Tax audit report

Issued: January 15, 2019

Audited company / group: A Group

Audited fiscal years: 2014-2016

Summary

On January 2, 2018, the Large Taxpayers' Office (LTO), part of the Finnish Tax Administration, initiated a transfer pricing audit in A Group for fiscal years of 2014-2016.

Based on the audit, the following observations were made:

- In the 2014–2016 tax year, the A Group companies have been manufacturing and selling construction products.
- In the transfer pricing documentation prepared by the A Group, the arm’s length compliance of the license fees charged by A Oy from the other group companies was determined according to the Comparable Uncontrolled Price (CUP) method.
- The arm’s length compliance of the transfer prices used for the sale of the Group's finished products between group companies were validated according to the resale price method.

Based on its findings, the LTO issued a tax assessment against the Finnish parent company A Oy and the Finnish manufacturing entity (A Finland Oy) based on the view that the contracts used as external comparable information for licensing transactions covered different products, contract terms and market areas, and, as such, were not sufficiently comparable to be utilized for arm’s length validation.

With regard to the sale of finished products between group companies, the resale price method was not considered to have given a sufficiently reliable picture of the performance of the comparable companies, as only four of the companies found in the benchmark were considered to be comparable and only one company had sold similar products to those of the A Group. Based on the OECD's Transfer Pricing Guidelines for 2010, the LTO considered that the best method for determining the market conditions of A Group companies' profit levels was the residual profit split method.

As A Oy and a Finland Oy had made incorrect tax returns when they determined the arm’s length compliance of their transfer prices on the basis of the CUP and the resale price methods, the LTO issued a tax assessment decisions for the covered years, according to which A Oy will have to pay EUR 14.1 million in additional taxes and EUR 9.1 million in penalty charges and interest.

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1. Background

A Group has been in the construction business since early 1980s and has been one of the leading producers of construction materials in Europe during the past decades.

The Group has manufacturing operations in Finland, Sweden, Lithuania and Poland. It also has sales offices and representative offices in 13 European countries.

The Group's business operations are organized into three sales divisions and one production division. The D Division has supplied construction products for all types of buildings. The T division has been responsible for the production and delivery of value-added products for various industrial processes, machines and ships. The F Division has manufactured and delivered structural panels for external and internal walls and ceilings. The E-division has been responsible for all line production, factory functions and process, technology and material development that has been associated with construction material. Sales divisions have been responsible for developing product solutions to meet customer needs. In most cases, several divisions have been represented in a manufacturing or sales company. On the other hand, the divisions may also have acted beyond the boundaries of legal units.

During the audited fiscal years (2014-2016), A Finland Oy manufactured and sold products and raw materials to other manufacturing companies, licensed intangible rights related to its own technology to other manufacturing companies in the Group and was responsible for providing R&D services for the entire Group. For its part, A Oy has been responsible for providing R&D services to the needs of the entire Group and licensing its intangible rights to the Group's manufacturing companies.

The most significant competitive factors of the A Group have been customer orientation, product quality, product range, security of supply, efficient management of the production process and technology. As a driving force, the emphasis is on customer orientation, which has been supported by other competitive factors.

2. The transfer pricing model applied by A Group

Sales of finished products to sales companies

Manufacturing companies (including A Oy) have sold the products themselves or through a local sales company. The company has analyzed the arm’s length compliance of the pricing of pricing between the manufacturing company and the sales company by using the resale price method.

The LTO notes that the key factor in application of the resale price method is the similarity between the activities and the risks and assets associated with them. As regards to the company's benchmarking analyses, the LTO considers that the grounds for rejection of the method have been justified and, for example, the lack of information for the period under consideration, especially in the case of a cyclical sector, or the differences in activities should be considered as sufficient grounds for rejection.

The LTO notes that the decisive factor in the choice of method is that the application of the resale price method has been accompanied by considerable uncertainty as to the different accounting practices. In the Amadeus database used by the company in its comparable search, the basis for calculating gross margins has fluctuated significantly and the differences may have had a major impact on the sales margins under review. The LTO considers that the Company has not shown that the uncertainties related to accounting practices has not affected significantly the calculation and comparison of results to the results of the A Group companies. Therefore, in these circumstances,

the resale price method could not be reliably applied, and therefore it has not been found as the most suitable transfer pricing method for determining the market pricing of finished products.

Royalties charged from manufacturing companies

A Oy has entered into a license agreement with three manufacturing companies (Poland, Sweden and Lithuania) on the basis of which the manufacturing companies have paid a royalty to it. The amount (1.5% of turnover) is based on the level of comparable royalties paid to third parties (CUP method).

In the transfer pricing model applied by the company, the market-based nature of the royalties inherited by A Oy has been tested by the CUP method and the use of royal agreements with companies outside the Group has been used as reference agreements. The LTO notes that, in applying the CUP method, the OECD Transfer Pricing Guidelines set very high standards of similarity when assessing comparability. External contracts used as comparables should not be materially different from the transactions under review unless adjustments can be made to correct them.

The four external contracts submitted by the company for comparability analysis have differed in substance from the Group's internal agreements. The comparable contracts have not granted the right to use the trademark, whereas intra-group agreements have instead included the right to use the trademark A. The LTO considers that the right to use the trademark A, which has been developed over the decades, should have had an impact on the pricing of the licensing transaction.

In addition to the licensing of technology, the Contracts have also covered, inter alia, the procurement of raw materials or production machinery or on the distribution of certain products. The essential difference between the agreements is that the agreements with the independent companies have affected different market areas than the tested intra-group contracts. Internal agreements with manufacturing companies have dealt with the Group's core market areas in Northern and Eastern Europe, whereas external contracts with independent companies presented by the company have covered markets where A Group has no interests, such as Australia / New Zealand or Iceland / Faroe Islands / Greenland. In addition, the Group companies are involved in a business model in which valuable intangible assets have been created in cooperation with different companies which deviates significantly from the circumstances in which agreements have been signed with external parties.

The LTO notes that the differences found in the contracts and the circumstances are such that it has not been possible to adjust them to ensure proper arm's length validation and testing. The comparability of the comparable external agreements has been so uncertain that they cannot be considered to meet the very high comparability requirements required by the CUP method and therefore could not be used as comparables. The CUP method has therefore not been reliably applied in these circumstances and has therefore not been the most suitable transfer pricing method for determining arm's length pricing for royalty transactions.

Sales of raw materials

The transfer pricing model applied by the company has utilized a cost plus mark-up method for raw materials sold to manufacturing companies. For the purpose of verifying the arm's length level of the mark-up, the company has performed a comparable search.

The LTO considers that the benchmarking applied by the company has not provided the best possible picture of the market-based profit margin for raw material sales, as the benchmarking has sought to determine the profit margin that should have been earned for contract manufacturing of construction materials. This activity is significantly different from the company's operations related to sales of raw materials. The cost plus method has therefore not been the most appropriate transfer pricing method for determining the market price of raw materials.

As a result of the above, the LTO considers that the transfer pricing model applied in A Group with respect to sales of raw materials has not resulted in an arm's length outcome.

3. The transfer pricing model applied by the LTO

Due to the particular involvement by the Group's manufacturing companies in the development of operations, the LTO notes that A Group has been in a situation (further described in paragraph 2.109 of the OECD Transfer Pricing Guidelines) where the parties to the transactions have performed unique and valuable value-added contributions in relation to the transactions. The LTO therefore considers that for the pricing of intra-group transactions the profit split method has been the most appropriate transfer pricing method since (1) the CUP method cannot be reliably applied and (2) it has not been possible in the present case to divide the value-adding attributes and the unique intangible assets between several manufacturing companies in an arm's length manner.

In A Group's business model, independent companies would have sought to agree on the terms under which each company would have received an arm's length return for its routine operations (routine return), after which the excess profit over the routine return (i.e. share of the residual profit) would be distributed and allocated to those companies that have contributed to the value-added development activities and carried related risks. Therefore, the LTO considers that the profit split method is also the only method that takes into account the integrated activities of A Group and the intangible assets generated by the value-added operations, and thus it should be considered as the most suitable transfer pricing method for the pricing of the intra-group transactions.

The profit split analysis prepared for tax audit purposes has used an operating profit percentage to determine the routine return on sales because it can be considered to be based on net sales outside the Group. In the case of manufacturing operations, the surplus of the net operating costs (i.e. mark-up on total costs) has been used, since the calculation is based on the most reliable comparable information, and the sales to the sales companies do not affect the calculations. Based on adjusted benchmarking analysis, routine return of sales has been determined to be 3.4 percent (operating profit). The arm's length routine return of manufacturing operations has been 3.9 per cent (mark-up on total costs). When calculating the routine return, royalty payments received by A Oy and royalties paid by manufacturing companies have been adjusted and eliminated from operating profit. The LTO considers that the above-described calculation for determining appropriate return for the routine operations of different group companies results in an arm's length outcome.

The LTO notes that A Group's business model, in particular as a result of product development, existing product range and process performance and efficiency, has generated added value for which an independent entity would have been willing to pay a higher price compared to routine operations.

The method used for Profit Split and consequent tax adjustment takes into account the costs associated with the value-added activities (Product Development, R&D, Production Development, Engineering and Production) identified during the functional analysis.

According to the tax audit findings, the divisional product development work has been based on a three-year strategy. With regard to the salaries of the persons involved in the product development of the sales and marketing organization, considering the time span of the strategy work, it is considered appropriate to use three-year cumulative costs in the assessment.

Furthermore, according to the tax audit findings, with regard to market risk, the intra-group distribution agreement defines a specific pricing model for D and T products which has shifted part of the risk related to sales to the manufacturing company. The intra-group transaction pricing has been carried out according to the following formula:

External retail price

- VAT

- Discounts

= Net selling price

- Freight costs, customs duties and customs duties (if distributed by the distributor)

- Gross margin (15%)

= Purchase price from manufacturer

The gross margin due to the sales company is calculated on the basis of the net selling price presented in the calculation. The purchase price from manufacturer has been adjusted during the year, if necessary, so that the sales margin specified in the contract has been reached. In addition, it has been agreed in the agreement that the margin level could be changed in the negotiations if the conditions in the area have deviated significantly from the forecasts. This price mechanism has not guaranteed the sales companies a certain level of margin, for example at the operating profit level, but the company has had to cover the variable and fixed costs of the sale at the level of sales level specified in the contract. However, the model has shielded the sales company in a situation where it has not been possible to maintain a budgeted price level for the customer list. In this case, according to the agreement, the manufacturing company has had to adjust its own selling price in such manner that the sales company has been able to reach its gross margin level. Taking into account the pricing model, some of the market risk has become borne by manufacturing companies.

For F products, the above-mentioned automatic correction mechanism has not been used, so the sales company has carried the market risk in relation to its own sales. In this respect, however, it has been necessary to take into account the change in the level of gross margin agreed in the agreement in the negotiations, if the conditions in the area have deviated significantly from the forecasts.

The LTO considers that, in particular, the market risk of the sales companies is limited when the internal agreement states that the manufacturing company must change the price list in order to ensure that the sales company reaches an average sales margin of 15% of net sales in each calendar year. Therefore, the LTO considers that the terms of the internal agreement in question reduce the risk borne by the sales companies, which would have been taken into account as a downgrading factor in the transactions agreed between independent parties. The LTO also notes that the manufacturing company is obliged to give the sales company instructions on marketing, advertising and sales. The internal agreement between manufacturing and sales companies also notes that any intangible assets generated by the sales company will be transferred to the manufacturing company without any separate compensation.

The LTO notes that even though the sales companies in the Group have been responsible for their own marketing costs, the companies in question have not been shown to make significant and non-standard marketing activities, but the activities have been the usual sales and marketing activities of the sales companies. In the Group, sales companies have been involved in the actual product and process development work only by forwarding impulses from the market to the division level, and local modifications to the products have been made within the framework defined by the Group and, thus, based on previous development work.

In the case of sales companies, it can also be observed that the sales and marketing costs have not been significant in relation to turnover, and that the share of sales companies' contributions to group-level marketing has been reduced by the fact that the Group's centralized marketing costs have been allocated to manufacturing companies.

Normal sales and marketing activities can not be considered to create added value and unique intangible assets. Similarly, sales companies cannot be considered to carry out activities related to the development of activities that would have generated significant added value and intangible assets, since the role of sales companies in development is limited to impulse transmission from the market. In addition, when assessing the nature of the activities of the sales companies, it must be taken into account that they have not been found to be exposed to exceptional risks. The stock risk normally associated with the activities of sales companies should be considered to be negligible for sales companies, as local inventories have been small or have been completely missing.

The LTO notes that intangible assets and added value created cannot be considered to be limited to patents and other intangible assets on the balance sheet, but to all the value generated by the Group's business model and its development, which is reflected in higher returns from routine operations and for which an independent company would have been willing to pay in the potential acquisition.

Furthermore, the LTO notes that the A Group's operations have been deliberately organized based on the chosen business model in which the A Group has reliably sought to provide a wide and high-quality range of products and solutions to its customers. The Group has sought to generate added value in many ways and the value-added operations have been specifically connected to the development of the A Group's business model. Thus, the creation of added value has not been about individual innovations or exceptional marketing campaigns related to products or processes, but maintaining quality, reliability and competitiveness has required continuous product and process development at different stages of the Group's value chain. Consequently, it has not been a matter of transferring certain individual intangible assets within the Group, but development work has been continuous. The LTO therefore considers that, in these circumstances, the distribution of the residual profit has to take place in order to compensate the development contributions made by several group companies whereas valuation of individual intangible assets is not necessary.

R&D costs

According to the tax audit findings, the role of the R&D department has been to develop the long-term technological know-how of the Group. This development work has included both product development work on raw materials and structures, and development technology related to production technology.

The task of the Marketing Department has been to innovate new products based on the customer's needs. If necessary, the R&D department has also been involved. The Engineering Department serves to bring existing production technology into new production machine investments. After the investment, the factory's production personnel have been tasked with getting the new production line module into the existing production chain.

On the basis of the customer needs, the product portfolio is modified and the production technology used is improved. This knowledge is intended to be utilized within the Group over a long period of time. The time limit for utilizing this knowledge has been set by patent time limits that have been in Finland for 20 years. In order to take long-term development into account in the Profit Split analysis, the LTO has used the R&D costs over a longer period of time. The term of validity of patents has limited the economic lifetime of the results achieved.

4. Conclusion

According to the findings during the audit, the comparable agreements underlying the application of the CUP method have not been sufficiently comparable and the application of the resale price method has not been carried out taking into account the weaknesses associated with its application or the market conditions. The best available method has therefore been the Transactional Profit Split Method (hereinafter referred to as the Profit Split Method) as it enables taking into account the intangible assets associated with the customer-oriented approach and value-added activities.

When applying the Profit Split method, the appropriate returns for the parties' routine operations are first determined. Then, the remaining residual profit is divided according to the costs incurred by the parties carrying out the operations required for the customer-oriented approach. The allocation takes into account the salaries of the people involved in the development of the sales and marketing organization, R&D expenses, Production Development and Engineering, and the salaries of key production personnel.

Taking into account the findings concerning the Group's operations, assets and risks, the LTO considers that the Profit Split method produces an arm’s length outcome compared to the transfer pricing methods applied by the company. Consequently, the LTO has been able to make a transfer pricing adjustment for which the arm’s length pricing is determined by utilizing a different transfer pricing method than the company has applied itself.

Following the application of the Profit Split Method and as A Group has not complied with the arm’s length principle during the audited period, it is ordered to pay EUR 14.1 million in additional taxes and EUR 9.1 million in penalty charges and interest for the period of 2014-2016.

A Group’s response to initial tax audit report

In its response to the initial tax audit report, A Group has opposed the tax assessment presented by the LTO and has justified its claims, among others, as follows:

- The Group's business is based on the production and delivery of special solutions made of construction material for the needs of building technology, process industry and shipbuilding. The Group's manufacturing companies manufacture and sell the Group's products either directly to the market or to the Group's sales companies. Due to the cost of transportation, manufacturing operations need to be placed close to the market, which is why the Group invests in the factory in a market where it estimates demand.
- The Group’s business is a traditional manufacturing and sales business, where the Group companies operate in successive stages of the value chain. In the Group's business operations, value is created not only by production investments, but also locally through customer relations, product management and manufacturing know-how, whereby a comprehensive manufacturing and sales network is key. The value of the Group's business is central to the local nature of operations. Local sales companies act as full-risk distributors, including local sales by producing sales forecasts and local budgets. In addition, they are responsible for marketing and pricing of products. The Group strategy is also based on local companies and divisions. Responding to customer needs is the responsibility of the sales organization and customer-friendliness, customer understanding and customer needs mapping and market-specific product development. For this reason, sales organizations have extensive decision-making rights locally and carry the risks inherent in their business and decisions by division.
- In addition to the competitive properties of the end product, the Group's business operations are focused on the cost-effectiveness and quality of the product manufacturing. The cost-efficiency requirement has required continued investment in local production facilities. On the other hand, the Group’s business is also very local in terms of product characteristics. Local construction practices and standards set high quality standards for manufacturing companies (production). In addition to the quality of the products, it has been essential for the Group's competitiveness that a new, modified product can be manufactured quickly on the local market, where the local manufacturing company has played a key role.
- The transfer pricing model applied by the Group has been customary and has been based on arm’s length transaction-specific pricing for transactions between group companies. Such transactions include, in particular, the sale of raw materials and finished products and the licensing of intangible assets between the Group's manufacturing companies. The company's transfer pricing documentation has met the content requirements set out in section 14b of the Finnish Tax Procedure Act. The transfer pricing model uses so-called traditional methods that are best suited to assessing market-based prices in the context of OECD guidelines, in cases where transactions used as controls are sufficiently similar to the transaction being tested, or that transactions can be made with sufficiently reliable adjustments.
- Tax adjustments presented by the LTO have been prepared by applying an exceptional profit sharing method (residual profit split) which should be utilized only in situations where the activities of the related parties are exceptionally integrated. It would also be possible to apply the method in a situation where the transaction is subject to valuable and unique intangible assets of both parties, so that independent parties could be considered to be in a similar situation to share the risk and potential profit of the transaction in proportion to the parties' transaction-related inputs.

- The Group's manufacturing and sales companies could act in a similar way as non-group, independent companies. The group companies have also had related transactions with non-Group companies. The value of the intangible assets related to the A-Group business in relation to the value of other assets, in particular production investments, has also been misunderstood.
- Applying the exceptional profit sharing method to situations where it is not intended to apply will, in practice, always lead to a result which is contrary to the arm's length principle. Due to the proposed revenue adjustments, the company is allocated such a significant share of the Group's total result that the return on investments made by the Group's foreign manufacturing companies would be negative. It is clear that this does not correspond with what the independent parties would have agreed to. The error is a direct result of the profit sharing method applied by the LTO.
- The tax administration has rejected the transfer pricing methods applied by the company on inadequate grounds and has gone directly to apply the profit distribution method without analyzing the potentially more appropriate methods for the case, as required by the OECD Transfer Pricing Guidelines. The LTO should have sought primarily to correct the shortcomings identified in the comparable information and then consider the suitability of other unilateral transfer pricing methods for assessing the arm's length pricing. The LTO could also have tested the pricing of the Group's related-party transactions also using the transfer pricing methods applied by the company. If, after these measures, the LTO had considered either individual or more unilateral methods to be insufficient to secure arm's length pricing, it could have assessed whether the conditions for applying the profit sharing method were met to test the transaction pricing within the A Group.
- As a result of the application of the profit sharing method to the entire Group, fictitious intangible asset transactions between the Group companies have been identified. The choice of a testing method that is not suitable for the company's case and its misapplication has, in fact, led to the analysis prepared by the LTO to not reflect the level of arm's length pricing and therefore it cannot serve as a basis for a transfer pricing adjustment by the Tax Administration under section 31 of the Tax Procedure Act. Applying the selected profit sharing method for verifying transaction pricing actually leads to the exclusion and re-characterization of the entire operational business model and the Group's value chain. Consequently, the LTO has re-assessed the Group's operating model, created new transactions between companies and combined transactions.