales to third parties, etc.

The nature of the scheme is a "mix" between a traditional binding ruling and a unilateral APA. Similar to an APA, the scheme requires a close review of the client's facts by the Oil Taxation Office with factual issues presented by the taxpayer. Similar to a traditional binding ruling, a rendered ruling is binding for tax assessment purposes if the actual implementation thereof is in accordance with the assumptions on which the ruling is based and the taxpayer has not submitted incomplete or incorrect information. Tax assessments that are based on a binding ruling may not be appealed or brought before the courts.[321]

An application for a binding ruling under this scheme must contain information of certain defined related persons, which ensures that the Norwegian Tax Administration can fulfil its obligation to spontaneously exchange information about a given binding ruling. The possibility to obtain binding rulings with respect to sales prices of natural gas prices has been utilized by taxpayers in limited circumstances.

[317] *See* Tax Administration Act, Chapter 6; Reg. no. 1360, Nov. 23, 2016, Chapter 6.

[318] The Tax Directorate is the supreme agency in the Norwegian Tax Administration.

[319] Tax Assessment Act, §6-1(2).

[320] Ot. prp., no. 1 (2005–06).

[321] Tax Assessment Act, §6-1(3) and §6-2.

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XVII. Transfer Pricing and Other Legislation

A. *Company Law*

Arm's length requirements are provided for in Norwegian company legislation. Such provisions are established in the general laws regulating private and public limited companies, and in the Act governing financial institutions.[322] Section 3-9 of the Private Limited Company Act, 1997 (*aksjeloven*), and Section 3-9 of the Public Limited Company Act (*allmennaksjeloven*), 1997, require that transactions between companies within a group must be founded on "ordinary commercial conditions and principles" and that "costs, losses, income, and gains which cannot be attributed to any particular group company, must be attributed to the various group companies in accordance with 'good business practice'."[323]

These provisions serve company law and accounting purposes and emphasize the fundamental principle that each limited company is regarded as a separate entity for company law purposes. There is no direct legal link between these provisions and the general attribution rules or the arm's length provision in the Tax Act. But the underlying principles are similar, and the Supreme Court has pointed out that if transactions are carried out in violation of the company law provision, it may lead to discretionary assessment of taxable income based on §13-1 of the Tax Act.[324]

In tax case law and administrative practice, one cannot regularly find extensive discussion of the requirements in §3-9 of both the Private Limited Company Act and the Limited Company Acts. However, these fundamental company law principles are often referred to as a starting point and basic premise in discussion as to whether an income adjustment is justified under tax law.[325] As described in IX.F.2., above, the Supreme Court in *Statoil Angola* (2007) relied heavily upon the wording of §3-9 in the Private Limited Company Act and its legislative preparatory work in considering whether a loan transaction should be recharacterized on the basis of §13-1 of the Tax Act.[326] Section 3-9 of the Limited Company Acts further requires that material intra-group agreements be in writing. However, the writing requirement is not a condition for the validity of the agreement.[327]

B. *Customs Duties*

Customs duties are levied on agricultural products, processed agricultural products, and a limited number of industrial products, such as clothes and textiles, etc. In Norway, customs duties are levied on the basis of either volume, weight, pieces (specific duties), or the value of the imported goods (ad valorem duties). The customs valuation rules are laid down in Chapter 7 of the Customs Act, 2007 and supplementing regulations.[328]

The internal valuation provisions are generally a transformation of the principles and rules in the World Trade Organisation (WTO) Valuation Agreement.[329] In an introductory provision in the Customs Act, an explicit reference is made to the WTO Valuation Agreement, and the provision states that the customs valuation must be determined in compliance with the WTO Valuation Agreement.[330] Furthermore, it is stated in the legislative preparatory work that the administrative practice by bodies established under the WTO Valuation Agreement, such as the Customs Valuation Committee, are of relevance for the interpretation and application of Norwegian internal rules.[331]

As a main rule, valuation for customs purposes must be based on the transaction value.[332] The transaction value is the price actually paid or payable for the goods when sold for export to the country of importation, subject to certain adjustments in accordance with the provisions in §7-17 and §7-18 of the Customs Act. As opposed to several other countries, the First Sale for Export-Rule is not applicable under Norwegian law, as it is specified in the statute that the relevant sales price is the price agreed upon in a sale where the goods are sent to a Norwegian buyer.[333]

There is no direct legal link between the valuation applied for customs purposes and for income tax purposes. Although variations exist, valuation for income tax purposes and for customs purposes share a common founding principle — the price established for goods traded between related parties must be consistent with the price that would have been realized if the parties were unrelated. Therefore, in related-party transactions, the transaction value is only acceptable for customs purposes if the price is not influenced by the relationship. The transaction value established at or about the same time as the transaction in question must be accepted (and not replaced by a substitute value) if either of the following circumstances are satisfied:

- the value closely approximates the transaction value in sales to unrelated buyers of identical or similar goods for export to Norway; or
- the value closely approximates the customs value of identical or similar goods determined in accordance with the valuation methods in §7-14 or §7-15 of the Customs Act (which reflects the valuation methods in Article 5 and 6 of the WTO Valuation Agreement and which is similar to the resale minus and the comparable profit method (CPM), respectively).

If the above conditions are not met, the transaction value cannot be used for customs purposes and should be substituted by a value determined on basis of the methods described in §7-11 to §7-15 of the Customs Act (which correspond to the valuation methods in Articles 2 through 6 in the WTO Valuation Agreement). In contrast to the OECD Transfer Pricing

[322] Act on Financial Institutions and Financial Groups (Financial Institutions Act), 2015, Section 18-3.

[323] Author's translation.

[324] Rt. 2000 p. 1473 *Brødrene Dahl.*

[325] Rt. 2000, p. 1473, *Brødrene Dahl,* Utv. 2010, p. 199, *Conoco Phillips Scandinavia AS.*

[326] *See* IX.F.2. Section 3-9 and the accompanying preparatory work stipulate that income, costs, etc., that cannot be allocated to any particular group company should be allocated among group companies based on respective business interests in the transaction concerned.

[327] Rt. 2010, p. 790, *Telecomputing.*

[328] Regulations Dec. 17, 2008, no. 1502, §7-10-1.

[329] Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994.

[330] Customs Act, §7-2.

[331] Ot. prp., no. 58 (2006–07), p. 65.

[332] Customs Act, §7-10.

[333] Customs Act, §7-10(3).

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Guidelines applicable for income tax purposes, the methods applicable for customs purposes are generally required to be used in a strictly hierarchical order.

There is a wide possibility to exchange information between the national customs authorities and the national tax authorities. However, there is no systematic information exchange between the two authorities of reported related-party transactions or of valuation or pricing adjustments actually made.

C. Value Added Tax

Norway introduced a Value Added Tax (VAT) in 1970. Originally the VAT system encompassed goods and services separately mentioned. As of July 1, 2001, the scope was extended to include the supply of all services not specifically exempted. The VAT rules are provided in the VAT Act,[334] and secondary regulations were promulgated on December 15, 2009, in no. 1540. The Norwegian VAT system is, to a large extent, based on the principles in the European Union Council Directive 2006/112/EC, but the EC Directive is not implemented as such since Norway is not a member of the European Union.

VAT is levied on the supply of goods and services within Norway by taxable persons, on withdrawals from a VAT registered enterprise and on imported goods and services. A taxable person is any business entity or individual that supplies goods and services in Norway in the course of its business. The general VAT-registration threshold is 50,000 Norwegian kroner during a 12-month period. Since 2005, the standard VAT rate has been 25%, but reduced rates are applicable to certain products.

In relation to cross-border transactions, the Norwegian VAT system is founded on the destination principle. This implies that VAT is levied in the country where the goods and services are consumed or are supplied to consumers. Therefore, under the Norwegian system, VAT is (with some exemptions) levied on goods and services supplied in Norway, on imported goods, and on services delivered from a remote location abroad. On the other hand, VAT is not levied on goods and services that are exported from Norway to a foreign buyer. This is achieved by applying a zero output VAT rate on the exported goods and services and providing deductions for any related input VAT paid by the exporter.

There is no legal link between the direct taxation valuation rules and the valuation of goods and services for VAT purposes. On domestic supplied goods and services, VAT is levied on the basis of the consideration paid.[335] The same applies to services that are delivered from a remote location abroad. An arm's length principle is incorporated in the sense that it is specified in the VAT Act that when there exists a community of interests that might have influenced the consideration paid, the VAT cannot be levied on a value that is lower than the general sales value of the goods or services.[336]

With regard to imported goods, however, the valuation for VAT purposes is linked to the customs valuation. The VAT must be levied on the basis of the value determined in accordance with Chapter 7 of the Customs Act, plus any customs duty, fees, and other duties levied on the imported goods.[337]

Enterprises that are neither established nor obliged to register for VAT in Norway may be refunded VAT paid on purchases of goods and services that are supplied in Norway (and therefore not treated as export). A non-established enterprise may obtain a Norwegian VAT refund to the same extent that a Norwegian taxable person may deduct input VAT incurred in the course of a similar business in Norway. Norway does not apply the reciprocity principle to refunds. Consequently, the refund scheme does not exclude claimants on the basis of the country in which they are established.

[334] The VAT Act, June 19, 2009 no. 58.

[335] The VAT, Act §4-1.

[336] The VAT, Act §4-4.

[337] The VAT, Act §4-11.

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