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Awakening of transfer pricing

BY JACEK PAWLAK

Transfer pricing – the concept presented in Polish tax law for the last few years is currently one of the hottest tax issues. Just as a reminder – transfer prices are prices used in transactions conducted between two related entities. If their relationship has an impact on the determination of non-market conditions of such a transaction (i.e. different than the conditions that would be determined between independent entities), the tax authority will calculate income disregarding the conditions

resulting from such relations. Then such an additional income will be taxed with a 19 percent or 50 percent (in case of lack of a TP report) tax rate.

Last July, a substantial amendment of the Regulation of the Minister of Finance governing the basic set of rules for analyzing taxpayers' transfer pricing by the tax authorities came into force. Since the beginning of January 2015, the provisions concerning transfer pricing included in the corporate income tax act

have also been changed and we should expect further amendments in the future. Moreover, this sudden "transfer pricing awakening" concerns not only legislative changes, but also the actual actions of the tax authorities which are gradually gathering in strength and detail the scope of conducted tax audits. What is the cause of such a situation?

Despite appearances, the answer is quite obvious – growth. The permanent growth of business structures, which is a totally natural and required process for every modern and successful business organization, causes the number and volume of intercompany transactions to rise at an enormous rate. Corporations establish separate entities to specialize in a particular field of activity – there are intra-group service centers, research and development facilities, entities responsible for purchase, etc.

WHAT DO YOU FORESEE AS THE NATURAL COURSE OF PROGRESSION REGARDING TP REGULATIONS IN POLAND AND TAXPAYERS' ADJUSTMENT TO THE NEW DEMANDS?

Indeed, for a couple of years we could observe a renaissance in transfer pricing. Although the Polish TP regulations are adjusted with delay to solutions based on OECD guidelines, which are widely adopted in other countries, the process has begun and we should expect more changes in the coming years. The tax authorities are also active. Every tax audit of corporate income tax calculations results in the audit of transfer pricing and one of the first official papers received by the taxpayers is a request for submission of TP reports. Unfortunately, it is still quite common that the taxpayers do not prepare such reports on a regular basis, which causes a lot of unnecessary nerves and stress. The statutory deadline for submission of TP reports is 7 days from receipt of the request. This is definitely very short notice and in practice makes it impossible to prepare a comprehensive and high-quality TP report, not to mention the possible consequences of not submitting the reports within the deadline. Taxpayers should realize that comprehensive and well-considered TP reports will constitute one of the strongest lines of defense supporting the arm's length nature of transfer prices.



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All of these are set-up, in principle, to increase the efficiency and cost effectiveness of the whole organization, however it brings also the temptation to use such type of entities/transactions to transfer profits into more tax-friendly regions of the world. That is why transfer pricing became a subject of interest not only for the Polish tax authorities, but also for other countries. The expression of this international interest is the intensified work of the OECD, which currently seems to play a major role as the main driver in introducing measures aimed at preventing countries from conducting transfers of corporate incomes.

In 2013, the OECD published a report called "Addressing Base Erosion and Profit Shifting" (BEPS) and on its basis created an Action Plan consisting of 15 actions that should support a global economy taking into account fair distri-



bution of profits. The first package of reports, concerning seven actions, was already published in September 2014, and the remainder should be finished till the end of 2015. Several reports relate directly to transfer pricing and even though they are not considered as binding law, for sure those reports indicate the direction of the upcoming changes in local jurisdictions, including the Polish law.

What does it mean for Polish entities? Firstly, they should track more attentively than usual all changes in regulations and familiarize themselves with the work of the OECD. The principle that prevention is better than the cure, seems to be the most appropriate advice in this case, but prevention requires knowledge on how to act in order to increase transfer pricing safety. Secondly, TP reports/documentation, which are required for most intercompany transactions (threshold criterion), should not be treated as a negligible obligation that taxpayers need to check off when they are requested to do so by tax investigators, but mainly as a very powerful tool, which, if well prepared, may provide a very high level of protection.

Even today, many taxpayers are still convinced that TP reports are just a formality. The tax of-

ice asks. The tax office gets. The tax office does not investigate and review it. Nothing could be more wrong. Every year, the professionalism and knowledge of tax investigators increases and they do not just read provided reports, but also analyze them and compare them with market conditions. Teams of professionals investigating TP issues and supporting their colleagues from tax offices are being appointed and employees of the Ministry of Finance actively participate in the work of international groups involved in transfer pricing. For several years, transfer pricing is announced as one of the main objectives of tax audit/inspections.

In 2013, there were 3,157 tax audits concerning transfer prices. Of those, 1,621 cases were considered as incorrect, resulting in an upward adjustment of taxpayers' profits by a total of PLN 206,575,389. This means that in more than 51 percent cases of tax audits, there were upward adjustments on average amounting to PLN 127,437. These figures vary considerably if total tax audits are divided into those conducted by tax offices and tax audit offices. The first category conducts more audits (3,015), but their average (in terms of additional profit estimation) is lower (PLN 82,000). The tax audit offices conducted "only" 142 audits and

28 have finished with upward adjustments amounting to PLN 2,674,550 on average.

Taking into account data from previous years, a tendency can be observed that the numbers of audits and amounts of upward adjustment are consistently increasing. What is interesting, partial data considering the first half of 2014 shows that out of 1,462 tax audits conducted 1,307 were positive, which means that tax investigators have found irregularities in the total amount of PLN 52,754,000. The 89 percent rate of accuracy, raises the question whether it is a coincidence or a result of the organized and planned activities of tax authorities.

The above gives a clear signal that a subject of transfer pricing, in particular the TP reports, should no longer be treated only as a hypothetical threat and tax risk. Development of transfer pricing policies and ensuring ongoing preparation for high-quality and comprehensive TP reports should start to be recognized as one of the priorities for taxpayers, especially for those, where intercompany transactions represent a significant portion of their costs or revenues, and challenging the applied transfer prices by the tax authority may cause some serious financial consequences. ♦