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EU JOINT TRANSFER PRICING FORUM

Final Report on Secondary Adjustments

Meeting of 25 October 2012

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1. Background

1. The EU Joint Transfer Pricing Forum (JTPF), as part of its work programme for 2011-2015 considered so-called secondary adjustments in transfer pricing, as these adjustments may result in double taxation. A questionnaire launched in June 2011 took stock of the situation prevailing in each EU Member State at 1 July 2011 and served to prepare an overview on the legal and administrative/practical aspects in the different Member States. All 27 Member States' responses were included in document JTPF/018/REV1/2011. A draft discussion paper on secondary adjustments (doc. JTPF/010/2012/EN) was prepared and discussed at the JTPF meeting in June 2012. The present report was discussed and agreed at the JTPF meeting in October 2012.

2. Definition and Scope

2. It is possible that a transfer pricing adjustment is accompanied by a so-called "secondary adjustment". The OECD defines secondary adjustments in the Glossary of the OECD Transfer Pricing Guidelines (TPG) as *"an adjustment that arises from imposing tax on a secondary transaction in transfer pricing cases",* and a secondary transaction as *a constructive 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".*
3. Transfer pricing legislation in some States allows or requires "secondary transactions" in order to make the actual allocation of profits consistent with the primary adjustment. Double taxation may arise due to the fact that the secondary transaction itself may have tax consequences and results in an adjustment. For example, the amount of the income adjustment to a subsidiary on a transaction with a non-resident parent may be treated by the subsidiary's jurisdiction as a deemed dividend paid to the parent and a withholding tax may be applicable.
4. Secondary adjustments are reversed if the primary adjustment is reversed. Secondary adjustments taking the form of constructive dividends may create double taxation if the other State does not provide a corresponding tax credit or relief under Article 23 of the OECD Model Tax Convention (MTC) for the withholding tax arising from the secondary adjustment. Although the Commentary on Article 10 of the OECD MTC already states in paragraph 28 that constructive dividends are covered by Article 10 and by the rules for eliminating double taxation, the other State may simply not recognise such a deemed transaction, which gives rise to withholding tax (see par. 4.69 OECD TPG).
5. The OECD MTC does not prevent secondary adjustments from being made where they are permitted under domestic law[1]. Tax administrations are however "*encouraged to structure such adjustments in a way so as to minimise the possibility of double*

[1] Paragraph 9 of the Commentary on Article 9 OECD MTC.

taxation as a consequence thereof except where the taxpayer's behaviour suggests an intent to disguise a dividend for the purposes of avoiding withholding tax." (par. 4.71 OECD TPG).

6. Out of the 27 EU Member States, 9 have legislation on secondary adjustments. The responses to the questionnaire indicate that secondary adjustments in some of those 9 Member States are discretionary.

R1:

The application of secondary adjustments may lead to double taxation. Therefore, if secondary adjustments are not compulsory, it is recommended that MS refrain from making secondary adjustments when they lead to double taxation. Where secondary adjustments are compulsory under the legislation of a Member State, it is recommended that Member States provide for ways and means to avoid double taxation (e.g. by endeavouring to solve it through a MAP, or by allowing the repatriation of funds at an early stage, where possible). These recommendations assume that the taxpayer's behaviour does not suggest an intent to disguise a dividend for the purpose of avoiding withholding tax[2].

7. In most Member States where secondary adjustments are possible/compulsory, these adjustments are treated as hidden profit distribution and therefore considered as constructive dividends which are potentially subject to withholding tax.

8. Secondary adjustments may also take other forms e.g. a constructive loan. The OECD TPG (par. 4.70) highlight that these constructive transactions carry their own complications e.g. issues related to imputed interest on those loans. In their replies to the questionnaire most Member States did not refer to these types of constructive transactions. The reason may be that Member States want to avoid the related complications and generally make secondary adjustments in the form of constructive dividends/contributions. Constructive contributions and constructive dividends between an EU subsidiary and an EU parent company minimise the risk of double taxation, as they do not entail withholding tax consequences (see section 3).

R2:

Given the additional complications they raise, it is recommended that within the EU Member States characterise secondary adjustments as constructive dividends or constructive capital contributions rather than as constructive loans, as long as there is no repatriation.

9. A more problematic situation arises if the primary adjustment is made between parties that are indirectly related. Some MS may deal with this situation by way of hypothesising a distribution to the parent company and a contribution of the parent to the other subsidiary (par. 4.70 OECD TPG).

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[2] Reservation by Italy: Italy does not have internal provisions on secondary adjustments and is of the opinion that it should be primarily up to those Member States with legislation on secondary adjustments to structure these adjustments in such a way so as to minimize the possibility of double taxation as a consequence thereof. In principle, Italy will not grant relief for the withholding tax arising from the secondary adjustment made by the other Member State which led to double taxation.

10. This report concentrates on secondary transactions between EU resident/established entities and in the form of constructive dividends and addresses – based on the legal framework existing in the EU – ways to minimise double taxation and other administrative and financial burden (e.g. penalties) resulting from secondary adjustments[3].

11. The following sections address the application of the EU Parent Subsidiary Directive (PSD) (see section 3)), situations where MS may consider giving relief if the taxpayer repatriates funds (in a Mutual Agreement Procedure (section 4.2) or at an earlier stage (section 4.3)) and also discuss penalties and procedural/administrative aspects (sections 5 and 6).

3. Parent Subsidiary Directive (PSD)

12. When secondary adjustments are treated as hidden profit distribution/contribution and therefore considered as constructive dividends, the application of the PSD (Articles 4 and 5) results in no withholding tax being imposed on a distribution from a subsidiary to its parent within the EU.

13. Nine EU Member States currently apply secondary adjustments - Austria, Bulgaria, Denmark, Germany, France, Luxembourg, the Netherlands, Slovenia and Spain. In a situation whereby *a subsidiary in a MS is subject to a secondary adjustment based on a primary transfer pricing adjustment relating to a transaction with its parent company situated in another MS*, seven[4] of those nine MS would not impose any withholding tax on the basis of the provisions of the PSD. Two MS[5] would consider that the PSD is not applicable to constructive dividends.

4. Repatriation of funds

4.1 General

14. In essence, repatriation means effectively reversing the funds so that the accounts of the parties involved are in line with the economic intent of the primary adjustment. The OECD TPG (par. 4.73) describe some of the possible ways in which repatriation might be made. The OECD Manual on effective mutual agreement procedures (MEMAP)[6] also contains guidance on repatriation. The OECD TPG (par. 4.76) recommends discussing repatriation in a MAP where it has been initiated for the related primary adjustment.

15. The terms in a mutually agreed MAP settlement between the competent authorities in respect of a transfer pricing adjustment are specific to the particular settlement between the two CAs. Once the CAs have reached an agreement on the characterisation of the deemed transaction, a MAP also involves examining the following two issues:

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[3] Minimising the possibility of double taxation as a consequence of secondary adjustments is recommended in paragraph 4.71 of the OECD TPG.

[4] Austria, Denmark, Germany, Luxembourg, the Netherlands, Slovenia and Spain.

[5] Bulgaria and France.

[6] http://www.oecd.org/document/1/0,3746,en_2649_33753_36195905_1_1_1_1,00.html

- whether the TA which made the secondary adjustment would abstain from withholding tax or the other TA would eliminate the resulting double taxation, and,
- when repatriation is considered, how it will be made and how it is ensured that it does not result in a further taxable burden that may itself cause double taxation.

16. The MEMAP indicates that a repatriation agreement may also be reached at an earlier stage, e.g. during an audit (see 4.3).

4.2 Repatriation in the course of a MAP

17. If repatriation is part of a settlement, the terms may vary, but often 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 State out of which the repatriation is made and from any additional taxable treatment in the State to which the repatriation is made. Repatriation may be subject to audit verification.

R3:

Where competent authorities agree in a MAP on the need to effectively put the accounts in line with the economic intent of the primary adjustment, Member States consider repatriation by a direct reimbursement or through an offset of inter-company accounts as an appropriate tool for achieving this result.

R4:

Tax administrations should be aware that taxpayers would need up to 90 days from the date of the notification of the agreement to actually implement the repatriation.

R5:

When repatriation is agreed in a MAP settlement, it is recommended that the MAP agreement states that no withholding tax will be applied by the Member State out of which the repatriation is made and no additional taxable burden will be imposed in the Member State to which the repatriation is made.

18. As a repatriation is made after the initial transaction, the Member State to which the repatriation payment will be made may consider that the payment should 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. Such an approach would, however, result in further complicating the repatriation and may also have its own tax consequences.

R6:

Where the MAP is between Member States it is, on grounds of simplification, recommended that MS allow, as far as possible, the repatriation without an interest component and state this in the MAP agreement.

4.3 Repatriation at an early stage, e.g. an audit

19. Some States have developed approaches to avoid potential double taxation by refraining from secondary transactions and secondary adjustments if a repatriation is already made at the stage of an audit. Repatriation at an earlier stage, e.g. at the stage of an audit, would from a taxpayer's perspective require an arrangement on how to conform the accounts to the primary adjustments and from a TA's perspective the agreement to this arrangement (some MS may only be able to agree on refraining from secondary transaction/adjustment in the context of a MAP). Further a corresponding treatment by the other TA involved is needed. Ensuring the latter may require informing the other MS based on the exchange of information rules or initiating a MAP as already the primary adjustment might not be acceptable for this TA. It should be noted that under Article 25 of the OECD MTC it would be possible for a taxpayer to initiate a MAP already when he considers that actions of one country are likely to result in double taxation[7].

R7:

If a Member State considers repatriation at an early stage, e.g. at the stage of an audit, it is recommended to ensure that the other Member State is informed concurrently based on an exchange of information procedure, or by the taxpayer (if the taxpayer agrees).

R8:

A repatriation agreement reached at the audit stage should not preclude a request by the taxpayer for a MAP, nor should it indicate agreement or disagreement with an audit statement.

5. Penalties

20. Secondary adjustments may in some Member States be subject to specific penalties or result in penalties under the general penalty regime. The EU JTPF's summary report on penalties[8] already elaborates on different penalty regimes within the EU and reveals in section 5 that in most Member States a possibility to abstain from imposing penalties (as long as they are not considered by a Member State as a serious penalty) exists. Further it contains the message that penalties should be in line with the final, agreed transfer pricing. This conclusion may also be read in a way that penalties should only relate to the transfer pricing adjustment itself, i.e. the primary adjustment and not to the secondary adjustment.

R9:

When a secondary adjustment is required, Member States should refrain from imposing a penalty with respect to the secondary adjustment.

[7] Par. 14, Commentary on Art. 25 of the OECD MTC
[8] EU JTPF Summary report on Penalties accompanying the communication on the work of the JTPF in the period March 2007 to March 2009 (COM(2009)472 final).

21. In case penalties on secondary adjustments are nonetheless applied, it is worth to consider addressing those penalties in a MAP to ensure the removal of double taxation resulting from secondary adjustments.

R10:

When the tax consequences of a secondary adjustment are eliminated or reduced in a MAP, it is recommended to eliminate or commensurately reduce the related penalty, respectively.

6. Procedure for removing double taxation

22. In their responses to the questionnaire on secondary adjustments (JTPF/018/REV1/2011), most Member States which apply secondary adjustments stated that they do not consider double taxation issues resulting from secondary adjustments as being covered by the Arbitration Convention (AC), only a few consider them covered by the AC Convention, and some other MS indicated that the applicability of the AC to secondary adjustments remains an open question for them. However, most MS applying secondary adjustments would be willing to address them in the course of a MAP. Therefore, in cases where it is not possible to avoid double taxation at the outset, e.g. by way of applying the PSD, a taxpayer would – in a case of (potential) double taxation resulting from a secondary adjustment – have to file two requests, i.e. a request under the Arbitration Convention and a request for a MAP. The latter would require in each case a treaty being concluded between Member States that includes a MAP provision comparable to Article 25 of the OECD MTC (preferably including an arbitration clause as per Article 25 (5) OECD MTC).

R11:

As taxpayers may not be aware of the fact that in certain situations a separate request needs to be made for avoiding double taxation resulting from secondary adjustments, Member States which do not consider that secondary adjustments can be treated under the AC are encouraged to highlight in their public guidance the fact that a separate request under Art 25 OECD MTC may be needed to remove double taxation. For reasons of efficiency, it is recommended that taxpayers submit both requests in the same letter.