



Extract from the report to the
Public Accounts Committee on
the Danish tax authorities' control
of transfer pricing

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1. Introduction and conclusion

1.1. Purpose and main conclusion

1. This report concerns SKAT's (the Danish tax authorities) control of transfer pricing. Transfer pricing is the valuation, for tax purposes, of cross-border transactions between associated companies. According to the principles of international taxation defined by the OECD and the UN, among others, transactions between associated parties must be conducted in compliance with the arm's length principle, i.e. prices and terms should be the same as they would have been, had the parties to the transaction not been related to each other.

2. The tax base of a company liable to pay tax in Denmark may unlawfully be moved outside the country, if the company fails to comply with the arm's length principle. For instance, if a Danish parent company sells a patent to a subsidiary in Ireland at too low a price, part of the income generated by the patent will be moved to Ireland despite the fact that value creation took place in Denmark. Erosion of the Danish tax base may also be the consequence if a Danish subsidiary is overcharged by its parent company – located abroad – for a loan, services provided or goods delivered.

3. The purpose of SKAT's control of transfer pricing is to ensure that companies that are liable to pay taxes in Denmark comply with the arm's length principle and thus pay correct taxes.

The purpose of the report is to examine whether SKAT has organised its control of transfer pricing effectively. The report answers the following questions:

- Is the number of companies engaged in transfer pricing known to SKAT?
- Is SKAT's control of transfer pricing effective?
- Are the preventive aspects of SKAT's control effective?

The arm's length principle is the OECD's international consensus on transfer pricing.

In Denmark, the arm's length principle is addressed in section 2, sub-section 1 of the Danish Tax Assessment Act. The principle applies to all cross-border transactions between associated companies and to transactions between a shareholder with a controlling influence over another enterprise.

MAIN CONCLUSION

It is Rigsrevisionen's assessment that SKAT is effectively selecting the companies for control that represent the biggest risks. At the same time, however, Rigsrevisionen is of the opinion that SKAT's control of transfer pricing has significant weaknesses that can and should be improved.

SKAT disagrees with Rigsrevisionen's criticism of its transfer-pricing control, which it considers to be one-sided and disproportionate. Rigsrevisionen, however, maintains that SKAT in addition to continuing its current efforts should also ensure that the control efforts include all companies engaged in transfer pricing. SKAT also needs to step up the administration of data provided by the companies in their tax returns, and thus use its legitimate authority to check that the companies comply with the documentation requirements concerning transfer pricing. Finally, SKAT should more consistently follow up on the effect of its control.

Rigsrevisionen finds it satisfactory that SKAT's control is systematic and targeted at the companies that represent the greatest risk in terms of transfer pricing. SKAT's selection of companies for control is largely in accordance with the OECD's risk assessment recommendations. In 2013, SKAT selected approximately 100 companies for control following a systematic search among the approximately 4,500 companies that had stated that they were engaged in transfer pricing arrangements. Upward adjustments of the companies' taxable income amounting to around DKK 17 billion were imposed on approximately three quarters of the 100 companies that were selected for control. How much these adjustments will contribute to the Treasury is, however, uncertain since adjustment cases are often appealed or end before the courts.

Rigsrevisionen has identified significant weaknesses in the following areas:

- SKAT is unable to pinpoint the number of companies engaged in transfer pricing, but estimates the number to be between 13,000 and 14,000. It is essential for SKAT's performance in the area to know the population of these companies and Rigsrevisionen is therefore of the opinion that the size of this group of companies should have been determined by SKAT sooner.

The uncertainty concerning the number of companies is, among other things, rooted in SKAT's business procedures for registration of the appendix to the tax return – the 3B form – in which the companies report details on transfer pricing. SKAT has failed to register approximately 20 per cent of the 3B forms correctly. The data provided in these forms may therefore be missing for a number of reasons; SKAT may have decided to exclude companies engaged in small inter-company transactions, the forms may not have been forwarded to SKAT or they may have been lost. Rigsrevisionen finds SKAT's handling of the 3B forms unsatisfactory. SKAT expects to resolve the problems when the DIAS system is implemented (IT system designed to handle electronic company tax returns).

- SKAT is not setting targets for the effect and outcome of its control of transfer pricing and has not consistently followed up on the effect of control projects. It is Rigsrevisionen's assessment that transfer-pricing adjustments in practice become the only target that SKAT strives to achieve, since no overall effect and outcome targets have been defined. SKAT's focus is therefore on control of the transfer-pricing cases that represent the biggest risk and therefore also potentially the largest upward adjustments of the companies' taxable income. Rigsrevisionen agrees with SKAT on the importance of focusing on the potentially large upward adjustments. Yet, having focus exclusively on upward adjustments will bias the control effort to the extent that small-scale transfer-pricing transactions – which are not systematically selected for control by SKAT – will hardly ever be checked. It is Rigsrevisionen's assessment that almost two thirds of the companies with inter-company cross-border transactions are not being controlled.

The risk of being selected for control has therefore, so far, been close to zero for companies that have only small-scale inter-company transactions with related parties and are not part of a large Danish group of companies. Since the risk of being selected for control is one among several initiatives that motivate companies to declare their income correctly, Rigsrevisionen recommends that SKAT should take this aspect into consideration when selecting companies for control.

Rigsrevisionen is of the opinion that SKAT should also manage and organise its control to ensure that *all* companies engaged in transfer pricing can be selected for control, yet taking into consideration the size of the company and the risk of irregularities. SKAT has informed Rigsrevisionen that the current risk-based control will be supplemented with activities that cover all companies engaged in transfer pricing. This is considered satisfactory by Rigsrevisionen.

- The Folketing has authorized SKAT to control the companies' compliance with the documentation requirements, but SKAT has only made limited use of this authority in its preventive efforts. This approach is not considered expedient by Rigsrevisionen, which sees it as a reflection of the uncertainty related to SKAT's internal business procedures for processing the 3B forms.
- SKAT has launched a tax governance project (TAX G) under which it has invited the largest Danish companies to enter into extended cooperation with SKAT. The project has been initiated despite the fact that there is no evidence of the effectiveness of this approach compared with other more traditional control measures. Rigsrevisionen finds it unsatisfactory that SKAT – five years after the launch of the pilot – is unable to determine whether the companies that participate in the project are better at complying with the rules, or whether TAX G is a more or less resource-intensive method to reduce the tax gap.