www.pwc.pl

Transfer-pricing related disputes in Poland

February 2014

Implications of recent Polish and international legislative changes, as well as practical lessons drawn from tax audits and court proceedings

Contents

1. Introduction

Transfer pricing (TP) is quite possibly the hottest topic on the international tax agenda at present. Early in 2013, the OECD (Organization for Economic Co-operation and Development) produced a report on (tax) Base Erosion and Profit Shifting (BEPS), and in July followed this up with an Action Plan. The international press reports almost daily on well-known MNCs which pay very little tax. And in Poland, on 18 July 2013, an amendment to the Decree on Transfer Pricing introducing significant changes in TP regulations, came into force. The Decree, along with the guidelines of the OECD in its Action Plan, should be considered by all Groups when considering transactions between related entities.

Taxpayers should expect and be prepared for challenge from the tax authorities. The past is not necessarily safe. Significantly, the Decree will apply to all new tax proceedings i.e. including those related to earlier tax years.

The increased focus of tax authorities on transfer pricing area is also confirmed in the annual objectives of fiscal control offices. A primary objective of the tax authorities remains to prevent income taxation avoidance using transfer of income to related entities.

A positive aspect is that the Courts clearly expect the tax authorities to analyze each case thoroughly as well as professionally from the TP perspective. However, a major concern is that the proceedings tend to be very protracted. Thus, while the judgments are usually sound, the cost and time involved is considerable.

The key message is that it is essential for taxpayers to focus on the pre-assessment stage by being able to prove the substance of transactions during a tax audit. It is worth taking the time to prepare comprehensive, well planned TP documentation for significant transactions together with benchmarking studies. This really is the “first line of defence” and should, in the long run, save time and money.

Our report presents an overview of the practical and legal issues which arise in relation to transfer pricing tax audits and court proceedings in Poland. We believe this publication will prove a valuable source of information for all transfer pricing practitioners.

2. Transfer-pricing issues

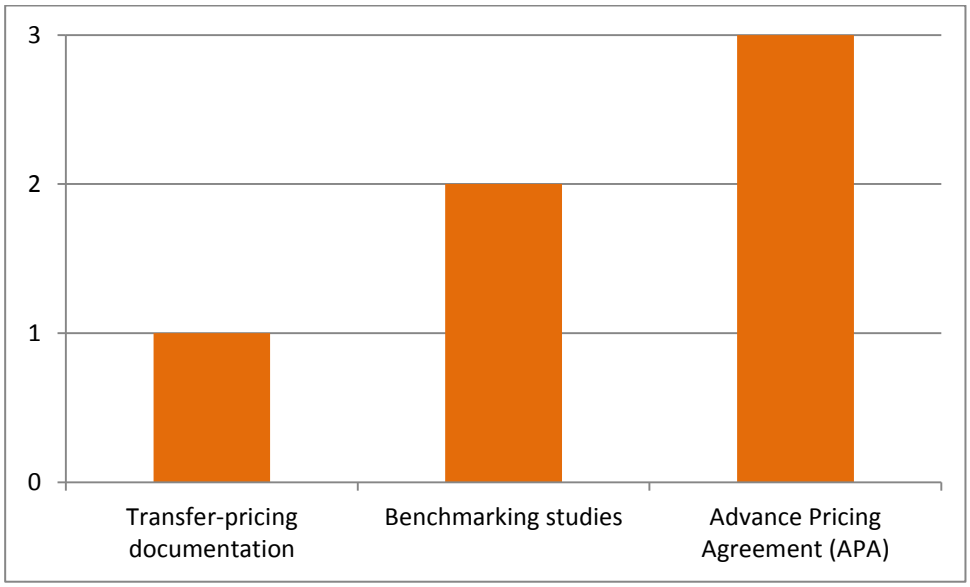
A transfer price (or transactional price) is the price used in transactions between related entities. Since many business transactions are between related parties, transfer prices used in such transactions are crucial to the profit or loss of individual entities within a group. In order to limit the risk of income being transferred between countries to minimize tax, regulations are in place to ensure that enterprises determine transfer prices on an arm's-length basis.

Polish tax law has contained transfer-pricing regulations for more than a dozen years. Managing the related risk is one of the most important tax considerations.

Important ways of securing a taxpayer's position in related-party transactions include:

- preparing comprehensive documentation (concerning related-party transactions) supporting the transfer-pricing methodology applied;
- determining the arm's-length level of prices based on external or internal comparables, to confirm that the price used by the taxpayer remains within a range comparable to prices used in transactions between unrelated parties;
- entering into an advance pricing agreement (APA) with the Ministry of Finance.

Table 1
Levels of security for taxpayers



3. Transfer pricing related tax audits – where are the authorities now and where are they heading?

Will the tax authorities question related-party transactions?

When a tax audit involves a taxpayer participating in related party transaction, the audit is extremely likely to include transfer pricing. Even in their first information request, inspectors frequently ask that "the documentation referred to in Art. 9a of the Corporate Income Tax (CIT) Act, be presented in the place in which the control activities are being carried out, within 7 days of the date of delivering the request". Therefore, a taxpayer who expects a tax audit should anticipate questions about the correctness of the manner in which he documents related-party transactions.

On the sometimes underestimated need to have transfer-pricing documentation

Even now, despite widespread knowledge about the need to have appropriate tax documentation, not all taxpayers prepare it. This is surprising.

Incomplete or erroneous transfer-pricing documentation will not protect taxpayers against the penal 50% tax rate (rather than the normal 19%). A few years ago the authorities were more focused on formal evaluation of the documentation than its technical content. At that time, to comply with statutory obligations, it was sufficient to have documentation which did not necessarily contain detailed analysis of transactions. Practice shows that times have changed. Now, detailed analysis of related-party transactions should be the absolute minimum. Comprehensive TP documentation supported by benchmarks for significant transactions is necessary. We see proceedings where the ultimate outcome is adjustments in the millions of Polish zlotys.

Legislative initiatives as well as the activities of the authorities suggest we can expect an even more stringent approach in future.

3.1 What are the trends from tax audits?

The table below shows some statistics regarding TP audits. Conclusions that can be drawn include the following:

1. audits by fiscal control offices result in vastly more income being assessed per audit compared with tax offices (these bodies being the two control authorities). The former conduct far fewer audits;
2. the number of TP audits is increasing;
3. the income assessed by the control authorities is increasing.

Table 2
Data related to transfer-pricing audits carried out by tax offices and fiscal control offices

	2010	2011	2012
Total number of transfer pricing audits carried out by tax offices and fiscal control offices	**2,925**	**3,286**	**3,293**
Including audits by tax offices	2,662	3,089	3,108
Including audits by fiscal control offices	263	197	185
Total number of audits carried out by tax offices and fiscal control offices resulting in a tax assessment	**1,396**	**1,835**	**1,717**
Including audits by tax offices resulting in a tax assessment	1,372	1,819	1,689*
Including audits by fiscal control offices resulting in a tax assessment	24	16	28
Total amount of income assessed additionally by tax offices and fiscal control offices [in PLN'000]	**196,906**	**218,439**	**219,469**
Including total amount of income assessed additionally by tax offices [in PLN'000]	38,687	27,968	48,469
Including total amount of income assessed additionally by fiscal control offices [in PLN'000]	158,219	190,471	171,000
Average amount of income assessed additionally as effect of audit by a tax office [in PLN'000]	**28**	**15**	**29**
Average amount of income assessed additionally as effect of audit by a fiscal control office [in PLN'000]	**6,592**	**11,904**	**6,107**

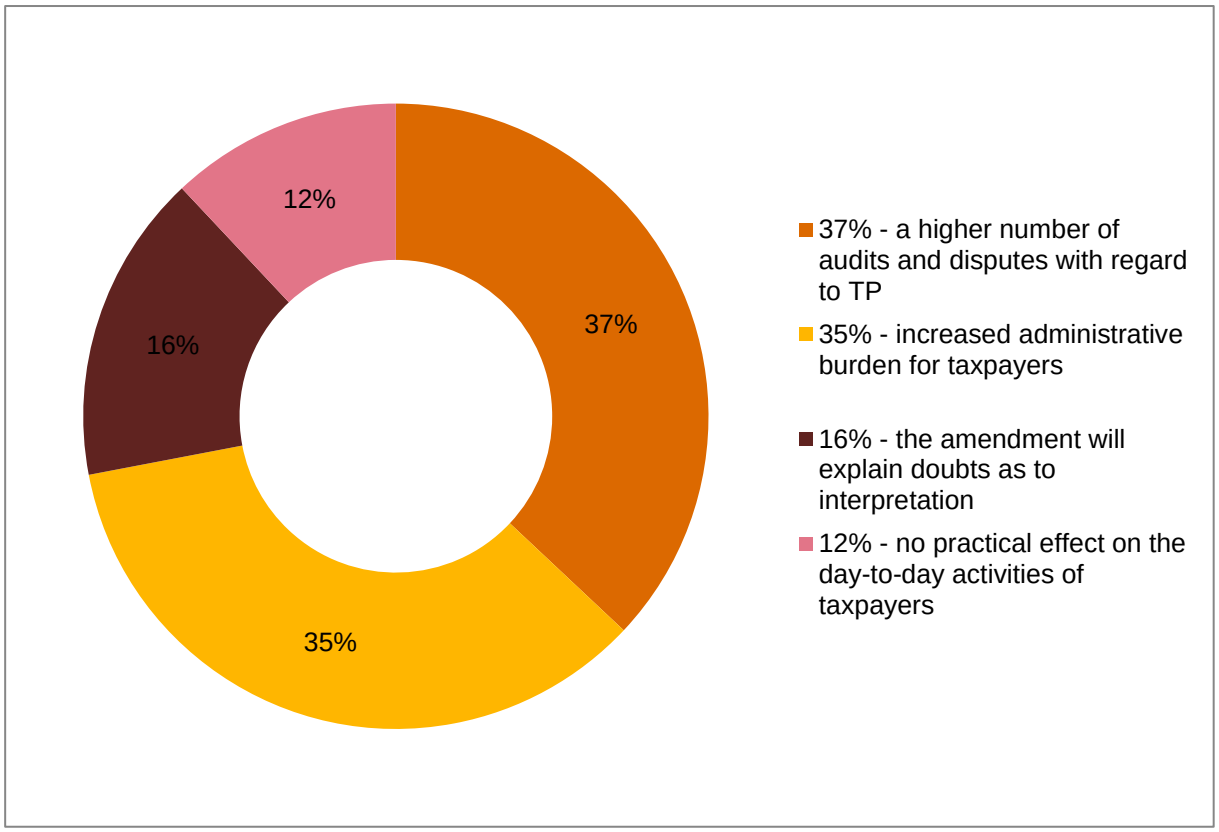
Source: Fiscal Control Department in the Ministry of Finance
** estimation– assuming that the effects of audits in the 2nd half of the year were the same as in the 1st half.*

3.2 Amendments to the Transfer-Pricing Decree – new areas of interest to the control authorities

The TP decree is primarily addressed to the tax authorities. Clearly, however, it's an important guide for taxpayers.

More than one-third of taxpayers who participated in a recent PwC survey anticipate that "the amendment to the Decree will result in a higher number of TP audits and disputes". We believe these concerns are justified. The amended decree is also likely to result in more income being assessed in tax audits.

Table 3
What outcome do you expect from the amendment to the Transfer-Pricing Decree?



Source: PwC

The amendment to the Decree, which introduces many of the international trends and practices into the Polish regulations, indicates the direction the control authorities will follow in future. This includes:

1. assessing the restructuring of business activities (previously an unregulated area in Polish tax law);
2. benchmarking of transactions;
3. shareholder expenses.

Restructuring of business activity

Most organizations need to restructure their business from time to time. The introduction of regulations related to restructuring indicates that the Polish tax authorities will now look at this area more closely.

The definition of restructuring in Polish law is very broad, similar to the OECD Guidelines . According to the Decree, a change in the business model involves transferring economically significant functions, risks or assets between related entities. For example:

- change in the entity's profile from a manufacturer with full functions and risks to a contract or toll manufacturer;
- change in profile from a distributor with full functions and risks to a distributer with limited-risks;
- centralization of functions within a group e.g. procurement , export sales, R&D;
- centralization of assets within a group e.g. the rights to R&D results, rights to trademarks.

Benchmarking

Another area of increased activities of the control authorities will be analyzing the comparability of transactions. The new regulations refer to the process presented in the OECD Guidelines[1]. In order to assess the income of a related entity, the inspectors will be obliged to carry out an analysis of the terms and conditions agreed between the related parties and verify the consistency of such terms and conditions with terms and conditions which would have been agreed by independent parties.

As stated previously, although the amended Decree is addressed primarily to control authorities, taxpayers should use the information to safeguard their position. A taxpayer who wishes to remain one step ahead of the inspectors should prepare a new benchmarking study (or modify an existing one (the Decree also applies to prior years)) taking into account the guidelines in the Decree.

Shareholder expenses

Shareholder's expenses are costs which do not benefit the taxpayer, but are carried out for the benefit of the shareholder. They are not tax deductible for the taxpayer. Shareholder's expenses relate, for example, to:

- the shareholder's legal structure e.g. costs of organizing shareholders' meetings, an issue of shares, the Supervisory Board;
- reporting requirements, including costs related to consolidated financial statements;
- costs of financing the purchase of shares.

A list of shareholder expenses is given in Appendix No. 2 to the Decree.

[1] The OECD definition is broader – it also includes termination of agreements or significant renegotiation of the terms and conditions of agreements.

Press releases of the Ministry of Finance and fiscal control authorities indicate that the area which will be most important for taxpayers will be the provisions on restructuring / change in business model.

Fiscal authorities will look at how profits are shifted

Some tax advisors claim, however, that the Decrees are vague and as a result, any restructuring of the group can be regarded by the fiscal authorities as an attempt to avoid taxation. According to Monika Laskowska, Deputy Director of the Income Taxes Department at the Ministry of Finance, not every movement of assets or risk in a group will attract the interest of inspectors.

- What is of interest to us is restructuring operations which result in a shift in profit – said Laskowska at a conference organized by the Transfer Pricing Centre Association (Centrum Cen Transferowych). And she announced that the Ministry would soon be publishing some explanations on its website regarding which restructuring operations will be subject to detailed scrutiny. At the same time, the OECD Guidelines have to be taken into account.

- Paweł Rochowicz, Rzeczpospolita, 26 September 2013.

Fiscal control offices will also verify earlier transactions

The obligation to examine restructuring was introduced with regard to controls that were commenced from 18 July and those not yet completed by that date – says Andrzej Bartyska, fiscal control inspector, spokesman for the Fiscal Control Office in Gdańsk.

According to the provisions of the amended Decree (...) we are obliged to examine the consistency of the conditions agreed or imposed under the restructuring with the arm's-length conditions. Our interest will be focused on transfers of economically significant functions, assets or risks. During the audit, we will evaluate both the economic rationale for the restructuring, and the expected benefits. We will verify whether the entities participating in the transaction have chosen from among the available scenarios the option which allows them to maintain arm's-length terms.

- Agnieszka Pokojska, GazetaPrawna.pl, 1 October 2013.

It is important to note that the provisions of the Decree have the nature of rules of procedure. The obligation to carry out restructuring on arm's-length conditions is imposed on taxpayers under Art. 11 of the CIT Act, the wording of which has not changed in recent years. This means that the tax authorities can, based on the Decree, review restructurings by taxpayers before the amendments to the Decree.

Therefore, we recommend taxpayers to review earlier restructurings considering:

- whether the restructuring was justified from an economic / business perspective;
- the alternative options available to the related entities in the restructuring;
- the expected benefits resulting from the restructuring.

The tax authorities can control restructuring operations carried out by taxpayers before the amendments to the Decree

3.3 Selection of entities for audit according to the OECD

Developments in the Polish TP environment run parallel to many of the changes happening internationally.

On 30 June 2013, the OECD issued a draft version of **a report on the assessment of transfer-pricing risk**[2] . The report is addressed primarily to the tax authorities in OECD member states. The report indicates risk factors which help the tax authorities to identify entities which should be subject to a TP audit as well as issues which should be paid particular attention.

The table below summarizes key risk factors indicated by the OECD.

Table 4

Risk driver	*Description*
Significant transactions with entities based in tax havens	Transactions involving entities based in tax havens should draw the attention of the tax authorities, due to the risk that the profit will be allocated to an inappropriate country.
Transfer of intangibles to a related entity	Such transactions are often so exceptional that it is difficult to determine whether their valuation is arm's length. In many situations there is a lack of comparable data on which to base any evaluation.
Change in business model / restructuring	The issue of changing the business model is extensively discussed in Chapter 9 of the OECD Guidelines. Similar regulations are contained in the amended version of the Decree. According to the regulations, any change in the business model, including the transfer of functions, limiting risks or the transfer of significant assets between related entities should be analysed from the perspective of the transfer-pricing regulations.
Specific types of transactions / payments	According to the OECD, the payment of interest, royalties, insurance premiums or other such payments to related entities should attract the attention of the tax authorities, because in many situations the benefits do not reflect the level of payments.
Operating loss	An operating loss, in particular if incurred for a number of years, can indicate that the conditions of cooperation between related entities do not reflect the actual value of the functions performed.
Low operating profit	Similarly to the above, results considerably lower than expected in a given industry / of competitors can indicate that the entity is not being appropriately remunerated for the functions performed.
Low effective tax rate	A low effective tax rate of the company / group, in particular if significantly less than nominal tax rates, can indicate that too large a portion of the income is being allocated to countries with lower tax rates / tax havens.
Incomplete / missing documentation	In the absence of appropriate documentation / economic justification indicating how prices were determined in related-party transactions it is very likely that they are not on an arm's-length basis

[2] Draft handbook on Transfer Pricing Risk Assessment, April 2013, OECD.

Risk driver	*Description*
Excessive indebtedness	According to the OECD Report, excessive debt of a company, in particular higher than the company would be able to access without being a member of a group, can also indicate that the conditions of the loan are not on an arm's length basis.

This list of risk drivers is helpful for taxpayers. If any of the factors exist, related-party transactions should be examined more closely, although it does not necessarily mean that the company's transactions are not arm's length. It is important to consider whether the conditions in such transactions have business justification and whether it is necessary to revise the transfer pricing methodology to adapt it to market conditions.

4. Summary of judgments of administrative courts

Transfer-pricing regulations are open to different interpretations. Courts provide important guidance which helps taxpayers make appropriate decisions.

The next section of this report summarizes some court judgments in the period 2010 - 2013 where the issues (rather than the amounts) are significant from a TP perspective.

Three trends in particular are extremely positive:

- the Courts expect the tax authorities to analyze the facts thoroughly and professionally from the TP perspective e.g. full benchmark analysis;
- as intimated above, the Courts follow the law and expect the tax authorities to do so too. If not the case is dismissed;
- if the Taxpayer believes his approach is appropriate from the TP perspective and the amounts are worth defending, he should have confidence in the court system.

In the table below, we have summarized the subject matter and conclusions from the cases we have reviewed in detail:

Table 5

Subject matter	*Case*	*Conclusion*
Business Model: use of related party intermediary	1	Involvement of a related party without economic justification can be disregarded
Failure to pay/receive interest on a related party loan	2	While the conditions of a related party loan agreement may be arm's length, how the agreement is applied in practice is also crucial. Not enforcing the obligation to pay interest implies a non-arm's length relationship and additional income can be assessed.
Failure to invoke related party law provisions	3 & 4	The tax authorities must use related party law provisions when assessing additional income. They cannot simply invoke another provision which may be easier for them.
Nature of the transaction: goods or services or both	5	The tax authorities must thoroughly analyse the situation where the nature of the activities is not necessarily clear and/or where there is more than one activity, in order that the arm's length income (for the relevant activity) can be determined

Evaluation of arm's length nature of a related party loan	6	Thorough analysis of loan conditions is required: • benchmarking analysis, supplemented by an indication of how controlled transactions differ from arm's length • tax authorities must justify fully the method and manner of estimating income • absence of collateral for a loan is not decisive in establishing conditions are not arm's length.
Thresholds for TP documentation: which transactions to add together ?	7	The same type of services with the same taxpayer

Certain other wider TP matters emerge from the cases:

- The tax authorities carry out benchmarking analyses to verify the arm's-length nature of prices in related-party transactions. They look closely at the type of business activity conducted by the taxpayer and the nature and specific features of the relevant market;
- Financial transactions are verified by the authorities particularly thoroughly because of their value. The authorities increasingly verify not only the arm's-length conditions of granting and repaying loans, but also the implementation of the provisions of loan agreements;
- The tax authorities verify all relevant elements of the transfer-pricing documentation e.g. cost base, risks borne by the parties, and even payment deadlines. They also look at the consistency e.g. between documentation and tax returns;
- The conditions in agreements and their nature are subject to detailed scrutiny and compared with market conditions;
- Agreements governing related-party transactions do not necessarily constitute statutory transfer-pricing documentation. The absence of documentation required under the transfer-pricing regulations does result in the 50% tax rate being imposed;
- The tax authorities verify the substance / functions actually performed by the parties;
- When assessing additional income, identifying comparable transactions is of key importance. Competitor information to which the tax authorities have access provides guidance e.g. to payment deadlines and the approach to pricing, including the cost base.

5. Selected judgments of administrative courts

5.1 Does involving an intermediary increase the risk?

Overstatement of tax costs by including an intermediary in a transaction

- *Duration of the proceedings: 2.5 years*
- *Audited year: 2006*
- *Additional tax due: PLN 265 thousand*
- *Type of transaction: goods*
- *Scope of transaction: domestic*
- *Date of judgment: 27March 2012*
- *File No.: II FSK 1882/10 – judgment of the Supreme Administrative Court*
- *Result: dismissal of taxpayer's request for cassation*

Overview of the case

The tax authorities found that prices for supplying goods (forged steel) to the Company by its parent entity were not arm's-length, which resulted in tax-deductible costs being overstated. To establish whether the prices were determined on an arm's length basis, it was necessary to compare them with the prices used by unrelated entities which conduct the same type of business activities. According to the tax authorities, purchasing forged steel directly from manufacturers, and not from the parent company would be more advantageous in terms of prices.

In the view of the administrative courts, the authorities correctly established that arm's-length prices were not applied, and the taxpayer overstated tax-deductible costs. In the opinion of the courts, the optimal business model for the taxpayer, and at the same time cheaper, would be to purchase the goods in question directly from steel mills, without the participation of the parent. The courts did not agree with the Company's view that there was synergy, because cooperating with the parent company led to an increase in the costs.

Practical implications for taxpayers

The tax authorities are increasingly verifying the economic rational of business relations between related parties. In evaluating the transfer prices, the Supreme Administrative Court disregarded a business model based on the unjustified involvement of an intermediary (the parent company) in the transaction for the purchase of goods. The judgment confirms the correctness of the tax authorities in verifying the functions performed by the intermediary and their impact on tax-deductible costs.

The Supreme Administrative Court confirmed that the economically unjustified involvement of a related entity in the purchase of goods can result in additional income being assessed.

5.2 Can additional income be assessed if a related entity is not made to pay interest on a loan?

- *Duration of the proceedings: more than 3 years*
- *Audited year: 2003*
- *Additional tax due: PLN 57 million*
- *Type of transaction: financial*
- *Scope of transaction: domestic*
- *Date of judgment: 25 June 2013*
- *File No.: II FSK 2226/11 – judgment of the Supreme Administrative Court*
- *Result: dismissal of the judgment issued in the first instance*

Overview of the case

The tax authorities stated that granting an interest-bearing loan to a related entity but not collecting the interest (contrary to the contract) still results in revenue for the taxpayer (Art. 11 of the CIT Act). The revenue is the interest from the agreement, and whose payment could be enforced if the taxpayer concluded similar agreements with independent entities. According to the tax authorities, the Company did not report income due to the group relationship.

The Company argued that not taking enforcement actions was not enough to state that the prices were not arm's length. It argued that since the interest was not received in cash, it could not be taxed.

In the opinion of the Supreme Administrative Court, Art. 11 also applies to agreements concluded on arm's-length terms, but implemented differently. The concepts of "provides benefits" and "terms and conditions of the benefits" cannot only be considered at the moment of concluding the agreement. Assessing additional income is possible when the parties do not follow the agreement.

Practical implications for taxpayers

The tax authorities are increasingly verifying not only the terms and conditions for granting and repaying loans, but also the implementation of the provisions. The loan provider's failure to enforce contractual provisions/penalties related to delayed repayment of a loan or interest by a related party can be regarded as not arm's length. The failure to claim interest from a related company can result in assessing additional taxable income in respect of interest not received.

The Supreme Administrative Court confirmed that not requiring a related entity to pay interest on a loan, can be assessed from the perspective of transfer-pricing regulations.

5.3 Can the tax authority disregard group relationships when estimating proceeds from the sale of real property?

- *Duration of the proceedings: ca. 3 years*
- *Audited year: 2005*
- *Type of transaction: goods*
- *Scope of transaction: domestic*
- *Date of judgment: 15 December 2010*
- *File No.: II FSK 1528/09 – judgment of the Supreme Administrative Court*
- *Result: dismissal of the tax authority's request for cassation*

Overview of the case

The tax authorities questioned the price for the purchase of real property between related entities stating that it did not correspond to arm's-length terms and conditions. The authorities commissioned the valuation of the land from expert appraisers. Their valuation determined that the market value of the real property was higher than the sale price.

The tax authorities determined the amount of revenue without the need to apply the provisions on related-party transactions (art. 14 (3) of the CIT Act, the application of which is sufficient to determine the correct amount of proceeds from the sale.)

In the opinion of the Supreme Administrative Court, the valuation prepared by expert appraisers at the request of the tax authorities cannot justify ignoring Art. 11. The estimation method applied by the tax authority did not take into account the provisions of Art. 11 which might justify a deviation from the market price due to the transactions involving related parties.

Practical implications for taxpayers

During tax proceedings, the tax authorities cannot disregard Art. 11 by applying the less complicated and less time-consuming procedure assessing additional income in Art. 14 (3) of the CIT Act. The burden of proving the relationships and their impact on the sale price lies with the tax authorities. The tax authorities should assess the value of the transaction by comparing it to market prices applied in similar transactions, taking into account all circumstances surrounding the conclusion of the contract. If a relationship exists, the tax authority cannot disregard it.

The Supreme Administrative Court denied the tax authority the right to apply Art. 14 (3) of the CIT Act while ignoring instruments for estimating income in Art. 11.

5.4 Is a finance lease subject to transfer pricing regulations?

- *A tax interpretation*
- *Type of transaction: financial*
- *Scope of transaction: domestic*
- *Date of judgment: 16 February 2012*
- *File No.: I SA/Po 827/11 – judgment of the Municipal Administrative Court in Poznań – valid*
- *Result: dismissal of the taxpayer's complaint*

Overview of the case

The case (where the principle involved is similar to the previous case) involved a finance lease. It considered if Art. 11 (related party provisions) must be applied to calculate the fee for using trademarks of a related entity and the repurchase price.

The Company claimed that lease instalments can be determined by related entities simply taking into account that the repurchase price, is at least the initial value of the leased object. Art. 11 is not relevant to the finance lease agreement included.

In the opinion of the Voivodeship Administrative Court, the estimation of income pursuant to Art. 11 CIT Act is necessary even for a financial lease. Such agreements between related entities may contain conditions that are more favourable than if the parties involved were unrelated. According to the Court, the provisions concerning the estimation of income between related entities are specific and are always applicable.

Practical implications for taxpayers

Although the CIT Act specifies the minimum total value of lease instalments, in the case of an agreement concluded between related parties, the fee should be arm's-length in accordance with Art. 11 of the CIT Act. Assessing whether the fee adopted is arm's-length value depends on the circumstances each case.

Related entities which are parties to a finance lease agreement may not disregard transfer pricing provisions in the calculation of lease fees.

5.5 Warehousing or sale?
Type of business activity and the level of profitability

- *Audited year: 2005/2006*
- *Additional tax due: PLN 302 thousand*
- *Type of transaction: services / goods*
- *Scope of transaction: international*
- *Date of judgment: 5 July 2011*
- *File No.: I SA/Kr 716/11 – judgment of the Voivodeship Administrative Court in Kraków – valid*
- *Result: dismissal of the taxpayer's complaint*

Overview of the case

The taxpayer's activity is wholesale trade in the heating and sanitary goods sector. The main supplier was a related entity from Germany, and the recipients of the goods are both domestic and foreign, the latter being related companies from Latvia and Ukraine. Approximately 30 % of sales are to related entities.

In the case of related-party transactions, the sales prices were determined at the level of purchase prices from the supplier. The taxpayer argued that the business essence of the transaction with the related parties was not a sale of goods, but providing warehousing services. In connection with the functions performed (in particular: accepting and transferring orders, warehousing goods, their unloading and loading, invoicing sales and handling customs matters) and the costs incurred (foreign exchange differences), the taxpayer received an equalization margin of 5% from the supplier.

The tax authorities argued that (a) the scope of activities of the taxpayer in transactions with related entities, and (b) the fact that under such transactions the legal title to the goods was transferred to the taxpayer, indicated that the essence of the transaction was distribution of goods, not simply warehousing them. The authorities determined the taxpayer obtained margins considerably higher on sale of goods to unrelated entities.

Consequently, the tax authorities questioned the arm's-length nature of the sale of goods to related entities and assessed income pursuant to Art. 11. They used the transactional net margin method (TNMM), based on data from transactions with third-parties. The tax authorities rejected the method of calculating the profitability of the controlled transaction presented by the taxpayer as "(...) confined to selectively allocating the costs incurred to these transactions, disregarding the economic rules for calculating the sale price of a given item (...)". The additional income assessed was taxed at the 50% penalty rate. The taxpayer failed to present the required transfer pricing documentation but only submitted written agreements with the supplier.

The Voivodeship Administrative Court dismissed the taxpayer's complaint. In the opinion of the Court, the tax authorities proved the margin on goods for the Polish market was considerably higher than the margin in agreements with related parties. The tax authorities justifiably stated that the activities could not be treated only as running a logistics warehouse. Sale of goods at the purchase price (dictated by the main shareholder), and thus without any profit, differs considerably from arm's-length conditions. Therefore the Company did not disclose income which could have been expected had the relationships not existed.

Practical implications for taxpayers

This case demonstrates tax audits are becoming increasingly comprehensive. The tax authorities do not limit themselves to reviewing agreements, the taxpayer's explanations or a cursory review of the transfer pricing documentation. They try to understand the business substance to identify relevant comparable transactions. When estimating prices, the tax authorities are increasingly willing to apply the transactional profit methods and carry out detailed financial analyses of the controlled transactions.

Taxpayers should establish the conditions of transactions with related parties carefully and prepare justification for differences with non-related parties in advance. Taxpayers should also be able to present a methodologically correct comparison of the profitability of individual transactions.

Two comments of the administrative courts with regard to evidence presented by taxpayers during tax audits are worth specific note:

"Transfer pricing documentation (...) is the basic source of evidence containing information that makes it possible to carry out an analysis of the essence of business operations and evaluate them to indicate whether the remuneration in a related-party transaction was determined at arm's-length conditions."

- *"The tax authority can refuse the party's request to consider evidence if it considers that the circumstance which is to be proved by the evidence has already been sufficiently proved by another piece of evidence".*
- *It cannot be assumed that agreements governing related-party transactions can substitute statutory transfer pricing documentation. It was emphasized that the absence of documentation "... cannot constitute an argument which allows the acceptance, without any evidence, of the view that the relationships between subsidiaries and third parties were determined according to different rules.".*

5.6 *Interest is not everything…*
Full evaluation of the arm's-length nature of a loan is required

- *Duration of the proceedings: ca. 1 year*
- *Audited year: 2006*
- *Additional tax due: PLN 49.5 thousand*
- *Type of transaction: financial*
- *Scope of transaction: domestic*
- *Date of judgment: 15 October 2010*
- *File No.: I SA/Kr 1188/10 – judgment of the Voivodeship Administrative Court in Kraków – valid*
- *Result: waiving the disputed decision*

Overview of the case

The taxpayer carried out an investment project. A special-purpose vehicle (SPV) was established as the taxpayer's subsidiary. Management links also existed between the taxpayer and SPV. To finance the investment, the taxpayer provided the SPV with loans in 2004 – 2006. The deadline for repayment of the principal debt and interest for each loan was 31 December 2007. Based on annexes, concluded in 2008, the deadlines were extended to 31 December 2008.

An audit by the Fiscal Control Office for 2006, stated that the conditions deviated from arm's-length . The loans were not repaid within the deadline, and the taxpayer did not seek to recover the funds and the accrued interest. The tax authorities stated that they did not question the method of determining the terms and conditions of the loans.

The Voivodeship Administrative Court stated that the complaint of the taxpayer merited consideration. The Court emphasized that the tax authorities did not indicate clearly which conditions of the agreements differed from arm's length. The Court also stated that comparable transactions had not been identified (only that the terms and conditions of the loan drawn by the taxpayer were less favourable than the conditions of the loans granted to SPV).

In the opinion of the Voivodeship Administrative Court, in this case "the tax authorities will be obliged primarily to carry out proceedings in order to establish comparable transactions (…). After identifying such transactions, the tax authorities will have to carry out a benchmarking analysis of the loan agreements against the identified comparable agreements, and (…) establish whether such agreements differ from agreements concluded on the open market". Only on the basis of such analysis will it be possible to assess additional income.

Practical implications for taxpayers

The terms and conditions of related party loan agreements are often questioned by the tax authorities. The tax authorities consider if the conditions seem more favourable for the loan recipient than loans granted by banks. In addition to the interest rate, the tax authorities will consider (i) repeatedly deferring repayment of the principal and interest (ii) no penalty interest being charged (iii) no collateral and (iv) no commission for granting the loan.

Estimation of a taxpayer's income by the tax authorities should be preceded by full analysis of the terms and conditions of comparable transactions as well as the transaction itself

Comments of the Voivodeship Administrative Court in the judgment are helpful for taxpayers if the tax authorities question the arm's-length nature of inter-company loans.

It was emphasized in the reasoning for the judgment that:

- To estimate income under Art. 11 , the tax authorities should carry out a full benchmarking analysis for the controlled loan. The tax authorities must indicate clearly which element(s) of the controlled transaction differ from market conditions.

- The tax authorities should justify fully the method and manner of estimating income. The CIT Act (art 11) does not give the tax authorities liberty to freely determine the taxpayer's income - "*(...) such income should have been estimated disregarding the conditions of the transaction which did not correspond to market conditions*".

- When the loan provider has significant control over the activities of the loan recipient (e.g. holds a majority share in a subsidiary), absence of collateral is not decisive in determining that the conditions were not arm's length. When the loan provider holds the majority share in the recipient "(...) *loan agreements concluded can be regarded as adequately secured without the need to use traditional forms of collateral*".

5.7 Which service should be added together when determining the documentation threshold?

- *Refers to a tax interpretation*
- *Type of transaction: service*
- *Date of judgment: 10 May 2012*
- *File No.: II FSK 1894/10 – judgment of the Supreme Administrative Court*
- *Result: dismissal of the taxpayer's request for cassation (but conclusions from the judgment favourable for taxpayers)*

Overview of the case

The taxpayer applied for a tax ruling. In the application the taxpayer indicated that he was planning to enter into an agreement with a related entity to provide various services, which were similar in nature. However, the price for each type of service was calculated differently. According to the taxpayer, the value of services should be determined separately for each type of service. Thus the obligation to prepare transfer pricing documentation would only apply to those services whose value exceeded the statutory threshold (30 000 EUR).

In a lengthy case, the Voivodeship Administrative Court & the Supreme Administration Court supported the Ministry of Finance (which disagreed with the taxpayer). The taxpayer should add together the value of transactions of the same type (services which are the same in nature), and check if they exceed the statutory threshold to prepare transfer pricing documentation.

However, the Court indicated that the values do not have to be accumulated if the taxpayer has concluded a number of transactions with the same related entity but they refer to different services for which different prices were determined.

In the opinion of the Supreme Administrative Court, the taxpayer does not have to add together the value of all service transactions with each party, but only those of the same nature.

Practical implications for taxpayers

Although in this specific case the taxpayer was unsuccessful, the conclusions are favourable for taxpayers:

- The total value of service transactions should be calculated by adding together the value of services of the same type only. The Supreme Administrative Court stated that "*if the taxpayer concluded several transactions with the same related entity, but they relate to different services for which different prices were determined, the value of such individual services does not have to be added together*". This can limit the number of transactions for which tax documentation has to be prepared.

- Re-invoicing constitutes a transaction for which transfer pricing documentation should be prepared if its value exceeds the statutory threshold. But the Court indicated that *"as the price agreed between the parties – related entities – is a simple repetition and reflection of the price previously determined between unrelated entities, and therefore there is no risk of using non-market prices, then [the description of the pricing method] will be simple information that the price applied is the result of re-invoicing"*. Thus preparation of such documentation will be greatly simplified.

6. Focus on transfer pricing in Poland and worldwide

Transfer pricing is extremely important for taxpayers, the tax authorities and international organizations. This is reflected in the legislative changes that have taken place in Poland (amendment to the Decree) and neighbouring countries (e.g. the introduction of transfer-pricing regulations in Russia and Ukraine). Moreover the OECD frequently publishes reports in which it explains specific issues related to transfer pricing and amends its Guidelines[3]. Transfer-pricing is a "hot topic" worldwide.

6.1 OECD actions – efforts to eliminate tax avoidance

The OECD is looking closely at issues related to international taxation and tax avoidance. In February 2013, it published the BEPS Report, in which it pointed out flaws in international tax law and transfer-pricing regulations. The OECD raised awareness that some MNCs exploit these flaws to generate profits which are not taxed in the country of their registered office or in the country of the source of profit. Subsequently, during the G20 Summit in Moscow, the OECD proposed its Action Plan on Base Erosion and Profit Shifting to improve the situation.

The Action Plan proposes specific measures with deadlines to improve the situation. A number of independent steps, according to the OECD, should be taken over the next 18–24 months. These include:

- regulating tax aspects of the digital economy;
- strengthening regulations concerning controlled foreign companies (CFC);
- countervailing harmful tax practices, taking into account the principles of transparency and business substance;
- increasing transparency of tax information and developing cooperation between national tax authorities;
- counteracting the artificial avoidance of Permanent Establishments;
- ensuring consistency of transfer pricing with business substance and actual (economically justified) flows of inter-company transactions;
- revising the documentation requirements.

With regard to transfer pricing, the plan focuses on substance. The OECD emphasizes that key to preventing double tax avoidance is to verify whether transfer prices are determined in accordance with the arm's-length principle, and the value chain in a group is economically justified and has "business substance". Therefore, the Action Plan encourages the tax authorities in various countries to verify related-party transactions more closely.

The OECD recognizes that although the arm's-length principle effectively and efficiently allocates the income of MNCs among tax jurisdictions, it is subject to abuse as taxpayers try to "separate the income from the actual income-generating activities". Therefore, the OECD proposes to introduce "special measures, both within and outside the arm's-length price principle, which may be required in respect of intangible assets, risks and capital engaged, in order to remove the areas of abuse".

[3] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

6.2 Transfer-pricing issues in respect of intangibles

A key focus of the OECD with regard to transfer-pricing is intangibles.

In late July 2013, the OECD published a revised draft of its guidelines relating to the transfer-pricing aspects of intangibles[4]. The draft is to be included in the OECD Guidelines by September 2014.

The draft covers a range of issues, including a new definition of intangibles, guidelines for comparability factors, appropriate methods for valuing intangibles, and proposals for allocating benefits between entities involved in the process of creating and maintaining intangible assets.

The document proposes dramatic changes, in particular with regard to the principles of allocating benefits derived from intangibles to the legal owner of an asset. In particular, it limits the role of the legal owner of the intangible (and his right to draw benefits therefrom), while increasing the role of entities responsible for (i) performing or (ii) controlling key functions related to the development, improvement and protection of intangibles (ensuring such entities have the right to an appropriate part of the benefits generated by the intangibles).

The draft guideline should be considered for all transactions involving intangible assets. The document has widespread application but will apply, in particular, to licensing transactions, and services performed under R&D contracts and distribution activities i.e. very common business activities.

[4] Revised discussion draft on transfer pricing aspects of intangibles, July 30, 2013; http://www.oecd.org/ctp/transfer-pricing/revised-discussion-draft-intangibles.pdf

7. Conclusions

Transfer-pricing is one of the most significant sources of tax disputes. The extent to which transfer prices have gained importance in everyday business practice is clear from Polish and international legislative changes, tax audits and court judgements.

Legislative changes made recently as well as anticipated clearly indicate the TP focus will only get stronger. The amended Decree, a valuable weapon in the hands of the control authorities in their fight against the transfer of income between related entities, as well as action by the OECD to "tighten up the system" of income taxes, demonstrate the focus by national tax and fiscal administrations on transfer-pricing issues.

Putting the legislative changes to one side, activities of the tax authorities over recent years clearly shows increasing attention to transfer-pricing issues and an even more strict approach. We certainly expect that the number of audits will increase and income assessed will rise.

Court judgements show that the tax authorities verify related-party agreements in great detail with regard to the application of arm's-length prices. The experience of the tax authorities is evident. All circumstances affecting the activities of related parties are considered, in particular the nature of the market and the type of business activity conducted. In many cases the tax authorities have comparative (competitor) information relevant to determining the appropriate tax liability.

The message for taxpayers is that their related party transactions need to have substance (which can be evidenced) and that pricing is arm's length. The days of any other approach are numbered. Comprehensive TP documentation for significant transactions still has a very important role.

8. Any questions? Please contact us

Piotr Wiewiórka
Director
tel. : +48 22 7464645
mob.: +48 502184645
e-mail: piotr.wiewiorka@pl.pwc.com

Sebastian Lebda
Director
tel. : +48 22 7464675
mob.: +48 502 184675
e-mail: sebastian.lebda@pl.pwc.com

Jan Tokarski
Senior Manager
tel.: +48 22 5234651
mob.: +48 502184651
e-mail: jan.tokarski@pl.pwc.com

Piotr Niewiadomski
Manager
tel.: +48 22 7467279
mob.: +48 519 507279
e-mail: piotr.niewiadomski@pl.pwc.com

Appendix

Provisions of law used in this report

Provisions of the Corporate Income Tax Act

Art. 9a Documenting transactions.

1.Taxpayers conducting transactions with related parties within the meaning of Article 11, paragraphs 1 and 4 or transactions in connection to which the payment of due amounts resulting from such transactions is conducted, directly or indirectly, to an entity having its place of residence, registered office or management within the territory of a country applying harmful tax competition practices, shall be obliged to prepare tax documentation of such transaction(s) to include:

1) a specification of the function of the entities participating in the transaction (taking into account the assets and risks involved),

2) a specification of all costs anticipated in connection with the transaction and the manner and deadline for payment,

3) the method and manner of calculating gains and a specification of the price of the subject of the transaction,

4) a specification of the economic strategy as well as other activities within the framework of this strategy - where the value of the transaction was influenced by such a strategy adopted by an entity,

5) an indication of other factors - where such factors were taken into account by the entities participating in the transaction in order to determine the value of the transaction,

6) in the case of agreements comprising performances (including services) of intangible nature, a specification of the benefits the entity, which is required to prepare the documentation, anticipates in connection with receiving such performances.

2. The duty referred to in paragraph 1 shall pertain to such transaction(s) between related parties where the aggregate amount (or its equivalent) resulting from the agreement or the aggregate amount of due consideration actually paid within the tax year exceeds the equivalent of:

1) EUR 100,000 - where the transaction value does not exceed 20 per cent of the share capital determined under the provisions of Article 16, paragraph 7, or;

2) EUR 30,000 - in cases of rendering services, sales or granting access to intangible assets, or;

3) EUR 50,000 - in other cases.

3. The duty to prepare documentation referred to in paragraph 1 shall also apply to, such transactions where the payment in consideration resulting from such transaction is performed, directly or indirectly, for the benefit of an entity having its place of residence, registered office or management within the territory, or in a country applying harmful tax competition practices, where the aggregate amount (or its equivalent) resulting from the agreement or the aggregate amount of due consideration actually paid within the tax year exceeds the equivalent of EUR 20,000.

4. On request of tax authorities or fiscal inspection authorities, taxpayers shall submit the documentation referred to in paragraphs 1-3 no later than 7 days from the date when the request for this documentation was served.

5. Amounts denominated in euro, referred to in paragraphs 2 and 3, shall be converted into Polish currency at

the average rate published by the National Bank of Poland, prevailing on the last day of the tax year preceding the tax year during which the transaction covered by the duty referred to in paragraph 1 took place.

5a. The provisions of paragraphs 1-5 shall apply accordingly to taxpayers referred to in Article 3, paragraph 2, conducting activity via a foreign establishment located within the territory of the Republic of Poland.

6. The Minister responsible for matters of public finance shall lay down, by means of a regulation, a specification of countries and territories applying harmful tax competition practices. In preparing a specification of said countries and territories, the Minister responsible for matters of public finance shall, in particular, take into consideration the decisions made in that regard by the Organisation for Economic Co-operation and Development (OECD).

Art. 11 Relationships with foreign entities.

1. Where:

1) a payer of income tax having their registered office (management) or place of residence within the territory of the Republic of Poland, hereinafter referred to as a „domestic entity", participates, directly or indirectly, in the management of an enterprise located abroad or in the control thereof, or holds a stake in the capital of such enterprise, or

2) a natural person or a legal person with its place of residence or registered office (management) abroad, hereinafter referred to as a „foreign entity", takes part, directly or indirectly, in the management of a domestic entity or in control thereof, or holds a stake in the capital of this domestic entity, or

3) the same natural or legal persons simultaneously, directly or indirectly, participate in the management of a domestic entity and a foreign entity or in control thereof, or hold a stake in the capital of these entities

- and if, as a result of such relationship, conditions are adopted or imposed that differ from those that would have been adopted by unrelated entities and consequently an entity reports no income or reports lower income that would be expected had there been no such relationship - the income of such an entity and the due tax shall be determined disregarding the conditions resulting from such a relationship.

2. The income referred to in paragraph 2 shall be determined by means of assessment by application of the following methods:

1) the comparable non-controlled price method,

2) the resale price method,

3) the reasonable margin „cost-plus" method.

3. Where it proves impossible to apply the methods referred to in paragraph 2, transaction profit methods shall be applied.

3a. Should the relevant tax authority issue a decision pursuant to Tax Ordinance regulations affirming the correctness of the selection and application of the method pursuant to which the transaction price between related parties is determined, one shall apply the method indicated in this decision within the scope specified therein.

4. The provisions of paragraphs l-3a shall apply accordingly, where:

1) a domestic entity participates, directly or indirectly, in the management of another domestic entity or in control thereof, or holds a stake in the capital of a different domestic entity, or

2) the same legal or natural persons participate simultaneously, directly or indirectly, in the management of domestic entities or in the control thereof or hold a stake in their capital.

4a. Should a domestic entity engage in a transaction with an entity having its place of residence, registered office or management within the territory of, or in a country listed in the Regulation referred to in Article 9a, paragraph 6 and the conditions adopted in such transaction differ from the conditions that would have been adopted by unrelated entities and consequently the domestic entity reports no income or understates income - the income of the domestic entity shall be determined by means of assessment, applying the methods referred to in paragraphs 2 and 3, or Article 14 shall be applied accordingly.

5. The provisions of Article 4 shall also apply to relationships of a family nature or those resulting from employment or capital ties between domestic entities or persons performing management, supervisory or control functions in such entities or if any person jointly performs management, control or supervisory functions in such entities.

5a. Holding a stake in the capital of another entity, as referred to in paragraphs 1 and 4, denotes a situation where a given entity directly or indirectly holds a stake of no less than 5 per cent in the capital of another entity.

5b. When specifying the size of the stake indirectly held by an entity in the capital of another entity, it shall be assumed that, where an entity holds a specific stake in the capital of another entity and the other entity holds an identical stake in the capital of a third entity, the first entity shall be deemed to hold an indirect stake in the capital of the third entity of the same size; where these amounts differ, the lesser amount shall be adopted as the size of the stake indirectly held.

6. The reference to family ties referred to in paragraph 5 shall be construed as marriage, consanguinity and affinity to the second degree.

7. (repealed)

7a. (repealed)

8. The provisions of paragraph 4 shall not apply in the case of intercompany activity between companies forming a tax capital group.

8a. The provisions of paragraphs 1-3 shall apply accordingly in determining such portion of the income of the taxpayer referred to in Article 3, paragraph 2, conducting his activity via a foreign permanent establishment located within the territory of the Republic of Poland, that is attributable to this establishment.

8b. Where the income of a taxpayer being a domestic entity is deemed, by the tax administration of another country, to be income of a foreign entity related to the taxpayer and treated as taxable income of this foreign entity, in order to avoid double taxation, the income of the taxpayer being a domestic entity shall be adjusted provided that the provisions of the relevant international agreements, to which the Republic of Poland is a party, foresee such an adjustment.

8c. The adjustment of income referred to in paragraph 8b serves the purpose of determining the income of the taxpayer being a domestic entity that would have been earned by this entity had the trading or financial conditions adopted in dealing with the foreign entity, referred to in paragraph 8b, correspond to the conditions that would have been adopted between unrelated parties.

8d. The provisions of paragraphs 8b and 8c shall apply accordingly to a foreign entity having a foreign establishment within the territory of the Republic of Poland - in respect of the income through such establishment and recognised among its income.

9. The Minister responsible for matters of public finance shall set forth, by means of a regulation, the manner and procedure for determining income by means of assessment and the manner and procedure for eliminating double taxation in the case of correcting income of related enterprises, taking into account, in particular, the guidelines of the Organisation for Economic Co-operation and Development as well as the provisions of the Convention of 23rd July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises and the Code of Conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (Official

Journal C 176 of 28.7.2006, pp. 8-12).

Art. 14 Sale of property.

1. Revenue from transfer for consideration of things and property rights, subject to paragraphs 4 and 5, shall be their value reflected in the price specified in the agreement. Where the price differs significantly from the fair market value of these things or rights, the revenue shall be determined by the tax authority in such amount as the fair market value.

2. The fair market value of things and property rights, referred to in paragraph 1, shall be determined based on market prices used in the circulation of things and rights of the same type and kind, taking into account, in particular, their condition and degree of wear and tear, as well as the time and place of their transfer for consideration.

3. Where the value reflected in the price specified in the agreement differs significantly from the fair market value of these things or rights, the tax authority shall call the parties to the agreement to change this value or provide grounds for specifying a price that differs significantly from the fair market value. In the event of failure to reply, to change the value or to provide the grounds for specifying a price that differs significantly from the fair market value, the tax authority shall determine the value taking into account the opinion issued by an expert or experts. Where the value determined in such a way differs by more than 33 per cent from the value reflected in the price, the cost of obtaining the opinion of an expert or experts shall be borne by the transferor.

4. The provisions of Article 12, paragraph 4, subparagraphs 7, 9 and 10 shall apply accordingly.

5. (deleted)