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EU JOINT TRANSFER PRICING FORUM

Supplementary Discussion Paper on Compensating/Year-End Adjustments

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1. Background and structure of this supplementary discussion paper

1. For the JTPF meeting of 25 October 2012 a discussion paper was prepared (JTPF/012/2012/EN) which was not discussed due to time constraints. Nevertheless JTPF Members were invited to send comments voluntarily by the end of the year. The comments received (see Annex A) indicate that before discussing the detailed questions outlined in discussion paper (JTPF/012/2012/EN) some more general theoretical issues and the terminology used should be addressed. Further PSM submitted a contribution on the business view on the practical need for compensating adjustments and circumstance in which third parties adjust prices (see Annex B).

2. This discussion paper intends to inform an initial discussion of the topic. It elaborates on the theoretical issues with the intention to clarify the concepts used by MS, identify the issues arising and to suggest how they might be addressed in the future work of the JTPF.

2. Conclusions from the JTPF questionnaire

3. Members States' responses to the JTPF questionnaire on compensating/year-end adjustments (doc. JTPF/019/REV1/2011/EN) show that

    - not all Member States (MS) have specific legislation or administrative guidance on the issue of compensating/year-end adjustments and for some MS the need for compensating/year-end adjustments is a consequence from the arm's length principle

    - from those MS who have some kind of guidance and/or administrative practice none is definitely excluding the possibility of compensating/year-end adjustments, but there are differing views and practices in certain areas. (Those 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)

    - many MS require that compensating adjustments are reflected in the accounts (not off balance) and

    - that there is a consensus among those MS which allow compensating/year-end adjustments that transfer pricing issues resulting from such adjustments can in principle be addressed under the Arbitration Convention (AC).

4. The fact that compensating/year-end adjustments have not yet been addressed in many MS and that differing views exist among the MS which have addressed them, lead to the conclusion that it is worth evaluating what kind of further work can be done on the issue of compensating/year-end adjustments with the aim to prevent transfer pricing disputes in the future.

3. Compensating/year-end adjustments

5. In the Glossary, the OECD Transfer Pricing Guidelines (TPG) define a compensating adjustment 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 seen 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 is an adjustment outside the books (off balance sheet) and just for tax return purposes. As there may be a doubt whether the OECD definition includes year-end adjustments that are made within the accounts, the term "compensating/year-end adjustment" as used in this paper covers all kind of compensating adjustments regardless of at what point in time they are made and whether they are reflected in the accounts of made off balance sheet.

4. Concepts for determining transfer prices

4.1 General

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

   - transfer prices should be set and established at the time of the transaction and reasonable efforts should be made to comply with the arm's length principle (**ex-ante or arm's length price setting approach**), or whether
   - the actual outcome of the transaction should be tested and adjusted with respect to its arm's length character at a later point in time, e.g. at year-end (**ex-post or arm's length outcome testing approach**).

7. 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). Further the value of contemporaneous information as well as its limited availability is recognised.[1]

4.2 Ex-post or arm's length outcome testing approach

8. MS who 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. 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 the transaction was undertaken = contemporaneous data) should/could be used by the tax administration to determine/test the transfer prices.

[1] 2010 OECD TPG 3.69

4.3 Ex ante or arm's length price setting approach

9. MS who follow the reasoning of an ex-ante approach would generally require the taxpayer to make reasonable efforts when establishing 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. This would also imply that a taxpayer initiated adjustment at year-end would 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 between third parties (**retrospective adjustment**). For some States these adjustments may even fall under their definition of "hindsight", a term not commonly defined in the OECD TPGL and currently discussed controversially.

10. An ex-ante approach may, however, allow adjusting the prices during the year for the future if third parties would have done so (**prospective adjustment**). The reasons for agreeing on different prices could be in the nature of the business, e.g. if prices on the market are subject to a high degree of fluctuation and third parties would only agree on short term validity of prices (**regular price adjustment**). Adjustments may also be grounded in circumstances that would also lead third parties to exceptionally renegotiate a price for the future (**exceptional price adjustment**) or even for the past. Regarding the circumstances that would lead third parties to change prices it is referred to section 3 of the PSM contribution to compensating adjustments (see Annex to this paper). For practical reasons it may be possible to actually perform these prospective adjustments at year end or before closing the books Exceptional price adjustments may even be allowed retrospectively if it would have been agreed between third parties, too.

11. The ex-ante approach may also imply that at the time of an audit only the data available to the taxpayer at the time of transaction or an appropriate prospective adjustment can be used by the tax administration to proof the arm's length character of the taxpayer's pricing

5. Issues arising

5.1 Need for addressing the topic

12. Issues arise, when MS apply the respective approaches differently or when one MS follows the arm’s length setting and the other MS the arm’s length outcome approach. If these issues arise at the stage of an audit, an adjustment made by one MS may result in a corresponding adjustment or, in case of dispute in a MAP. The AC finally ensures that double taxation is removed at one point in time.

13. A more difficult situation arises at the time when the taxpayer files his tax return. If at that stage MS require the taxpayer to apply different approaches and to reflect eventual adjustment in the accounts, the taxpayer may be put in a difficult situation as he may

    - either be obliged to report different transfer prices (what could create double taxation or white income) in the two MS involved or

- if want to achieve a corresponding treatment in the books of both companies involved, may be obliged to report a price that may conflict with one MS's domestic law (what may expose the taxpayer to penalties.

14. The scope of JTPF work would be limited to guidance for the time until closing books/filing a tax return rather than the later audit. If an adjustment is made in the course of an audit the mechanisms of corresponding adjustments under Article 9 (2) or – in case of disagreement – the MAP under the AC is available to solve the problem.

5.2 Areas conflicts

15. When both MS apply an ex ante approach, issues and a risk of double or double non taxation may arise with respect to the following aspects of these adjustments:

    - Whether and under which conditions prices may be changed for the future

    - Under which exceptional circumstances third parties would have agreed on retrospectively changing the prices

    - How to determine the adjustment

    - Whether prospective adjustments can actually be implemented at a later stage, e.g. when closing the books

16. When both MS apply an ex post approach, and require compensating/year-end adjustments, issues and a risk of double or double non-taxation may arise with respect to the following aspects of these adjustments:

    - 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 point of a range the adjustment should be made (closest quartile, Median etc.)

17. In a third scenario, where the transaction under review is between two related parties which are situated in a MS who follows an ex-ante and another MS who follows an ex-post approach with an obligation to reflect the adjustments in the books, all the issues described in the two paragraphs above may arise.
18. The issues described results in the need to give taxpayer guidance on what to do when closing the books or filing the tax return.

5.3 Possibilities to address these conflicts

19. Although likely to be difficult, the most beneficial outcome of a discussion would of course be if MS could agree on following the same approach when it comes to closing the books/filing the tax return.

20. It may also be helpful to discuss whether it is possible to follow the same approach (either the arm's length price setting or the outcome approach) in certain circumstances. In light of the JTPF's discussion on risk management, the administrative burden for tax administrations and taxpayers could be reduced if a certain approach would generally be used for certain low risk transactions if certain conditions e.g. no tax planning, similar tax rates, within EU, consistent behaviour etc. are met. It may therefore be worth to explore whether it is possible to agree on a recommendation along these lines[2].

21. The JTPF work may result in guidance on the issues arising within the application of the approaches themselves, i.e. those described in paragraph 15 for the ex-ante approach and in paragraph 16 for the ex-post approach. For this purpose, section 4.2 of the discussion paper (JTPF/012/2012/EN) discusses prospective adjustments in general and section 4.3 retrospective adjustments between third parties[3].

22. The guidance on the approaches themselves may then be supplemented with guidance on what a taxpayer can/should do in situations where his controlled transactions take place in MS which follow different approaches. If it is not possible to agree on a common approach, the issue may be addressed in an APA.[4]

23. The minimum outcome – basically already available – would be to provide an overview on the respective MS' practices with regard to the general acceptability, timing, implementation and documentation of compensating/year end-adjustments. The questionnaire already issued would, however, need to be revised and updated.

Items for discussion

PSM are invited to present the feasibility and implications each of the approaches mentioned above have on their daily practice. MS are invited to present their approaches and their respective advantages and disadvantages.

Do you see a possibility to agree on one common approach for the time when books are closed or the tax return is filed?

Do you see a possibility to agree on a common approach for certain transactions?

Do you agree that further work as described above should be done for achieving a more uniform treatment of compensating/year-end adjustments or for giving guidance to taxpayers on how to deal with conflicting approaches between MS?

[2] This proposal is addressed in section 4.1 of the discussion paper (JTPF/012/2012/EN)

[3] The practical issues arising when applying an ex post approach are discussed in section 4.4 of the discussion paper (JTPF/012/2012/EN)

[4] see section 4.5 of discussion paper (JTPF/012/2012/EN)

ANNEX

Compilation of comments received on the general issue of compensating/year-end adjustments from PSM and the United Kingdom (the comments on specific questions in doc JTPF 2012/012/EN received from Denmark, UK, Germany and Cyprus will be distributed when this paper is discussed in detail at a later stage):

A. Contribution received from the United Kingdom

Pricing of transactions between third parties

1. This is our understanding of how businesses price transactions with unconnected parties, (subject, of course, to comments from PSMs):
   - Third parties will always price ex-ante[5].
   - They may agree to change the price of a transaction in advance if there is a clause in the contract allowing them to do so – e.g. a stepped royalty clause
   - In exceptional circumstances third parties may re-negotiate a price prospectively, even if there is no clause in the contract, provided it is in the parties' best interest to do so. Please see the example at Annex A.
   - We think that third parties will rarely agree to change the price of a transaction after it has taken place.

Pricing for Transfer Pricing: General principles

2. Please note that the following discusses principles of transfer pricing (TP) and excludes consideration of domestic TP legislation in MSs.
3. TP concerns the arm's length principle as expressed in Art 9 OECD MTC[6]. For practical tax purposes it is often taken to mean whether the price used in a transaction would have been used by independent parties. Transfer pricing is not about asking associated parties to replicate the behaviour of third parties – see 1.11 and 9.174 TPG – it's only the conditions (i.e. price) that are to be followed. In applying the arm's length principle TPG recommends the use of comparability analysis– 1.33TPG.
4. The date and time of a transaction is one of the economic circumstances to be taken into account in the factors of comparability – 1.55 TPG.
5. Therefore it is possible to price a connected party transaction using ex-ante and ex-post[7] TP approaches. We are not constrained to using the ex ante approach (unlike independent businesses).
6. Both TP approaches (ex- ante and ex-post) aim to arrive at the AL price which would have been determined on an ex-ante basis.

[5] i.e. at the time or before the transaction takes place. 3.69 TPG uses the term " the arm's length price-setting" approach

[6] OECD Model Tax Convention

[7] i.e. after the transaction has taken place. 3.70 TPG uses the term " the arm's length outcome-testing" approach

7. No matter which approach is taken, it is unlikely that contemporaneous comparables will be available at the time the taxpayer determines its transfer prices.

8. Consequently in EITHER case a **comparability adjustment** for the date and timing of the transaction MAY be necessary in accordance with paragraph 1.55 of the Guidelines.

9. In EITHER case the result should (subject to the usual imprecision of transfer pricing) be approximately the same and give the price that third parties would have agreed on an EX-ANTE basis.

When is information about comparables available?

10. Information about comparable uncontrolled transactions which occurred at the same time as the tested transaction ("contemporaneous comparables") is unlikely to be available until sometime after the transaction. This is illustrated by a simple example:

Transaction date:	2010
Return filing date:	2011
Tax administration audit date:	2012

Date	Date of comparables available	Price per available comparables
2010	2008	€100
2011	2009	€200
2012	2010	€150

The appropriate arm's length price is clearly €150. A taxpayer should attempt to make comparability adjustments to reflect the factors that caused the AL price of the transaction to increase so substantially. Given the magnitude of the increases those factors should be fairly obvious. (Note: the 2009 comparable is no more valid than the 2008 comparable in determining the appropriate price for a transaction occurring in 2010)

What information can be used to determine the ALP?

11. 3.68 TPG sets out the principle that uncontrolled transactions undertaken or carried out during the same period of time as the controlled transaction ("contemporaneous uncontrolled transactions") are expected to be the most reliable information to use. They reflect how independents parties have behaved in an economic environment that is the same as the economic environment of the taxpayer's controlled transaction. Availability of information on contemporaneous uncontrolled transactions may be limited in practice, depending on the timing of collection.

12. Pricing intra-group transactions ex-ante may require the use of databases which are probably about 2 years behind the date of the transaction: 'Y-2'. The need for a comparability adjustment to reflect the date and timing of the tested transaction should then be considered in accordance with 1.55 and 3.69 OECD TPG. For example companies that were pricing intra-group transactions during the last quarter of 2008 should have taken into account the turbulence in the financial markets, albeit that database comparable

information available to them at that time would have reflected transactions which occurred in earlier years.

13. Pricing intra-group transactions ex-post may entail the use of a database to price the transaction when preparing the accounts. The database may be Y-1. Y-1 may be less accurate than Y-2, because Y-2 may better reflect the price in Y. Information about the market may also be used, but care must be taken not to use hindsight. (See paragraphs 23-27 below.)

14. Depending on the timings of the transaction, the preparation of the accounts and the filing of the tax return, it may be that only the tax administration is able to view the database 2 years after the transaction, i.e. the group is required to file its tax return before the relevant contemporaneous information is available on the database.

When can a tax administration argue for a different price?

15. A tax administration can argue for a different price to be used when that used by the taxpayer is not at arm's length, as demonstrated by a contemporaneous comparable. If third party comparables cannot take into account later unforeseen events, then no adjustment can be made to the price by the tax administration for those events. However if the comparables have taken into account a foreseen event, then so should the taxpayer. This is not a hindsight issue. It's just using the most appropriate comparables – contemporaneous ones.

16. Substituting a more contemporaneous comparable for the price used by the taxpayer is in accordance with 1.55 TPG.

17. There is no requirement for there to be a price adjustment clause in the contract between the parties to the transaction for the price to be adjusted under 1.55 TPG, or any assumption that such a clause would have been present in a contract between unconnected parties. We are just substituting a more reliable arm's length price.

The potential for confusion with terms that can have more than one meaning

18. The term 'price adjustment' may refer to:

    a. Price adjustment clauses that have (or would have, at arm's length) been included within an agreement when it was entered into (such as stepped royalties, milestone payments etc)

    b. 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.

    c. 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.

19. The term 'price setting' may refer to:

    a. The approach to determine the price of a transaction as set out in 3.69 TPG, i.e. on an ex ante basis, using information available at the time of the transaction

b. The setting of a price of a transaction by whatever means, be it between third parties, between connected parties on either an ex ante of ex post basis. It is part of every day speech.

20. Therefore reviewers must take care to specify exactly what they mean when either the term ‘price adjustment’ or the term ‘price setting’ is used otherwise confusion may arise.

Hindsight

21. Hindsight is an issue that gets raised when discussing year-end adjustments. The word “hindsight” is not defined in the TPG. WP6 is currently discussing draft guidance on its use in TP.

22. Changes in the economic and market factors that occur after the date of the transaction should not be taken into account when determining the transfer price - see paragraph 17 above.

23. Another question is whether the use of information about arm’s length transactions that occur at the same time as the tested transaction constitutes the use of hindsight in the context of transfer pricing. Such information is seldom known at the time of the tested transaction, but generally becomes available later. The use of this third party information is recognised by the TPG as a valid approach at 3.70.

24. Hindsight is also considered at 3.74 TPG. Information from the years following the transaction can be taken into account when analysing transfer prices, but only to the extent that it does not take into account subsequent events. This is not what concerned PSMs in their original paper and it does not need to be addressed by the JTPF.

25. The use of data on contemporaneous comparables that was not available to a MNE at the time it set or tested its transfer prices but which a tax administration uses to check the reasonability of the MNE’s efforts to make comparability adjustments is not a matter of hindsight but rather can reasonably be viewed as a risk assessment tool.

Other related issues

26. There are other associated issues that may be raised in connection with year-end adjustments, including whether a tax administration can assume a price adjustment clause in a contract and whether the price of the other leg of the transaction has also been adjusted. We do not think these are issues that are directly related to year end adjustments, but for the sake of completeness they are included at Annexe B.

Summary – what we are trying to achieve

27. This paper sets out the theoretical framework described in the TPG for determining the conditions in accordance with Article 9 MTC. Solutions for resolving the practical issues that arise when considering compensating adjustments should be based on this framework.

UK's example of third parties re-negotiating the price prospectively, even if there is no clause in the contract permitting them to do so

- Distributor B is engaged by Manufacturer A to distribute its products under a 10 year contract.
- The contract between the parties specifies:
    - a price per item to be paid by B to A.
    - a minimum (but not a maximum) marketing spend to be undertaken by B
    - a minimal early termination penalty
        - The price was based on projections which anticipated a particular level of end sales.
        - The level of sales was significantly less than anticipated and resulted in Distributor B incurring losses in the first 3 years of the agreement.
        - Distributor B seeks to re-negotiate the price failing which it will terminate the contract.
        - Manufacturer A undertakes a revised projection exercise which suggests that if it reduces its prices to B, both parties will make future profits, albeit A’s will obviously be less than if it maintained the original price AND distributor B continued its distribution activities.
        - However, if A does not agree to a price reduction, B will terminate the agreement and A computes that the switching costs of appointing a new distributor will produce a smaller profit for it than an agreement to reduce the price to B.
        - It is the interests of both A and B to agree a new, lower price in Year 4, even though the original contract was a fixed price for 10 years.

B. Contribution from Private Sector Members

Prices set and Year-end adjustments - commercial reality

1 Introduction

Following the EUJTPF meeting of October 25th, 2012, Private Sector Members offered to share a short note with the Secretariat clarifying why tax payers apply year- end adjustments in intercompany transactions and provide insight in commercial arrangements where year-end adjustments are applied.

2.1 Rationale of year- end adjustments in intercompany transactions

The arm's length principle dictates related parties to agree prices that would have been agreed between unrelated parties. The ultimate price agreed should be reflective of what would have happened between parties acting and negotiating at arm's length in similar circumstances. Generally, benchmarking exercises are undertaken where TNMM is the appropriate method to determine the result of parties acting and negotiating at arm's length and will include comparable companies trading in similar circumstances. Consequently, the benchmarking result is used in the related party transaction by applying prices that ultimate lead to a result that unrelated parties would have also achieved. In this regard companies set their prices at the beginning of the year based on budgeted costs and sales, with the aim of targeting the benchmarking result. However, due to market fluctuations, actual costs and sales will almost always differ from the budgeted numbers leading to a result different from the benchmarking result. Therefore year- end adjustments to prices are required to ensure that a result is achieved the same as would have been the case had the parties been unrelated whilst trading at arm's length. As such, year- end adjustments are not instigated by companies to unfairly manipulate the result but are simply undertaken to bring the actual result in line with the arm's length result as dictated by the benchmarking analysis undertaken.

In applying the arm's length principle, it is important to consider the difference between business sectors that operate in a relatively stable market and business sectors where the predictability of sales and margins can be subject to huge endogenous or/and exogenous factors, driving to continuous budgets and forecasts adjustments during the year. The so called ex ante approach, used in determining prices, based on information that is reasonably available at the point in time the transactions are undertaken, do not fit to a very significant number of companies operating in unstable businesses with fluctuating market circumstances. Therefore, companies operating in such unstable businesses, need to be given the opportunity through year- end adjustments to adjust their prices in order to be compliant with the arm's length principle. Even so companies operating in a relatively stable market that may not have a well established discipline providing accurate forecasts, will also need to apply year- end adjustments in order to be compliant with the arm's length principle. Typically, benchmark results include companies that have a well established forecast discipline and companies that have a less well established forecast discipline. Given the results of both type of companies end up in the final benchmarking result, related parties should be performing year- end adjustments to be compliant with the arm's length principle.

Therefore for most MNCs that have routine operations (e.g. distribution) there will be a need to ensure compliance with the arm's length principle through the achievement of a particular result or range of results and true ups will often be required to ensure this. In third party situations this may not always happen because in such cases there will be negotiations truly at arm's length which cannot and should not be replicated within an MNC. The true up will be required to ensure the result is the same as would have happened within those third party situations.

That said we have observed in practice that as part of normal commercial arrangements, third parties agree negotiation clauses or year- end adjustment clauses that allow parties to adjust their prices. Thus frequently similar arrangements exist between third parties. Section 3 provides examples of such arrangements.

2.2 Additional challenges

However, making a year-end adjustment may be followed by impacts not only on direct taxes, but also on indirect taxes such as Value Added Tax ("VAT") and customs duties. Governed by different regulations, different motivations, and different methods and filing periods, post-importation adjustments to import prices corresponding to transfer pricing year-end adjustments may also require thorough documentation and analyses from a customs perspective. This poses additional challenges since the corporate tax and indirect tax administrations may have opposing interests. Although more countries such as Australia, the US, and Canada are seeking to better integrate transfer pricing and customs, harmonising the two may still prove to be difficult despite the recent efforts of the World Customs Organisation and resulting changes to the Commentary 23.1 of the Technical Committee on Customs Valuation.

MNCs face an increased risk of unaccepted year-end adjustments or of unaccepted no year-end adjustments from a corporate tax perspective and reassessed duties and penalties from custom authorities if transfer pricing year-end adjustments are not well-managed or are not implemented. It is therefore recommended to the Secretariat, to support a simple common procedure or preferably a more standardized way to conduct acceptable year-end adjustments, and to point to the indirect tax issues and recommend coordination if not ideally, harmonisation in this field.

3 Commercial arrangements

There are at least three situations regarding prices set and year-end adjustments that can be distinguished in third party transactions.

3.1 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 party 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 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 post the budgeted price 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 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 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.

3.2 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 or 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 endeavor 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”.

3.3 Price protection between entrepreneurial parties

There are also great number of industries where transactions between third parties, who do as such act as full entrepreneurs and are accordingly exposed to a full range of above mentioned risks, agree on 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.

Agreements with price protection clauses cannot be executed without year-end adjustment type of periodic true-ups between the parties. Naturally these payments can take place monthly, quarterly, annually etc – but this does not change the nature of the underlying transaction; which is to correct the initially set transfer prices between the parties.