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EU JOINT TRANSFER PRICING FORUM

Draft Report on Compensating/Year-End 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/year-end 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 (summary record of the June 2011 meeting, doc. JTPF/015/2011/EN).
2. The Secretariat prepared a questionnaire for MS' tax administrations and circulated it for input on 30 June 2011. The questionnaire was based on an earlier contribution to the Forum by JTPF members (doc. JTPF/015/2010/EN).
3. The answers to the questionnaire informed the preparation of an initial discussion paper which was tabled at the JTPF meeting on 25 October 2012 (doc. JTPF/012/2012/EN). However, it was not discussed due to time constraints. Nevertheless JTPF members were invited to send written comments by the end of the year. The comments received indicated that before discussing the detailed questions outlined in the discussion paper, some more general theoretical issues and relevant terminology should be addressed. To clarify the business view on the practical need for compensating adjustments and the circumstances in which third parties adjust prices the Non-Governmental Members of the Forum (NGM) submitted an additional contribution (doc. JTPF/006/2013/EN). Based on the above, a supplementary discussion paper which outlines the more general issues (doc. JTPF/004/2013/EN) was drafted by the Secretariat and discussed at the JTPF meeting in February 2013. It was decided that a draft report should be prepared for discussion at the next meeting.

2. JTPF questionnaire: findings

4. MS' responses to the JTPF questionnaire on compensating/year-end adjustments (doc. JTPF/019/REV1/2011/EN) indicate the following:
   - MS seem to interpret differently the scope of compensating or year-end adjustments,
   - not all MS have specific legislation or administrative guidance on compensating/year-end adjustments and for some MS the need for compensating/year-end adjustments is a consequence from the arm's length principle,
   - among those MS which have some kind of guidance and/or administrative practice, most do not definitely exclude the possibility of compensating/year-end adjustments. However, there are differing views and practices in certain areas (these range from general restrictions over the time limits for making and accepting compensating/year-end adjustments to the way such adjustments – if accepted – will have to be implemented),
   - some MS require that compensating adjustments are reflected in the accounts (i.e. not "off balance sheet"),

- at least one MS only accepts an adjustment of transfer prices exclusively in cases where such an adjustment would have been made between third parties in comparable circumstances and
- there is a consensus between MS that transfer pricing issues resulting from such adjustments can in principle be addressed under the Arbitration Convention (AC).

3. Scope of this report

5. It is recognised that MS apply different approaches with respect to compensating/year-end adjustments. It is further 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 transactions[1], the availability of comparable data and the quality of benchmark studies created on the basis of commercial databases[2] and what constitutes the inappropriate use of hindsight in transfer pricing[3].
6. Although the JTPF recognises that further work on these more fundamental principles would be needed, 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 clarification on some of the concepts and practical solutions for the issues arising from different approaches applied by MS.
7. In this context Section 4 of this report clarifies the differences between compensating/year-end adjustments and what is commonly referred to as price adjustments. Section 5 contains examples on price adjustments which occur between third parties and their implications for transactions between related parties. Section 6 addresses compensating/year-end adjustments within the EU.

4. Price adjustments vs. compensating/year-end adjustments

8. In general, the term ‘price adjustment’ refers to:
   - Price adjustment clauses that have been (or would have been) included within an agreement when it was entered into (such as stepped royalties, milestone payments etc.).
   - Renegotiations of prices during the period of an agreement where there is no specific adjustment clause within that agreement, whether or not the parties are acting at arm’s length.
   - The action of a transfer pricing reviewer when substituting the original price of a connected party transaction with the arm’s length price. The use of this phrase, or similar ones, (such as, “I adjusted the transfer price because…”) is everyday speech and does not refer to any contract or clause.

[1] 3.68 TPG
[2] 3.30 TPG
[3] 3.73 TPG

9. In the context of this report the term **'price adjustment'** refers to the situation where a predetermined price is adjusted. In commercial relations between third parties there may be situations where prices which have been agreed are adjusted for future transactions (prospective price adjustment) or with respect to past transactions (retrospective price adjustment). It will have to be clarified, in which circumstances third parties would have agreed to pro- or retrospectively adjust their prices, how such an adjustment would then have been made and what consequences should be drawn from such a situation for a comparable situation in the commercial relation between related parties.
10. 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.' In practice those adjustments are often made at year-end, what can be regarded as the reason why these adjustments are also called 'year-end adjustments'. It should be noted that this definition contains the element 'even though this price differs from the amount actually charged'. This element suggests that a compensating adjustment as defined in the OECD TPG may be an adjustment outside the books (off balance sheet) and just for tax return purposes. As it may be not entirely clear whether the OECD definition includes compensating adjustments that are made within the accounts, the term **'compensating/year-end adjustment'** as used in this report covers all kinds of compensating adjustments regardless of the point in time they are made and whether they are reflected in the accounts or made 'off balance sheet'.
11. In summary, the issue in relation to price adjustments is whether there is a situation between related parties that would between unrelated parties result in a pro- or retrospective adjustment, i.e. an adjustment based on third party behaviour. As regards compensating/year-end adjustments, the issue is whether the approach taken for setting transfer prices requires or allows an adjustment to the transfer prices set. It is important not to confuse both concepts and the related issues, even if both kinds of adjustment may be made at year end and/or in a similar technical manner.

5. Price adjustments

12. Price adjustments as defined in Section 4 above are made between third parties when the agreement underlying the transaction or transactions explicitly allows/requires a pro- or retrospective adjustment of the price[4]. Guidance on circumstances under which third parties would agree on such an adjustment clause is given in paragraphs 3.72/3.73 OECD TPG. Additionally, the ANNEX to this report contains examples of commercial arrangements where, as part of their normal commercial arrangements, third parties allow parties to adjust their prices. Third parties may also make price adjustments in other situations, e.g. in case of exceptional and extraordinary events such as a major change in the economic environment even without an explicit clause.

[4] Price adjustment, protection of renegotiation clauses etc.

For discussion:

Do you think it is useful to include the examples from NGM in the ANNEX to this report?

13. In general, the JTPF agrees that in the related party context a transfer price should be adjusted if in light of the considerations in the precedent paragraph an adjustment would also have been made in a comparable situation in commercial relations between third parties. The adjustment would then have to have a symmetrical effect on both participants to the transaction.
14. In order to determine whether the arm's length principle has been applied with respect to price adjustment arrangements that have or should have been established between related parties, a reviewer[5] will have to answer the following questions:
    - Do the facts and circumstances at the time when the commercial arrangement was entered into indicate that third parties would have agreed on a price adjustment mechanism, too?
    - Is the price adjustment mechanism agreed comparable to what third parties would have agreed?
    - Is the adjustment made in accordance with the price adjustment mechanism?
15. In order to determine whether the arm's length principle has been applied with respect to other situations that cause or should have caused a price adjustment between related parties, a reviewer will need to answer the following questions:
    - Would third parties have agreed to adjust the price in the same circumstances?
    - How would such an adjustment have been made?
16. If, under the aforementioned considerations transfer prices are adjusted, the adjustment made should be such that would have been agreed between unrelated parties in accordance with the respective contractual arm's length arrangements or the facts and circumstances of the event causing the adjustment.
17. Generally such a price adjustment should be implemented at the time when the respective event results in the need for the adjustment. For reasons of simplification it is possible that the taxpayer reflects the adjustment in the books when he reviews its transfer pricing at the end of the respective year, i.e. before closing the accounts.

For discussion:

Do you agree with this guidance?

6. Compensating/year-end adjustments

6.1 General

18. In general, compensating/year-end adjustments touch upon the important theoretical issue in transfer pricing on whether

[5] The term reviewer applies to the reviewer function exercised either by the taxpayer or the tax administration.

- 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**)[6], 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**)[7].

19. MS who 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 for a period of time that would be comparable to the period that would have been agreed between third parties. An adjustment of these prices would only be possible after the period or in a situation where third parties would have agreed to adjust prices[8]. This could also imply that a taxpayer-initiated adjustment at year-end would generally not be allowed as being an adjustment with implication to the past, i.e. to a transaction that already took place and would not have been made in comparable circumstances between third parties. Therefore the concept of compensating/year-end adjustment would in principle not fit in a pure ex-ante approach.
20. 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 return[9]. 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).
21. When both MS apply an ex-post approach, and require compensating/year-end adjustments, issues and even a risk of double or double non-taxation may arise with respect to the following:
    - When such an adjustment should/can be made (year-end, closure of books, filing of the tax return)?
    - Which data should be used for determining the need for an adjustment and the adjustment itself?
    - Whether an adjustment can be made in both directions (upwards and downwards)?
    - To which price the adjustment should be made (in case of ranges e.g. closest quartile, median etc.)?
22. If the transactions under review are between two related parties which are situated in two different 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.

[6] 3.69 TPG
[7] 3.70 TPG
[8] See section 5 on price adjustments
[9] 4.38/4.39 TPG

23. The guidance in the OECD TPG on those issues is currently rather limited. Both the arm's length price setting and the arm's length price outcome approach are recognised as being applied by MS and in case of dispute, the OECD refers to the Mutual Agreement Procedure (MAP)[10].

24. 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.

25. To address these practical issues, MS agree on conditions under which taxpayer-initiated compensating/year-end adjustments should be accepted (see section 6.2). The decision whether to oblige the taxpayer to make such an adjustment is left to the discretion of the MS.

6.2 Compensating/year-end adjustments in the EU

26. The responses on the questionnaire indicate that MS' approaches on the conditions, the timing and the manner of those adjustments vary. To address the practical issues arising from this situation as described in section 6.1 above, MS agree that an adjustment should as a minimum[11] be acceptable if the following conditions are fulfilled:

- At the time of the transaction the taxpayer made reasonable efforts to achieve an arm's length outcome.

For discussion:

Do you think more guidance should/can be developed on what 'reasonable efforts' means or should this be left to the facts and circumstances of the respective case?

- The taxpayer is able to demonstrate for what reasons his forecast did not match the result envisaged.

For discussion:

Do you think more guidance should/can be developed on how to demonstrate these reason or should this be left to the facts and circumstances of the respective case?

- The taxpayer makes the adjustment symmetrically in both MS involved.
- The taxpayer applies the same approach consistently over time.
- The taxpayer makes the adjustment before filing the tax return.
- The adjustment is reflected in the accounts when it is required in at least one MS. Recharging/reallocation of expenses is in these circumstances regarded as an appropriate tool for reflecting a compensating/year-end adjustment in the accounts.

[10] 3.71 TPG and 4.39 TPG

[11] This means that if the MS involved have less prescriptive rules on compensating/year-end adjustments, these less prescriptive rules apply.

For discussion:

In their contribution NGM mentioned that various approaches are found in practice. While sometimes an adjustment of each transaction is required, in other cases also an aggregate lump sum payment is allowed. At other occasions expenses are recharged or allocated out or new service charges (e.g. a marketing support payment) are suggested. In the JTPF questionnaire the question on the form of a compensating/year-end adjustment in the accounts has not been raised. However, with respect to the suggestion of "creating" a service, the issue arises that services generally require a benefit to be received by the purported recipient.

Do you, based on the aforementioned considerations, agree with the above conclusion?

27. If the aforementioned conditions are fulfilled, the adjustment should be made based on information that was used to determine the transfer price at the time of the transaction. If more recent information is available to the taxpayer, this information may also be used.

For discussion:

Do you agree with the above conclusion?

28. 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 question arises about the point in the arm's length range which should be taken as the basis for an adjustment. Possible alternatives might be to require an adjustment:

    - to the result originally targeted, or
    - to the point in the range closest to the actual result, i.e. the upper or lower quartile, or
    - to a point of central tendency (e.g. the median).

Upward as well as downward adjustments should be accepted.

For discussion:

To which point in the range should the adjustment be made?

Do you think more guidance on how to make the adjustment should be developed?

29. Accepting an adjustment in the aforementioned manner should be regarded as a practical approach to avoid conflicts and should not be understood as indicating a MS's view on the more fundamental principles elaborated in 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)[12].

[12] Par 3.60 OECD TPG: "If the relevant conditions of the controlled transaction (e.g. price or margin) is within the arm's length range, no adjustment should be made".

ANNEX: Non-Governmental Members' contribution describing three situations regarding prices set and year-end adjustments that can be distinguished in third party transactions

1. Rationale for transactions between an entrepreneur and limited risk party

The first situation is a transaction between third parties where one of the parties accepts most of the risks (such as market risk, R&D technology risk, product liability risk, etc.) and acts as the entrepreneur, while the other party functions as a limited risk entity in the transaction. In these circumstances, parties may agree a price upfront on which basis the transactions will take place. Such price may be set based on budgeted costs and sales, and includes a profit element that allows the limited risk entity to make a profit in line with the limited functions and risks it assumes. Given the fact that the limited risk entity does not assume certain risks, it is therefore also not held responsible for the financial consequences, if such risks materialize. As a result, if after the budgeted price has been agreed, events or risks occur outside the responsibility of the limited risk entity that lead to actual costs and sales that deviate from budgeted costs and sales, a price adjustment to the transaction takes place to ensure that the limited risk entity receives a profit in line with its functions and risks. Such price adjustment is not uncommon between third parties in the scenario where one party assumes most of the risks and can be regarded as the sole entrepreneur of such transaction. Such arrangement is merely a reflection of the desire of parties to trade off certain risks for a lower guaranteed reward.

There is experience with different forms of price adjustment clauses in contracts with third parties. Price adjustments generally take place after year-end in a retrospective manner in which case any deficit or surplus of the period or year in question is adjusted to the previously set budgeted result (i.e. year-end adjustment). Also, price adjustments take place in a prospective manner in which case any deficit or surplus of the period or year in question is taken into account in the price setting for transactions in the following period or year. This is often the case if actual sales and costs do not materially differ from budgeted sales and costs.

A real life example of price adjustment clause, in this particular frame, is described below.

Exert of a contract between 3rd parties for allocating costs by a limited risk service provider:

X.X COMPANY's reporting requirements in respect of the annual payments referred to in Articles X.X and X.X b) respectively, shall be as follows:

(a) By the beginning of June of each year, as confirmed in advance by XXX on an annual basis, COMPANY shall submit, certain of the information necessary for XXX to calculate the estimated share of COMPANY in XXX's estimated costs of the next calendar year. It is on the basis of XXX's provisional estimate that COMPANY shall be invoiced for that year.

(b) COMPANY shall be obliged to confirm to XXX within XXX days after the end of each calendar year, the information required by XXX to finalise the amount owed by COMPANY with respect to its sharing of actual costs for the previous year and COMPANY and XXX shall reconcile the balance between themselves.

2. Rationale for transactions between entrepreneurial parties

Alternatively, there are transactions where both third parties act as full entrepreneurs, exposed to a full range of risks (such as market risk, supply risk, credit default risk, product liability risk, etc.). In these circumstances, parties may agree a price upfront on which basis the

transactions will take place. Such price may be set based on market reference data at the time of the transaction, insofar such data is available, or based on negotiated prices between buyer and seller bearing in mind information on demand and supply factors. In those circumstances, it is not uncommon to have the price fixed at the beginning of the transaction. However, as a fact of commercial reality, also in these cases (especially in a long terms relationship), price setting is frequently combined with adjustments and/or re-negotiation clauses. This depends on the relative contractual power of the two parties which is almost never balanced. The need for the weaker party not to be "imprisoned" into a "killing agreement" and for the stronger party not to be considered commercially dominant, so incurring the risk of fines or other legal consequences is normally reflected in third parties agreements by using several different "way out" solutions. One of those (probably the most used) being the price adjustment clause.

In a non-related party transaction both specific adjustment formulas and generic assumptions can be observed. In the first case, apart from highly unexpected events, there will be no need for the parties to enter into new negotiations, while in the second case, generic contractual statements such as: "the parties will make their best effort in order to reach an agreement in case….", could lead to litigations and be legally enforced by a Court, in case of a significant and undesired economic detriment to one of the two parties.

This is to say that, also in a situation where both parties act as a full entrepreneur, the parties will often bargain on prices and other contractual conditions allowing lower prices or price flexibility in exchange for risk limitation. Examples of contractual formulas can be:

1) Take or pay commitment (a contractual formula which guarantees, in the frame of a contract manufacturing agreement, a minimum volume commitment driven to allow the manufacturer to recover fixed costs through prices or lump sum payments)

2) Decreasing prices based on volumes range (the typical "the more you buy the less you pay")

3) Inflation or public index links

4) Cost of capital linked price (normally alternative to "take or pay")

5) Commercial subsidies given through price incentive (based on qualitative targets, opposed to quantitative targets as utilized in point 2 above)

The application of all of the above mentioned clauses drive to prospective or retrospective price adjustments (see par. 3.1) or lump sum payments as agreed between the parties.

A real life example of a price adjustment clause, in this particular frame, is described below.

Exert of a contract between 3rd parties assuming similar risk levels:

XX In addition to the Purchase Price, the Purchaser shall pay Pro Rata to the Seller, an amount up to EUR XXX based on the market development in Country Y regarding the products between January 1, 20XX and December 31, 20XX. The Additional Price shall be paid by way of three yearly interim payments plus one further payment based on the market development in the calendar years 20XX and 20XX. The Purchase Price as increased by the Additional Price (if any) shall be referred to as the "Final Purchase Price".

3. Price protection between entrepreneurial parties

There is also a great number of industries where third parties which act as full entrepreneurs and are accordingly exposed to a full range of above mentioned risks, do agree on a price protection clause in their agreement.

A real life example of a price protection clause, in this particular frame, is described below.

XX Seller and buyer agree, whereby (i) in the case of a price increase, the buyer will be able to continue purchasing the product at the lower price for a period of time after the price increase, and (ii) in the case of a price decrease, the seller will give the buyer a credit or rebate for the difference in price between the old price and the new price for all of the stock the buyer has on hand which was purchased at the higher price.

Indeed, we have experienced that most commonly such clauses, which are typically used in businesses where prices fluctuate and/or erode materially, are used when the other entrepreneurial party to the agreement (typically reseller of the product) is granted (either for free or against compensation) a hedge from the fully-fledged seller (manufacturer of the product) to cover the potential effects that price erosion could have on its profitability if the value of purchased goods went down. In case there indeed is price erosion within a specified time agreed in the agreement (does not necessary require that the reseller has the said products in stock anymore), this is covered by a credit or rebate for the reduced price of the product.