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EU JOINT TRANSFER PRICING FORUM

Discussion paper on secondary adjustments

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Introduction

1. During the JTPF meeting of 9 June 2011, members agreed the new JTPF work programme which, in relation to secondary adjustments states the following:

JTPF members have considered that it is useful to take stock of the situation prevailing in each MS and prepare an overview. This will be achieved by launching a questionnaire on the legal and administrative/practical aspects in the different MS, including on whether these adjustments fall within the scope of the AC.

Based on an analysis of the answers additional work might take place.

Background

2. The Secretariat issued in July 2011 a questionnaire. All 27 contributions are included in JTPF document number doc. JTPF/018/REV1/2011.
3. A first discussion about this topic took place at the JTPF meeting in October 2011 and can be summarised as follows:
 - The Chair commented that this issue may lead to double taxation cases and therefore requires attention.
 - The Secretariat was asked to perform a research on the OECD MEMAP to provide additional background about what has already been agreed on secondary adjustments at the level of the OECD (see annex for the respective extract from the MEMAP).
 - The Chair listed 3 possible options for progress to be considered by the JTPF members:
 - 1) Recognize the value of the results of the survey carried out, but not take the topic any further;
 - 2) Issue a recommendation that as very few MS apply secondary adjustments it is better not to apply them at all within the EU;
 - 3) Agree that secondary adjustments can be dealt with under the AC as they are the direct consequence of a TP adjustment.
 - The Chair concluded that the options would need further consideration by the members and would be addressed at the next meeting.

Secretariat's analysis based on TA's contributions to the questionnaire

4. The responses to the questionnaire show that, out of 27, only 9 MS (AT, BG, DE, DK, ES, FR, LU, NL, SI) have domestic legislation referring to and allowing for secondary adjustments: generally they are compulsory (AT, BG, DE, ES, FR, NL). Only Greece is currently examining the possibility to introduce such legislation.

5. In most MS these adjustments are treated as hidden profit distribution/hidden contribution and therefore considered as dividends subject to withholding tax. Within the EU the application of the Parent-Subsidiary Directive implies that withholding tax should not be imposed between the parent and the subsidiary. This situation has been highlighted by several MS which mentioned that they apply in practice secondary adjustments only to non EU countries. Another route that can be taken by TAs is to request the repatriation of profits to avoid the secondary adjustment.
6. Generally secondary adjustments are not subject to penalties (as they are the consequence of a primary adjustment).
7. Although only a limited number of MS allow secondary adjustments through domestic law the procedures in those MS' domestic law vary.
8. As the primary adjustment is based on the application of Article 9 of DTC Model, it seems logical to link the examination of both adjustments, but the majority of MS consider issues resulting from secondary adjustments are not covered by the AC. They are however prepared to address those issues in a MAP.
9. Secondary adjustments can also take the form of loan or equity contributions but in their replies MS did not refer to these kinds of adjustments. The reason may be that generally secondary adjustments take the form of a hidden distribution/contribution.

Secretariat's analysis of the suggested options

10. As stated by the Chair (see par.3 above), 3 options for further proceeding with secondary adjustments are currently considered:

- Option 1: limit the JTPF outcome to the publication of a state of play table

This option would result in the publication of the country survey together with some general conclusions on secondary adjustments similar to what has been developed in the OECD MEMAP. Additionally some reference to the parent-subsidiary directive could be included

- Option 2: issue a recommendation rejecting the application of secondary adjustments

This option would build on option 1 (i.e. publish the survey) supplemented by a recommendation based on the JTPF conclusions and the MEMAP.

As the MEMAP includes a recommended best practice for several issues but not for secondary adjustments, the JTPF considers developing a specific recommendation that would be applied amongst MS.

The recommendation could read as follows:

Considering the EU context where the Parent-Subsidiary Directive prevents in most cases the application of withholding taxes on any distribution (hidden or not) and the low number of

MS allowing secondary adjustments, it is recommended not to apply any secondary adjustment linked to a primary adjustment between EU related parties.

- Option 3: issue a limited recommendation to consider secondary adjustments as covered by the AC.

This option would build on option 1 (i.e. publish the survey), supplemented by a recommendation to consider secondary adjustments under the AC

Question to the members:

1. Do JTPF Members wish to suggest further options?
2. Which option is preferred by JTPF Members?

Extract from the MEMAP:

4.6. Secondary Adjustments, Withholding Tax, and Repatriation on Transfer Pricing Adjustments

Transfer pricing adjustments made under domestic law may also give rise to so-called “secondary adjustments”. For example, the amount of the income adjustment to a subsidiary for its excessive payment on a transaction with a non-resident parent may also be treated by the subsidiary’s jurisdiction as a deemed dividend paid to the parent and therefore a withholding tax may be applicable. Under normal circumstances, these secondary adjustments are reversed if the primary adjustment is reversed or, in the case where correlative relief is provided by the other competent authority, if the taxpayer repatriates funds from the non-resident equivalent to the amount of the transfer pricing adjustment. In these two instances, relief from the secondary adjustment should be a consequence of the MAP settlement.

A mutually agreed upon settlement between the competent authorities in respect of a transfer pricing adjustment will normally include agreed terms for repatriation of funds involved in the primary adjustment. These terms are specific to the particular settlement between the two governments. The terms may vary, but generally allow for the repatriation of funds to be effected either by a direct reimbursement or through an offset of inter-company accounts. Typically, the agreed terms also allow a taxpayer to repatriate within a mutually agreed reasonable time period, free from withholding taxes by the country out of which the repatriation is made and from any additional taxable treatment in the country to which the repatriation is made. Repatriation may be subject to audit verification.

Subject to the discussions and best practices on interest relief, normally there is no waiver for interest applicable to the tax liability attributable to the initial primary adjustment, or part thereof, if it remains in place as part of the MAP resolution. However, where the country to which the repatriation payment will be made would otherwise require that payment to include an interest component to compensate its resident taxpayer for the foreign associated enterprise's use of that taxpayer's funds between the time of the initial transaction and the repatriation, the competent authorities may agree to allow the repatriation to occur without any interest component, in order to minimize the complications from the repatriation.

A repatriation agreement reached at an audit stage should not preclude a request by the taxpayer for competent authority assistance nor should it indicate concurrence or agreement with an audit adjustment. Where a taxpayer proceeds to request competent authority assistance after concluding a repatriation agreement, it is appropriate for the competent authority to amend the repatriation agreement for any changes made to the amount of the adjustment as a result of the MAP process and to waive any requirement for the repatriation to include an interest component. Where a taxpayer proceeds to request competent authority assistance without having concluded a repatriation agreement at the audit stage, the competent authority may agree on terms of repatriation with the competent authority of the treaty country

MEMAP glossary:

Secondary adjustment

An adjustment that arises from imposing tax on a secondary transaction in transfer pricing cases.

Secondary transaction

A constructive (that is, notional) transaction that some States assert under their domestic transfer pricing legislation after having proposed a primary adjustment in order to make the actual allocation of profits consistent with the primary adjustment. Secondary transactions may take the form of constructive dividends (that is items treated as though they are dividends, even though they would not normally be regarded as such), constructive equity contributions, or constructive loans.