

Breaking Tax News

Transfer pricing related tax audits

In contrast to our monthly Tax News+, in our Breaking Tax news you will be informed immediately of regulatory changes affecting your business but without commentary by our experts.

Deloitte's annual transfer pricing conference took place on 4 December 2014. Agnes Fotiadi in her capacity as the head of the Advance Pricing Arrangement and the Transfer Pricing Audit Department of the Hungarian Tax Authority ("TP Department") was invited to present some relevant case studies.

According to the case studies, **transfer pricing related tax audits are increasingly focusing on reviewing transfer pricing from a substantial perspective.** Furthermore, the tax authority possesses the necessary knowledge and assets (e.g.: databases) required to carry out in-depth transfer pricing analyses. This background enables the tax authority to make substantial assessments in transfer pricing. The head of the TP Department drew the audience's attention to the fact that transfer pricing adjustments often lead to assessments in other tax types (mainly in VAT and local business tax). Based on the experience of the tax authority **transfer pricing related assessments usually enter into force in the first instance** because taxpayers do not appeal against the assessments of the tax authority. However, Deloitte's experience differs from that of the tax authority. We are of the view that the assessments made by the tax authority may be challenged in most cases on a technical basis. As a result of a potential appeal, (even if the challenged assessment cannot be fully abolished) the magnitude of the tax shortage and the respective legal consequences may be significantly reduced.

According to the overall tax audit practice of the tax authority (not solely in those cases in which the auditors of the TP Department are involved) most of the assessments made in respect of related party transactions are not based on the grounds of the arm's length principle and/or an appropriate transfer pricing analysis. Rather they are assessed on the basis of the requirement of reasonable management and general deductibility principles. The risk of the assessments made by the tax authority on this basis may be effectively reduced if the taxpayer is in possession of the appropriate transfer pricing documentation in addition to well-structured documents and information supporting the deductibility of the incurred costs and expenditures. The collection of supporting documents is not difficult during the preparation of the transfer pricing documentation. Deloitte has been engaged several times in the preparation of a "defence file" (which aims to support the deductibility of costs and expenditures, the fulfilment of the transaction and the business reason thereof) prior to tax audits. The preparation of a "defence file" may be of essential value, specifically when purchases of high-value services are involved.

Among the respective transfer pricing related tax risks, the amount of default penalty applied is exceptionally rigorous. Although the amount of default penalties assessed due to missing or incomplete transfer pricing documentation is a well-known fact, taxpayers often overlook the default penalty related to the reporting liability of related entities. The tax authority's interpretation of this regulation results in penalties being levied on each instance of default, i.e. **on each related entity**. As a result, default penalties may reach a significant amount.

According to the head of the TP Department the **following situations are most likely to** lead to an in-depth transfer pricing investigation at the company:

- The taxpayer is continuously in a lossmaking position although the group generates profit;
- The taxpayer accounts for significant year-end transfer pricing adjustments;
- The profitability of the company differs significantly from the industrial average;
- The company applies different pricing methods to related entities than to third parties;
- The tax payer carries out transactions in tax haven countries and in countries which do not apply transfer pricing regulations.

Based on the presented cases studies, the transfer pricing related assessments of the tax authority are mostly due to the following issues:

In terms of **benchmark analyses**, a usual issue is that the applied data are not updated and/or cannot be reproduced. A further issue is that the search strategy is usually incomplete or specifically tailored to the company's needs and the arm's length range is incorrectly determined (e.g. lossmaking companies are not excluded; statistical narrowing is not performed etc.).

In addition to the above, the calculation of the **profit level indicator** may be incorrect and may not correspond to any accounting standards. It was also mentioned that (in reasonable cases) the effect of certain one-off items may be adjusted upon the calculation of the profit level indicator. However the adjustment of these items has to be supported by appropriate documentation.

The tax authority had several transfer pricing related assessments related to **financial transactions** as well. These assessments relate essentially to the incorrect pricing being applied to related party loans and deposits.

Based on the above it is apparent that companies should focus on their related party transactions not only in terms of formal perspectives, but from a substantial perspective as well. Deloitte's new risk assessment methodology (the TPQS) aims to provide assistance in this respect. For further information please contact one of our tax experts or visit our [website](#).

Should you have any remarks or questions regarding the above, please contact our professionals:

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