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Transfer Pricing Documentation: Introduction and Fundamental Application

The disclosure of transactions between associated enterprises to the tax authorities of each country and the preparation of the Documentation File (Master and/or Local) for these transactions is a requirement in tax legislation that increasingly attracts the concern of consultants, auditors and other professionals. The main objective for the examined party (company, person etc) is to prove that it deals on the same pricing terms both with related parties (companies, persons etc) and with independent parties (companies, persons etc). The examined party is required to prove that the arm's length principle of is respected in the transactions carried out.

What is the arm's length principle? The definition of the Arm 's Length Principle is referred in the first paragraph of Article 9 of the OECD Model Tax Convention and states that: ***([Where] conditions are made or imposed between the two [associated] 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.*** (Article 9 of the OECD Model Tax Convention))

How is it proven? The OECD suggests five methods for documenting the inter-company transactions. The company is required to choose the most appropriate method according to the nature of the transaction in order to prove that the examined transaction complies with the arm's length principle. With this, the Tax Authority ensures that it is not losing tax revenue.

What are the methods? The 5 methods of documentation in a nutshell are as follows:

1. CUP (Comparable Uncontrolled Price): This method compares the price at which the same goods or services are sold in an intragroup transaction (between related enterprises) with the price of the similar goods or services are sold in an independent transaction (between unrelated enterprises) in the same or comparable circumstances.

2. Resale Price Method: The resale price method assesses whether a transaction between related companies is compliant with the arm's length principle by comparing the gross margin resulting from similar transactions between unrelated companies. It is generally considered more suitable for documenting transactions of companies engaged in commercial activities, such as product distributors. This method is more applicable to sales of goods than to services.

3. Cost Plus Method: Under the cost plus profit method, the cost of providing goods or services is increased by the appropriate profit in relation to the functions performed, the assets used and the risks assumed by the firm. This profit margin is compared between related and third parties.

4. Transactional Net Margin Method: With the Transactional Net Margin Method (TNMM), you need to determine the net profit of a controlled transaction of an associated enterprise (tested party). This net profit is then compared to the net profit realized by comparable uncontrolled transactions of independent enterprises. As opposed to other transfer pricing methods, the TNMM requires transactions to be “broadly similar” to qualify as comparable.

5. Profit split method: The profit split method requires the total profit (e. g. from production, distribution and sale) arising from transactions between related parties to be determined and then allocated between related parties on an economically valid basis.

A valid basis of apportionment is one that leads to the same result in terms of profit sharing between associated companies as that resulting from a contract drawn up on the basis of the principle of equal distances (e. g. between companies participating in joint-ventures, joint ventures).

Transfer Pricing Documentation: Introduction and Fundamental Application

For the application of the above methods, comparative data are used, which are divided into:

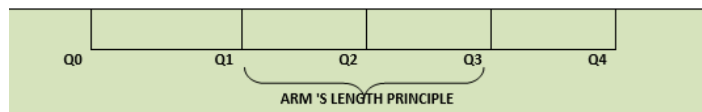
(a) internal, arising from comparable transactions of the undertaking under review with an independent undertaking or comparable transactions of an associate of the undertaking under review with an independent undertaking and

(b) external, arising from comparable transactions between parties independent of the undertaking under assessment.

How do I choose the appropriate method for documenting transactions?

The company chooses the appropriate method depending on the type of transaction and the available comparative data (internal or external). By applying the followed intra-group pricing method and using comparables, a range of prices or profit is obtained, 25% of the lowest prices are discarded and 25% of the highest prices are discarded, using quartiles. Any price between the first (Q1) and the third (Q3) quartile (25th percentile up to the 75th percentile), with sufficient justification for the choice, is considered acceptable under the Arm's Length Principle. The table below indicated the quartiles, in between the examined observation is accepted.

What the documentation file contains? The choice of the appropriate method, which demonstrates compliance with the principle of equidistance, is the largest and most essential part of the documentation file. But overall, transfer pricing documentation includes the below mentioned three main points:



- ⇒ transfer pricing Country File
- ⇒ transfer pricing Master File, and
- ⇒ CbC Report, if is needed (local legislation shall be consulted)

Country File

- ⇒ provides a general overview of the company as well as of the industry where it operates
- ⇒ maps cross-border intragroup transactions entered by the company
- ⇒ analyses intragroup transactions i.e. details the functional profile of the company with respect to each controlled transaction
- ⇒ determines the most appropriate transfer pricing methods for each controlled transaction and provides reasons for their selection

Master File

- ⇒ **Main difference** between the Country File and Master File is that Master File provides a general overview of the entire Group, while the Country File is focused on the local company and provides a detailed analysis of its controlled transactions, its functional profile, etc.

JPA INTERNATIONAL IN **GREECE** / Athens

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Transfer pricing documentation and benchmark realization

JPA INTERNATIONAL and **BDA AVOCATS** set up a team specialized in Transfer Pricing to assist their clients in this very specific area.

JPA INTERNATIONAL propose a worldwide Transfer Pricing assistance

Groups falling within the scope of Transfer Pricing rules and OECD principles must justify on a yearly basis all their cross-border intragroup transactions.

Our dedicated team can prepare a complete and OECD compliant Transfer Pricing documentation that will enable groups to avoid automatic penalties applied in many countries and justify their intragroup transactions in case of specific request of tax authorities.

Anticipate justification of Transfer Pricing transactions enable to limit costs in case of tax audit

To strengthen the economic analysis and benchmark part of the documentation, we rely on a close relation with economic experts specialized in Transfer Pricing that can provide relevant comparables to support groups' Transfer Pricing policies: **TP QUBE.**

Most transfer pricing policies and documentations require a robust economic analysis.

TP QUBE performs economic analyses in support of transfer pricing policies for international groups of all size

TP QUBE relies on Artificial Intelligence techniques to facilitate the realization of transfer pricing benchmarks used notably in application of the Transactional Net Margin Method.

TP QUBE benchmarks are enhanced by in-house and proprietary Artificial Intelligence tools

TP QUBE's tools main advantages are three-fold:

⇒ Quality - The robustness of a benchmark is key to defend a transfer pricing policy to tax authorities and face serenely any tax audit. TP QUBE is performing state of the art benchmarks, more robust than the ones performed by competitors and with unparallel audit trail;

⇒ Delay - TP QUBE can deliver preliminary results in 10 working days;

⇒ Costs - These techniques also allow TP QUBE to propose competitive prices.

JPA INTERNATIONAL CONSULTING IN **FRANCE** / Bordeaux

BDA AVOCATS is a law firm specialized in tax and business law. Didier Brézillon and Alexis Degagny run the firm and assist small, medium and large/MNE groups to deal with their tax and corporate issues.

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EXTERNAL SPEAKER

TP QUBE has been created by two economists specialized in transfer pricing, Hugo Chary and Thibaut Roques. Hugo and Thibaut have more than 20 years of experience in transfer pricing.

www.tpqube.com

Brief on the Lebanese economic and financial crisis from a tax point of view

Current context

Since December 1997, the Lebanese pound has been pegged to the US dollar at the official rate of 1,507.5 LBP by the Central Bank (BDL) in order to ensure monetary stability conducive to investment. The crisis of confidence, which has worsened since the popular uprising of October 17, 2019 and the panic of savers (bank run) that led to a de facto exchange and capital control, imposed by Lebanese banks without a legal framework until now, has put an end to the monetary stability established by the Central Bank of Lebanon (BDL) and led to the devaluation of the Lebanese pound on the parallel markets which reached 20,000 LBP for 1 USD in October 2021.

In this context, private sector companies are left to their fate and are forced to look for the US Dollar on the parallel markets to ensure fresh money that allows them to buy or import the goods essential to their activity generating negative differences of exchange that to this day are still not officially recognized by the Ministry of Finance despite an ambiguous decision #893 issued at year-end 2020 that didn't specify neither the reference source to extract the parallel market exchange rate to be used by the taxpayers nor the VAT implications of such procedure.

The accounting treatment of the difference of exchange in a hyperinflationary context

International accounting standards address the issue of exchange rate fluctuations in a hyperinflationary environment in two separate standards:

IAS 21 - The Effects of Changes in Foreign Exchange Rates

IAS 29 - Financial Reporting in Hyperinflationary Economies

The main definitions and accounting rules established by these two international standards and their practical application in Lebanon as well as their limitations in the current context are detailed hereafter:

Under IAS 21, an entity's financial statements must be prepared in its functional currency which is the currency of the primary economic environment in which it operates (e.g. LBP in Lebanon). At each balance sheet date, monetary items (e.g. operating receivables and payables) in foreign currencies should be translated using the closing rate, while non-monetary items (e.g. fixed assets and inventory) in foreign currencies that are measured at historical cost should be converted using the exchange rate at the date of the transaction. Exchange differences arising from the settlement of monetary items should be recognized in the income statement in the period in which they arise.

According to IAS 29, hyper-inflation is revealed by certain characteristics of a country's economic environment that include, but are not limited to, the following:

the general population prefers to hold its wealth in non-monetary assets or in a relatively stable foreign currency. Amounts held in local currency are immediately invested to maintain purchasing power;

the general population values monetary amounts, not in the local currency, but in a relatively stable foreign currency. Prices can be expressed in this currency;

sales and purchases on credit are concluded at prices that take into account the expected loss of purchasing power during the credit period, even if this period is short

interest rates, wages and prices are linked to a price index;

the cumulative rate of inflation over three years approaches or exceeds 100%.

IAS 29 requires the restatement of financial statements that have been prepared under the historical cost convention. This restatement consists of applying a general price index, so that the financial statements are expressed in the unit of measurement in force at the balance sheet date.

Brief on the Lebanese economic and financial crisis from a tax point of view

Thus, all non-monetary assets and liabilities must be adjusted for inflation to reflect their "real value" at the balance sheet date. Similarly, the statement of comprehensive income (income statement and other comprehensive income) is restated to correct for inflation in the period. Monetary items do not need to be restated as they already reflect purchasing power at the balance sheet date.

Adjustments to non-monetary assets and liabilities and the income statement are to be recognized on a separate line within the income statement in accordance with the requirements of IAS 29, which requires the gain or loss on the net monetary position to be part of profit or loss and separately disclosed.

Under IAS 21, an entity cannot avoid this restatement by, for example, adopting a stable currency (such as the currency of its parent) as its functional currency.

The IAS 29 - Financial Reporting in Hyperinflationary Economies, has recently been applied in Argentina which is now considered to be a hyperinflationary country as of 1 July 2018.

Inflation in Argentina has reached a cumulative rate of 120% over three years for consumer prices and 100% for wholesale prices which has led to a devaluation of the Argentine peso.

IAS 29 requires all companies to use the same general price index to measure the evolution of inflation. Given the unreliability of locally published data in some periods, determining the general price index is a delicate exercise.

The standard setter should publish a table of indices to be used by entities whose functional currency is in a hyperinflationary country.

The particular case of Lebanon

Given the economic context, one might be tempted to consider Lebanon as a country in hyperinflation as one of the criteria established by IAS 29 to consider a country in hyperinflation is the fact of having a cumulative rate of inflation over three years close to or exceeding 100%; which is the case in Lebanon since mid-2020.

However, the unreliability of locally published data does not allow the determination of a reliable general price index to establish a unit of measurement in force at the closing date.

Furthermore, the persistence of the official US dollar exchange rate imposed by the Lebanese regulator (BDL and Ministry of Finance) as well as the multitude of other subsidized rates set up by the BDL circulars prevent a proper application of this IAS 29 standard in Lebanon for the time being.

The tax treatment of the difference of exchange

To date, the Lebanese Ministry of Finance does not recognize the difference of exchange generated by the purchase of foreign currency on the parallel markets, especially since this difference of exchange, which is often negative, is not justified by a receipt from the exchange office or the currency dealer.

This exchange loss will probably be non-deductible from the taxable result while Lebanese traders have passed on this negative difference of exchange in their selling price. Lebanese companies will therefore find themselves fiscally profitable while they are actually making a loss.

Case study and proposed solution

How do I record purchases invoiced in US dollars and paid in Lebanese pounds at the black market rate?

A company receives an invoice of $1,000 from its supplier for the purchase of imported goods and must pay it in "fresh money".

The company must buy the " fresh " dollar on the black market at 20,000 LBP/$, i.e. a total of LBP 20,000,000 for $1,000, whereas at the official rate, its purchase is LBP 1,500,000. The company therefore notes a negative exchange rate difference of LBP 18,500,000.

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When the supplier is a Lebanese tax resident, he will apply 11% VAT on his invoice (i.e. in LBP 165,000) while he will collect $110 "fresh" VAT, i.e. LBP 2,200,000

Thus, the difference of LBP 2,035,000 (LBP 2,200,000 - LBP 165,000) would not have been declared by the supplier, who would have recorded it as a positive difference of exchange, and the client would not have been able to deduct the full amount of VAT actually paid.

In this case, the supplier and the customer are in violation of the VAT Law #379/2001 because the amount actually collected has not been declared.

Solution:

To remedy this situation, the sale and purchase of the imported goods should be invoiced and accounted for in Lebanese Pounds at the effective rate of the parallel market, i.e. LBP 20,000/$ in this example.

⇒ Thus, the supplier's revenue and the customer's purchase cost will reflect the actual gross margin of the transaction in their functional currency (LBP).

⇒ The negative difference of exchange should be recorded in a direct cost account (costs related to the purchase of goods) so that the purchase price of the goods sold recorded by customs is clearly identifiable.

⇒ This solution also eliminates the VAT risk as the amount declared will be equal to the amount collected or disbursed.

Conclusion

As mentioned earlier, the application of IAS 29 is not yet possible in Lebanon, especially in the absence of official guidelines from the regulator (government and BDL). It is therefore appropriate to account for monetary transactions in Lebanese Pounds at the market rate and to recognize an exchange difference which will de facto adjust the income statement and the monetary items of the balance sheet until the Ministry of Finance officially recognizes these exchange differences and puts in place a clear regulation and a unified exchange rate that companies could follow.

JPA INTERNATIONAL IN **LEBANON** / Beirut

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EU VAT - The New OSS (ONE-STOP SHOP) Regime

ONE-STOP SHOP

With effects **1st July 2021**, it entered into force one of the most important reforms to the VAT obligations for B2C e-commerce sellers and marketplaces.

This includes the following key areas:

⇒ Launch of the **One**-Stop Shop **EU VAT return**

⇒ End of low-value import VAT Exemption and introduction of the **Import One-Stop Shop** (IOSS) return

⇒ Making **marketplaces** deemed supplier for VAT

1. One-Stop Shop EU VAT return

With the aim of boosting cross-border online trade, promote trade across the EU's digital single market by reducing compliance obligations and reduce the VAT fraud gap, it was implemented this new regime applicable to e-commerce sellers who **voluntarily** wish to adhere to it.

As part of the simplification process, the (different) distant selling **thresholds** across the EU have been abolished. Just a threshold for small businesses of 10.000 euros (for all EU cross border sales together!) is established.

Moreover, this regulation has implemented the so called **One-stop Shop**, making it possible for e-commerce sellers to report all the sales under the scope of OSS (which includes all the VAT charged under the VAT rates of the country of consumption) in a unique VAT return submitted in the registration country. In this country, the Tax Office will collect all the VAT due to redistribute it to the competent Tax Office.

As a result, the need of the **previous** VAT **registrations** across the multiple EU nations is cancelled.

Importantly, The OSS declaration does not allow to deduct any VAT expenses (**Input VAT**). If there were any, the domestic VAT refund procedure should be followed.

⇒ Since July 2021, (pure) e-commerce sellers are able to close their foreign VAT registrations. They can instead complete a quarterly OSS return for their home country's tax authority.

⇒ Non-EU-resident sellers may use OSS, too.

2. End of low-value import VAT exemption and introduction of the Import One-Stop Shop (IOSS) return

The IOSS regulations have implications in the importation regime. With effects 1st July, the **€22 VAT exemption** on goods imported from third states was cancelled. Instead, VAT must be charged at the point-of-sale for consignments not exceeding €150.

⇒ **EU sellers** will no longer be disadvantaged on price vs third countries as VAT will have to be charged in all the imported goods.

⇒ **Third countries** will have the option to register in IOSS in one EU state to declare the incomed VAT expenses on shipments <150 EUR.

3. Marketplaces become the deemed supplier and VAT collector in certain cases

⇒ From July 2021 on, **marketplaces** are **responsible** for charging and collecting VAT on deemed supplier transactions. However, the marketplace does not take on product liability or regulatory obligations.

JPA INTERNATIONAL IN **SPAIN** / Barcelona

MARTINEZ-COMIN, is a Professional firm founded in 1948, specialised in Accounting, Tax, Corporate and Labour Law, and providing a full-service of business consulting and compliance. The firm has taken part in developing successful business projects, providing not only legal, tax and economic advice, but also supporting clients in making strategic and organisational decisions.

From their offices in Barcelona and Madrid, a team of more than 30 experts strives to offer an excellent service, people-focused and useful service.

"There is only one way to do things, and that is to make them the right way"
Antonio Martínez Comín (1925 – 2015)

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Comparison of real estate tax and incidental acquisition cost

When purchasing real estate, additional costs and taxes are incurred.

On the occasion of our meeting on October 14th in Paris, the question was about the costs and taxes for an acquisition with a purchase price of € 700.000 or comparable in local currency. We received the data from partners in 11 countries.

Transfer tax – stamp duty – Tax de mutation immobilière - Grunderwerbsteuer

Taxes are levied differently from region to region in many countries, so what is given here, are often mean values.

Please note the following special features: Ireland: the tax (stamp duty) of 1% applies only to acquisitions up to 1 acre, beyond that there are 7,5%. Luxembourg: The tax is actually 7% but it was assumed that the property would be purchased by a married couple, each with a tax saving of € 20.000. Netherlands: buyers between the ages of 18 and 35 will not have to pay tax on their first purchase. UK: until 125.000 GBP 0%, for the next 125.000 GBP 2%, above 8% tax. Germany: in certain cases, e.g. when transferring from parents to children, there are no taxes.

Legal Cost

There is a variety of legal transfer costs, mostly notary and court costs. Possible broker costs were not included here.

Acquisition Cost

	Purchase price	Transfer Tax	Legal Cost	Total
Luxembourg	700.000	9.000	2.000	711.000
Ireland	700.000	7.000	5.170	712.170
Colombia	700.000	11.690	1.750	713.440
Netherlands	700.000	14.000	1.750	715.750
United Kingdom	700.000	35.350	2.300	737.650
China	700.000	38.500	1.000	739.500
Lebanon	700.000	38.500	7.000	745.500
Portugal	700.000	47.600	350	747.950
France	700.000	40.670	8.912	749.582
Austria	700.000	32.200	17.500	749.700
Germany	700.000	45.500	17.500	763.000

Another question is whether depreciation on the building can be deducted as cost in the current taxation of rental income. This is handled very differently and in many cases other types of deductions are taken into account instead of depreciation, as the adjacent table shows.

Considering Depreciation in Rental Income Tax Calculation

Austria	1,50 %	-8.258	price of building + proportional additional cost
China	2%		
Colombia	2,22 %	-15.841	For Legal entities only, calculation from the whole acquisition cost
France	-	0	In real regime only actual expenses deductible
Germany	2%	-11.260	price of building + proportional additional cost
Ireland	-	0	
Lebanon		-1.400	5% from rent
Luxembourg		-11.020	2% if year of construction > 6 years and < 60 years
Netherlands			No real income minus cost calculation but "notional income", here 700.000 x 3,93% (estimated)
Portugal	-	0	no amortisation accepted
UK	-	0	

JPA INTERNATIONAL IN **GERMANY** / Bonn

The Tax Club is an integral part of JPA International regular‘s meetings. Our member RENTROP & PARTNER, often asks for practical comparisons from our professional activity in advance, which go beyond the purely theoretical comparison of tax rates and legal regulations.

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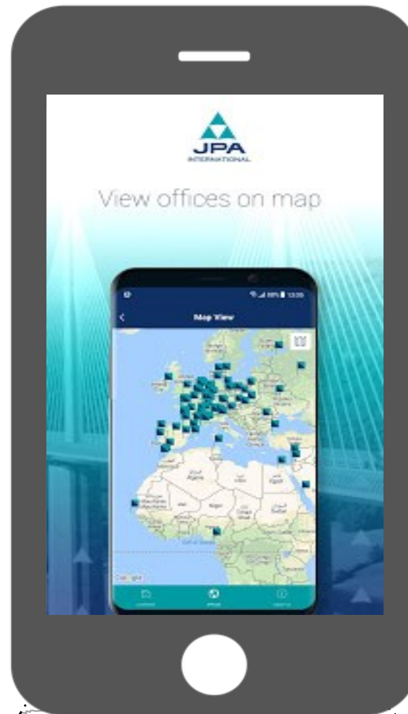

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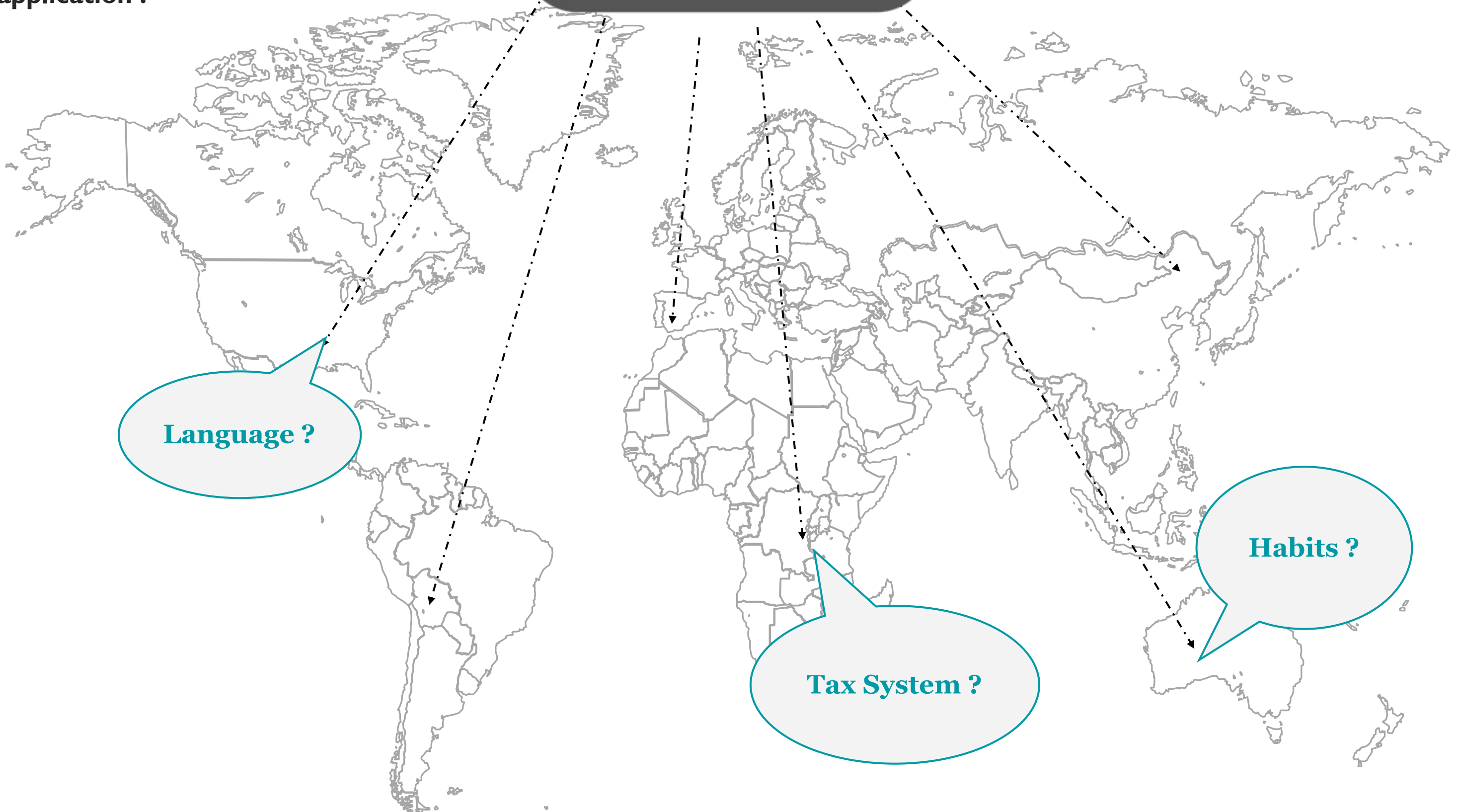

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