Adapting to Change - Recharacterization Trends and Rethinking Transfer Pricing

Transfer Pricing webinar series: TP Lab

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pwc

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Who we are

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Adapting to Change - Recharacterization Trends and Rethinking Transfer Pricing

- Why is it important?
- Fundamental basis for TP models
- TP models in practice
- Review your TP model: what you need to know
- Importance of intercompany agreements
- Post-transformation “to-do’s”
- Recent tax case experience
- Key takeaways and Q&A

01

Why is it important?

Why it is important to monitor and rethink the TP model ?

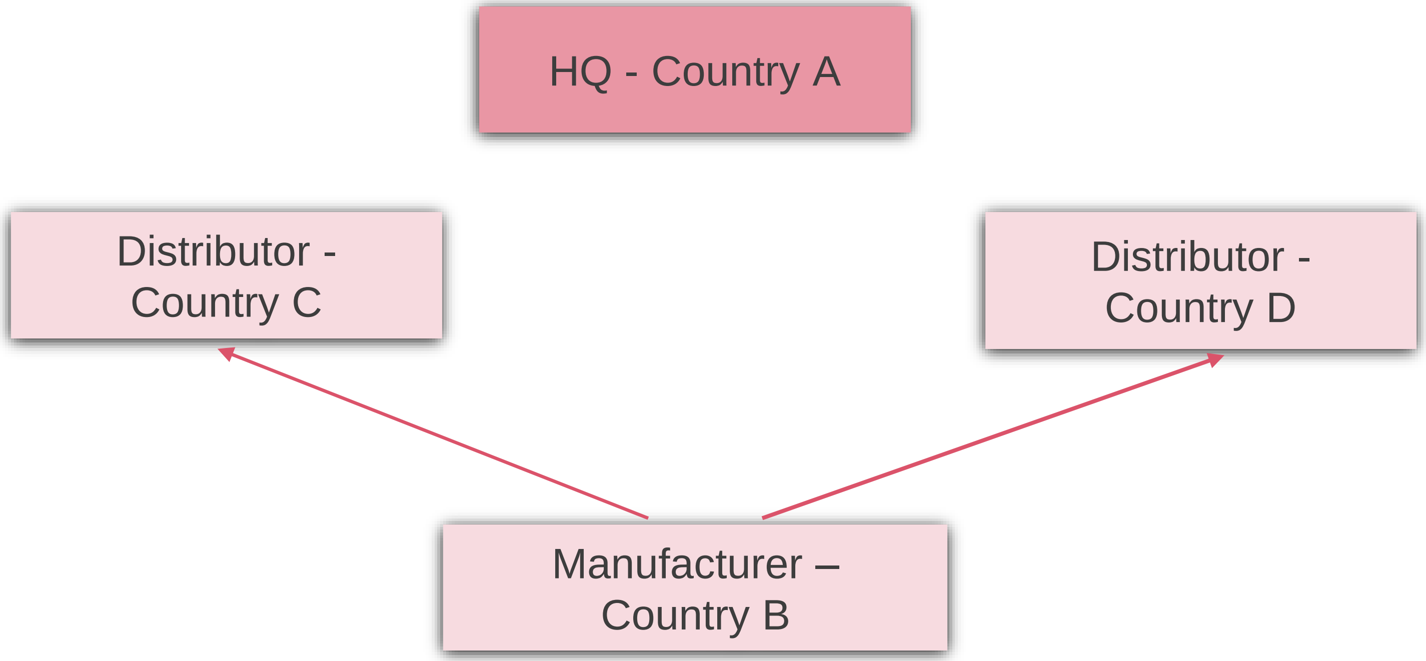
Transfer pricing (TP) model or set-up

A set of transfer pricing principles designed to provide an arm’s length outcome in economic transactions between the affiliated companies

Why it is important to monitor and rethink the TP model ?

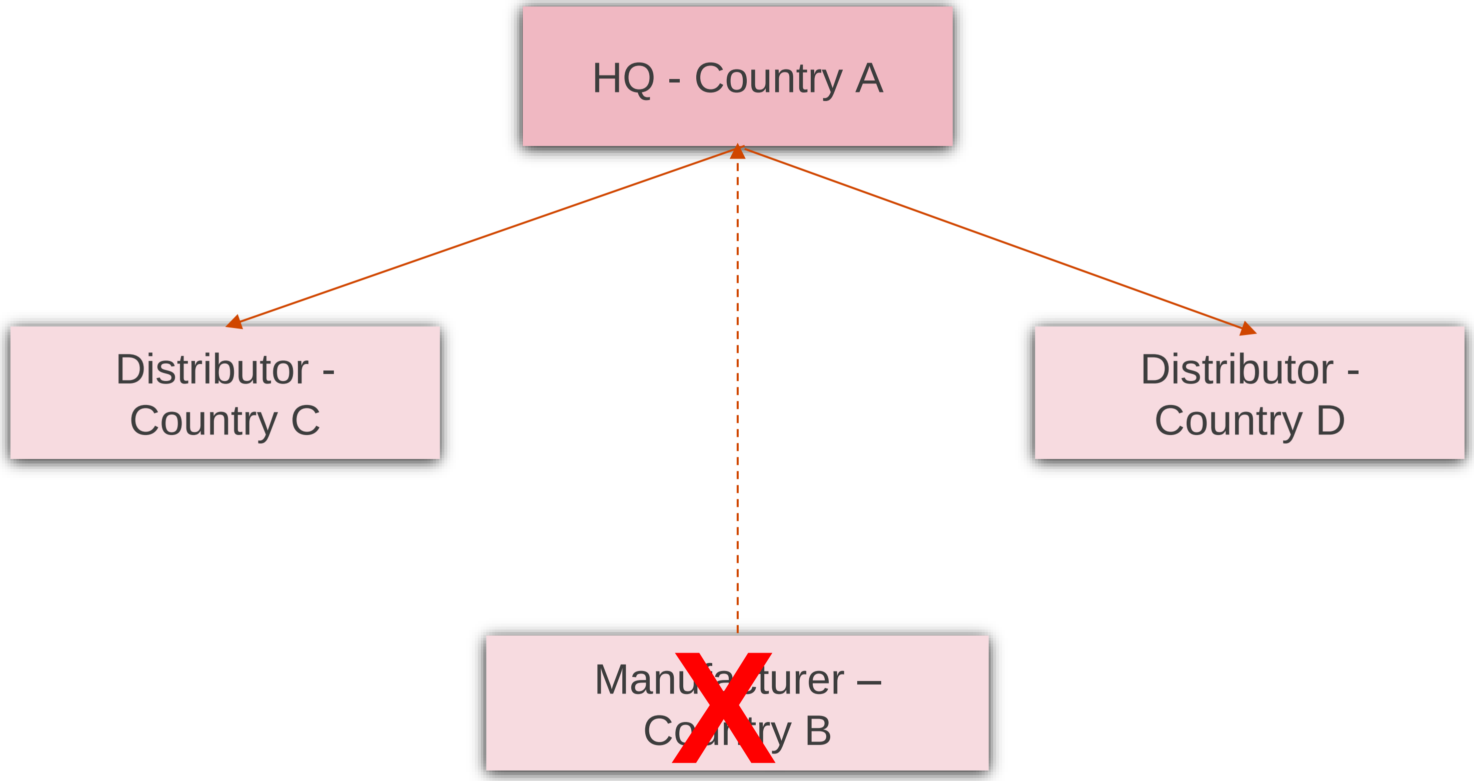
- **Impact raised by recent economic disruptions:**
  - Relocation of functions and assets
  - Remote workers
  - Changes supply chains
- **Impact of presidential elections in the US**
  - Uncertainty in relation to future US economic policy
- **Regulatory aspects**
  - Continuous scrutiny of the TP set-ups by the tax authorities in Denmark and abroad
  - Increased documentation requirements
- **M&A activities**
  - Integrations of new businesses
- **Global mobility**
  - Movement of individuals across the countries

Impact on supply chains



- Manufacturer (Country B) sells products to distributors in Countries C and D.
- Due to economic constraints the Group decided to terminate manufacturing activity in Country B.
- Production equipment was sold locally in Country B and inventory was scrapped.
- Production of the same products is started in Country A utilizing knowledge and technology. accumulated during production activity in Country B.

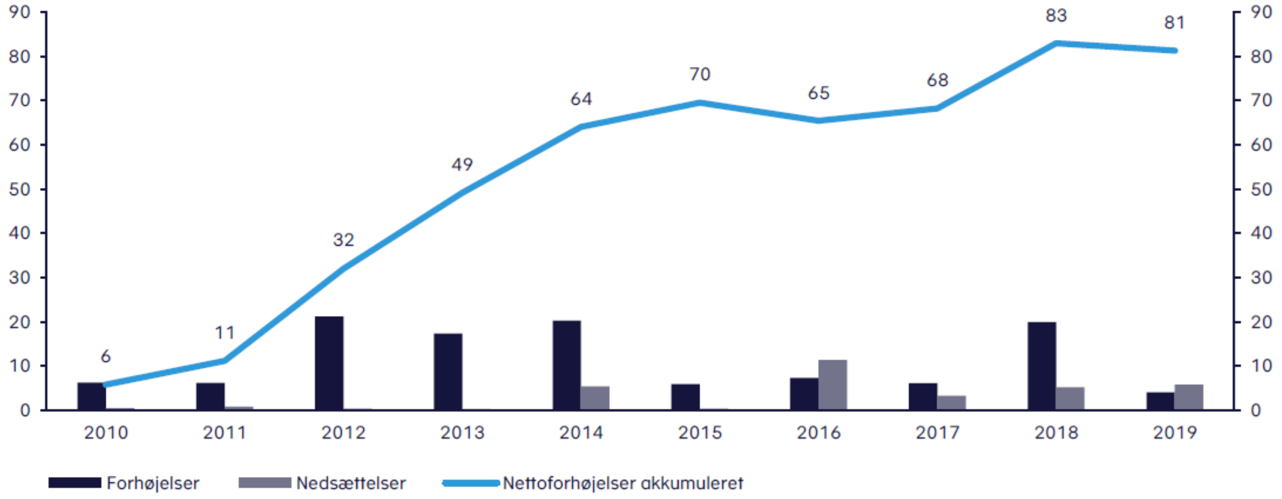
Impact on supply chains



- Shall Company in Country A compensate Manufacturer in Country B for transfer of knowledge, profit potential, etc.?
- Shall Company in Country A compensate Company in Country B for the costs associated with termination of production?
- How to remunerate future sale of goods by Company in Country A to the distribution entities?

Statistics on tax cases

Figur 1. Nettoforhøjelser af selskabers skattepligtige indkomst, 2010-2019, mia. kr.



Kilde: Skattestyrelsen.
Anm.: Det er ikke muligt at fastsætte skatteværdien af transfer pricing-reguleringerne. Det skyldes, at skatteværdien afhænger af mange forhold i de involverede selskaber, fx selskabernes anvendelse af fremførselsberettigede underskud, sambeskatningsforhold, efterfølgende korrektioner mv.

Tabel 1. Forhøjelser og nedsættelser i 2010-2019

Mia. kr.	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	I alt
Forhøjelser	6,3	6,2	21,2	17,4	20,3	5,9	7,3	6,1	19,9	4,1	114,7
Nedsættelser	0,5	0,8	0,4	0,3	5,4	0,4	11,5	3,3	5,2	5,8	33,5
Nettoforhøjelser	5,8	5,4	20,8	17,1	14,9	5,5	-4,1	2,8	14,7	-1,7	81,2

Kilde: Skattestyrelsen

Tabel 2. Resultater af domstols- og klagesager pr. 31. december 2019

Mia. kr.	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	I alt
Forhøjelser foretaget af Skattestyrelsen	6,3	6,2	21,2	17,4	20,3	5,9	7,3	6,1	19,9	4,1	114,7
Forhøjelser verserende i LSR og domstole	1,0	0,5	6,2	0,2	3,9	0,1	0,8	1,3	8,5	0,8	23,3
Nedsættelser som følge af LSR- og domstolsafgørelser	0,1	0,5	0,2	0	0	0	0	0,1	0	0	0,9

Kilde: Skattestyrelsen

Tabel 3. Resultater inkl. nedsættelser som følge af MAP pr. 31. december 2019

Mia. kr.	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	I alt
Forhøjelser foretaget af Skattestyrelsen	6,3	6,2	21,2	17,4	20,3	5,9	7,3	6,1	19,9	4,1	114,7
Forhøjelser stadig i MAP	0,1	1,4	4,6	1,0	10,0	0,8	0,4	1,2	6,7	0,2	26,4
Nedsættelser som følge af MAP	0,1	1,2	0,3	9,4	2,3	0,3	2,0	0,0	0,5	0,0	16,1

Kilde: Skattestyrelsen

Tax cases in media

EU states back plan to expose big companies' tax avoidance

Majority of member states back proposal to bring in country-by-country tax reporting

The New York Times

Nvidia Securities Fraud Case   Conservatives Debate Retirements   Trump's Agenda   Louisiana Voting Map

How a Legal Fight Over a $15,000 Tax Bill Could Upend the U.S. Tax Code

The Supreme Court ruling in the Moore case could cost the federal government billions of dollars in lost tax revenue.

Apple told to pay Ireland €13bn in tax by EU

10 September 2024

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Charlotte Edwards and Theo Leggett
BBC Business

Hedge fund accused of masterminding tax fraud in £1.4bn High Court trial

Cum-ex lawsuit brought by Danish tax authority against defendants including Sanjay Shah kicks off in London

$29B Microsoft tax bill shows how big transfer pricing disputes can get

02

Fundamental basis for TP models

Basis for TP models - applying the arm’s length principle

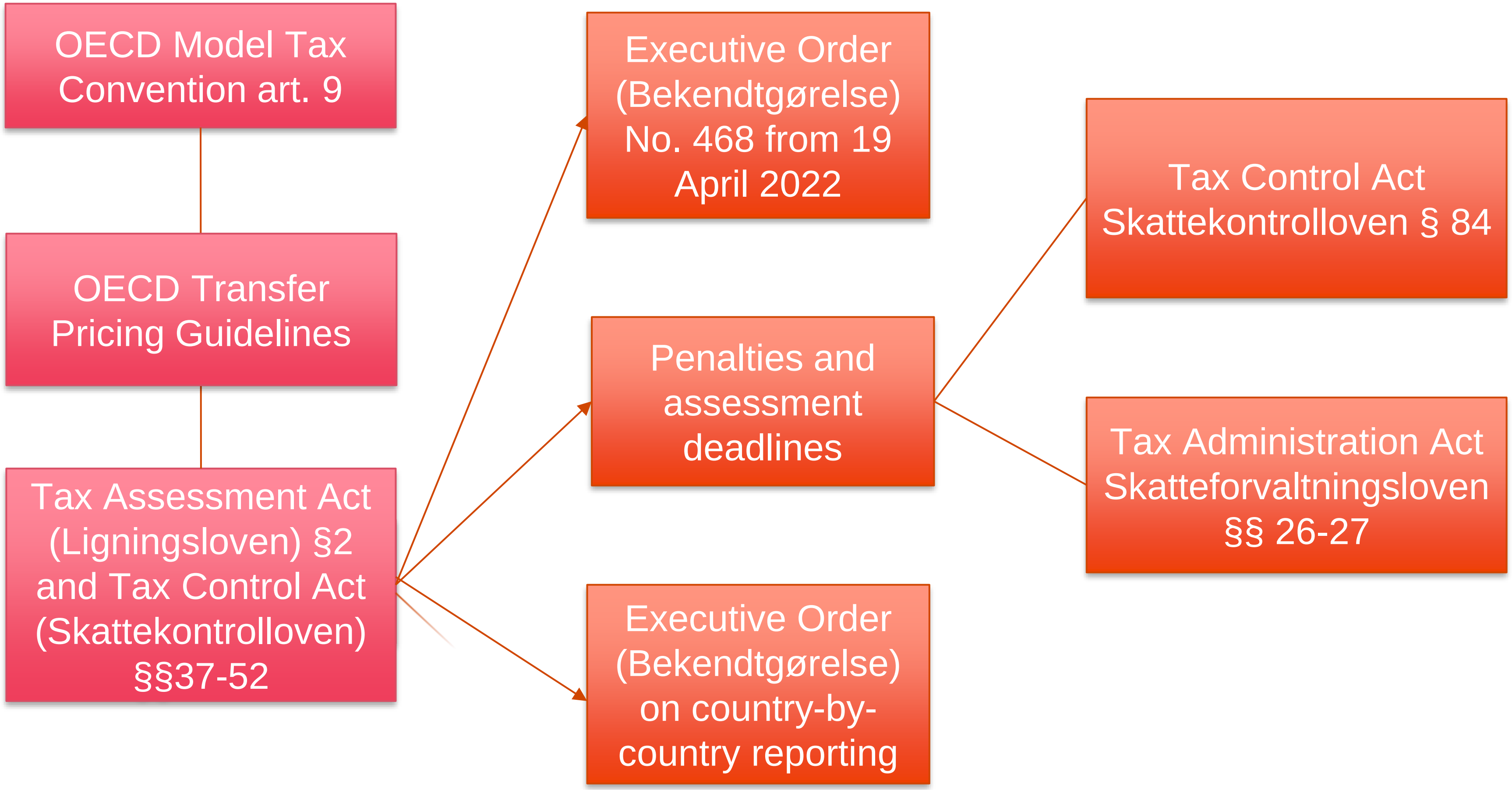
Arm's length principle

- The international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 o of the OECD Model Tax Convention as follows:

> where
> “conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

Basis for TP models - applying the arm's length principle

The Danish legislation generally adheres to the arm's length principle as defined by the OECD.



Basis for TP models - applying the arm's length principle

Danish transfer pricing legislation

- The arm's length principle is provided in Danish Tax Assessment Act (Ligningsloven) §2
- Applies to all intercompany transactions, including DK-DK
- No thresholds for the application of the arm's length principle
- Applies to allocation profits to permanent establishments / branches
- The Danish tax authorities may initiate a transfer pricing audit even though a company is below the thresholds for formal transfer pricing documentation requirements

Basis for TP models – applying the arm's length principle

Transfer pricing outcomes of the application of the TP model must be in line with value creation in the group!

Business perspective

- Where is value created in the Group?
- What drives costs?
- What generates profits across the Group?

Transfer-pricing perspective

- Accurate delineation of actual transactions is fundamental
- Focus on actual allocation of functions each enterprise performs to identify economically significant activities taking into account assets used and risks assumed
- Assumption of risk requires control of the risk and financial capacity to assume this risk

Basis for TP models – applying the arm's length principle

Intangible assets – important part of transfer pricing considerations

- Intangible assets are broadly defined as:
    - something which is not a physical asset or a financial asset, and
    - is capable of being owned or controlled for use in commercial activities, and
    - whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances

Concept of economic ownership of intangible assets is crucial for transfer pricing purposes

- The economic ownership is determined by considering factors such as who controls the asset, who funds its development, and who benefits from its use.
- An economic owner bears economic risks and receives rewards associated with the ownership of intangible assets, even if it is not the legal owner of these intangible assets.
- Determining economic ownership can be complex due to the involvement of multiple entities across different jurisdictions.

Basis for TP models – applying the arm's length principle

Remember!

- Focus on actual people functions and value creation
- Legal contracts alone do not serve as an evidence of actual conduct
- Legal ownership of assets alone does not create entitlement to profits (concept of "economic ownership")
- TP model shall follow and address the operational set-up rather than "drive" the operational set-up

03

TP models in practice

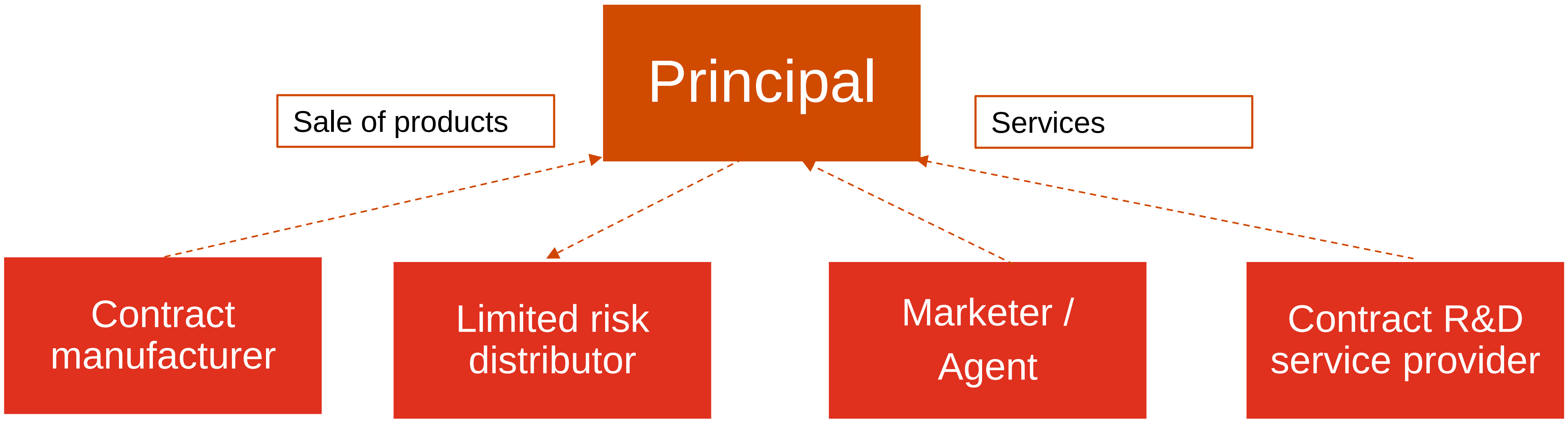
TP models in practice

Principal model

- **Entrepreneurial entity:** The principal, or entrepreneurial entity, is responsible for bearing the majority of the economic risks and making key business decisions.
- **Routine entities:** These entities perform limited functions and bear low risks, such as limited risk distributors, contract R&D service providers, contract manufacturers, or sales support and marketing service providers.
- **Profit allocation:** The principal earns all group profits in excess of the routine profits provided to the routine entities. Routine entities receive a limited but stable level of profit for their functions and risks.
- **Economic risk:** The principal bears most of the economic risks within the group, including potential losses during business downturns.
- **Transactions:** the model is characterised by extensive transactions between the affiliated companies

TP models in practice

Principal model



TP models in practice

Principal model

Outcome of the principal model

Routine entities earn routine profits in their respective tax jurisdictions while the principal receives residual profit or loss

+

Advantages

Relatively easy to manage

Relatively easy to document (but requires a benchmarking study/ies)

Well known to the Danish Tax Agency as well as to the tax authorities in many foreign countries

–

Downside

Requires monitoring and periodic / year-end adjustments

Can have an adverse cash tax effect, e.g. if the principal is in a loss-marking situation it still must allocate profits to routine affiliated companies

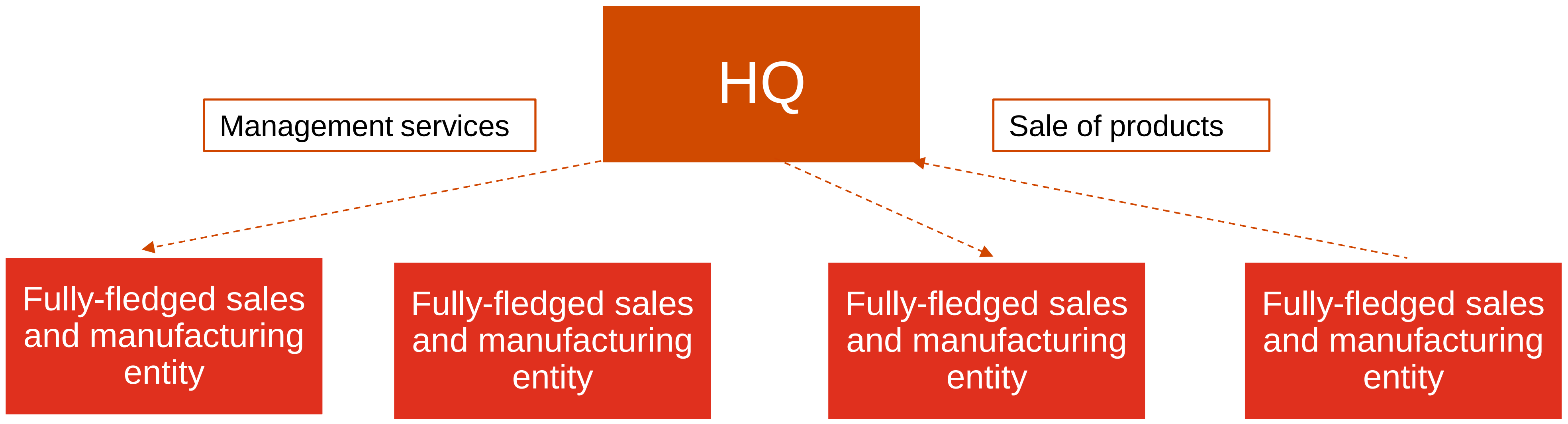
TP models in practice

Decentralised model

- **Autonomous operation:** Each entity operates independently, making decisions without central control.
- **Intellectual property ownership:** Entities may own their intellectual property (IPs), leveraging them within their operations.
- **Occasional intercompany transactions:** Transactions (sales/services) between affiliated companies occur infrequently and on an as-needed basis.
- **Low dependency on intercompany trade:** Affiliated companies generally do not rely on intercompany trade for their primary operations.
- **Headquarters support:** The headquarters may provide occasional management or shared services, but these are not central to the operations of the individual entities.

TP models in practice

Decentralised model



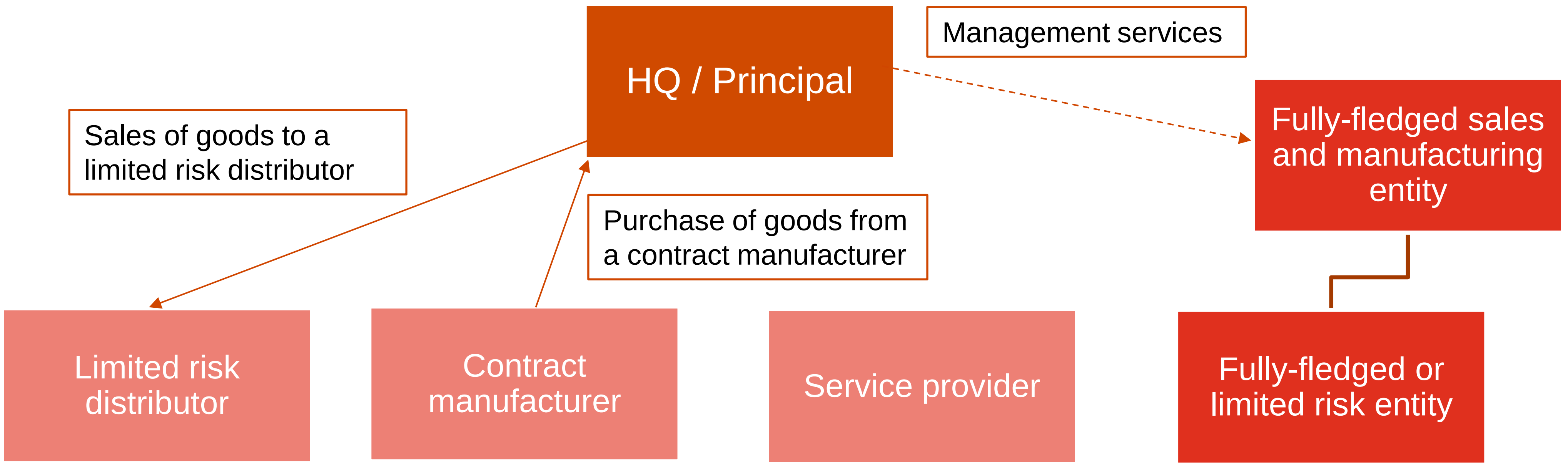
TP models in practice

Hybrid model - example

- **Principal model application:** The Group primarily uses a principal model for its operations.
- **Autonomous entities/subgroups:** Some entities or subgroups within the Group operate independently.
- **IP ownership:** These autonomous entities/subgroups own their intellectual property (IPs).
- **Occasional intercompany transactions:** Sales and service transactions between these autonomous entities/subgroups and the rest of the Group occur infrequently.
- **Newly acquired businesses:** This model is often seen when there is a newly acquired business.

TP models in practice

Hybrid model - example



TP models in practice

Other models – Licensing model

Licensing model involves licensing intangible assets, such as patents, trademarks, or know-how, from one entity to another within a group.

- **Intangible assets:** The licensor owns valuable intangible assets, such as patents, trademarks, or industrial know-how, which are licensed to the licensee.
- **Royalty payments:** The licensee pays royalties to the licensor based on the use of the licensed intangibles. These payments are typically calculated as a percentage of sales or profits.
- **Control of intangibles:** The licensor retains control over the intangible assets and ensures their protection and proper use.
- **Risk and remuneration:** The licensor bears the risks associated with the development and ownership of the intangibles, while the licensee benefits from their use in its operations. Licensee operates relatively autonomously and assumes economically significant risks.

04

Rethink your TP model: what you need to know

Rethink you TP model

Some of the matters to consider

Were there any recent changes in the allocation of functions and risks across the Group (restructuring)?

Any new acquisitions, mergers, business integrations, etc.?

Do some of the affiliated companies assume economically significant risks, but do not control these risks?

Which entity undertakes key control and risk mitigating functions and has the financial capacity to assume the risks?

Rethink your TP model

Objectives that may lead to changes in the operational model and, consequently, may require changes in the TP set-up

- Focus on maximizing synergies and economies of scale
- Streamlining the management of business lines
- Improving the efficiency of the supply chain
- Preserving profitability or limit losses, e.g. in the event of an over-capacity situation or in a downturn economy
- Enabling easy integration in relation to the future growth into new markets and product areas

Rethink your TP model

Examples of shifts in TP models (conversion)

- Conversion of full-fledged distributors into limited-risk distributors, marketers, sales agents, or commissionaires for an affiliated enterprise that may operate as a principal
- Conversion of full-fledged manufacturers into contract manufacturers or toll manufacturers for an affiliated enterprise that may operate as a principal
- Transfers of intangibles or rights in intangibles to a central entity (e.g. a so-called “IP company”) within the group
- Concentration of functions in a regional or central entity, with a corresponding reduction in scope or scale of functions carried out locally; examples may include procurement, sales support, supply chain logistics.
- More intangibles or risks are allocated to operational entities (e.g. to manufacturers or distributors).
- Rationalisation, specialisation or de-specialisation of operations: manufacturing sites and/or processes, research and development activities, sales, services), including the downsizing or closing of operations.

Rethink your TP model

One-off reallocation of functions and risks

OR

Continuos (gradual) changes

Alignment of the transfer pricing outcomes with the value creation

Rethink your TP model

Transitioning to a new model: restructuring

- **Business restructuring:** a cross-border reorganization of the commercial or financial relations between associated enterprises, including termination or substantial renegotiation of existing arrangements
- Transition / changes in the actual functional and risk profile of the parties
- Shift of personnel or assets from one entity to another
- Arm’s length principle: would independent parties have agreed to the same conditions in comparable circumstances? I.e. whether the nature of the restructuring is arm’s length, including:
    - actual delineation of the transaction
    - business reasons for and the expected benefits
    - other options realistically available to the parties

Rethink your TP model

Compensation payment (exit taxation)

- Its important to assess whether the transition to a new model gives a rise to a form of compensation either in Denmark or abroad. Has there been:
  - A transfer of something of value, including profit potential in relation to rights or other assets, or
  - A termination or substantial renegotiation of existing arrangements, where compensation may be due between independent parties in comparable circumstances?
    - Does commercial law support rights to indemnification (compensation) for a party bearing the costs?
    - Does the existence or absence of an indemnification clause or similar provisions in existing contractual framework is arm’s length?
    - Which party should ultimately bear the costs related to the indemnification of the party that suffers from the termination or re-negotiation of the agreement?

Rethink your TP model

Transitioning to a new model: no restructuring

- Is the shift to a new model just a reflection of historic conduct of the parties, i.e. the historical set-up was not up to date?
- Continuous evolvement of operating model
- Functional and asset profiles of the affiliated companies remain unchanged before and after the transition to a new model
- Alignment of remuneration with the actual conduct of the parties and with the function, asset and risk profile of the affiliated companies
- **Before reaching any conclusion – conduct a throughout analysis and consult!**

Rethink your TP model

Prepare to a transition to a new TP model

- Conduct a detailed functional and risks analysis: interviews with key management and stakeholders
- Simulate operating results of the companies involved (results after the shift to a TP new model)
- Prepare arguments and basis from the Danish and foreign tax and transfer pricing perspective
- Consider impact on other taxes, i.e. VAT, withholding tax, customs duties
- Revise intercompany agreements and prepare for changes
- Determine whether a compensation for restructuring is necessary and if so, determine the arm's length price for this compensation
- Determining TP policies to be applied in the new TP model

05

Intercompany Agreements and Arm's Length Principle - in short

Intercompany agreements and the arm’s length principle

- **Intercompany (“IC”) agreements govern transactions between related entities within a corporate group**

- **IC agreements are beneficial (and highly recommended) instruments for ensuring compliance with TP regulations**

- **Arm’s Length Principle in relation to IC agreements**

    - The principle must also be reflected in IC agreements
        - Clauses re. price adjustments, liability, termination, payment terms, IP ownership etc. must be on market terms

        - Such clauses serve as aids to interpretation of the IC agreement and related transactions; whether such are on arm’s length terms

            - If several clauses do not reflect market terms, and related transactions are under scrutiny by tax authorities, the clauses may support that the transactions themselves are inconsistent with market terms (i.e. leading to recharacterization/adjustments by the tax authorities and, hence, potential tax liability)

Intercompany agreements and the arm's length principle

- **Arm's Length Principle in relation to IC agreements *(continued)***
  - The principle must also be reflected in IC agreements *(continued)*
    - It may be that few clauses - when isolated from the rest of the IC agreement - are not deemed to be on market terms. However, other clauses - and thus taken into context of the rest of the agreement - may compensate for this and maintain the arm's length:
      - E.g. a short termination notice of 1 month for an internal customer (which itself is not often seen in market) may be balanced by a higher price by the internal supplier → resembling what independent parties would have agreed in the situation (market terms)

        (what the market practice is naturally depends on the market in question and will be subject to a comparability analysis)

Intercompany agreements and the arm's length principle

- **If a TP model changes - remember to (also) update related IC agreements**
  - Example: A group transfers from a centralized TP model to a decentralized model
    - Costs for shared services (e.g., IT, HR, R&D) were previously allocated by the parent company, but regional subsidiaries will now share and allocate costs based on their usage and benefit → new/update MSA

- **Act in accordance - and consistent - with your IC agreements**
  - Tax authorities assess whether the intercompany agreements are consistent with the actual conduct of the parties.
    - Misalignment can undermine credibility of transfer pricing policies and documentation
    - If the substance of transactions does not align with the form presented in IC agreements, authorities may disregard the agreements and recharacterize the transactions based on their actual conduct (which again could lead to transfer pricing adjustments and potential tax liability)

06

Post-transformation “to-do’s”

New TP model: post transformation “to-do’s”

After the transition to a new TP model

Summarise your arguments in a defense file / memo

Consider applicability / reportability of DAC 6 rules

Prepare new intercompany agreements

Prepare benchmarking studies (if needed)

Implement and monitor new TP policy

Elaborate the analysis in the TP documentation

07

Recent tax case experience

TP case - EET Group (Case: BS-6035/2021-OLR)

Background

- EET Group A/S is the large European distributors of IT components and spare parts.
- The case concerned intra-group sales and transfer pricing documentation for fiscal years 2010-2012.
- The prices were set using a cost-plus as a basis.
- The results in sales affiliated companies were tested using a gross margin as a profit level indicator (PLI).
- The margines were supported by a benchmarking study prepared by the company.

Substance of the case

- The Danish Tax Authorities (“DTA”) claimed that EET Group's intra-group prices were not in compliance with the arm’s length principle resulting in higher operating margins for the sales companies.
- The DTA claimed that the provided transfer pricing documentation was inadequate.
- The DTA assessed that the sales companies have a routine profile and thus, operating profit (EBIT) shall be used as a more reliable PLI to establish an arm’s length remuneration of the sales affiliated companies.
- In 2016 the DTA increased the EET Group's taxable income by DKK 128,810,000 for the years in question aligning sales companies’ EBIT margins with the median of benchmarking study prepared by the DTA.

TP case - EET Group (Case: BS-6035/2021-OLR)

Court proceedings

- EET Group A/S appealed this decision to the National Tax Tribunal, which reduced the increase to DKK 29,587,135 in 2020.
- The Danish Ministry of Taxation appealed the Danish National Tax Tribunal's ruling.

Final Ruling

- On June 19, 2024, the Eastern High Court ruled in favor of EET Group, holding that the company's taxable income should not be increased as claimed by the Ministry of Taxation.
- The Easter High Court concluded that the company’s transfer pricing documentation valid and comparability analysis based on gross margins appropriate.
- The Eastern High Court also found in favor of EET Group A/S that any gross margins exceeding the interquartile range could only be adjusted to the nearest point within the arm's length range (the third quartile).
- The Ministry of Taxation has since appealed the judgment to the Danish Supreme Court.

TP Case - SKM2024.292.LSR

Background

- The case involves the group operating in shipping industry and concerns the fiscal years 2011-2013.
- The operational and transfer pricing set-up of the group was structured in a way that the manning/crew company chartered a vessel from the vessel owner on bareboat charter terms, staffed the vessel and chartered the fully equipped vessel to the principal (Danish company) on time charter terms.

Substance of the case

- The DTA has increased taxable income of the Danish company for income years 2011-2014 on the basis that the income was determined not in accordance with the arm’s length principle.
- The DTA argued that the ship-owning company did not have a control over the risks which were connected with its operational activity, i.e. chartering of the ship.
- The DTA claimed that the company in reality had no emoyees to control the risk and the company shall be treated as an empy company with no activity except for legal ownership of the ship.

TP Case - SKM2024.292.LSR

Court proceedings and outcome

- The National Tax noted that the decision of the DTA did not demonstrate that the company had no control over the risk associated with the acquisition and operation of the vessel.
- As a result, the court ruled to reduce to zero the transfer pricing adjustment proposed by the DTA.

07

Key Takeaways

Key Takeaways

- Assess allocation of functions and value creation across the Group vs. allocation of income: is there any mismatch?
- Review transfer pricing set-up and any indications that the model have to be changed
- Focus on actual conduct and not a mere contractual framework
- Use effectively intercompany agreements to support transactions between the affiliated companies

Q&A

Attend the next TP Lab webinar:

Navigating Tax Challenges in the Era of Global Workforces and Permanent Establishments

Date: Tuesday
25 February 2025
09:00-10:00 am CET

Thank you!