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HARMONIZATION AND DETERMINATION OF TRANSFER PRICING PENALTIES IN THE EU, AS PREMISE OF SUSTAINABLE AND SECURE DEVELOPMENT

Jonas Mackevičius[1], Martynas Novikovas[2]

Vilnius university, Saulėtekio av. 9, Vilnius LT-10223, Lithuania
International Business School at Vilnius University, Saulėtekio av. 22, Vilnius LT-10223, Lithuania
E-mails: [1]jonas.mackevicius@ef.vu.lt, [2]martynasnovikovas@yahoo.com

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Abstract. The transfer pricing penalties applied in EU countries are analysed in the article. The authors recommend the transfer pricing determination and imposition methodology which could be applied in EU countries as well as in countries where the transfer pricing requirements are based on the OECD transfer pricing guidelines. The authors recommend setting the penalty taking into account: 1) the difference of income tax rates in countries where the transaction parties are acting; 2) value of the transaction; 3) the difference between the arm's length price and the transfer price; 4) the risk multiplication factor.

Keywords: Transfer pricing, the arm's length principle, penalties, tax, transfer pricing audit, sustainable and secure development.

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1. Introduction

Sustainable and secure development of European countries' economies requires taking into account contemporary issues, which, among others (e.g. Makštutis *et al.* 2012; Tvaronavičienė *et al.* 2008; Tvaronavičienė, Kalašinskaitė 2010; Bilgin *et al.* 2010; Korsakienė, Tvaronavičienė 2012; Sikka, Willmott 2010; Stanczyk 2011; Dudzevičiūtė 2012) are related to increased scale of international transactions too. Due to the globalization the amount of cross-border transactions concluded between related parties significantly increased and exceeded 50% of all international trade. The tax rates and tax accounting principles are different in various countries. In order to increase the after-tax profits by shifting taxable income from high tax countries to low tax countries multinational companies often set transfer prices that differ from market prices, i.e. prices which would have been applied by unrelated parties in similar transactions under similar conditions. Changes therefore in the transfer prices can substantially affect the revenue of the government in which it operates. Thus, in order to control these manipulations of the transfer pricing many countries regulate transfer pricing by means of the so call arm's length principle. In case the group companies determine the transfer prices with are not in line with the arm's length principle, the tax authorities may adjust these prices and impose a penalty.

The transfer pricing requirements are based on the OECD transfer pricing guidelines and thus are similar in EU countries; however, the types, principles and rates of transfer pricing penalties are different in EU. The variety of penalties is mainly caused by the differences in the overall tax systems and/or judicial systems

maintained in the countries for which these penalty regimes have been designed. There are several reasons why penalties deserve special attention in the context of transfer pricing and the issues raised by the subject matter are not to the exclusive interest of the business sector. They affect trade between associated companies within the EU but also the administration of tax rules and compliance by the tax authorities of the Member States (EU Joint Transfer Pricing Forum 2005).

Therefore, the harmonization of transfer pricing penalties in EU countries is very relevant issue nowadays. There has been a large number of theoretical and empirical literature on transfer pricing responses to income tax differences, penalties, transfer pricing regulations (Halperin and Srinidhi 1987; Eden 1998, 2003; Eden *et al.* 2004; Miesel *et al.* 2002; Elliot and Emanuell 2000; Levey and Wrappe 2001; Hyde and Choe 2005; Bernard *et al.* 2006; Oylere and Emmanuel 1998; Sorensen 2004; Conover and Nancy 2000; Gresik 2001; Overesh 2006; Rolfe 2005 and other). However, there are very few scientific researches on the transfer pricing penalties harmonization and determination issues. The purpose of this article to provide the transfer pricing penalties determination and imposition methodology which could be applied in EU countries as well as in countries where the transfer pricing requirements are based on the OECD transfer pricing guidelines. The following research methods were applied preparing this article: systematic and comparable analysis of scientific literature, interpretation and analysis of transfer pricing legislation.

2. Transfer pricing requirements

The main purpose of transfer pricing is the allocation of profit tax base between the countries in which transaction parties are performing their activities. The principle of transfer pricing is the arm‘s length principle which is set in the Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties. The arm‘s length principle, on the one hand, ensures the right of each country to tax the profit accrued under the its market condition and, on the another hand, ensures that the results from the same activity will not be taxed in several countries, undertaking to make adjustments of taxable profits under the arm‘s length principle. In some EU countries the arm’s length principle was incorporated into the tax legislation almost 100 years ago (e.g. in France – from 1933; in Great Britain – from 1926; in Sweden – from 1929; in Germany – from 1972). However, the transfer pricing rules, e.g. the methods how the arm’s length prices have to be determined and transfer pricing documentation requirements were legitimized only in the end of 20th century (see 1 Table).

Table 1. Legitimation of transfer pricing rules in EU countries

Legitimation of transfer pricing rules	EU country
Until 1995	Great Britain, France, Germany, Italy
From 1995 to 2000	Belgium, Denmark, Spain, Poland, Hungary
From 2001 to 2005	Cyprus, Lithuania, Portugal, Holland, Rumania, Slovakia, Slovenia
From 2006	Bulgaria, Estonia, Latvia, Finland, Sweden
Not legitimized till 2009	Ireland, Austria, Czech Republic, Greece, Luxemburg, Malta

Source: authors

One of the main reasons the transfer pricing rules were not legitimized till 2009 in such countries as Ireland, Luxemburg, Malta (although the arm’s length principle are introduced into the tax law in these countries) is the low profit tax rates, various tax exemptions for multinational companies (especially for holding companies) provided in the tax laws in these countries. Therefore, it is not likely that the multinational companies will shift taxable income from these low tax countries to high tax countries by altering transfer prices.

It should be noted that the transfer pricing rules in most EU countries are based on OECD transfer pricing guidelines. Thus, the transfer prices in these countries have to be set applying the same pricing methods:
comparable uncontrolled price,
resale price,
cost plus,
profit split,
transaction net margin method.

Applying all the aforementioned transfer pricing methods, except the comparable uncontrolled price method, the arm’s length price is determined using various profit level indicators (e.g. gross margin, operating margin, mark up on costs, return on assets, Berrio ratio, etc.).

The choice of the profit level indicator is usually depends on the activity the transaction party is engaged in, the

type of inter-company transaction, the distribution of functions, risks and assets between transaction parties, the availability of information, etc. (Mackevicius, Novikovas 2008). Also, similar transfer pricing documentation requirements are applying in EU countries. The transfer pricing documentation has to include all the analysis performed showing that the transfer prices were set at the arm's length. Given the complexity of most transfer pricing issues, it is likely that tax administrations and taxpayers apply different conditions in order to determine an at arm's length price for a related party transaction. Such difference may give rise to an adjustment of a taxpayer's taxable base. In case of cross-border transactions, such difference may even result in a difference of opinion between tax administrations of different States. As a consequence, double taxation may occur. Such double taxation should, however, generally be resolved either via a mutual agreement procedure or a procedure pursuant to the EU Arbitration Convention. The situation mentioned above is different in the case where penalties are imposed upon the adjustment of a taxpayer's taxable base. As penalties are normally not reduced or waived in a mutual agreement procedure or an AC procedure, they will constitute additional costs for the taxpayer (EU Joint Transfer Pricing Forum 2005).

Transfer pricing penalties in EU countries

There are various types of transfer pricing penalties are applied in different countries around the world. The EU transfer pricing forum provides classification of penalties into such groups as: administrative, criminal, and other specific penalties (EU Joint Transfer Pricing Forum 2005). Authors recommend distinguishing two types of the transfer pricing penalties:

Penalties for non-compliance with the transfer pricing documentation requirements, regardless of whether the transfer pricing in line with the arm's length principle. Among the EU countries, such type of penalty is applied in Denmark, Finland (maximum penalty is 25,000 Euros), Hungary (penalty up to 8,000 Euros, in the absence of a transfer pricing documentation) and Germany (maximum penalty up to 1 million Euros).

Penalties for unpaid taxes (e.g. income tax, VAT, customs duties) due to the transfer pricing adjustments. These penalties depend on the amount of unpaid taxes and the various EU countries range from 3% (in Ireland) to 260% (in Italy) from the amount of unpaid taxes. Luxembourg is the only EU country where such type of penalty is not applied.

Furthermore, the interests are applied for the unpaid tax on time.

The classification of countries depending on transfer pricing penalties is provided in the Table 2.

Table 2. Transfer pricing penalties in EU countries, 2009

Penalties for non-compliace with the arm's length principle	EU country
No penalties	Luxemburg
Penalties less than 10% of unpaid taxes	Ireland, Austria, Greece, Cyprus, Malta, Finland, Germany*
Penalties from 10% to 100% of unpaid taxes	Belgium, Bulgaria, Czech Republic, Great Britain, Spain, Lithuania, Poland, Holland, Portugal, France*, Rumania, Slovenia, Sweden, Hungary
Penalties from 100% of unpaid taxes	Italy, Latvia, Denmark*
Penalties depends on late payment interest rates and unpaid taxes	Estonia, Slovakia

*-these countries also apply penalties for non-compliance with the transfer pricing documentation requirements
** - in Ireland the penalties may range from 3 % to 100 %, however, usually 5 – 30 % penalties are applied
*** - in Finland the penalties range from 5 % to 30 %;
**** - in Belgium the penalties may range from 10 % to 200 %, however, usually 10 – 50 % penalties are applied

Source: authors

The transfer pricing penalties lower than 10% from unpaid taxes are applied in countries with low tax rates, such as Ireland, Cyprus, Luxembourg, Malta (as it is not likely that the multinational companies in these countries will shift taxable income from these countries to high tax countries by manipulating with transfer prices). The low penalties are applied in countries where the transfer pricing requirements are not legitimated, for example, in Austria, in Greece, in Malta, in Luxembourg. It should be noted that in some countries, e.g. in Germany, the penalties for transfer pricing adjustments are relatively small (10-50% of the unpaid taxes), however, the penalties (up to 1 million Euros) are applied for the companies which do not have a transfer pricing documentation.

The penalties higher than 50% are applied in the following EU countries: Slovenia (60%), France (80%), Great Britain (100%), Latvia (100%), Belgium (200%), Denmark (200%), Italy (up 260%). It

should be noted that in most EU countries the range of penalties fluctuates very significantly, e.g., in Belgium the penalty may range from 10% to 200% of unpaid taxes, while in Italy - from 100% to 260%. The major issue is that there is no clear criteria how these penalties are determined.

Only in few EU countries the amount of penalty depends on certain criteria, e.g. in Slovenia 20% penalty is applied if the unpaid taxes amount does not exceed 420 Euros, 40% penalty is applied if the unpaid taxes amount from 420 to 4200 Euros, 60%penalty is applied if the unpaid taxes amount of more than 4200 Euros.

Such substantial differences between the applicable penalties regimes within the EU should be avoided as such can lead to significant distortions. For instance, a severe penalty regime in one country may give rise to overstatements of the taxable income of group companies in that particular Member State and understatements of the taxable income of group companies residing in Member States that apply more lenient penalty regimes. As a result, the arm's length principle will not be the main principle used to establish transfer prices in related cross border transactions. Therefore, in order to avoid these distortions, the applicable penalty regimes within the EU should to a certain extent be harmonized (EU Joint Transfer Pricing Forum 2005).

3. Determination and imposition of transfer pricing penalties

The transfer pricing penalties could be calculated and determined based on Hyde and Choe (2005) transfer pricing model. Hyde and Choe (2005) examine the effects of transfer pricing on economic incentives (for corporate management purposes) and tax compliance (for tax purposes) in a model where the multinational company sets two transfer prices: one for managerial decision-making and the other for tax compliance. Hyde and Choe (2005) show in their model that both the incentive and tax transfer prices decrease as the penalty for non-arm's length pricing increases, or the profitability of being penalized increases. According to Hyde and Choe (2005) model international company A owns subsidiary B in foreign country B. The company A manufacturers goods and sells a part of these goods in the home country A (q_A) and in the country B (q_B) through its subsidiary. The quantity of goods q_B to be manufactured is ordered by the company B. The transfer price (t) for which the goods are sold to the company B is determined by the Company A.

The costs of goods sold incurred by the Company A is equal C (q_A+q_B), where C > 0. The company B incurs costs that equals to q_Bt (it is assumed that the operating costs incurred by the company B is not material, thus, these costs is not included into the model).

The company A maximizes the consolidated profit of the group:

$$\max \prod_{Gr} = \prod_A + \prod_B \qquad (1)$$

where $\prod_A$ is the pre-tax profit of the company A and $\prod_B$ is the pre-tax profit of the company B. The pre-tax profit of companies is calculated under the following formulas:

$$\Pi_A = R_A(q_A) - C(q_A + q_B) + tq_B \qquad (2)$$

$$\Pi_B = R_B(q_B) - tq_B \qquad (3)$$

where R_A is the company's A income from the sale of goods in the home country and R_B is the company's B income from the resale of goods purchased from the company A.

The after – tax profit is calculating deducting the profit tax (the profit tax rate in country A is p_A, the profit tax rate in country B is p_B). However, in case the transfer price (t) will differ from the market price (a), the transaction parties assume risk that tax authorities may adjust this transfer price imposing penalty (P). If the transfer price t is higher that the market price it is likely that the penalty P will be applied to the company B (as the company B earned less taxable profit and paid less taxes into the budget of the county B). In case the transfer price t is lower that the market price this risk will be assumed by the company A.

The probability that the tax authorities will perform the transfer pricing audit and impose the penalty P is described by the cumulative function F(t – a), where F(0) = 0 and F(a_r – a) = 1, where a_r is threshold transfer price in the sense that if t > a_r, then one of the transaction parties is penalized with certainty.

Therefore, the consolidated after tax profit is given by

$$\Pi_{Gr} = (1 - p_A)[R_A(q_A) - C(q_A + q_B)] + (1 - p_B)R_B(q_B) - (p_A - p_B)tq_B - F(t - a)P \qquad (4)$$

Hyde and Choe (2005) provide the following equation:

$$-(p_A - p_B)\, q_B = F(t - a)P \qquad (5)$$

Based on this model the transfer pricing penalty could be calculated as follows:

$$P = (p_B - p_A)\, q_B / F(t - a) \qquad (6)$$

The size of penalty depends on the difference of income tax rates in countries where the transaction parties are acting, value of the transaction (quantity of goods/services, value of a loan, etc.) difference between the arm's length price and the transfer price, probability that the transaction parties will be audited. As it would be too complicated to evaluate the probability of transfer pricing audit, instead of this criterion it is recommended to apply certain risk multiplication factor.

In order to determine this factor all transaction parties (tax payers) should be group into several groups depending on probability to conclude the transactions with related parties not under the arm's length principle (the grouping of companies could be based on historical data which type of companies manipulated with transfer prices most of all). In order to identify such type of companies the following criteria should be taken into consideration:

The transaction party continuously incurs operating losses.

The transaction party concludes transactions with related party which is located in the low tax jurisdiction.

The transaction party is reorganized or transfer part of its functions (together with profits potential) to other related party.

The transaction party concludes specific transactions such as transfer of intangible assets, management services, etc.

It should be noted that the transfer pricing penalty can be determined using this approach making transfer pricing adjustments of sale – purchase of goods/ services transactions as well as loans, transfer of intangible assets, rent of assets and other type of transactions.

The transfer pricing penalties imposition stages are provided in the Figure 1.

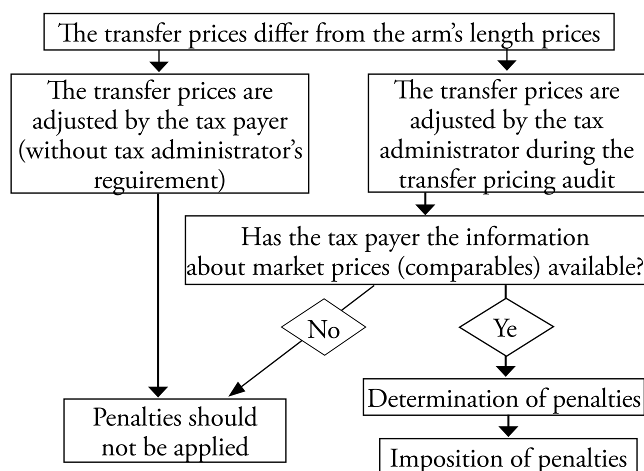

Fig. 1. The imposition stages of transfer pricing penalties

Source: Hyde and Choe (2005)

It is important that the penalty should not be applied in case the tax payer made transfer pricing adjustments itself without any requirement of tax authorities.

Moreover, it would be unfair to impose sizable penalties on taxpayers that made a reasonable effort in good faith to set the terms of their transactions with related parties in a manner consistent with the arm's length principle. In particular, it would be inappropriate to impose a transfer pricing penalty on a taxpayer for failing to consider data to which it did not have access, or for failure to apply a transfer pricing method that would have required data that was not available to the taxpayer (OECD Transfer Pricing Guidelines 2001).

Conclusions

The transfer price can substantially affect the revenue of the state budget, thus, in order to control the possible manipulations of the transfer pricing many countries regulate and control transfer pricing by means of the so call arm's- length principle. The transfer pricing requirements are similar in EU countries; however, the types, principles and rates of transfer pricing penalties are different. The substantial differences between the applicable penalty regimes within the EU should be avoided as such can lead to significant distortions of the arm‘s length principle.

In order to harmonize the transfer pricing penalties in EU countries, it is recommended to set the penalty taking into account:

the difference of income tax rates in countries where

the transaction parties are acting;

value of the transaction (quantity of goods / services, value of a loan, etc.);

the difference between the arm's length price and the transfer price;

the risk multiplication factor.

Evaluating the risk factor to be assigned to the transaction party it is recommended to estimate whether it continuously incurs operating losses, concludes transactions with related party which is located in the low tax jurisdiction, is reorganized or transfer part of its functions, concludes specific transactions, etc.

It is important that the transfer pricing penalties should not be applied in case the tax payer made transfer pricing adjustments itself without any requirement of tax authorities and in case the tax payer did not have available data about the market prices.

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