

Keeping your branch at  
arm's length

Branches and transfer  
pricing

Tax Alert



This Newsletter is intended to draw attention to the effective transfer pricing rules relevant to permanent establishments and branches, and to those entering into force in 2010.

# Branches and transfer prices



## Definition of related parties

Under the currently effective regulations, in addition to the "traditional" relationship of a parent company and its subsidiaries, a non-resident enterprise and its Hungarian permanent establishment (including branch office) also qualify as related parties.

In accordance with the newly adopted amendments to the tax law, as of 1 January 2010 the definition of related parties is further extended to include domestic companies and their foreign branches. By further specifying Section 18 of the Corporate Income Tax Act, the amendment also clarifies that transfer pricing rules shall apply to "transactions" between the "head office" and the permanent establishment in the case of non-resident companies and their Hungarian branches, as well as Hungarian companies and foreign branches.

Previous uncertainty was caused by the fact that the permanent establishment and its "head office" are parts of the same legal entity; therefore no contractual legal relationship could exist between them, while transfer pricing rules apply to contracts between associated parties. Nevertheless, the interpretation and practice of the Ministry of Finance have always supported and required the application of transfer pricing rules in case of transactions conducted between a Hungarian permanent establishment (for example a branch) and its associated parties (i.e. the head office and other affiliates). Consequently, transfer pricing documentation shall be prepared for all controlled transactions of the permanent establishment/branch, and if the prices applied are not of arm's length rate, the tax base shall be modified accordingly.

## Controlled transactions

While the concepts of contract and transaction are clear in case of separate legal entities, several questions may arise when it comes to identifying transactions between the permanent establishment and the head office. Branches tend to use the assets of the head office, and employees are often employed by the head office too, with the associated costs simply allocated to the branch by the head office. In our experience it is rarely obvious that by providing assets or resources, the head office would be rendering services to the branch, even though in case of separate legal entities it is clearly the case.

We have listed a few examples of typical business transactions between the branch (permanent establishment) and the head office and the relevant transfer pricing issues:

- Allocation of tangible assets owned by the head office but used by the branch - if they were not allocated at an arm's length price, depreciation recognised was not calculated on an arm's length basis either.
- Under what legal title are assets allocated to the branch? E.g. sale or lease? The arm's length price may vary accordingly.
- Functions of the head office also serving the interest of the branch (e.g. marketing, IT support, administration, business development etc.) – if these were not disclosed and recognised at the branch as services used, or not at a price that would be applied by independent parties, it could distort the financial results of the branch;
- Division of funds allocated to the branch as capital and liabilities over capital; interest rate of the funds shown as liabilities over capital, its accountability for CIT purposes – with regard to the OECD recommendations.

The above examples demonstrate that it is worth focusing on transfer pricing issues in the case of permanent establishments/branches too, since through a close cooperation with the head office, presumably a high number of related party transactions may be identified; therefore branches bear an increased rate of transfer pricing risk.

\* \* \*

**Deloitte is organizing a seminar on 29 October 2009, expectedly from 9 am to 1 pm, specifically focusing on the taxation and accounting issues of branches, including the above transfer pricing rules.**

**We will soon inform you of the details and proposed topics of the seminar.**

# Contact

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