

## Ordinances setting forth the principles for determination of income in related party transactions

### Transfer Pricing Alert October 2009

#### New Transfer Pricing Ordinances

The Polish Minister of Finance issued two new ordinances related to transfer pricing:

- Ordinance of the Minister of Finance of 10 September 2009 regarding the method and procedure of determination of personal income as well as the method and procedure of eliminating double taxation in case of related party profit adjustment (item 1267 and
- Ordinance of the Minister of Finance of 10 September 2009 regarding the method and procedure of determination of corporate taxpayers' income as well as the method and procedure of eliminating double taxation in case of related party profit adjustment (item 1268).

Both ordinances entered into force on 14 October 2009. The amended regulations apply to transfer pricing audits and proceedings commenced after that date.

The aforementioned ordinances supersede the Ordinance of the Minister of Finance of 10 October 1997 on the method and procedure of determining taxpayers' income by determining prices in transactions with related parties (Dz. U. No. 128, item 833, with subsequent amendments), which had been in force for the last 12 years.

The ordinances apply to two areas:

- provisions related to transfer pricing audits,
- elimination of double taxation.

#### Provisions related to transfer pricing audits

Provisions related to transfer pricing audits implement a number of significant changes:

- it has been pointed out directly that examination of income in related party transactions and transfer pricing adjustments can be made by the tax authorities and the fiscal control authorities only based on the 5 methods specified in tax regulations – it should be noted that this may give rise to problems with the authorities' application of other methods of analysis, e.g. income-based ones (DCF); a question arises as to whether analyses conducted based on such other methods (e.g. valuations by expert appraisers) will still be accepted by the authorities, which has been common (and reasonable) practice so far, or whether the authorities will try to conduct their own, separate analyses based on tax regulations;
- the provisions setting forth the principles for analyzing comparability of transactions are presented in a separate section: "Transaction comparability analysis" – which indicates that the conditions specified therein are applicable to comparability analyses based on all tax methods used for transaction analysis and not only the "traditional methods" (the comparable uncontrolled price method, the cost plus method and the resale price method) as it seemed to be the case under previous regulations;

- it has been emphasized that a transaction comparability analysis should take into account “differences in economically significant features of comparable transactions”, while an analysis of the entities participating in a transaction should specify which of the entities performs functions, employs assets and incurs risks which are economically significant; additionally the list of typical factors which should be considered by the tax auditors in the analysis has been extended and it explicitly enumerates the factors that have to be taken into account in a transfer pricing analysis (these include factors which, though usually taken into consideration by the taxpayers themselves, so far have been frequently disregarded by the tax auditors);
  - it has been pointed out that the provisions apply to determination of the income which should be allocated to a permanent establishment of:
    - a domestic entity abroad (which results from – not particularly precise wording of – Article 11 clause 1 of the Corporate Income Tax Act and Article 25 clause 1 of the Personal Income Tax Act);
    - a foreign entity in Poland (which is the effect of implementation of the provisions of Article 11 clause 8a of the Corporate Income Tax Act and Article 25 clause 6a of the Personal Income Tax effective from 1 January 2007);
  - a provision has been added, that allows for conducting a benchmarking analysis with respect to the industry which a given transaction concerns (in the event where “the method applied does not require strict comparability of the transactions”);
  - an additional condition has been introduced in respect of the tax auditors’ application of the method selected by the taxpayer: compliance with transfer pricing documentation regulations (such a condition was not provided for by the previous ordinance); it should be emphasized that the tax auditors may apply the method selected by the taxpayer only in the case of the comparable uncontrolled price method, the resale price method or the cost plus method; the authorities are not bound by the above obligation where the taxpayer applies the profit split method or the transactional net margin method;
  - the principles for the application of the cost plus method have been amended: rules governing cost base calculation (which is to include direct and indirect costs, excluding general and administrative costs) as well as profit mark-up calculation have been set out. The adopted provisions may substantially limit the practical application of profit level indicators based on balance sheet data (e.g. ROA or the indicators not based on full costs, e.g. berry ratio); in light of the above verification of compliance of transfer pricing analyses already conducted with the amended regulations should be considered;
  - the principles for the application of the profit split method based on a residual analysis have been amended; it has been pointed out that the first stage of the analysis should involve splitting the basic profit based on a functional analysis of the entities performing standard functions, employing typical assets and assuming standard risks; at the same time the definition no longer refers to cases when the total profits made by the parties to the transaction are lower than the total profits allocated during the first stage of the residual analysis (i.e. a loss is to be split in the next stage) – discrepancies in the provision’s interpretation in the context of residual “loss” splitting may surely be expected.
- It needs to be emphasized that the new regulations do not resolve some of significant interpretation issues, e.g.:
- a clear definition of general and administrative costs has not been provided, which is at present a source of ambiguity in practice and numerous interpretations issued by the tax authorities;
  - additionally, the provisions have not introduced a consistent procedure for performing benchmarking analyses regarding the profitability of unrelated entities in order to assess whether the conditions of transactions entered into by related parties are in line with the arm’s length principle; introduction of relevant provisions would allow to considerably increase the taxpayers’ certainty that a methodology used in a given transaction to determine the amount of remuneration and a benchmarking analysis conducted by the taxpayer will be accepted by the tax auditors and to limit the tax auditors’ freedom in making such comparisons. Although the amended regulations provide more precise definitions of the tools at the disposal of the authorities, the ordinances do not include provisions combining the individual elements (comparability analysis, actual status analysis, benchmarking analysis, application of the detailed rules referred to in section 5), which would allow to eliminate another area of freedom in conducting transfer pricing controls.

### **Procedure of eliminating double taxation in case of transfer pricing adjustments**

The new regulations include also a section dedicated to the procedure of eliminating double taxation based on the Arbitration Convention and the Double Tax Treaties. The procedure is initiated based on the taxpayer's application submitted to the Minister of Finance. The ordinance determines the form of the above application, deadlines for initiating the proceedings by the Minister of Finance and its completion as well as the procedure for conducting and completing the proceedings. In particular, the new ordinances determine the deadlines for submitting applications for initiation of the Mutual Agreement Procedure under the Double Tax Treaties or under the Arbitration Convention.

It should also be noted that the initiation of the procedure of eliminating double taxation is conditional on an arbitrary assessment by the Minister of Finance whether "the application (...) is justified and the case may be resolved in line with national procedures with consideration of the taxpayer's application". Furthermore, the result of a completed procedure is not a sufficient basis for a corresponding adjustment and refund of the tax paid twice. It is the first step for the initiation of proceedings by the local tax authorities regarding the determination of a taxpayer's income / loss.

The possibility of a general adjustment of tax liabilities in transactions entered into with foreign entities (without instituting the mutual agreement procedure) has also been maintained, while a change was introduced as to the competent authority – from the tax office head to the Minister of Finance. The above solution will contribute to a more frequent application of the provision in practice (the solution introduced by the initial version of the ordinance was not used in practice).

At the same time, the Ordinances do not provide for corresponding adjustments in the case of domestic transactions entered into by Polish related parties – which clearly makes their position worse compared to the entities concluding transactions with foreign associated enterprises. Such provisions were also missing in the 1997 version of the Ordinance.

### **Growing interest of tax authorities in transfer pricing issues**

The introduction of the new regulations indicates increased interest of the Polish tax administration in transfer pricing issues what combined with economic slowdown in some industries and overall decrease in fiscal revenues from tax collection, leads to the conclusion that an increased number and scrutiny of tax audits can be expected. This remains in line with the official plan of fiscal inspections for 2009 published by the Ministry of Finance.

Additionally, during the last few years the tax authorities have gained experience in transfer pricing issues and they are much more sensitive to the conditions set in transactions concluded by related parties. The foregoing is also confirmed by the changes introduced by the new Ordinances. It should also be noted that – in light of the amendments implemented with respect to the methodology of transfer pricing audits – in order to provide an effective defense tool, tax documentation should include a benchmarking analysis confirming the arm's length nature of the adopted solutions.

Deloitte Transfer Pricing Team is ready to assist you in clarification of any doubts or questions relating to transfer pricing issues as well as provide support in mitigating the tax risk resulting from related party transactions.

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