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EU JOINT TRANSFER PRICING FORUM

Report on Compensating Adjustments

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1. Background

1. In line with the work programme of the Joint Transfer Pricing Forum (JTPF) for 2011-2015 (doc. JTPF/016/2011/EN), Member States (MS) agreed during the JTPF meeting of 9 June 2011 that in relation to compensating adjustments it would be useful to take stock of the situation prevailing in each MS by 1 July 2011, establish an overview and evaluate whether further work might be done on this issue (doc. JTPF/015/2011/EN).
2. The Secretariat prepared a questionnaire for MS' tax administrations and circulated it for input on 30 June 2011. MS' responses to the JTPF questionnaire on compensating adjustments (doc. JTPF/019/REV1/2011/EN) and further contributions by non-government members of the JTPF (doc. JTPF/006/2013/EN) and MS informed a JTPF discussion on compensating adjustments which led to the preparation of a draft report (JTPF/009/2013/EN) for the JTPF meeting in June 2013.
3. The present report reflects the discussion on compensating adjustments that the JTPF had in June and November 2013. It proposes guidance for a practical solution to issues arising from the application of different approaches to compensating adjustments by MS. Price adjustments and theoretical issues remain outside the scope of this report.

2. Definition

5. In the Glossary of the OECD Transfer Pricing Guidelines (TPG) the term “compensating adjustment” is defined as “an adjustment in which the taxpayer reports a transfer price for tax purposes that is, in the taxpayer's opinion, an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between the associated enterprises. This adjustment would be made before the tax return is filed.”

3. Scope of this report

6. MS' responses to the JTPF questionnaire on compensating adjustments (doc. JTPF/019/REV1/2011/EN) indicate that MS apply different approaches with respect to compensating adjustments. It is recognised that these differences are often grounded in a different understanding of more fundamental principles in transfer pricing, e.g. timing issues and the use of information relating to contemporaneous uncontrolled transactions¹, the availability of comparable data and the quality of benchmark studies created on the basis of commercial databases² and what constitutes the inappropriate use of hindsight in transfer pricing³.
7. The guidance in this report should not be understood as indicating the JTPF's view on these more fundamental principles. Rather, the purpose of this report is to provide a practical solution for the issues described in section 4.1 below which arise from different approaches applied by MS. Moreover, the acceptance of compensating

¹ 3.68 TPG

² 3.30 ff. TPG

³ 3.73 TPG

adjustments should not be understood as limiting a tax administration's ability to make an adjustment at a later stage.

8. The recommendations in this report are applicable to compensating adjustments which are made in the accounts and explained in the taxpayer's transfer pricing documentation.

4. Compensating adjustments

4.1 General

9. In general, the adjustment, at a later point of time, of transfer prices set at the time of a transaction touches upon the important theoretical issue in transfer pricing on whether
 - taxpayers should be required to establish transfer pricing documentation that demonstrates that they have made reasonable efforts to comply with the arm's length principle at the time their intra-group transactions were undertaken based on information that was reasonably available to them at that moment (**ex-ante or arm's length price setting approach**)⁴, or whether
 - taxpayers can or should test the actual outcome of their controlled transactions to demonstrate that the conditions of these transactions were consistent with the arm's length principle (**ex-post or arm's length outcome testing approach**)⁵.
10. MS which follow the reasoning of an ex-ante approach would generally require the taxpayer to make reasonable efforts to establish the transfer prices at the time of transaction. If prices were set in a way third parties would have done and with the information reasonably available to third parties at the time of transaction, these prices and the economic result would be binding.
11. MS which follow the reasoning of an ex-post approach would generally allow or even require taxpayers to test and, if necessary, to adjust their transfer prices at the end of the year, before closing the books or when filing the tax return⁶. Following an ex-post approach may also imply that at the time of an audit the best data available (e.g. data relating to the time when the transaction was undertaken) may have to be used.
12. When both MS apply an ex-post approach and require compensating adjustments, problems and even a risk of double taxation or double non-taxation may arise with respect to the following:
 - The point in time when such an adjustment should/can be made (year-end, closure of books, filing of the tax return),
 - The data which should be used for determining the need for an adjustment and the adjustment itself,

⁴ 3.69 TPG

⁵ 3.70 TPG

⁶ 4.38/4.39 TPG

- Whether an adjustment can be made in both directions (upwards and downwards) and
 - To which price the adjustment should be made (in case of ranges e.g. closest quartile, median etc.).
13. If the transactions under review are between two related parties which are situated in two MS one of which follows an ex-ante while the other follows an ex-post approach with an obligation to reflect the adjustments in the books, a conflict arises on whether such an adjustment can be made at all.
14. The guidance in the OECD TPG on those issues is currently rather limited. Both the arm's length price setting approach and the arm's length outcome-testing approach are recognised as being applied by MS and in case of dispute, the OECD refers to the Mutual Agreement Procedure (MAP)⁷.
15. However, a MAP may not yet be available or may not yet provide a solution for the conflict at an early stage, e.g. at the time when the taxpayer is obliged to file his tax return.
16. To address these or related practical issues, MS agree on conditions under which taxpayer-initiated compensating adjustments should be accepted for the tax return. The decision whether to oblige the taxpayer to make such an adjustment is left to the discretion of the MS.

4.2 Practical solution to compensating adjustments in the EU

17. To address the practical issues arising from the situation described in section 4.1 above, MS agree that: (i) the profits of the related enterprises with respect to the commercial or financial relations between them need to be calculated symmetrically, i.e. enterprises participating in a transaction should use the same price for the respective transactions, and that (ii) a compensating adjustment initiated by the taxpayer should be accepted if the conditions listed below are fulfilled. This means that if the MS involved have less prescriptive rules on compensating adjustments, these less prescriptive rules apply; furthermore, this report does not encourage MS to introduce more conditions for compensating adjustments than currently apply. The conditions are:
- Before the relevant transaction or series of transactions, the taxpayer made reasonable efforts to achieve an arm's length outcome. This would normally be described in the transfer pricing documentation of the taxpayer.
 - The taxpayer makes the adjustment symmetrically in the accounts in both MS involved.
 - The taxpayer applies the same approach consistently over time.
 - The taxpayer makes the adjustment before filing the tax return.
 - The taxpayer is able to explain for what reasons his forecast did not match the result achieved, when it is required by internal legislation in at least one of the MS involved.

⁷ 3.71 TPG and 4.39 TPG

18. In case the actual result is outside the range of arm's length results targeted when setting the price at the time of the transaction, the adjustment should be made to the most appropriate point in an arm's length range. In this context the guidance in paragraphs 3.55 ff. of the TPG may be helpful. Upward as well as downward adjustments should be accepted.
19. Accepting an adjustment in the aforementioned manner should be regarded as a practical solution to issues arising from the application of compensating adjustments and should not be understood as indicating a MS's view on the more fundamental principles referred to in Section 3, paragraph 6 above. Further it should not be understood as limiting a tax administration's ability to make an adjustment at a later stage (e.g. in an audit) and has no bearing in a MAP procedure.