Evaluating TP policies in loss-making companies

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November 25 2019

During tax audits, tax authorities frequently focus on companies within multinational groups that book steady losses over several years. In these companies, behind the losses authorities often find transfer pricing policies that are not in compliance with the arm's-length principle. This observation is supported by the 2017 OECD Transfer Pricing Guidelines 2017 (para 1.129 – 1.131).

According to the OECD Guidelines, when a company that belongs to a multinational group consistently books losses while its multinational parent remains profitable, authorities must analyse its tax practices, paying particular attention to the TP policies.

This is because an independent company would not tolerate recurring losses for an undetermined period. It would rather, under those conditions, opt to cease its activities. However, a company that belongs to a multinational group can tolerate such losses if its commercial activities generate benefits for the multinational group as a whole.

In some cases, as provided for by the OECD Transfer Pricing Guidelines, recurring losses, borne for a reasonable period, can be justified by a company strategy of establishing low prices in order to enter a market and launch a new product. However, those low prices can only be applied for a limited period with the goal of increasing profits in the long term.

If this pricing strategy lasts too long, an adjustment to the transfer prices could be deemed appropriate. This would especially be the case where data reveals that losses have been suffered for a longer period than in the case of comparable independent companies.

Alternatively, a multinational group could be compelled to produce a full range of products and/or services to remain competitive and realise an overall profit, while some product lines regularly recorded losses. A company in a multinational group could also realise significant losses from the manufacturing of loss-making products while other members of the group manufactured profitable products. In this case, the necessary remuneration granted to the company should be accounted for.

It is therefore necessary to understand the reasons behind losses on a case by case basis, and only later to evaluate how TP policies affect the negative results. It is also important to carefully analyse the TP method adopted and the profit indicators that are selected for compliance-checking the TP policy with the arm's-length principle.

In certain cases, the TP policy may not indicate any problems; for example, if a company uses the resale minus method and selects gross profit as the profit level indicator, and this profit indicator is in line with the selected comparables.

On the contrary, using operating profit margins as the profit level indicator may be out of line with the one of the comparables because, for example, the taxpayer has a heavy cost structure with an effect on the operating profit margin, or there are extraordinary costs unconnected to the intercompany transactions that should not be considered in the identification of the profit level indicator.

Recently, the Regional Tax Commission of Lombardy (decision no. 928/20/2019) expressed its view on this topic. The Italian taxpayer in the case had an operative loss for an extended period (1997 to 2013), while the consolidated balance sheet of the group showed positive results over the same period. According to the auditors, the existence of the Italian company was justified by the fact that the group wished to keep an international profile and the Italian company performed marketing activities in favour of the foreign holding which boosted the visibility and presence of the group in the Italian market.

This led to the claim over missed remuneration for the intercompany marketing services carried out by the Italian company.

During the tax audit, the taxpayer explained to the auditors the management evolution, the type of marketed products, the peculiarity of the pharmaceutical market and the governmental policy on the prices of medicines that triggered the company's losses in the Italian market. However, the losses were supported by the foreign shareholder, which continuously provided the Italian company with the financial and capital means to ensure its continuity.

According to the Regional Tax Commission of Lombardy, the Revenue Agency assumed that there were unsubstantiated intercompany services. However, the taxpayer demonstrated that the loss was not due to transfer pricing policies that failed to comply with the arm's-length principle. The taxpayer did this by submitting broad documentary evidence during the audit and explaining the economic reasons behind the loss.

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