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EU JOINT TRANSFER PRICING FORUM

REVISED

Draft 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 revised draft report reflects the discussion on compensating adjustments that the JTPF had in June 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 revised draft report. Comments received from MS are included in boxes throughout the text.

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.” The element “even though this price differs from the amount actually charged”, may suggest 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 is not entirely clear whether the OECD definition includes compensating adjustments that are made within the accounts, the term “compensating adjustment” as used in this report covers compensating adjustments regardless of the point in time they are made and whether they are reflected in the accounts or made 'off balance sheet'.

Note:

Based on a suggestion made at the MS pre-meeting the terminology was aligned to the one used by the OECD, i.e. reference is made to “compensating adjustments” rather than to “compensating/year-end adjustments”.

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.

4. Compensating adjustments

4.1 General

8. In general, the adjustment of transfer prices set at the time of a transaction at a later point in time 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.
9. 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.
10. 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

¹ 3.68 TPG

² 3.30 TPG

³ 3.73 TPG

⁴ 3.69 TPG

⁵ 3.70 TPG

⁶ 4.38/4.39 TPG

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.

Note:

The ending of the sentence above was added following an observation by **Germany** that it was unfinished in the former version of the draft.

11. When both MS apply an ex-post approach and require compensating adjustments, problems and even a risk of double 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,
 - 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.).
12. 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.
13. 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.

Note:

The paragraph is redrafted in accordance with **Germany's** suggestion to exactly follow the agreed OECD terminology, and replace “price outcome” with “outcome-testing” in the second sentence.

14. 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.
15. To address these practical issues, MS agree on conditions under which taxpayer-initiated compensating adjustments should be accepted. The decision whether to oblige the taxpayer to make such an adjustment is left to the discretion of the MS.

⁷ 3.71 TPG and 4.39 TPG

4.2 Compensating adjustments in the EU

16. To address the practical issues arising from the situation described in section 4.1 above, MS agree that

- 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 use the same price for the respective transactions and
- a compensating adjustment initiated by the taxpayer should at least⁸ be acceptable if the following conditions are fulfilled:

Note:

The first bullet point was added by the Secretariat to clarify the key purpose of this paper (ensure a symmetrical declaration of profits in the tax returns of related enterprises with respect to their transactions with each other and to avoid that compensating adjustments result in double taxation or double non taxation).

The second bullet point is redrafted in accordance with **Denmark's** suggestion to make clear that the report and its guidance only apply to adjustments made by the taxpayer.

- 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?

Note from the Secretariat:

AT, BUL, CYP, DK and UK support leaving the decision whether the efforts of the taxpayer were reasonable to the facts and circumstances of the case. DE and PL support further guidance.

The comments from DE and UK also show the different views on transfer pricing (outcome testing vs. price setting). It was not possible to overcome this different view at the level of the OECD. The paper in new paragraph 6 indicates that more work on the more fundamental issues would be needed. However, the **purpose of this report** is

- to ensure that for avoiding situations of double taxation or double non taxation, profits are calculated and reported symmetrically for both enterprises participating in transactions and
- that for achieving this, a common approach needs to be developed on how to deal with compensating adjustments in the EU.

There are two possibilities in principle: generally abandoning the possibility of compensating adjustments or allowing them (under certain conditions). As the majority of

⁸ This means that if the MS involved have less prescriptive rules on compensating/year-end adjustments, these less prescriptive rules apply.

MS and the NGMs seem to have no problem with compensating adjustments or even require them, the approach taken in this paper is to generally allow these adjustments but to make it subject to certain conditions. These conditions aim at countering the misuse of compensating adjustments. Accepting a compensating adjustment in this context means not drawing negative consequences (estimation, penalties etc.) solely from the fact that such an adjustment was made.

With respect to the issue on whether more guidance should be developed with respect to the condition of reasonable efforts at the time of price setting, a reference to the facts and circumstances of the case was supported by the majority of comments received. This would create an element of judgment in favor of TAs as regards the decision whether the taxpayer's efforts were reasonable or not. However, an actual discussion between a TA and the taxpayer on whether efforts would be sufficiently reasonable would probably occur at a later stage return (for example an audit) and not when filing the tax return. The MAP procedure would then be available to finally agree on an arm's length result.

For discussion:

Do you agree to the drafting of this paragraph?

Do you agree on adding the language suggested by Germany?

- 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 reasons or should this be left to the facts and circumstances of the respective case?

Note from the Secretariat:

AT, BUL, DK and UK support not making an effort to give more guidance on how to demonstrate the reasons for forecasts not matching reality and leaving it to the facts and circumstances of the case. CYP and DE request more guidance. The UK is open for discussions.

For discussion

Do you agree to the drafting of this paragraph?

Do you agree to the additional condition suggested by Germany?

Do you have concrete suggestions for further guidance?

- 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 adjustment in the accounts.

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 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?

Note from the Secretariat:

Comments received reach from a general rejection of book entries to a more facts and circumstances approach. It seems that an explicit preference for a certain approach is not supported. Other comments suggest that the possibility of creating a service should explicitly be excluded.

For discussion:

Should the second sentence be removed as there seems to be a preference for not regarding a certain approach as preferable?

Should the possibility of creating a service explicitly be excluded?

17. 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?

Note from the Secretariat:

There are differing views but a slight preference for a more neutral language with respect to the question which information should be used and for explicitly rejecting the use of hindsight.

For discussion:

Do you agree to the following drafting suggestion?

If the aforementioned conditions are fulfilled, the adjustment should be made based on the most reliable information without using hindsight. (second sentence removed)

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 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?

Note from the Secretariat:

The comments received show again a wide range of views. It seems difficult to prescribe a certain point in the range and therefore it seems appropriate to require the adjustment to be made to the most appropriate point in the range. This would leave judgement to the taxpayer. However, the aim of this report is to provide a practical solution only for a symmetrical treatment of tax payer initiated compensating adjustments for the purpose of the tax return. There is always the possibility to challenge the result as not being arm's length at a later stage. Protection from double taxation is ensured by the AC. An eventual risk resulting from this judgment is therefore considered as being rather limited. For giving more guidance on how to make the adjustment it may be referred to par. 3.60 – 3.62 TPG which may be applied by analogy.

For discussion:

Do you agree to the following drafting suggestion?

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 the range. In this context the guidance in paragraphs 3.55 ff. of the TPG may be helpful.

19. Accepting an adjustment in the aforementioned manner should be regarded as a practical solution to issues arising from the application 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)⁹ and has no bearing in a MAP procedure.

Note:

Denmark suggested adding the last part of the sentence.

⁹ 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".