

Transfer Pricing and year-end: keep your checklist ready

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Transfer Pricing and year-end: keep your checklist ready

- Transfer Pricing Adjustments
- Impact of VAT & Custom Duties
- Benchmarking Studies



Who we are



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01

Transfer Pricing Adjustments



Year end is approaching!!! (1/2)

Transfer pricing and year-end closing are complex topics that require careful attention. Here are some common errors that companies make in relation to transfer pricing and year-end closing:

- 1. Year-end adjustments:** Companies often use year-end adjustments to ensure that actual financial results match what is defined in transfer pricing policies and intercompany agreements. However, year-end adjustments can be a double-edged sword. While they are simple to execute, they can be heavily scrutinized by local tax authorities. It is recommended to avoid or at least minimize year-end adjustments and implement prospective transfer pricing adjustments instead.
- 2. Transfer pricing documentation:** Transfer pricing documentation is a crucial aspect of transfer pricing compliance. Companies often make errors in transfer pricing documentation, such as failing to document the selection of the most appropriate transfer pricing method or failing to document the comparability analysis. It is important to follow best practices for transfer pricing documentation to avoid penalties and disputes with tax authorities.
- 3. Mismanagement of local losses:** Year-end adjustments should not be used to cover up local mismanagement. If a loss position of a limited risk distributor is not caused by transfer prices but rather local mismanagement, year-end adjustments may not be challenged from foreign tax authorities but could still be challenged from a domestic tax perspective.

Year end is approaching!!! (2/2)

- 4. Lack of intercompany agreements:** Intercompany agreements are essential for transfer pricing compliance. Companies often make the mistake of not having intercompany agreements in place or having agreements that are not in line with the actual conduct of the parties. It is important to have intercompany agreements that reflect the actual conduct of the parties and to ensure that they are updated regularly.
- 5. Inadequate comparability analysis:** A comparability analysis is a critical part of transfer pricing documentation. Companies often make errors in the comparability analysis, such as failing to identify the most appropriate comparables or failing to adjust for differences between the tested party and the comparables. It is important to conduct a thorough comparability analysis to ensure that the transfer prices are arm's length.

Why bother? (1/2)

Typical topics from recent TP audits:

- 1. Industries Concerned:** Dominance of goods manufacturers/distributors and extractives.
- 2. Types of Transaction:** Mainly goods, followed by intangibles.
- 3. Continued Losses:** Justifying continued losses by reference to an unsuccessful business strategy (remember Corona).
- 4. Choice of Tested Party:** The court allowed the tax administration to benchmark the manufacturer rather than the related party sales companies.
- 5. Business Reorganisations and Restructurings:** Reallocation of significant risks of a business derived from a restructuring between associate enterprises without supported economic substance, will be challenged.
- 6. Interest and Royalties:** Certain payments among related parties such as interest and royalties, back-to-back loans and expense allocations, including for research and development (R&D), will be closely scrutinised.

Why bother? (2/2)

7. **Exit Tax, Existence of Permanent Establishments, and Substance:** Reviews are based on different angles, including exit tax, existence of permanent establishments, and substance.
8. **Transfer Pricing Documentation:** Inadequate transfer pricing documentation can lead to failure in justifying continued losses.
9. **Benchmarking Approach:** The taxpayer's transfer pricing documentation justified its benchmarking approach.
10. **Tax Treaty Shopping Indicators:** Tax administrations are planning and programming their reviews by considering the types of transactions companies engage in, including intercompany transactions, level of revenues, treaty shopping indicators, restructurings, recurring losses, and types and quantity of assets, among others.

What actual adjustments have we seen? (1/2)

Transfer Pricing Adjustments:

- 1. Transfer Pricing Valuation:** Multinational enterprises should take into account the increased focus of tax authorities and international organizations on transfer pricing valuation.
- 2. Hard-to-Value Intangibles (HTVI):** Tax administrations can consider ex-post outcomes as presumptive evidence regarding the appropriateness of the ex-ante pricing arrangements relating to the transfer of an HTVI.
- 3. Profit Diversion Compliance Facility (PDCF):** Encourages multinational enterprises (MNEs) using, or having used, tax arrangements linked to DPT to reconsider their transfer pricing policies and make full disclosure of the facts for all relevant accounting periods.
- 4. Master File and Local File Documentation:** The UK government intends to introduce a formal requirement for businesses to maintain, and provide on request, master file and local file documentation, following the OECD approach.
- 5. Summary Audit Trail Requirement:** There will also be an additional “summary audit trail” requirement, which will be “a short, concise document” setting out the work undertaken in arriving at the conclusions in the local file and master file.

What actual adjustments have we seen (2/2)

- 6. Diverted Profits Tax (DPT) Rules:** Transfer pricing enquiries including those related to the application of the diverted profits tax (DPT) rules to situations in which a UK permanent establishment has been avoided, or to transactions or entities that lack sufficient economic substance.
- 7. Downward GST Adjustment:** A downward GST adjustment is required when the TP adjustment results in a decrease in the price of the supply or import of goods or services.
- 8. Market Value Rule:** In the UK market value, rule only applies where the supply is taxable and the relevant input vat is not fully recoverable.
- 9. TP Adjustments:** TP adjustments resulting in a decrease in the price of the supply or import of goods or services.
- 10. GST Treatment for TP Adjustments:** GST treatment for TP adjustments.

Recent Court Cases

- 1. Intercompany Royalties:** The Danish Supreme Court ruled in favor of a taxpayer in a landmark case on intercompany royalties. The court held that there was no basis for the Danish tax authorities' royalty adjustment, setting aside previous rulings of the Danish National Tax Tribunal and High Court.
- 2. Transfer Pricing Documentation:** During a transfer pricing audit, the Danish tax authorities disqualified the transfer pricing documentation based on deemed flaws and made a discretionary tax assessment.
- 3. Loss-Making Position:** The tax authorities argued that the intercompany license arrangement did not adhere to the arm's length principle, including that the Danish taxpayer was in a loss-making position.
- 4. Marketing Services:** The tax authorities believed that the Danish taxpayer should have been remunerated for deemed marketing services rendered to the Swiss parent company, which would net out any royalty deduction, effectively resulting in a 0% royalty rate.
- 5. Sanity Check:** The tax authorities presented a "sanity check" based on the transactional net margin method with the Danish taxpayer as the tested party and relied on Danish resident companies as comparables.

Recent Court Cases

6. **Deductibility of Business Expenses:** The High Court agreed with the Ministry that the taxpayer had failed to prove that the royalties were deductible business expenses.
7. **Discretionary Tax Assessment:** The High Court of Eastern Denmark dealt a harsh blow to the Danish Ministry of Taxation in the largest-ever transfer pricing case in Danish history regarding a USD 1.5 billion increase of taxable income for the oil business previously owned by A.P. Møller Maersk (now by Total Energies EP).
8. **New Transfer Pricing Documentation Requirements:** The Danish government has introduced new transfer pricing documentation requirements.

These cases highlight the complexity and evolving nature of transfer pricing disputes in Denmark.

02

Impact of VAT & Custom Duties



VAT & Transfer Pricing (1/2)

- Resolving complex matters between VAT (Value Added Tax) and Transfer Pricing can be quite challenging due to the different principles they operate on.
- Transfer Pricing is a collection of international tax laws that compel businesses to apply the open market or “arm’s length” principle on transactions between related entities. This means that the conditions of a transaction between associated enterprises must not differ from those which would have governed a transaction between independent enterprises under similar circumstances.
- On the other hand, VAT is based on the existence of a supply for consideration, i.e., the price actually paid. The concept of consideration does not need to reflect the market value of the goods or services supplied, but rather it is construed as a subjective value which reflects the value actually received and not the value estimated according to objective criteria¹.

VAT & Transfer Pricing (2/2)

- The key point to examine is whether Transfer Pricing adjustments could be seen as consideration given in exchange for a supply of goods or services by a taxable person acting as such¹. A supply of goods or services is considered to be taxable only if there is a direct link between the services or goods provided and the consideration received.
- However, the VAT Directive does contain an anti-avoidance rule in article 80 which allows Member States to levy VAT on a transaction based on its open market value rather than the consideration actually paid.
- As you can see, there is a clear tension between the Transfer Pricing rules that seek to arrive at the arm's length principle for the valuation of a transaction (i.e., open market value) and the VAT rules that are based on the existence of a supply for consideration (i.e., the price actually paid).

Customs & Transfer Pricing (1/2)

- The challenge between transfer pricing and customs value arises from the different objectives and rules of the two systems.
- Transfer pricing rules are designed to ensure that transactions between related entities are priced as if they were between independent entities, i.e., at arm's length. This is to prevent profit shifting and tax avoidance.
- On the other hand, customs value is used to determine the amount of customs duty payable on imported goods. Customs authorities are interested in ensuring that the declared value of goods is not understated, as this would lead to lower customs duties.
- The tension arises because transfer pricing adjustments can lead to changes in the declared value of goods for customs purposes. For example, if a transfer pricing adjustment reduces the price of goods, this could lead to a lower customs value and hence lower customs duties. However, many countries do not permit post-importation adjustments to reduce the customs value declared.

Customs & Transfer Pricing (2/2)

- Moreover, while transfer pricing documentation may provide a useful reference point for customs purposes, the level of detail and information therein (as well as intercompany agreements) expected by tax and customs authorities may differ.
- Therefore, managing the interplay between transfer pricing and customs value requires close cooperation within multinationals when setting prices, documenting them, and communicating with various authorities. It remains a challenging task due to the different approaches between tax and customs authorities that could negatively affect total tax outcomes in each jurisdiction where goods are imported.

Custom Value – Transfer pricing adjustments (1/2)

Hamamatsu (C-529/16)

In a preliminary ruling, the Court of Justice of the EU has ruled on the possibilities for a change in the customs value when a previous Transfer Pricing price is subsequently changed.

In its decision, the European Court of Justice states:

- that the correct customs value for an item is the item's (transaction) value determined at the time of acceptance of the customs declaration
- that if a customs value was correctly determined at the time of assumption, a subsequent price adjustment on the basis of an adjusted transfer pricing price cannot form the basis for a (requested) change to the customs value with retroactive effect
- that the customs value, based on an invoice price unknown at the time of importation, cannot later form the basis for changing the previously determined transaction value

Custom Value – Transfer pricing adjustments (2/2)

- Until the Hamamatsu case the practise in most countries was that in case of a TP adjustment the importer of record was obligated to correct the customs value in case the TP adjustment resulted in a higher customs value.
- Based on the Hamamatsu case some EU customs authorities , e.g. Danmark and Germany, are now of the opinion that this practise is not in accordance with the customs legislation, i.e. as a main rule TP adjustment will not result in a correction of the customs value.
- For now the conclusion is that whether a TP adjustment results in an obligation or right to correct the customs value depends on a specific assessment of the situation and the reason for the TP adjustment.
- The Hamamatsu case does not change practise in relation to correction of VAT in case of TP adjustments on transactions within the EU. The VAT amount should be corrected if the TP adjustment relates to the price of the goods and a credit note is issued.

03

Benchmarking Studies



The challenges of benchmarking studies (1/2)

Benchmark studies for transfer pricing purposes can be challenging due to several reasons:

- 1. Selection of Comparables:** The process of identifying comparable transactions or entities can be complex and time-consuming. The selection criteria need to be carefully defined to ensure that the comparables are truly similar in terms of functions, risks, and assets.
- 2. Data Availability:** There may be limited availability of reliable data on uncontrolled transactions that are comparable to the controlled transaction.
- 3. Adjustments:** Making comparability adjustments where appropriate can be difficult. This is because such adjustments require a deep understanding of the differences between the controlled and uncontrolled transactions.
- 4. Dynamic Process:** The benchmarking process is not linear. Steps might need to be carried out repeatedly until a satisfactory conclusion is reached.

The challenges of benchmarking studies (1/2)

- 5. Regulatory Compliance:** As per existing laws, benchmarking studies are part of a transfer pricing documentation file. Failure to prepare and submit such documentation or submitting an incomplete documentation (e.g., without benchmarking studies) could result in fines, transfer pricing adjustment, and late payment penalties.
- 6. Subjectivity:** In audit or court case scenarios, tax authorities or judges may or may not agree with your benchmarking approach. The challenges from the tax authorities aim to tackle the decision-making process and the reasons for accepting a certain group of comparable data that ultimately alters the results.

These challenges highlight the importance of a well-planned and executed benchmarking study in the context of transfer pricing.

Ensuring reliability (1/2)

To ensure the reliability of your benchmarking study for transfer pricing, you can follow these steps:

- 1. Determination of Years to be Covered:** Usually, the benchmarking study covers one year in which the controlled transaction was performed. However, given the instability of the economy, it is recommended to update the benchmarks every year.
- 2. Broad-Based Analysis of the Taxpayer's Circumstances:** The “broad-based analysis” is an essential step in the comparability analysis.
- 3. Review of Controlled Transactions:** Review the controlled transaction(s) under examination, in order to choose the tested party.
- 4. Review of Existing Internal Comparables:** If any, review of existing internal comparables.
- 5. Selection of the Most Appropriate Transfer Pricing Method:** Depending on the method, determination of the relevant financial indicator.
- 6. Identification of Potential Comparables:** Identification of potential comparables.

Ensuring reliability (2/2)

- 7. Making Comparability Adjustments:** Determination of and making comparability adjustments where appropriate.
- 8. Interpretation and Use of Data Collected:** Determination of the arm's length remuneration.
- 9. Avoid 'Off The Shelf' Benchmarking Analysis:** Tailored benchmarking analysis to the taxpayers' circumstances is recommended because it appropriately addresses all of the comparability factors.
- 10. Keep Evidence of the Benchmarking Process and Decision-Making Reasons:** Transfer pricing is still considered a grey area and under the current environment with new legislation in various countries and new OECD Guidelines, there is uncertainty about the application of these new standards in a court case scenario.

Remember, the process is not linear. Steps 5 to 7 in particular might need to be carried out repeatedly until a satisfactory conclusion is reached.

04

Proactive management of transfer pricing can reduce tension with VAT and customs



Transfer pricing management - A digital approach

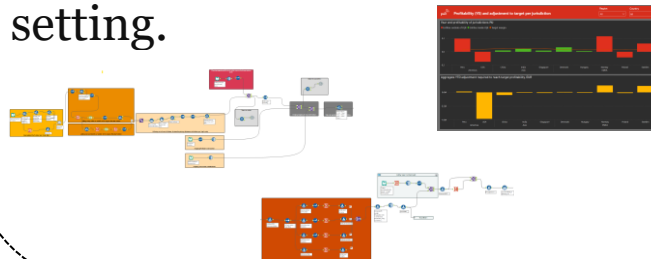
Standard data processes

Setting up standard data processes around the data used for transfer pricing calculations and to determine year end adjustments in spreadsheet/excel solutions is a recommended minimum to maintain traceability of transfer pricing.



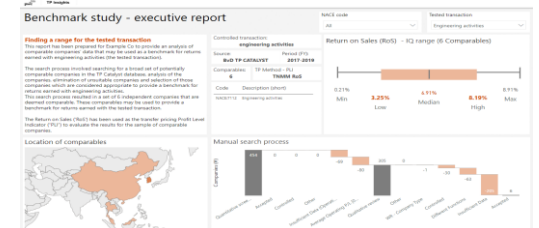
Profitability and adjustment management tools

These operational transfer pricing engines enable the monitoring of group entities performance throughout the year and at year end. In turn, it facilitates proactive decision making for Group Tax, reduces traceability issues within the TP calculations. It can also minimize year end adjustments and help price setting.



Benchmark dashboard

Integrated quantitative overview of the benchmarking results to provide visual insights and communicable summaries.



Q&A



The Checklist (1/2)

Here is a checklist for conducting appropriate transfer pricing adjustments at year end:

- 1. Review your intercompany transactions:** Assess the volume and pricing of each transaction. Identify any new transactions that you may need to document later.
- 2. Assess intercompany transaction financial results:** Review your company's financial data and operating results. Determine whether you met your intended year-end outcomes for these transactions.
- 3. Determine if you need to make adjustments:** If the outcomes are not within the arm's length range, transfer pricing adjustments may need to be considered.
- 4. Review & update intercompany agreements:** Ensure that you have agreements in place for each of your intercompany transactions and that those agreements accurately delineate the actual transaction that is taking place.
- 5. Avoid or minimize year-end adjustments:** Implement a clear process that helps to monitor actual transfer pricing results and allows companies to implement prospective transfer pricing adjustments rather than year-end adjustments.

The Checklist (2/2)

- 6. Document the reason for any year-end adjustment:** Whether the adjustment is for the benefit of the receiving company or to the detriment of a foreign company, it is recommended to clearly document the reason for any year-end adjustment.
- 7. Check if intercompany agreements allow for such true-down payments and document the specific case accordingly:** If such year-end adjustment is executed, companies are advised to check if intercompany agreements allow for such true-down payments and document the specific case accordingly.
- 8. Correct customs declarations if necessary:** Year-end adjustments often trigger a need to correct customs declarations which can be a burdensome and time-consuming process as year-end adjustments may have to be allocated to single transactions.

Join our next TP Lab webinar

7 February 2024

Updates to the OECD Guidelines that stem from Pillar I – Amount B

- Pricing of in-country baseline marketing and distribution activities



Thank you!



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