SECONDARY ADJUSTMENTS: A RISK OF DOUBLE TAXATION WITHIN THE EU

1. INTRODUCTION[1]

1.1 Secondary adjustments are a consequence of the assessment of primary adjustments, though not many tax administrations in Europe apply them generally (but occasionally to fight tax avoidance).

1.2 A secondary adjustment entails the recharacterisation of the primary adjustment amount. It implies the assertion of a constructive transaction (the secondary transaction) that attempts to explain why the cash is sitting differently to what would have been should the arm's length price had been applied by the related parties from the outset.

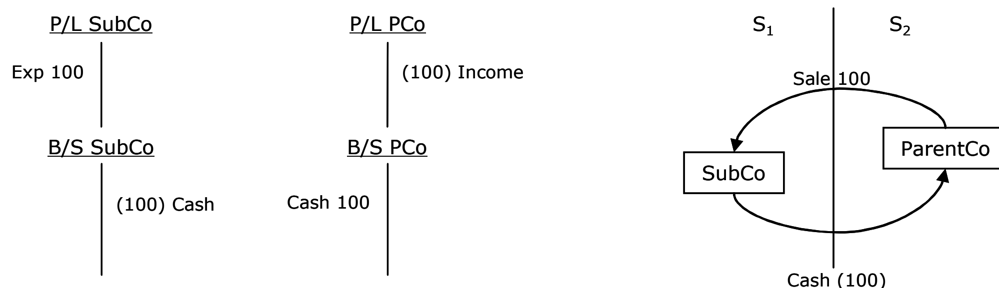
1.3 The usual forms applied to these constructive transactions by tax authorities are:

- Constructive dividends
- Constructive loans
- Constructive equity contributions (or repatriations)

1.4 However, certain jurisdictions allow the tax authorities suggest the related parties to repatriate the excess cash before the primary adjustment is assessed, so avoiding the need of a secondary adjustment.

1.5 Example

a) Original situation in the Corporate Income Tax books of the related companies[2]:



The original sale is later adjusted by S_1 so that the ALP should have been 90 (see P/L SubCo at b)). If S_2 accepts the primary adjustment with a corresponding adjustment, the result would be as shown in P/L PCo at 2. But the B/S of both companies would still not reflect the consequences of the primary adjustment so they would still reflect the original situation (see B/S at a)). The secondary adjustment, if made by S_1, would tackle this distortion as SubCo's B/S level by (i) recharacterising the original transaction on the difference (ie the adjustment amount), creating a constructive transaction or else (ii) allowing the related parties to repatriate said difference before making the primary adjustment and hence eliminating this distortion.

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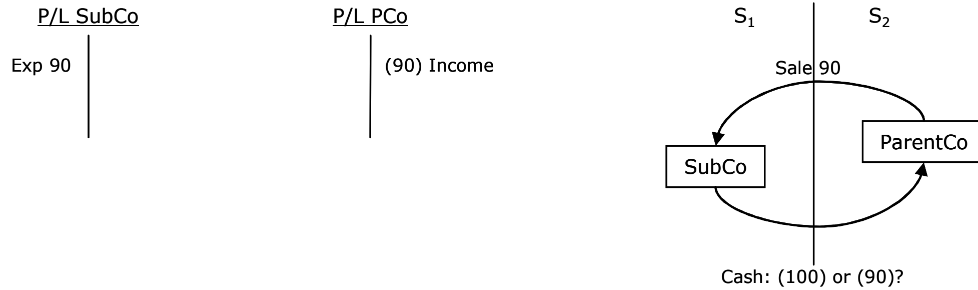
[1] For further background, see paragraphs nº 4.67 to 4.77 of the OECD Guidelines.

[2] This paper focuses only on the Corporate Income Tax implications arising from secondary adjustments although it is worth flagging that secondary adjustments can also trigger VAT and financial accounting ramifications.

b) Primary adjustment by S_1:



2. DOUBLE TAXATION RISK SCENARIOS

2.1 Because of the multiple complexities surrounding secondary adjustments, many States do not make them as a general practice following primary transfer pricing adjustments.

Others do only use this tool to attack avoidance transactions in specific circumstances, particularly as far as withholding tax on dividends is avoided (see paragraph nº 4.72 of the OECD Guidelines).

But the general trend is for more and more States to make secondary adjustments as long as Transfer Pricing consolidates as one of the main collection instruments in international taxation nowadays.

2.2 The main issue for taxpayers arising from the application of secondary adjustments is the risk of double taxation.

2.3 Double taxation following a secondary adjustment (see paragraph nº 4.69 of the OECD Guidelines) can manifest in two ways:

(a) Juridical double taxation on constructive transactions: if S_1 deems that the secondary transaction is a dividend distribution, it may withhold taxes on it whereas S_2 may not grant a tax credit/exempt the deemed dividend unless it accepts the recharacterisation made by S_1, thus causing double taxation.

(b) Economic double taxation on constructive transactions: if S_1 deems that the secondary transaction is a dividend distribution, 10 units of expense would not be deductible at SubCo level but would have been taxable at ParentCo level.

In general terms, the same effect would arise each time that both States do not agree on the terms of the recharacterisation, either because one of them do not accept secondary adjustments as a matter of tax policy or because they do not apply the same recharacterisation terms to the primary adjustment amount.

Further, the risk of multilateral double taxation exists when secondary adjustments are made on transaction between brother and sister companies of the same group and the secondary adjustment involves also the common parent company (see paragraph nº 4.71 of the OECD Guidelines) to the extent that there is not a uniform treatment on the characterisation of the primary adjustment amount by all the jurisdictions involved. Another unresolved issue in many jurisdictions deals with the compatibility of secondary adjustments and the interests of minority shareholders who are not party to the controlled transaction.

Pursuant to paragraph nº 4.70 of the OECD Guidelines, Article 9 of the Model Tax Convention does not deal with secondary adjustments and thus it neither forbids nor requires tax administrations to make them. By the same token, this paragraph ends saying that countries might refuse to grant relief in respect of other countries secondary adjustments and indeed they are not required to do so under Article 9.

3. CONCLUSION

The Business Members consider that the Arbitration Convention plays a fundamental role in this context to avoid this kind of double taxation even if as a last report tool but, in light of the above, would like to invite the EU JTPF to analyse the current treatment of secondary adjustments by Member States and, if necessary, to suggest other ways and means to eliminate in an expedite manner the risk of double taxation arising from this practice within the EU Internal Market.