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EU JOINT TRANSFER PRICING FORUM

Discussion paper on secondary adjustments

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1. Introduction

1. During the JTPF meeting of 9 June 2011, members agreed the new JTPF work programme which, in relation to secondary adjustments states that *it is useful to take stock of the situation prevailing in each MS and prepare an overview by launching a questionnaire on the legal and administrative/practical aspects in the different MS, including on whether these adjustments fall within the scope of the AC.* The Secretariat issued a questionnaire in July 2011. All 27 contributions are included in JTPF document number doc. JTPF/018/REV1/2011.

2. A first discussion about this topic took place at the JTPF meeting in October 2011. At this meeting it was confirmed that the issue may lead to double taxation cases and therefore requires attention. The following three possible options for progress to be considered by the JTPF members were suggested:

   - Recognize the value of the results of the survey carried out, but not take the topic any further;
   - Issue a recommendation that as very few MS apply secondary adjustments it is better not to apply them at all within the EU;
   - Agree that secondary adjustments can be dealt with under the AC as they are the direct consequence of a TP adjustment.

3. Most MS preferred the first option. At the JTPF meeting in March 2012 the Forum agreed that the completion of the state of play already constitutes the accomplishment of a part of the work programme. Members made several proposals on how to take forward the work, e.g. building up some recommendations on the OECD's MEMAP (France), a further questionnaire based on par 4.68 of the OECD TPG (UK) or a combination of options 2 and 3, i.e. issuing a non-binding recommendation not to apply secondary adjustments and, at least, recommending a repatriation as best practice to eliminate the adjustment (PSM). The group agreed to continue the discussion on the additional options, at the next meeting. The Secretariat would draft a discussion paper in line with the suggestions received from members and including as well some aspects relating to the Parent Subsidiary directive.

2. Preliminary conclusions from the Questionnaire

4. The responses to the questionnaire show that only some MS have domestic legislation referring to and allowing for secondary adjustments and generally they are compulsory. In most of these MS and situations these adjustments are treated as hidden profit distribution/hidden contribution and therefore considered as dividends potentially subject to withholding tax.

5. Most often secondary adjustments are not subject to penalties (as they are the consequence of a primary adjustment). Although only a limited number of MS allow secondary adjustments through domestic law, the procedures in those MS vary. The majority of MS consider issues resulting from secondary adjustments as not being covered by the AC. Those who apply them are however prepared to address those issues in a MAP.

3. The issue of secondary adjustments in transfer pricing

6. Transfer pricing adjustments made under domestic law may give rise to so-called "secondary adjustments". The general reasoning for secondary adjustments is an attempt, or a legal obligation, to account for the difference between the re-determined taxable profits and the originally booked profits. While this may be considered as a legitimate concern, the issue of double taxation may arise due to the fact that the secondary adjustment itself may have tax consequences. In some countries e.g. the – perhaps obligatory - treatment as a hidden profit distribution results in the general application of a withholding tax on this distribution. 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 therefore a withholding tax may be applicable.

7. Secondary adjustments may also take other forms as for example a constructive loan or equity contribution. The OECD TPG (par. 4.70) highlight that these constructive transactions carry their own complications because of e.g. issues related to imputed interest on those loans. In their replies most MS did not refer to those kinds of adjustments. The reason may be that MS want to avoid those complications and generally make secondary adjustments in the form of constructive dividends/contributions.

8. 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 MTC for the withholding tax arising from the secondary adjustment. Although the Commentary on Article 10 of the OECD MTC already states in par. 28 that constructive dividends are covered by Article 10 and by the rules for eliminating double taxation, the other MS may simply not recognise that such a deemed transaction gives rise to the secondary adjustment (see par 4.69 OECD TPG).

9. The OECD Model does not prevent secondary adjustments from being made where they are permitted under domestic law (par 9 of the Commentary on Article 9 OECD MTC). TAs are however encouraged to structure such adjustments in a way so as to minimise the possibility of double taxation as a consequence thereof (par 4.71 OECD TPG).

10. The responses to the June 2011 Questionnaire show that in most MS where secondary adjustments are possible/compulsory, these adjustments are treated as hidden profit distribution/hidden contribution and therefore considered as constructive dividends which are subject to withholding tax. The EU Parent-Subsidiary Directive (PSD) provides that withholding tax should not be imposed on profit distributions between the parent and subsidiaries within the EU. Several MS mentioned that they impose withholding tax mostly in relation to non EU countries.

11. Another route that can be taken by TAs is to give relief from the tax consequences of the secondary adjustment if the taxpayer repatriates funds equivalent to the amount of the transfer pricing adjustment.

4. Possible Scope of JTPF Guidance

12. Based on the Forum's conclusion in March to consider further options, the JTPF may evaluate which recommendations on the treatment of secondary adjustments in the EU can be proposed based on the legal framework available. For this reason this document evaluates the possibilities given to MS by the Parent Subsidiary Directive (PSD) and approaches to repatriation (in MAP or at an audit stage) as well as on the treatment of penalties.

5. Applying the Parent Subsidiary Directive (PSD)

13. The responses to the Questionnaire show that in most MS where secondary adjustments are applied, they are treated as hidden profit distribution/hidden contribution and therefore in the case of a hidden distribution considered as dividends potentially subject to withholding tax. Several MS highlighted that they apply the EU PSD providing that withholding tax should not be imposed between the parent and the subsidiary within the EU. This response leads to the conclusion that it is worthwhile to elaborate on the application of the PSD in the context of secondary adjustments.
14. Article 5 (a) of the PSD provides that profits which a subsidiary distributes to its parent company shall be exempt from withholding tax. With respect to secondary adjustments two issues arise: (i) whether a secondary adjustment assumed as a constructive dividend is qualified as a "profit distribution" in the meaning of Article 5 (a) of the PSD and (ii) whether the scope of Article 5 (a) PSD may also cover secondary adjustments resulting from primary adjustments between related parties other than between parent and subsidiaries (for example, sister companies).
15. With respect to the first issue the outcome of the survey on the implementation of the EC corporate tax directives conducted and published by the IBFD in 1995showed that most MS extend the application of the PSD to constructive dividends. This means that secondary adjustments resulting from a primary adjustment between parent company and subsidiary and made by way of assuming constructive dividends would be exempt from withholding tax under Article 5 (a) PSD.

Q1:

Do MS who - in the case of a primary adjustment between parent and subsidiary apply a secondary adjustment in the form of constructive dividends qualify them as a "profit distribution" in the meaning of Article 5 (a) of the PSD?

If not, what are the reasons?

16. A more problematic situation arises if the primary adjustment is made between parties that are indirectly related. Clarification is needed on whether and how in such a situation a secondary adjustment can be made in the form of a constructive dividend and if so whether this constructive dividend would be exempt from withholding tax under Article 5 (a) of the PSD.
17. 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). When assuming a purely intra EU case one may argue that also this assumed distribution may be considered as "profits distributed" in the meaning of Article 5 (a) of the PSD.

Q2:

In case a primary adjustment is made between indirectly related parties situated in the EU and the parent company is situated in the EU too, do MS who apply secondary adjustments make this adjustment in the form of a constructive dividend?

Q3:

Do MS who apply secondary adjustments in the case described in paragraph 17 consider them as "profit distributed" in the meaning of Art 5(a) of the PSD and exempt them from withholding tax?

If not, could you consider that the situation described in paragraph 17 merits an analysis to apply the same approach as in situations covered by Article 5 (a) of the PSD?

18. There may also be situations where the primary adjustment is made between two related parties situated in the EU but with the parent company being situated in third state. If a secondary adjustment is made in the form of a constructive dividend, a distribution to the parent followed by a contribution from the parent to the subsidiary within the EU is assumed. A distribution to a non EU parent company would not be considered as being covered by the PSD. However, given that the primary adjustment is made between EU residents and the distribution to the – foreign – parent is only hypothesised one may consider applying the same principles as laid down in the PSD to such a situation, i.e. abstain from levying withholding tax on the constructive dividend .

Q4:

Could MS consider that the situation described in paragraph 18 merits an analysis to apply the same approach as in situations covered in Article 5 (a) of the PSD?

6. Repatriation

6.1 General

19. In general terms, repatriation means effectively reversing the funds so that the accounts of the parties involved are in line with the economic intend of the primary adjustment. The OECD Guidelines (par 4.73 OECD TPG) describe some of the possible ways in which repatriation might be done but recommend discussing repatriation in the mutual agreement proceeding where it has been initiated (par. 4.76 OECD TPG). The relief from double taxation may be done by an agreement between the Competent Authorities so that the State who made the secondary adjustment would give up the withholding tax and the other State would agree that the repatriation would not result in further taxes being imposed in this state. The OECD MEMAP contains guidance on repatriation (see ANNEX X). Repatriation at an earlier stage, e.g. at the stage of an audit may generally be possible but would require a corresponding treatment in the other State involved.

Q5:
Would you as the State who made the secondary adjustment give up withholding tax if there is a repatriation?
Would you as the other State agree that the repatriation will not result in further taxes being imposed?

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

20. The MEMAP indicates that a repatriation agreement may already be reached at an audit stage. Some States have developed approaches to avoid potential double taxation resulting from secondary adjustments by abstaining from tax consequences if a specific kind of repatriation is already made at the stage of an audit, i.e. before an adjustment is made.
21. For example in Canada, prior to the issuance of an assessment for the primary transfer pricing adjustment, the Canadian taxpayer is provided with an opportunity to accept the primary adjustment and complete a repatriation, and thereby obtain relief from what would be the secondary adjustment and the resulting non-resident withholding tax[1]. Such an approach would however require that MS have the possibility to abstain from levying withholding tax under domestic law, i.e. without a MAP.
22. The OECD's MEMAP states that a repatriation agreement reached at an audit stage should not preclude a request by the taxpayer for competent authority assistance nor should it indicate concurrence or agreement with an audit adjustment. Where a taxpayer proceeds to request competent authority assistance after concluding a repatriation agreement, it is appropriate for the competent authority to amend the repatriation agreement for any changes made to the amount of the adjustment as a result of the MAP process and to waive any requirement for the repatriation to include an interest component. Where a taxpayer proceeds to request competent authority assistance without having concluded a repatriation agreement at the audit stage, the competent authority may agree on terms of repatriation with the competent authority of the treaty country (see section 6.3 below).

Q6:

Do MS which apply secondary adjustments have the possibility to abstain from levying withholding tax under their domestic law?

If yes, do you support developing further guidance related to repatriation at an early stage?

6.3 Repatriation in the course of a MAP

23. As already stated in the OECD's MEMAP, a mutually agreed upon settlement between the competent authorities in respect of a transfer pricing adjustment will normally include agreed terms for repatriation of funds involved in the primary adjustment. These terms are specific to the particular settlement between the two governments. The terms may vary, but 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 country out of which the repatriation is made and from any additional taxable treatment in the country to which the repatriation is made. Repatriation may be subject to audit verification.

[1] Transfer Pricing Memorandum 02 (TPM-02) of 27.03.2003, "Repatriation of Funds by Non Residents – Part XIII Assessments)

Q7:

Based on what is already said in the OECD' s MEMAP, do you agree to a recommendation saying that repatriation by a direct reimbursement or through an offset of inter-company accounts should be allowed and should be free from withholding taxes and from any additional taxable treatment?

Q8:

Do MS agree to recommend a certain time period for repatriation e.g. 2 months?

24. The MEMAP states that subject to the discussions and best practices on interest relief, normally there is no waiver for interest applicable to the tax liability attributable to the initial primary adjustment, or part thereof, if it remains in place as part of the MAP resolution. However, where the country to which the repatriation payment will be made would otherwise require that payment to 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, the competent authorities may agree to allow the repatriation to occur without any interest component, in order to minimize the complications from the repatriation.

Q9:

Do MS agree to a recommendation saying that repatriation should be allowed to occur without any interest component?

7. Penalties

25. According to their responses to the Questionnaire, only a few MS impose specific penalties on secondary adjustments. In other MS secondary adjustments may result in penalties under the general provisions. The EU JTPF's summary report on penalties already elaborates on different penalty regimes within the EU. As a secondary adjustment is a mandatory or a desired consequence of the primary adjustment and taxes eventually resulting from this adjustment may often not finally be imposed, it may be worth evaluating whether MS would have the possibility to abstain from imposing penalties on secondary adjustments. A justification may be the JTPF report's conclusion that penalties should be in line with the final, agreed transfer pricing and an interpretation of this conclusion 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.

Q10:

Do MS who apply secondary adjustments have the possibility to abstain from imposing penalties for secondary adjustments?

Do MS support a recommendation to not impose penalties on secondary adjustments?

26. In case a general agreement on recommending not to impose penalties on secondary adjustments cannot be reached it may be worth considering whether and how penalties may be addressed in a MAP requested for double taxation resulting from secondary

adjustments. As already stated in the JTPF's summary record on penalties, it is often the case that a transfer pricing adjustment is subsequently reduced during a Mutual Agreement Procedure. The JTPF considers that where such an adjustment initially attracted a tax geared penalty and such a penalty was applied it is appropriate that the penalty is reduced commensurately. This would put the penalty in line with the final, agreed transfer pricing. In the context of secondary adjustments this intention may be interpreted in a way meaning that penalties should only relate to the transfer pricing adjustment itself, i.e. the primary adjustment and not to the secondary adjustment.

Q11:

Do MS agree to a recommendation saying that penalties imposed on secondary adjustments should be removed in a MAP settlement?

8. Procedure for removing double taxation

27. In their responses to the Questionnaire, most MS stated that they do not consider double taxation issues resulting from secondary adjustments as being covered by the Arbitration Convention but would be willing to do so in the course of a MAP. In the Questionnaire on the three options for addressing the issue of secondary adjustments, only a few MS supported issuing a limited recommendation to consider secondary adjustments as being covered by the Arbitration Convention. 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 MAP. The latter would require treaties being concluded between MS that include a MAP provision comparable to Article 25 of the OECD MTC (preferably including an Arbitration clause, Article 25 (5) OECD MTC).

28. Taxpayers may not be aware of the fact that in certain situations two requests need to be made for avoiding double taxation resulting from secondary adjustment.

Q12:

Do you agree to a recommendation saying that MS who do not consider secondary adjustments to be treated under the AC are encouraged to highlight in their public guidance the fact that a request under Art 25 of the OECD MTC is needed to remove double taxation?