TAX RISK MANAGEMENT IN THE AREA OF TRANSFER PRICING

Marcin Jamroży*

Abstract

This paper aims to analyze the tax risk related to transfer pricing and methods of reducing it by Polish enterprises. Effective risk management requires identifying risk areas, quantifying the risk, as well as proper application of procedures that enable the reduction or an elimination of risk exposure. Creating or using adequate tax documentation, advance pricing agreements or internal transfer pricing procedures are the most important means of managing transfer pricing risk by Polish enterprises.

Keywords: *tax risk, tax risk management, transfer pricing, tax documentation, transfer pricing procedures*

1. Introduction

Transfer pricing policy is gaining importance in the business activity of many entities, especially as far as multinational corporations are concerned. Transfer pricing refers to the pricing arrangements set by international related entities in respect to transactions between them such as the sale of goods, provision of services or the transfer of intellectual property. It has become one of the most important international tax issues facing multinational corporations, whatever their size.

Thus, it is not surprising that entrepreneurs intend to optimize the overall tax burden of a group on the basis of existing regulations. However, each state has a vital interest in taxing the part of income achieved by a group of related entities in their territory under its tax jurisdiction, which results in restrictions imposed on the documentation of transactions between such entities. At the same time, the reduction of transfer pricing risk through tax documentation, advance pricing agreements and tax instructions is becoming increasingly important.

The transfer price is the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization (Markham 2005, s. 9). Although it is commonly confused with tax fraud, transfer pricing is a conventional financial and legal instrument

* Ph.D., Associate Professor, Institute of Finance, Warsaw School of Economics, email address: majmro@sgh.waw.pl.

for companies that facilitates inter-affiliate decisions upon whether to conduct transactions inside or outside a holding. It influences, e.g. profit formation and its distribution (Wyciślok 2006, s. 6).

The article's purpose is to analyze the tax consequences of transfer pricing in relations between related parties. The emphasis is put on international aspects of transfer pricing and its use by Polish and international companies which can be identified as related entities. A tax adjustment carried out by a state finding itself in danger of reduction of its tax income may lead to international double taxation (from the economic point of view) – the levying of tax on the taxpayer and the related entity. This article presents the means of reducing, or even eliminating such risk, especially through transfer pricing documentation or advance pricing agreements.

2. Transfer pricing risk

The tax problem of transfer pricing is closely related to the process of income transfer, resulting as an effect of establishing prices different from the regular, market ones in business relations between related entities. Owing to their reduced or increased values, the final price for performed services can be used as a tool to exploit differences between tax jurisdictions of states where their business activity is conducted.

The transfer price has a major influence on the final income achieved in each state and as a result, on the tax burden of both related enterprises. Income is usually transferred from the state with lower tax rates. Nevertheless, it is not uncommon to see transfers to countries where the effective rate of taxation is higher. However, regulations concerning thee covering of losses for related entities are more liberal, or when losses are foreseen in the upcoming fiscal years. Among companies that can be considered to be 'tax-wise and attractive', we can find entities entitled to tax exemptions ;for example, finding itself in a special economic zone or tax haven. Optimizing activities may involve assigning additional functions to the entity whose income is taxed in a more beneficial way. Such an entity has the justified right to demand higher remuneration, as its range of performances, functions and/or risk was augmented. More profitable functions or processes should be assigned to an entity acting under more beneficial taxation. Also recommended is the allocation of non-profitable or low-income activities, (e.g. research units), within entities based in countries with restrictive tax policy or with high tax rates, but with a developed public aid system, for example, providing support for innovativeness.

Transactions between associated entities may be controlled and reliably valuated by the Polish tax administration. A penal tax rate of 50% is applied

to shifted income unless the taxpayer presents adequate tax documentation in compliance with Art. 9a of the Polish Corporate Income Tax Act or Art. 25a of the Polish Personal Income Tax Act. In addition, penal-fiscal sanctions may be imposed on those responsible for transfer pricing policy.

Transfer pricing regulations are anchored in OECD Commentary to Model Tax Convention ("OECD-MC") and the Transfer Pricing Guidelines for Multinational Enterprises and Tax ("OECD-Guidelines"). OECD regulations pertain to a cost-profit separation within an enterprise operating in different tax jurisdictions and lay down general rules for parent-subsidiary and inter-subsidiary transactions. Art. 7 § 2 of OECD-MC ascertains the fundamental transfer pricing principle – „the functionally separate entity approach", which creates the legal fiction of the permanent establishment generating profits as if it was a „separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed". The use of this approach is the first step to valuation of transfer under "arm's length principle". The latter notion is introduced by art. 9 §1 of OECD-MC and is deemed an internationally accepted standard and stipulates that off-market conditions may be adjusted by tax authorities. OECD-Guidelines are another set of rules concerning "entities participating directly or indirectly in the management, control or capital". In essence, they offer guidance on practical application of the aforesaid principles and focus on the valuation of transaction conducted between multinational, associated entities. They do not, however, establish rules for tax documentation.

Regardless of motivations based purely on taxes, understood as exploiting differences between burden created by various states or settling tax losses, a number of other reasons for income transfer can be enumerated, including:

- Presenting a satisfactory result in financial reports,
- Reduction of insolvent assets with regard to the company in danger of bankruptcy,
- Circumventing restrictions imposed on foreign exchange,
- Reduction of custom duties,
- Reduction of other shareholder's due dividend.

3. Transfer pricing risk mitigation

Risk management in transfer pricing consists of selecting adequate instruments relevant to enterprises which are exposed to risk. Effective risk management requires identifying the risk areas as well as quantifying the risk, and afterwards proper application of procedures that enable the reduction or an elimination of risk exposure.

Is is becoming essential to manage transfer pricing risk through the application of proper management tools, like advance pricing agreements, tax documentation or tax instruction. The main goal of management is to optimize the tax burden while avoiding elevated or economically unjustified tax risk. Appropriate tax management in terms of transfer pricing increases the possibility of success in business and leads to better post-taxation results or reduction of development costs.

Polish law allows tax authorities to employ three basic methods of assessing transactional income: the comparable uncontrolled price method, the resale price method and the cost plus method, and two transactional profit methods (the transactional net margin method and the profit split method). All of them refer to a given transaction with a related entity, with the exception of transactional profit methods, which are based on the global share of income between all related enterprises involved in the transaction. However, transfer pricing methods of income approximation cannot take precedence over the duty to search for the whole truth about legal and economic state of affairs connected with the price of transfer, (e.g. market conditions, bundled deals).

Benchmarking studies have been done by enterprises in order to verify the prices and margins that are applied by related entities. Verification is aimed at checking if the transactions' conditions conform to the conditions of comparable transactions entered by non-related entities. Benchmarking studies are a necessary element of argumentation confirming that the prices established by the taxpayer are in the range of the market prices.

It is also difficult to overestimate the importance of the agreement with an affiliate itself. Such contracts between related entities drafted in accordance with the documentation requirements constitute vital evidence. Benchmarking studies and source evidence that can confirm performance of services are of paramount importance. A coherent and long-term transfer pricing policy established for a group of related enterprises combined with efficient documentation management contribute immensely to the increase of tax safety and the reduction of risk.

On the other hand, flexibility in the planning of transfer pricing policies is needed, in order to achieve the best possible settlement between related parties in accordance with tax laws. By drawing up settlement rules and principles, such as the calculation of prices/margins, specific economic goals have to be met.

3.1. Tax documentation

Creating and using adequate tax documentation is one of the most important means of managing transfer pricing risk. Since Polish Tax Law amendments entered into force in 2001, each taxpayer is obliged to provide

tax documentation concerning transfer pricing. As tax authorities are required to determine the market price of a subject of a transaction on the basis of all available data, it is in the interests of taxpayers to present information indicating what factors and circumstances have been taken into consideration when determining final transfer prices. Information prepared by the taxpayer at the time of determining the transaction price protects the submitting entity from falling victim to using data unavailable to the taxpayer or non-existing at the time the price is determined. Possessing reliable and objective data to support a decision in the choice of a certain method of assessment obliges tax authorities to apply the method adopted by the taxpayer.

Currently binding regulations determine requirements for such documentation to be fulfilled. However, they do not impose any specified form which should be employed. The law stipulates that such documentation shall at minimum consist of:

- the identification of roles of the entities participating in the transaction, taking into account the assets used and the risk taken by them,
- specification of all foreseen costs related to the transaction and the form and payment term,
- the method and manner of calculating the profits and specification of the price of the subject of the transaction,
- a description of the economic strategy and other actions within it if the strategy adopted by the entity has influenced the value of transaction,
- an indication of all relevant factors if the entities participating in the transaction have taken such factors into account for the purpose of determining the value of the subject of the transaction,
- an assessment of the benefits expected by the entity obliged to prepare the documentation, such benefits being connected with the performances in the case of contracts relating to intangible performances (including services).

The aforementioned obligations shall apply to transactions between related entities in which the total amount resulting from the contract, or the total amount of actually paid performances enforceable in the tax year is higher than the equivalent of:

- EUR 100,000 if the value of transaction does not exceed 20 per cent of the initial capital,
- EUR 30,000 in the case of performance of services, sale or making available intangible assets and legal values,
- EUR 50,000 in the rest of cases.

There is no doubt that these rules apply to given transactions with determined related entities, not the total amount of transactions with all related entities. One must remember that the Ordinance of the Minister of Finance (issued under art. 9a of the CIT Law and art. 25a of the PIT Law) determines

a list of tax havens. Transactions in relation to which the payment of sums due as a result of such transaction is made directly or indirectly for the benefit of an entity with place of residence, seat or board of management within tax haven countries are subject to these requirements even when they are concluded between independent enterprises if the total amount exceeds EUR 20,000.

Taking into consideration both Polish national regulations and OECD guidelines, it is obvious that tax documentation is extremely useful and can support taxpayers' interest formidably. Not only does its proper preparation guarantee compliance with the law, but also reduces the risk of being subject to potential penal taxation rates (50% in Poland, in comparison to standard 19% CIT rate). The amount of relevant data is often difficult to determine. Nevertheless, as it can be seen that on the basis of Polish law an exhaustive list of documents regarded as a sufficient minimum for each type of transaction can be enumerated. It should also be pointed out that this list was created bearing in mind the Arm's Length Principle.

Tax documentation should be complete and coherent. First of all, a careful functional analysis needs to be conducted. Its aim is to point out activities, risks and assets relevant from the point of view of a transaction. What is more, it should be accompanied by a cost and market remuneration analysis. They should all comprise of:

- a choice of income calculation method such as one of the methods mentioned in CIT Law stating the reasons for choosing one of the methods and explaining the reasons for rejecting the others as inadequate in the context of a certain transaction. A taxpayer is allowed to apply each of these methods to assess the market level of the transfer price in question. The choice must be based on certain circumstances under which the transaction is carried out. The taxpayer's decision is, according to § 4 pas. 4 of the Transfer Pricing Ordinance, biding for the tax authorities when they assess the price, unless the objectivity and reliability of the provided data is doubtful. The exception to granting priority to one of the methods is when using a particular method is „more appropriate" in the light of the provisions of the Ordinance and the available data and in particular in the case of the analysis of comparability of transactions. Imposing limits on the choice of a certain method usually stems from facts relevant to the transaction, which justify employing a different one,
- an indication of a method used for the calculation of profits by explaining specific application of the chosen method, revealing, for instance, the base cost and means for determining the margin, showing the planned calculation (ex ante) and the one based on already obtained data (ex post),
- a determination of the price of the subject of the transaction if one of the basic methods is initially chosen, together with providing the

grounds on which an invoiced remuneration is based as a consequence of: the calculation method chosen, the margin agreed upon as a result of the determination of the basis for calculating it or an indication of the reasons for price modifications (Jamroży 2009, s. 40).

The intention to implement „standardized and partially centralized" transfer pricing documentation for associated enterprises in the European Union should also be noted (Resolution of the Council and representatives of the Member States from June 27, 2006 concerning the procedural code on transfer pricing for the enterprises associated within the EU (2006/C 176/01)).

3.2. Advance Pricing Agreement (APA)

An advance pricing agreement is a means of significantly reducing or even eliminating transfer pricing risks. In its basic form it is a formal agreement between a taxpayer and tax authorities determining the method of setting a certain transfer price and usage in order not to violate tax regulations. Such agreements may be unilateral, bilateral or multilateral. In the first case, taxpayers sign an agreement with the tax authorities of one country, and in the second and third with two or more. APA's in such form are binding in such countries as the UK, France, the Netherlands, Spain and the USA (Ault, Arnold 2010, s. 531). Agreements of this kind can also become binding interpretations of tax authorities as is the case of Germany.

The Tax Code of Poland has already been amended to introduce this institution into the Polish legal system. However, it regulates this matter in a slightly different manner than in aforementioned states. In Poland, the final act is not an agreement between the Polish tax administration and an applicant, but an administrative decision – an advance pricing decision. However, for the consistency of terminology and due to its comparable effect, the abbreviation "APA" will be used in this article. Polish regulations distinguish 3 different types of the APA depending on the related parties applying:

- unilateral domestic APA's (only for domestic related entities) and unilateral foreign APA's (for domestic entity related to a foreign entity or two or more domestic entities related to the same foreign entity),
- bilateral,
- multilateral.

As of January 1, 2006 the Minister of Finance has the competence to issue a decision concerning aspects regulated by standard APA's and binding for tax authorities as far as tax procedures are concerned. Under Polish law only a CIT payer with a place of residence or management located within the territory of Poland or a foreign permanent establishment situated within the territory of Poland, may apply for such a decision. Not only is the APA

applicable to transactions between related parties, but also to relations between a permanent establishment and its head office.

According to the Tax Code (section IIA, articles 20a-20r) during the procedure to acquire such an agreement, it is mandatory to provide:

- a suggested method for determining transfer prices and, in particular, an indication of one of the methods defined in CIT and PIT tax acts,
- a description of the application of the suggested method concerning the transaction subject to the APA and, in particular, an indication of the principles for calculating the transfer price, any financial forecasts on which such calculation is based and analysis of comparable data used during calculating the transfer price,
- a description of circumstances which may affect assessment of the transfer price in question, in particular: type, object and value of the transaction, a description of the transactional course, including analysis of functions, assets and risks of the parties of the transaction, as well as a description of predicted costs to be paid by the parties with regard to the transaction and a description of the economic strategy and other relevant circumstances if they affect the price of the transaction; data concerning the economic situation in the branch of the industry in which the applicant operates including data on transactions concluded by unrelated parties which were used for calculating the transfer price; an organizational and capital structure of the applicant and its related parties who are also parties to the transaction and a description of financial accounting principles employed by the related parties who are also parties to the transactiondocuments which significantly influence the transaction price and, in particular, texts of agreements, arrangements and other documents indicating intentions of the parties to the transaction,
- the suggested duration of the APA,
- a list of the related parties with whom the transaction will be conducted with their consent and submission of all necessary documents concerning relevant transactions and to provide necessary explanations to the tax authorities.

The aforementioned elements are indispensable for the application to be reviewed. The application itself and accompanying documents must be submitted in Polish. The procedure regulated by the Tax Code guarantees ample means for solving potential uncertainties. Should any arise on the part of taxpayers, they can submit a request for information they require or a discussion meeting. When doubts appear after the APA procedure commences, further meetings can be organized before the final decision is made.

The Minister of Finance has 6 months to issue a decision on a unilateral agreement, 12 months for a bilateral agreement and 18 months for a multilateral agreement. These periods can be extended on the basis of general rules

mentioned in the Tax Code. The period for which the APA in Poland is valid cannot exceed 5 years. The APA may be repeatedly extended for another 5 years under the condition that the criteria used to evaluate such an agreement have not changed and the entity applies to extend the APA period at least 6 months before it expires. However, in case of non-compliance with the conditions agreed on in the published decision, the tax authority states ex officio its invalidity with an immediate effect from the date of notification that the original decision on the pricing agreement enters into force.

Signing an advance pricing agreement, which formidably limits the possibility of contesting the accepted price for transactions within multinational enterprises by any tax authorities, is undoubtedly advantageous. It is especially beneficial for companies when it has repetitive, basic and vital transactions that represent a significant share of income as a subject, or in the case of the involvement of intangible assets of high value. Each taxpayer deciding on entering into an advance pricing agreement has to assess the expected benefits and costs, including an agreement submission fee in particular. This fee is generally 1% of the transaction which is the subject of an agreement, with maximal and minimal limits imposed depending on the type of each agreement. In a domestic APA the fee cannot be less than 5.000 PLN and not more than 50.000 PLN. In a foreign unilateral APA the fee cannot be less than 20.000 PLN and not more than 100.000 PLN. In a foreign bilateral/multilateral APA the fee cannot be less than 50.000 PLN and not more than 200.000 PLN. The fee for extending an APA is equal to half of the initial payment for the APA application. More costs concerning the procedure may be imposed on the applicant, e.g. the remuneration of experts and translators, costs of travelling of witnesses, etc.

3.3. Tax instruction

Another means of reducing transfer pricing risk is tax instruction – an internal document which presents procedures with the purpose of optimizing tax burdens arising from transactions involving transfer pricing, while maintaining full tax safety. Its main aims are:

- identification of related entities and entities based at tax havens through constant control of contracts and transactions in terms of characteristics mentioned in the tax law,
- identification of all transaction requiring obligatory tax documentation owing to the fact they exceed thresholds established by the law,
- constant preparation of tax documentation for transactions,
- identification of transactions conducted with related entities in order to provide financial reports.

Tax instruction suited for the need of transfer pricing risk management should in particular provide regulations in the field of:

- responsibility and authorization,
- identification of transactions involving obligatory tax documentation,
- content,
- preparation of tax documentation,
- accounting records of transactions with related entities,
- control procedures,
- form and place of storage of tax documentation.

To prepare tax instruction on transfer pricing policy it is crucial to possess vast knowledge of an enterprise, its structure, as well as nature and course of its transactions. Each instruction should include a description of the full procedure from the moment of identification of a transaction with a related entity, to the complete preparation of transfer pricing documentation.

4. Conclusions

Polish tax regulations oblige taxpayers to establish the terms and conditions of transfer pricing as well as other provisions of related party transactions and pricing in particular, at the arm's length level. Violation of this rule empowers tax authorities to estimate the arm's length value of income and determine the proper amount of tax liability.

Transactions between related entities may be controlled and accurately evaluated. Income is taxed at a 50% tax rate if the taxpayer does not present evidence within 7 days a request for further information is received.

Transfer pricing risks can be effectively mitigated by Polish enterprises. Effective risk management requires identifying the risk areas, quantifying the risk, as well as the proper application of procedures that enable the reduction or elimination of the risk exposure. Creating or using adequate tax documentation, an advance pricing agreement or internal transfer pricing procedures are the most important means of managing transfer pricing risk.

References

Ault H.J., Arnold B.J. (2010), *Comparative Income Taxation*, Kluwer Law International, The Netherlands.

Brzeziński B. (1997), Skutki stosowania cen transferowych w świetle unormowań europejskiego prawa podatkowego, *Monitor Podatkowy* (7), 193-197.

Gumola M. (2006), Drugostronna korekta cen transferowych, *Przegląd Podatkowy* (12), 35-46.

Jamroży M. (2010), *Dokumentacja cen transferowych*, Gdańsk, ODDK. Jamroży M. (2011), *Zarządzanie ryzykiem podatkowym poprzez dokumentację podatkową, w:* FINANSE, RYNKI FINANSOWE,

UBEZPIECZENIA nr 40, Zeszyty Naukowe nr 667, Uniwersytet Szczeciński, Szczecin 2011, s. 33-45
Krasnodębski R. (1998), *Opodatkowanie podmiotów powiązanych – w umowach zagranicznych*, Glosa nr 5, 1-8.
Markham, M. (2005), *The transfer pricing of intangibles*, Kluwer Law International, The Hague.
Sojak S. (2001), *Ceny transferowe. Teoria i praktyka*, Warszawa, PWN.
Wyciślok, J. (2006), *Ceny transferowe: Przedsiębiorstwa powiązane, przerzucanie dochodów*, Warszawa, C.H. Beck.