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Compensating adjustments

- An international perspective

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Contents

Summary

The purpose of this essay is to investigate if there exist any differences in the handling of compensating adjustments between Sweden and the UK and why these differences exist together with what consequences it may bring.

Differences were identified, such as the fact that the UK only allows for compensating adjustments in an upward direction whilst Sweden accepts adjustments in both directions. The reason for the differences originated from a discrepancy in the interpretation of the OECD documents, such as the guidelines and the commentary, and how the ALP was interpreted, restrictive or extensive. Sweden interpreted the principle in accordance with its purpose and the UK argued for a prohibition of downwards adjustments due to the fact that independent enterprises always price ex-ante.

The consequences of the identified differences were considered to counteract the purpose of double taxation treaties in general. Further, the risk of economic double taxation was concluded to increase as a consequence of the described differences and is from an international perspective undesirable. It exist arguments, taking a state perspective, that motivates an interpretation similar the one taken by the UK but at the expense of the international endeavour to eliminate economic double taxation.

Sammanfattning

Uppsatsen syftar till att utreda huruvida det existerar skillnader i hanteringen av *compensating adjustments*[1] mellan Storbritannien och Sverige och utreda de underliggande anledningarna till dessa skillnader och vilka konsekvenser en olik hantering kan få.

Skillnader kunde identifieras, såsom att Storbritannien endast tillåter justeringar av vinster uppåt medan Sverige tillåter justeringar i båda riktningar. Skillnaderna berodde på en olik tolkning av OECDs riktlinjer och kommentar till modellskatteavtalet av de båda staterna som främst berörde huruvida en restriktiv eller extensiv tolkning, med syftet bakom principen som ledstjärna, av armlängdsprincipen har skett. I Sverige är det resultatet av transaktionerna som ska vara prissatt som på ett armslängdsavstånd där Storbritannien å andra sidan ansågs tolka armlängdsprincipen ordagrant, på grund av antagandet att kompenserande justeringar aldrig hade förekommit hos orelaterade företag eftersom de alltid bestämmer priset för en transaktion i förväg.

Konsekvenserna av de identifierade skillnaderna ansågs motverka syftet med dubbelbeskattningsavtal och risken för ekonomisk dubbelbeskattning ökade i och med den skilda hanteringen, vilket ur ett internationellt perspektiv anses vara icke-önskvärt. Argument kunde identifieras från ett statligt perspektiv som motiverar en tolkning likt den av Storbritannien men på bekostnad av den internationella strävan att eliminera ekonomisk dubbelbeskattning.

[1] Det engelska uttrycket används för att eliminera eventuella skillnader till följd av översättningen.

Preface

I would like to express my gratitude towards my mentor Mats Tjernberg for his valuable inputs and inspiration. Further I would like to thank my other mentor, Benjamin A. W. Morris for his precious time, valuable inputs and especially for answering my message on LinkedIn helping a complete stranger with nothing asked for in return.

Lund, 14th of May 2018.

Oskar Paladini Söderberg

Abbreviations

ALP	Arm’s length principle
BEPS	Base erosion and profit shifting
EU	European Union
HMRC	Her Majesty's Revenue and Customs
JTPF	Joint transfer pricing forum
MAP	Mutual Agreement Procedure
MNE	Multinational Enterprise
MS	Member state
OECD	The Organisation for Economic Co-operation and Development
OECD Commentary	Model Tax Convention on Income and on Capital, Condensed Version (as it read on 21 November 2017)
OECD Glossary	Glossary of Tax Terms
OECD Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Nov 2017
TIOPA 10	Taxation (International and Other Provisions) Act 2010
UK	United Kingdom

1 Introduction

1.1 Background

Since almost 70 percent of the world trade is estimated to be conducted between associated enterprises[2], and thus have a large economic impact, there is a need for companies to, in advance, secure the fact that they are setting a transfer price in conformity with the Arm's length principle (ALP). Many companies are using transfer pricing policies and other methods in order to determine their transfer prices according to the ALP, without an ulterior motive to escape taxation responsibility.[3] Some of these companies might still end up with results at the end of the year that is not at arm's length. Since the multinational enterprises (MNE) does not desire to be challenged by the tax authorities, compensating adjustments could be used in order to stay in compliance with said principle. This means that a company might decide to make adjustments to their own accounts in order to better comply with the ALP, and here is where the issue presents itself. There are no clear guidelines from neither the European Union (EU), the Organisation for Economic Co-operation and Development (OECD) or any other international organization on how domestic tax authorities should handle compensating adjustments. This could lead to different interpretations of the ALP and thus a different handling of compensating adjustments when countries domestic transfer pricing legislation is applied to each side of the same transaction.[4]

International taxation can be arguably complicated due to legislation both in domestic tax law and taxation treaties (which activates international law) together with international documents derived from international organizations (such as the OECD) and its relationship with domestic tax

[2] Sjöblom, (2012), p. 353.
[3] OECD Guidelines, Chapter I, section A, para 1(2).
[4] OECD Guidelines, Chapter III, section B.2, para 3(71).

law. On the ninth of June 2011 the EU Joint Transfer Pricing Forum (JTPF), and its members agreed, regarding compensating adjustments,

> *"(...) that it would be useful to take stock of the situation prevailing in each MS and prepare an overview. This will be achieved by launching a questionnaire."*[5]

The questionnaire was sent to the tax administrations of each member state (MS) and resulted on the fourth of June 2014 in a report regarding how compensating adjustments is handled in each state. [6]

1.2 Subject and purpose

The subject of this essay focuses on compensating adjustments and how it is handled in Sweden and the United Kingdom. The primary questions asked are if there exist differences in the handling of compensating adjustments between the two countries and why these potential differences exist together with what consequences it may bring taking an international perspective.

1.3 Method and materials

At this time there exist no previous research regarding the subject and the purpose of this essay. The questionnaire and the following reports presented by the JTPF are investigating the issue of compensating adjustments and how it is handled in different countries and will also be used as reference.

In order to successfully fulfil the purpose of this essay an introduction to the subject of transfer pricing together with key concepts and issues will be presented. The first part of the essay will therefore be written from an international perspective describing key concepts and issues in the context of international tax law. However, it should be noted that there exist

[5] European Commission, EU Joint Transfer Pricing Forum, *Member States' responses to Questionnaire on compensating adjustments/Year end adjustments,* JTPF/019/REV1/2011/EN (2011), p. 2.
[6] European Commission, *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee*, COM(2014) 315 final of the 4th of June 2015, appendix III.

separate domestic legislation in both countries, regulating transfer pricing, but will not be described in particular due to its resemblance with the international principle. This means that first and foremost the OECD model tax convention together with its guidelines, commentary and also doctrine will be used to describe the ALP and the associated elements such as the different transfer pricing adjustments. This material is not a direct source of law and depending on what method of application of international law in national law a country use; different methods of application will be needed for the guidelines and the commentary to obtain legal value. Doctrines will be used to describe key issues surrounding transfer pricing where context is needed due to the operative nature of the guidelines and the commentary. Governmental publications will form the description where there is a need to describe provisions of constitutional nature since such information can be trusted to be undisputed and unbiased.

Sweden takes a dualist view, meaning that international law will need to be incorporated in Swedish law in order to be legally binding.[7] Despite this requirement the Supreme Administrative Court stated in RÅ 1991 ref. 107 (the Shell case) that the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) can be used when interpreting the Swedish transfer pricing legislation stated in the Income Tax Act Section 14 para 19-20.[8] Further the Supreme Administrative Court of Sweden stated in RÅ 1996 ref. 84 (the Luxemburg case) that the Model Tax Convention on Income and on Capital (OECD commentary) can be used as guidance when interpreting international tax treaties when conformity with the model tax convention is at hand. This statement derives from the courts assumption that if an international tax treaty has been drafted using the model tax conventions wording, in conformity with Swedish contractual principles, the intentions of the parties must have been to include its commentary and to achieve the same results.[9]

[7] Linderfalk (2012), p. 175.
[8] Para 5(3) together with prop: 2005/06:169 s. 88-90.
[9] Para 4.

The United Kingdom (UK) is also taking a dualist view in its application of international law in the national legal system. International law is only a part of the domestic British law if it has been incorporated.[10] When interpreting the domestic transfer pricing legislation, according to the Taxation (International and Other Provisions) Act 2010 (TIOPA 10) Section 164, national legislation is to be interpreted as "best secures consistency" with the OECD documents, including the OECD guidelines and the OECD commentary. Due to the fact that both Sweden and the UK acknowledges the OECD Guidelines and the OECD Commentary, they can be used in order to successfully describe transfer pricing regulation and the arm's length principle from an international perspective.

Since there exists a shortage of legislation and case law when it comes to compensating adjustments, the questionnaire sent out by the JTPF, together with its following reports, will be used to describe the current interpretation and application of the ALP in both jurisdictions. This material is arguably viable due to the fact that it originates from the European Commission and the answers presented are provided from respective jurisdictions tax authority. The answers in the questionnaire thus receive its validity due to the fact that said authority is the first instance when trying transfer pricing matters. This will in some cases eliminate the reason for case law to be created when the tax authority finds reason to accept a construction made by companies since no dispute thus exist to be brought to the courts. The answers in the questionnaire are relatively dated, and it would be desirable to acquire more recent answers, but in the questionnaire both Sweden and the UK stated that they did not aspire to change the current handling of compensating adjustments. The questionnaire was updated in some parts 2018 by the OECD and its MS, and is in applicable areas coherent with the answers provided in the first mentioned questionnaire.[11]

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[10] UK Parliament, https://publications.parliament.uk/pa/cm201011/cmselect/cmeuleg/633/63304.htm, (gathered 2018-05-14).
[11] OECD, http://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profiles.htm, (gathered 2018-05-14).

After the description, an analysis is to be made using the Swedish interpretation and the corresponding British interpretation of the ALP regarding compensating adjustments. The main purpose of the essay is not to conduct a full comparative analysis between the Swedish and the British transfer pricing legislation. However, in order to examine if there exists a discrepancy in the application of the ALP regarding compensating adjustments, the different interpretations will need to be described together with the adjacent elements, such as the comparability analysis, and later compared to each other. When doing this one could argue that a comparative method is to be used, using the functionality principle, which means that the linguistic differences are to be disregarded from and the focus of the comparison is on how the two jurisdictions deal with the problem of compensating adjustments. [12]

1.4 Delimination

No light will be brought upon the different methods companies and the tax authorities could use in order to determine the correct transfer prices according to the ALP. Intellectual property and how it is handled from a transfer pricing perspective will not be discussed. The essay will further not discuss compensating adjustments that are carried out by the domestic tax authority as "Advance pricing agreement".

This essay will not discuss the base erosion and profit shifting (BEPS) project since its purpose is in contrast to compensating adjustments. Further will the issue of, and the controversy surrounding, hindsight information in regards to the comparability analysis not be discussed.

1.5 Outline

The essay is divided between 3 different chapters, i.e. chapter 2 – *Transfer Pricing,* chapter 3 – *Transfer Pricing Adjustments* and chapter 4 – *Analysis.*

[12] Korling & Zamboni (2013), p. 153.

Chapter 2 is used in order to prepare the reader with an explanation of useful key issues and concepts regarding transfer pricing and specifically the ALP. Here is first and foremost the ALP presented from an international perspective together with a description of adjacent elements such as the comparability analysis. Chapter 3 describes the different transfer pricing adjustments relevant to the subject and purpose of the essay. Compensating adjustments are at first described from an international perspective and the chapter later goes on and describes how the UK and Sweden handles the phenomenon. In the last chapter of the essay, Chapter 4, an analysis is presented to answer the essays primary questions and fulfil its purpose.

2 Transfer pricing

A transfer price is commonly referred to as the price agreed between two or more associated enterprises[13] when trading amongst each other.[14] Several different transactions are included in the transfer pricing concept. These could for example be about interest-free loans, intellectual property and assets or labour costs. Regardless of what the subject of transaction is, related companies often have a common interest in the outcome of the transaction, which indicates that the fundamental idea of competition is taken away from the transaction.[15]

To understand the rules regulating transfer pricing it is desirable to first understand the surrounding issue. Associated enterprises could transact with each other solely in order to reduce their taxable income which means that it is possible to sell goods, services, etc. between associated enterprises, below or above market value, to allocate most income where there are the biggest deductible costs and thus acquire tax benefits. This is no problem from a taxation perspective when the parties are located in the same country, since the overall profit is still accounted for in said country. Problems arise when the parties are located in different countries. By using a transfer price that differs from what unrelated parties would use, due to the lack of competition and the special structure with a common desired outcome, MNE could shift pre-tax profits between countries. By doing this they could increase their overall net profit only by paying less tax.[16]

The issue thus emerges from the discrepancy between the absence of a global tax law and the increasingly global business constellations. Taxation

[13] The term *"associated enterprises"* is often defined in the domestic legislation of different countries but is, in most cases, inspired by the article 9 of the OECD Model Tax Convention. The article includes two typical situations whereas a) includes the situation when a parent company is doing business with a subsidiary in another country in which it owns shares and b) when two sister companies are doing business amongst each other whilst both owned by the same parent company.
[14] Henshall (2016), p. 3.
[15] OECD Guidelines, Chapter I, section A, para 1(2).
[16] *Supra note 14*, p. 4.

on business profits is regulated in domestic law and therefore it exists differences in tax rates, and rules, between different countries. Without rules regulating transfer pricing, MNE could choose where to have parts of their business located and by doing this, select a country to shift profits to and accordingly pay tax in. By hindering MNE to shift profits, tax-authorities can ensure that the profit generated in one country is also taxed in that same country and thus prevent tax base erosion.[17]

2.1 The arm's length principle

In order to solve the presented issue many countries and their tax authorities have determined that there is a need for legislature that regulates transfer pricing. This has often been done through adopting a regulation that obliges associated enterprises to transact with each other on the same terms and conditions that independent enterprises would have done[18] - on an arm's length distance[19]. The principle is founded upon the assumption that when independent enterprises transact with one another the primal driving force when determining the conditions of the agreement are usually market forces[20], i.e. supply and demand[21], and each parties desire to maximize ones own profit[22].

This principle can be claimed to compose as an expression of the principle that all income is to be subject to tax by the authorities in which jurisdiction it arose because it intents to make sure that the party who, from a market perspective, deserves most profit also pays tax for it. In calculating what unrelated parties would have agreed on one must take into account the performed functions, employed assets and assumed risks.[23] One is not to

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[17] *Supra note 14*, p. 4.
[18] *Ibidem,* p. 5.
[19] Article 9 of the OECD Model Tax Convention.
[20] OECD Guidelines, Chapter I, section A, para 1(2-3).
[21] The Oxford dictionary of business, Second edition, 1996, p. 312, defines market forces as *"the forces of supply and demand that in the free market determine the quantity available of a particular product or service and the price at which it is offered".*
[22] *Supra note 14,* p. 5.
[23] *Ibidem*, p. 5.

forget that the ALP is to be applied on an entity-by-entity basis.[24] This means that there could be other parameters, such as economic conditions[25], to take into account when determining if related parties have acted as if they were unrelated. An example of this is the Swedish legislated exception that commercial reasons could make an otherwise wrongful transaction (from a transfer pricing perspective) to be made in accordance with the ALP. In Sweden the ALP is legislated through the Income Tax Act Section 14 para 19-20 and in the UK it is legislated through the TIOPA 10 Section 147 together with the other Sections in Part 4.

2.1.1 OECD model tax convention

When two or more associated enterprises are performing cross-border transactions, also called a controlled transaction[26], income often accrues that are supposed to be subject to tax in more than one state according to both jurisdictions domestic tax law. This phenomenon is called economic double taxation and is non-desirable from both a state and a taxpayer perspective.[27] If the same income is subject to taxation in more than one country it is likely that it will inhibit the cross-border exchange of services and goods and the movement of capital and persons.[28] This could lead to stagnating international growth and is therefore solved through states entering double taxation treaties that aim to divide countries taxation claims in situations where economic double taxation is due.

Tax conventions have up until recently been solely of bilateral character.[29] This means that the conventions have mostly been legally binding only between two sovereign states. This has also lead to the fact that there are no uniform contract principles applicable to these conventions, harmonizing the

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[24] *Supra note 14,* p. 5.
[25] *Ibidem*, p. 5.
[26] In the OECD glossary a "controlled transaction" is defined as a *"transactions between two enterprises that are associated enterprises with respect to each other*", http://www.oecd.org/ctp/glossaryoftaxterms.htm, (gathered 2018-05-14).
[27] OECD glossary, http://www.oecd.org/ctp/glossaryoftaxterms.htm, (gathered 2018-05-14).
[28] OECD Commentary, p. 9.
[29] Lodin, Lindencrona, Melz, Silfverberg & Almensdal (2017), p. 668.

application by the national authorities.[30] An obvious risk of dispute is immediately prominent if for example Sweden were to interpret tax conventions solely according to Swedish contractual principles. This is because of the highly likelihood that the other contracting state have its own contractual principles and therefore might practice the convention different than the Swedish authorities.[31] To minimize the risk of dispute, and to overall harmonize the handling of double taxation, OECD has prepared the OECD Model Tax Convention that can be used by countries when concluding tax agreements to secure a more uniform interpretation of international taxation.[32]

According to the model tax convention there are two different methods to eliminate economic double taxation – the exemption method[33] and the credit method[34]. Both of the methods entail the need for at least one of the states to reduce its tax claim. The exemption method states that income or capital is to be exempted from taxation in one of the states in favour of the other state. The credit method requires one of the states to allow, as a tax deduction, an amount equal to the tax paid in the other state.

The OECD has adopted the ALP, as stipulated in article 9 of the convention, as the basis for regulating the issue surrounding transfer pricing.[35] The article grants the taxation authorities of a Contracting State a right to re-write the accounts of an enterprise, for tax purposes only, when calculating the tax liability of said enterprise.[36] When determining if the transfer pricing is in conformity with the ALP, the tax authority is supposed to undertake a comparability analysis. The guidelines states that the comparability analysis is the natural foundation on which the application of the ALP is based upon and consists of a comparison between the terms of a transaction made

[30] *Supra note 29,* p. 668.
[31] *Supra note 14*, p. 36 f.
[32] OECD Model Tax Convention on Income and on Capital (November 2017).
[33] Article 23A of the OECD Model Tax Convention.
[34] Article 23B of the OECD Model Tax Convention.
[35] *Supra note 14,* p. 5.
[36] OECD Commentary, Article 9 para 1(2), p. 226.

between associated enterprises and the terms that independent enterprises would have agreed on.[37]

2.1.1.1 Comparability analysis and the timing issue

According to the OECD Guidelines there exist issues regarding the timing of collection of the information to be used whilst conducting the comparability analysis.[38] There are primarily two different approaches in regards to the timing issue, which is the ex-ante and ex-post approach. Depending on which approach is taken by the MS, different information is used to analyse what independent parties would have agreed on during equal circumstances. If an ex-ante approach is taken by a MS, the focus of the comparability analysis would be set on how independent parties would have agreed during similar economic circumstances and thus focus on the information reasonable available to independent enterprises pre-emptive, and during, the transaction.[39] If the MS instead are taking the ex-post approach it means that transfer prices should be set in regards to the actual outcome of the transaction.[40] This means that the focus of the comparability analysis is to be laid at a later point in time, when multiple transactions are completed or perhaps at the end of the year. Taking an ex-post approach, different from an ex-ante approach, tax authorities should be allowed to use the best data available when trying the transfer price and undertaking the comparability analysis.[41]

Both approaches together with a combination thereof are found amongst the OECD MS. The Guidelines have clearly recognized the prominent issue of economic double taxation when two countries take separate approaches whilst conducting the comparability analysis. This could, for example, happen due to a discrepancy between market expectations taken into

[37] OECD Guidelines, Chapter I, section D.1, para 1(33).
[38] *Ibidem*, Chapter III, section B, para 3(67).
[39] European Commission, EU Joint Transfer Pricing Forum, *Supplementary Discussion Paper on Compensating/Year-End Adjustments,* JTPF/004/2013/EN (2013) p. 3.
[40] OECD Guidelines, Chapter III, section B.2, para 3(70).
[41] *Supra note 39*, p. 2 f.

account when the ex-ante approach is used and the actual outcome that is used when taking an ex-post approach.[42]

2.1.1.2 Are double taxation treaties legally binding?

In order for the double taxation treaties to be legally binding, taking a dualist view, it needs to be incorporated in the national legal system. In Sweden it is done through incorporating the treaty in a special incorporating act where the treaty is attached as a supplement.[43] The method used when determining if Sweden holds a taxation claim on certain profits is clearly shown in Swedish case law. Firstly one is to determine if internal domestic law gives Sweden a right to claim tax on profits and when that is the case, the double tax treaty is used to determine if Sweden have a precedence right to tax, prior to the other contracting party claiming tax on the same profits.[44]

Since the UK is also taking a dualist view, double taxation treaties need to be incorporated in national legislation in order to be legally binding.[45] When it comes to double tax treaties it is usually done through the treaty being laid before the parliament and when completed all necessary procedures in order to become legally binding, published in the Treaty Series at the time it enters in to force.[46] It is incorporated in national legislation through the statutory instruments given in section 2 of the TIOPA 10 determining if the UK holds a taxation claim or not.

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[42] OECD Guidelines, Chapter III, section B.2, para 3(71).
[43] *Supra note 29,* p. 669.
[44] RÅ 1996 ref. 38.
[45] UK Parliament, https://publications.parliament.uk/pa/cm201011/cmselect/cmeuleg/633/63304.htm, (gathered 2018-05-14).
[46] UK Government, https://www.gov.uk/guidance/uk-treaties#practice-and-procedures, (gathered 2018-05-14).

3 Transfer pricing adjustments

3.1 Primary adjustments

A primary adjustment is allowed by the article 9(1) of the model tax convention and defined in the Glossary of Tax Terms (OECD Glossary) as:

> *"an adjustment that a tax administration in a first jurisdiction makes to a company's taxable profits as a result of applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction."*[47]

A primary adjustment entails an adjustment to the transfer prices in order to determine the correct taxable results of a company and does not include an adjustment to the actual payment between those same associated enterprises.[48] This means that if a transfer price is found to be not in conformity with the ALP, stated in both domestic transfer pricing legislation and applicable tax treaty, the tax authority of the first jurisdiction have the right to increase or decrease the transfer price to correct the result of the company. In practice, the jurisdiction of the first state might adjust the result of one of the associated enterprises and without a corresponding adjustment of the results to the other associated enterprise in the second jurisdiction, economic double taxation could occur. This could, in some cases, lead to consequences other than increased or decreased tax liability, such as penalties and interest to be paid on non-paid tax.[49]

3.2 Corresponding adjustments

A corresponding adjustment is offered as a solution, stated in article 9(2) of the OECD Model Tax Convention, to eliminate economic double taxation

[47] *Supra note 27*.
[48] OECD Commentary, Article 9, para 1, p. 226.
[49] An example of this is presented in the HMRC internal manual (2016) http://www.hmrc.gov.uk/manuals/intmanual/intm483120.htm, (gathered 2018-05-14).

post a primary adjustment in the other contracting state. It is defined in the OECD Glossary as:

> *"An adjustment to the tax liability of the associated enterprise in a second jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first tax jurisdiction, so that the allocation of profits by the two jurisdictions is consistent."*[50]

It exist a discrepancy between the phrasing of article 9(2) of the OECD model tax convention and its commentary presented by the OECD. The article stipulates that if there has been a primary adjustment in the first jurisdiction than there should be a corresponding adjustment appropriately amounting to the tax charged in the first jurisdiction. The articles phrasing indicates that the corresponding adjustment is mandatory[51], but at the same time, OECD commentary clearly states that the corresponding adjustment is due only if the second jurisdiction *"considers that the figure of adjusted profits correctly reflects what the profits would have been if the transaction had been at arm's length"*[52]. This means that if the state in which the corresponding adjustments is to be made does not consider the primary adjustment to be at arm's length, the state could refuse making a corresponding adjustment and thus cause economic double taxation. This could occur due to the fact that international treaty-law is based upon the consent of a sovereign state and is in that concern only binding to such an extent.[53]

If the tax authority of the other contracting state refuses a corresponding adjustment, article 25 of the model tax convention offer a solution to eliminate a potential economic double taxation, called a Mutual Agreement Procedure (MAP). This article enables the competent authorities of each tax jurisdiction to consult each other and agree on a solution. The method on

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50 *Supra note 27*.
51 OECD Guidelines, Chapter IV, section C.2, para 4(35).
52 OECD Commentary, Article 9, para 2, p. 227.
53 *Supra note 7,* p. 23-25.

which the countries choose to use when determining the adjustment is not presented in the OECD guidelines and is therefor left for the states to bilaterally agree on.[54]

3.3 Compensating adjustments

> *"An adjustment in which the taxpayer reports a transfer price for tax purposes that is, in the taxpayer's opinion, an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between the associated enterprises. This adjustment would be made before the tax return is filed."* [55]

Compensating adjustments, also called "*Year-End adjustments*", is a solution taxpayers in some jurisdictions could use in order to avoid a primary adjustment. It means that a taxpayer might, if the outcome of the transaction is concluded to be not at arms' length, make compensating adjustments to its own accounts in order to report a result that is in conformity with the ALP.

When the tax authorities tries a transaction and thus using the ALP, it mainly exist two different approaches. Either the transfer prices should be set taking an *ex-ante* or the *ex-post* approach. The ex-ante approach requires the transfer prices to be set at the time of the transaction and that reasonable efforts have been made in advance to comply with the ALP.[56] When this approach is dominant it means that compensating adjustments, initiated at the end of the year, would be prohibited since it is an adjustment to a transaction that has already taken place and would never occur between independent enterprises. Despite the fact that the focus of the comparability lies upon what independent enterprises would have agreed on prior to the transaction, one could argue, from an ex-ante perspective, that independent enterprises would in fact agree on adjustments to the established transfer prices, post the transaction, when it is in conformity with the nature of the

[54] OECD Commentary, Article 9, para 2 (6.1), p. 228.
[55] OECD Guidelines, Glossary, p. 25.
[56] *Ibidem*, Chapter III, section B.2, para 3(69).

business. When for an example prices are highly dependent on raw materials it is not uncommon for independent enterprises to agree on short term validity of prices.[57] When tax authorities are to undertake the comparability analysis, they should, when taking the ex-ante approach, be limited to use only the information reasonably available to the taxpayer at the time of the transaction.[58]

If the MS instead are taking the ex-post approach, the outcome of the transaction is what is supposed to be in compliance with the ALP.[59] Taking this approach one could argue that it comes as a sort of derived requirement for associated enterprises to use compensating adjustments in order to stay in compliance with the ALP. A general allowance of compensating adjustments is prominent when this approach is taken.[60] Since the associated enterprises are allowed compensating adjustments, tax authorities are supposed to use the best information possible when trying the outcome of the transaction and whether or not it is at arm's length.

3.3.1 Sweden

> *"No, we do not have any particular legislation but a practice which derives from domestic case law and interpretation of the OECD Transfer Pricing Guidelines"*[61]

As shown in the quote above Sweden does not have any legislation regarding compensating adjustments other than the Swedish version of the ALP stated in the Income Tax Act Section 14 para 19-20. There is further no restrictions regarding to what situations compensating adjustments is accepted and the only restriction regarding the time limit for when such an adjustment should be made, is prior to a tax audit or investigation.[62] Sweden views the compensating adjustments in a number of different ways and one

[57] *Supra note 39,* p. 3.
[58] *Ibidem,* p. 3.
[59] OECD Guidelines*,* Chapter III, section B.2, para 3(70).
[60] *Supra note 39*, p. 2.
[61] *Supra note 5,* p. 68.
[62] *Ibidem,* p. 68.

of which is as a deductible cost or taxable income. The adjustments will only be treated as price adjustments from an ALP perspective if the adjustments lead to an outcome at arm's length. The outcome of the transaction is thus the focus of the comparability analysis for the Swedish authorities.[63]

3.3.1.1 Timing issue regarding information on comparability factors

The Administrative Court of Appeal recently stated that the guidelines should be interpreted, if several years of data were used when setting the transfer price, so that the information from the year of, and years prior to the review should be used whilst conducting the comparability analysis.[64] This statement is not precedent but could serve as an indication for how the courts interpret the guidelines in regards to the timing issue and the comparability analysis.

3.3.2 The United Kingdom

> *"If the accounts are prepared on a non-arm's length basis and that does not make the person a potentially advantaged person, the legislation does not permit a downward adjustment to taxable profit in the tax computations"*[65]

When it comes to compensating adjustments the UK states that the overall legal requirement is for the taxpayer to report a tax return that is in conformity with the ALP. The legal requirement can be found in the *Taxation (International and Other Provisions) Act 2010* (TIOPA 10) Section 147(3) but there is no legal requirement that the accounts are to be prepared using the ALP. Taxpayers may thus adjust the transfer pricing at any time up until and including in the tax return solely for tax purposes.[66]

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[63] *Supra note 5,* p. 68.
[64] The Administrative Court of Appeal in Stockholm, 2018-01-16, case nr 1610-16
[65] *Supra note 5,* p. 71.
[66] *Ibidem,* p. 71.

The regulation states that it is only the profits and losses of a *potentially advantaged person*[67] that should be calculated as if the ALP would have been used when setting the transfer prices. Consequently the UK does not allow for downward adjustments to taxable profits in the tax computation to be made if the ALP has not been followed and it has resulted in the taxpayer not being a potentially advantaged person. This means that if the transfer pricing not being in conformity with the ALP leads to the fact that the taxpayer based in the UK accounts for to high profits instead of to low profits, from a transfer pricing perspective, the legislation will not allow the taxpayer to make compensating adjustments to correct its pricing.[68] The only option for a potentially disadvantaged person in relation to the UK is to either claim a corresponding adjustment to be made after a primary adjustment has been made in another state, or to demand a MAP in accordance with applicable double taxation agreement.

The UK presents the consequential view that it is what unrelated parties would have agreed on that should form the basis of the comparability analysis. The UK further takes the stand that third parties will always decide the price at the time of or before the transaction takes place (ex-ante). The UK specifies that third parties would perhaps agree on changing the price and terms of a transaction in advance, if there were a clause inside the transaction agreement that gives them the option to do so. Where it is in both parties best interest, parties could agree on new pricing going forward without a clause in the contract when exceptional circumstances occur.[69] The UK also recognizes that both the ex-ante and the ex-post approach aim to arrive at arm's length but states that it does not matter which of the two approaches is taken, *"(...) it is unlikely that contemporaneous comparables will be available at the time the taxpayer determines its transfer prices."*[70]

[67] A *potentially advantaged* person is defined in the TIOPA 10 Section 155 as the taxpayer that would either receive reduced profits or increased losses when making a tax return not in conformity with the ALP.
[68] *Supra note 5,* p. 71.
[69] *Supra note 39*, p 6.
[70] *Ibidem,* p. 7.

Therefore the results should approximately reflect the same price, as independent parties would have agreed on using an ex-ante approach. [71]

3.3.2.1 Timing issue regarding information on comparability factors

When it comes to what information that should be used when conducting the comparability analysis, the UK regards the contemporaneous comparables reasonably available to third parties as the most appropriate.[72] Contemporaneous comparables can in some cases be available first after some time post the transaction but reflects how independent enterprises was behaving in an economic environment equal to the enterprises undertaking the controlled transaction.[73] However, when it comes to unforeseen events post the transaction, they cannot be used in the comparability analysis if independent parties would not have been able to foreseen and used it. Regarding later foreseen events on the other hand, it should be used if third parties would have taken it into account.[74]

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71 *Supra note 39,* p. 7.
72 *Ibidem,* p. 7.
73 *Ibidem,* p. 7, 11.
74 *Ibidem,* p. 8.

4 Analysis

4.1 Differences and why

As presented, the two different countries handle compensating adjustments differently. The reason for the discrepancy originates from the differences in the interpretation of the ALP in regards to compensating adjustments and if they are allowed or not. Sweden allows for compensating adjustments in both directions as long as the outcome of the transactions arrive at arm's length in order to better fulfil the purpose of the principle. One could therefore argue that Sweden is taking an ex-post approach that requires associated enterprises to make certain that the outcome, the result, of the controlled transactions is in conformity with the ALP; accepting compensating adjustments as a tool for companies to better secure compliance with the principle. Sweden has, neither in legislation nor in case law, defined what information is supposed to be used whilst conducting the comparability analysis. Since an ex-post approach is dominating it could mean that the best information available is allowed in the analysis, disregarding if it was available to independent parties at the time of the transaction. If this turns out to differ from the information that is supposed to be used according to the UK, it could serve as one of the key factors arguing in favour of different approaches to be taken and thus explain the different handling of compensating adjustments.

However, when it comes to the UK, compensating adjustments are generally accepted and it is, just as the Swedish interpretation, the outcome of the transaction that is required to arrive at arm's length. The accepted form of compensating adjustments can be maid at any point up until, and including in the tax return, which also, together with the fact that there is no legal obligation for the accounts of a company to be prepared prior to the controlled transaction, indicates that the UK takes an ex-post approach. However, compensating adjustments, adjusting the profits of an enterprise inside the UK downwards is prohibited due to the argument that independent parties would always price ex-ante. One could thus argue that the described prohibition indicates an ex-ante approach to be taken. This is due to the fact that it indirectly forces MNE with an enterprise based in the UK to set correct transfer prices, prior to the transaction, since no compensating adjustment downward, is allowed. One could further argue that allowing compensating adjustments upwards but not downwards is to make a non-uniform interpretation of the ALP. If independent parties would not price ex-ante and therefor prohibit downwards adjustments, then why should adjustments be allowed in the other direction?

As stated, the best available data, according to the UK contemporaneous ones, is supposed to be used whilst conducting the comparability analysis. However, *prima facie*, this indicates that an ex-post approach is taken but a more deep analysis of what that data is restricted to, argue in favour of an ex-ante approach. The underlying restriction when it comes to what the best available data consists of is that it was reasonably available to third parties pre-emptive and during the time of the transaction. What the UK however is arguing for is the fact that these contemporaneous data might not be available until after some time has passed, and that should not in it self exclude the data from being used only because it was not directly available to the associated enterprises.

4.2 Consequences

It is therefor not possible to clearly define what approach is taken by the UK. There are strong arguments for both approaches and one could argue that the UK is using a hybrid of both where the ex-ante approach is dominant in regards to the prohibition of compensating adjustments of profits downwards. Clear is however that the discrepancy between the Swedish and the British interpretation of the ALP might lead to economic double taxation especially when a downwards compensating adjustment to profits inside the UK is needed to avoid a primary adjustment in Sweden. Because a compensating adjustment would not be allowed, the Swedish based enterprise would be subject to a primary adjustment and then have to rely on a corresponding adjustment to be made in the UK in order to avoid economic double taxation. Due to the fact that the countries may take different approaches, different information may found the comparability analysis and thus lead to a corresponding adjustment being refused and thus a risk of economic double taxation.

When differences like described are prominent, OECD in their guidelines, refers to the MAP in article 25 of the Model Tax Convention that offers a solution to eliminate economic double taxation. If the contracting states cannot come to a mutual agreement to how they are supposed to divide the taxable income then economic double taxation will occur. I would further argue that the presented issues does not derive from the countries separate interpretation of the ALP and handling of compensating adjustments in it self, but rather from the fact that there exists crucial differences. A prohibition towards compensating adjustments unilaterally and unidirectional, when the other country accept such an adjustments due to different interpretations of the same documents must be seen as one of the key reasons for the discrepancy in the handling of compensating adjustments which increases the risk of economic double taxation.

4.3 International perspective

One could argue that the Swedish interpretation may result in a relief of administrative burden for companies that operates in very unstable markets and also for companies that does not have the recourses or the competence to conduct a complete forecast to stay compliant with the ALP prior to the transaction. This is desirable from an international perspective since it could lead to economic growth at the same time as the principle is maintained. If associated enterprises choose to use benchmarked results as guidance when setting their transfer prices, and the actual results differs from the benchmarked result, the use of compensating adjustment could eliminate the risk of a primary adjustment and thus secure the results to stay in conformity with the ALP. Compensating adjustments would thus secure a fair international distribution of taxable profits between countries without adjustments being made on a state initiative.

It is however prominent how an interpretation similar to the one of the UK would be preferable from a state, rather than an international, perspective. It protects the tax base and ensures a higher taxation to be made inside the country at the expense of the international endeavour to eliminate economic double taxation. The later mentioned consequence of such an interpretation is however something that could counteract the purpose of the ALP and the double taxation treaties, and is something for the UK to consider when the legislation is to be evaluated. I would argue that the restriction of compensating adjustments downwards both prevents an effective compliance with the ALP and counteracts the purpose of double taxation treaties. One should bear in mind that associated enterprises is not in fact equal to independent enterprises and take into account the differences that actually exists, one of which I would argue is the need for self regulatory possibilities in order to effectively comply with the ALP in an unstable business environment.

4.4 Conclusion

To conclude I would argue that there exist a discrepancy between how the UK and Sweden handles compensating adjustments. This discrepancy originates from a different interpretation of the ALP, the OECD guidelines and the OECD commentary. The most important factor to why this discrepancy exist was concluded to be the interpretation deciding if compensating adjustments downwards should be allowed or not. The ultimate consequence of said discrepancy is economic double taxation when a mutual agreement cannot be reached.

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