

## Advance Pricing Agreements and Double Taxation – Key Concepts in the Context of Transfer Pricing

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### Abstract

*The paper presents the main advantages and disadvantages of an advance pricing agreement (APA), illustrates a practical example regarding a situation of double taxation of results and presents a comparative analysis between the number of advance pricing agreements granted by the EU countries and the number of Double Tax Treaties concluded by these countries.*

*Results show that an APA presents more advantages than a transfer pricing file, but its disadvantages (regarding the cost and the period of time needed for the issuance) have a big impact on the business of a company and determine most of the taxpayers to choose a transfer pricing documentation file rather than to apply for an APPA. The results of this research also show that countries which have concluded a big number of Double Tax Treaties tends to grant much more APAs compared with the other category of countries where the number of Double Tax Treaties is smaller.*

**Key words:** transfer pricing, advance pricing agreements, double taxation, tax treaties

**J.E.L. classification:** M40, K34

### 1. Introduction

In the context of increasing the number of multinational companies, the number of related party transactions increases as well and therefore transfer pricing has begun to be considered one of the most important aspects in terms of tax matters. This consideration takes into account the fact that through transfer pricing, multinationals may try to move their profits from a high tax jurisdiction into a low tax one. Given this, tax authorities are paying a special attention to the transfer pricing subject, initiating tax audits in order to verify if the prices invoiced by multinationals in relation with their related parties are complying with the legislative provisions. During these tax audits entities can be subject to transfer pricing adjustments which may determine a double taxation of the results at group level. The transfer pricing adjustments can be performed either when the prices invoiced by a company in relation with its related parties are not complying with the legislative provisions or due to an abusive approach of the tax authorities which do not agree with the analysis presented by the taxpayer. In order to avoid the risk of transfer pricing adjustments and implicitly of double taxation due to an abusive approach of the tax authorities, companies could apply for advance pricing agreements (i.e. a documentation issued by the tax authorities mentioning how the price within a related party transaction that will take place in the future, should be computed).

All the aspects mentioned above represented the motivation of writing this paper which briefly presents the main advantages and disadvantages of an advance pricing agreement, illustrates a practical example regarding a situation of double taxation of results and presents a comparative analysis between the number of advance pricing agreements granted by the EU countries and the number of Double Tax Treaties concluded by these countries.

The paper is structured as follows: section 2 presents the background literature, section 3 presents the research methodology, sections 4 – 6 present the results of the research and section 7 the main conclusions.

## 2. Literature review

According with Matei and Pirvu (2011) transfer pricing represent the prices invoiced within related party transactions (e.g. acquisition or sale of goods/services). Further on, the profit registered by each related party, and implicitly the level of the corporate income tax owed by these, are influenced by the prices at which goods or services were transferred between these related parties (Sansing, 2014). Moreover, Peralta et al. (2006) considered that multinationals can own entities in both high tax jurisdictions and low tax ones, and due to this situation these multinationals may try to benefit from the differences in tax rates and in this respect may try to use transfer pricing to shift profits from a jurisdiction into a another one. In addition, Neighbour (2002) emphasized the idea that through transfer prices governments might be deprived from the taxes owed by multinationals. As a consequence to this situation, governments adopted transfer pricing legislation, trying to assess if the transfer prices invoiced by multinationals entities are adequate (Yao, 2013).

Further on, Riedel et al. (2015) concluded that "transfer price documentation provisions have some effectiveness in limiting mispricing behaviour". On the other hand, Beer and Loeprick (2013) noted that the profit shifting within a multinational group has decreased by 60% among for years from the introduction of a compulsory transfer pricing documentation. The authors concluded that the profit shifting is discouraged due to the significant compliance impact of the documentation requirement on multinationals.

Looking at things from the perspective of good faith companies that are trying to set up the transfer prices in accordance with the arm's length principle (i.e. the prices are set in the same way as in the situation in which the transaction would be performed between independent companies and not between affiliated companies) and which analyse and sustain this aspect within the transfer pricing file, Becker et al. (2014) considered that these companies assume a double taxation risk as they do not know whether their analysis will be accepted by the tax authorities and in this situation whether the tax authorities will adjust their transfer prices. According to Lohse and Riedel (2012), companies could reduce the risk of double taxation through the application for advance pricing agreements (APAs).

According to Becker (2017) advance pricing agreements (APAs) set up in advance the transfer prices charged between affiliated entities. Therefore, APAs have as a main scope the establishment of the transfer pricing methodology for the prices that will be charged within a related party transaction (i.e. the APAs are concluded for a related party transaction which will be performed in the future). Depending on the number of tax authorities involved in negotiations, the APAs could be unilateral, bilateral or multilateral (Becker et al., 2014).

Regarding the double taxation, it involves the taxation of the same profit in the hands of different taxpayers. There could be a double taxation at national level (i.e. the profit is taxed twice in the same country) or an international double taxation. Cornelia Lefter and Simona Chirica (2010) noted that in the case of international double taxation, companies are taxed twice: once in the state where the income is realised (i.e. in the source state) and second one in their residence state.

The double taxation could be eliminated if there are met certain conditions. For the elimination of the national double taxation, countries over the world have established their internal regulations. In terms of international double taxation, it can be eliminated through the initiation of the mutual agreement procedure provided by the Double Tax Treaty concluded between the source state and the residence state. If between the two state is not concluded a Double Tax Treaty, the double taxation cannot be eliminated. However, the elimination of the double taxation involves the following of certain steps and procedures which need a long period of time (certain years) and these steps and procedures not always conduct to the desire results (i.e. the elimination of the double taxations).

## 3. Research methodology

Below are presented the objectives of this research. For each objective, there was presented the research methodology applied in order to achieve it.

Taking into consideration that in terms of transfer pricing regulations companies have two options, respectively to prepare a transfer pricing documentation file or to request to the fiscal authorities an advance pricing agreements, and considering that an APA presents a big advantage compared with a transfer pricing documentation file, namely the elimination of the double taxation risk, one of the objective of this research was to perform an analysis of the two options in order to asses which of them would be a better choice for a taxpayer. In this respect there was performed a comparison between the main advantages and disadvantages of an APA and the main advantages and disadvantages of a transfer pricing file.

The second objective of the paper was to illustrate a situation which conducts to a double taxation of the results in order to capture how the double taxation appear. In order to this, there was performed a quantitative research, using in this respect the case study as a research tool.

Within a country where companies request and implicitly the tax authorities grant a big number of APAs, the double taxation risk (from the transfer pricing point of view) is smaller compared with the countries where there is a small number of APAs granted. In this context, and also considering the fact that the elimination of the double taxation is conditioned by the existence of a Double Tax Treaty, there has been found interesting to set as a third objective of the research the performing of a comparative analysis between the number of the APAs granted and the number of Double Tax Treaties concluded by different countries. In this respect, the research was performed at the level of the EU countries as for these countries were found available the statistic data needed.

The number of the APAs granted was gathered from the official site of the Joint Transfer Pricing Forum and the most recent data published envisage the year 2015 (i.e. there is presented the number of APAs granted during 2015). The source of these statistic data is: [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/jtpf0152016enapa.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/jtpf0152016enapa.pdf).

The number of the Double Tax Treaties concluded by EU countries was gathered by accessing the Tax Treaties Database published by IBFD (International Bureau of Fiscal Documentation).

#### 4. Transfer pricing documentation file vs. APA

The table 1 below presents a comparison between the main advantages and disadvantages of an APA and the main advantages and disadvantages of a transfer pricing documentation file.

Table no. 1 APA vs. transfer pricing file

Indicator	APA	Transfer pricing file
Advantages	It is valid a long period of time (i.e. certain years).	It is cheaper than an APA.  It could be prepared in a short period of time, compared with an APA
	Transfer pricing analysis is performed before the related party transaction takes place.	
	It prevents future transfer pricing adjustments and double taxation of results at group level.	
	Through an APA entities could establish a good relationship with the tax authorities.	
Disadvantages	It is no longer necessary to prepare a transfer pricing file for the transactions and periods covered by the APA.	Transfer pricing analysis is performed after the transaction takes place and this could determine a risk of double taxation in the case that the prices are not in accordance with the arm's length principle.
	The issue of an APA by the tax authorities may take a long period of time (certain years), and during this time a company may not be interested in performing the transaction for which the analysis was requested or the result of the analysis may be obtained to late affecting in this way the business.	
	It is more expensive than a transfer pricing file.	

Source: own processing

*Results and interpretations*

As could be observed from the table above, an APA presents more advantages than a transfer pricing file, but its disadvantages (regarding the cost and the period of time needed for the issuance) have a big impact on the business and determine most of the taxpayers to choose a transfer pricing file. This assumption is based on the statistics data presented in section 6 below, according with the average number of APAs granted by the tax authorities from the EU countries did not exceed 44 in 2015.

However, in order to dismiss the risk of double taxation which would be covered by an APA, the taxpayer contracts different tax firms, requesting transfer pricing policies or the preparation of the transfer pricing documentation and the assistance during a tax audit. On the other hand, the choice for an APA or a transfer pricing file is a decision which should be taken by the companies according to its needs in that moment.

**5. Illustration of the double taxation**

An illustration of the double taxation can be performed starting from the following example: Company RO manufactures in Romania washing machines brand X and sells them to the affiliated entity Company BG which distributes the goods on the Bulgarian market. Company RO incurs costs of EUR 200 for the production and delivery of a washing machine. Company BG purchases the goods from Company RO paying in this respect EUR 250/product. Company BG sells the washing machines on the Bulgarian market at a price of EUR 290/product. In addition, in order to sell the washing machines in Bulgaria, Company BG incurs distribution costs of 10 EUR/product. Table 2 below illustrates all from the above.

*Table no. 2 Data for the study case*

Indicator (EUR)	Company RO	Company BG	Total
Sales revenues	250	290	540
Production and delivery costs	(200)	n.a.	(200)
Cost of acquisition	n.a.	(250)	(250)
Distribution costs	n.a.	(10)	(10)
Gross result	50	30	80
Corporate income tax	8 (50*16%)	3 (30*10%)	11
Net result	42	27	59



Source: own processing

During a tax audit, the tax authorities considered that the price of EUR 250 charged by Company RO to Company BG is not in accordance with the arm`s length principle required by the legislation, sustaining that the price charged by Company RO to Company BG should have been of EUR 270 instead of EUR 250. Therefore, the tax authorities performed a transfer pricing adjustment in order to increase the selling price from EUR 250 to EUR 270. The impact of this adjustment is presented in table 3 below.

*Table no. 3 Transfer pricing adjustment*

Indicator (EUR)	Company RO - before adjustment -	Company RO - after adjustment -	Company BG
Sales revenues	250	270	290
Costs	(200)	(200)	(260)
Result	50	70	30

Source: own processing

As a result of the transfer pricing adjustment from EUR 250 to EUR 270, the result of Company RO increased from EUR 50 to EUR 70, impacting the corporate income tax that should be paid by Company RO. The profit obtained by the Group before the adjustment was of EUR 80 (50+30), while after the adjustment this profit was in the amount of EUR 100 (70+30). Given this, the amount of EUR 20 (70-50) is taxed twice, once in Romania and once in Bulgaria, at Group level resulting a double taxation of the results.

## 6. Statistics regarding APA and Double Tax Treaties at the level of EU countries

Table 4 below presents the number of APAs granted by the tax authorities from the EU countries during 2015 vs. the number of Double Tax Treaties (DTT) concluded by these countries.

Table no. 4 Statistics regarding APA and DTT

No.	Country	Number of APAs granted in 2015	Number of DTTs in force	No.	Country	Number of APAs granted in 2015	Number of DTTs in force
1	Greece	0	57	15	Poland	6	80
2	Latvia	0	59	16	Denmark	8	79
3	Slovakia	0	66	17	Germany	9	95
4	Cyprus*	0	61	18	Hungary	11	82
5	Croatia*	0	61	19	Spain	16	94
6	Slovenia*	0	58	20	France	18	125
7	Estonia*	0	57	21	Finland	22	81
8	Bulgaria*	0	70	22	Czech Republic	27	88
9	Malta*	0	71	23	Italy	27	97
10		2	75	24	United Kingdom	37	131
11	Lithuania	2	53	25	Luxembourg	145	81
12	Portugal	3	76	26	Netherlands	236	99
13	Sweden	3	89	27	Belgium	602	92
14	Romania	4	85	28	Austria	**	89

\*Until 31 December 2015 these countries did not introduced in the local legislation the option to apply for an APA. Therefore, no APA was granted by these countries.

\*\* Data not available/submitted

Source: own processing based on the statistic data mentioned within the chapter regarding the research methodology

### Results and interpretations

As could be observed from the table above, in general, countries where no APAs was granted (e.g. Greece, Latvia, Slovakia etc.) or countries where a small number of APAs was granted (e.g. Ireland, Lithuania etc.) have concluded a small number of Double Tax Treaties compared with the countries that granted a big number of APAs (e.g. Belgium, Netherlands etc.). Therefore, generally speaking, countries which have concluded a big number of Double Tax Treaties tends to grant much more APAs compared with the other category of countries where the number of Double Tax Treaties is smaller.

Given all the above, companies which are operating within countries which grant a small number of APAs and which concluded a small number of Double Tax Treaties, are exposed to a bigger risk of double taxation compared with companies operating in the other category of countries (i.e. which granted a big number of APAs and also concluded a big number of DTTs). This risk may be mitigated either through the concluding by the countries of more Double Tax Treaties or by the development and implementation of regulations regarding APA and by encouraging of the taxpayers to apply for APAs (for example by offering certain tax facilities).

## 6. Conclusions

In the context of increasing the number of multinational companies and related party transactions, tax authorities are paying a special attention to the transfer pricing subject, initiating tax audits in order to verify if the prices invoiced by multinationals in relation with their related parties are complying with the legislative provisions. In this context, groups of companies may face

with a transfer pricing adjustment performed by the tax authorities and also may assume the risk of double taxation of results. In order to mitigate this risk companies have the option to apply for an advance pricing agreement instead of preparing a transfer pricing documentation file.

Despite the fact that an APA presents more advantages than a transfer pricing documentation file, its disadvantages (e.g. the cost and the period of time needed for the issuance) have a big impact on the business and determine most of the taxpayers to choose a transfer pricing file. This assumption is based on statistics data, according with the average number of APAs granted by the tax authorities from the EU countries did not exceed 44 in 2015.

Taking into consideration that an international double taxation could be eliminated through the initiation of the mutual agreement procedure provided by the Double Tax Treaty concluded between the source state and the residence state, companies which are operating within countries which grant a small number of APAs and which concluded a small number of Double Tax Treaties, are exposed to a bigger risk of double taxation compared with companies operating in the other category of countries (i.e. which granted a big number of APAs and also concluded a big number of DTTs).

The results of the research show that countries which have concluded a big number of Double Tax Treaties tends to grant much more APAs compared with the other category of countries where the number of Double Tax Treaties is smaller.

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