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Significant changes into Polish transfer pricing regulations

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in the years 2009–2015

The article presents the assessment of changes in transfer pricing regulations among associated companies. The new regulations will be introduced in Poland from 2019.

The assessment is based on comparison and verification analyses with respect to alignment of changes with OECD recommendations for transfer prices. Alignment with international standards is a condition for avoidance of economic double taxation in case of transfer pricing adjustment. The assessment concerns the crucial changes involving adjusted approach to arm's length principle.

Adjusted arm's length approach introduces a couple of changes among which the most important is to impose new obligations to improve setting transfer prices on daily basis as well as authorisation for tax authorities to non-recognition or recharacterization of transactions between associated companies. The proposed wording of statutory law do not include any particular safeguards against tax authorities empowerment to use this tool.

It was indicated in the article that some changes might rise uncertainty due to inconsistency with international standards. This might bring the growing number of international tax disputes where avoidance of double taxation will be impossible.

Keywords: transfer pricing, related entities, arm's lenght principle

General Remarks

The issue of international tax avoidance becomes more and more pronounced considering the progressing globalisation. The development of globalisation has allowed international groups of companies to transfer capital to any country of their choice. On the other hand, each country strives to secure their share in taxation of income derived from the capital invested on their territory. Countries makes sovereign decisions as regards taxation of income generated by companies that operate within their tax jurisdictions. Such an approach forces international groups of companies to adjust to the diverse systems used in each jurisdiction. Owing to the lack of coherence among the tax systems of various countries, the phenomenon of adjusting is accompanied by the phenomenon of using the inconsistencies to avoid taxation.

Tax solutions using transfer prices set by related parties in transactions between them are considered some of the most advanced forms of reducing the tax bases of countries. Due to its complex and multifaceted character, transfer pricing allows to transfer taxable income to any jurisdic-

tion where, e.g., a more advantageous tax rate applies. The most advanced form of income transfer is transfer of risk and the remuneration associated with it as well intangible assets and respective remuneration arising from their commercialization.

Owing to the negative influence of the use of transfer pricing for the purpose of transferring income from one country to another, the policy of countering this phenomenon, which is pursued by the majority of countries, develops around distribution of the rights of individual countries to impose taxation on income of international groups of companies. To this end, there have been stipulations included in international tax agreements regarding distribution of the rights to tax income of related parties in individual countries – assuming that the legal provisions on the commencement of a tax obligation as well as on the tax base remain outside the scope of international legal regulation.

As far as OECD Member Countries are concerned, and Poland among them, a commonly recognized standard for the distribution of the Member Countries' rights to tax income of related parties is the arm's length principle. This principle has been included among the stipulations of the OECD Model Convention with respect to income and capital.[1] It is based on an assumption that related parties should be treated as separate entities when assessing the correctness of the attribution of income to individual countries, which is the separate entity approach. In accordance with the arm's length principle, if entities are related and due to the links between them they set or impose terms and conditions that are different from the terms and conditions that unrelated parties would establish, any profit that could be attributed to one of such entities but has not been due to such terms and conditions may be attributed to this entity and taxed accordingly. The OECD Model Convention also stipulates that if in consequence of such attribution, economic double taxation arises, the other country that has taxed the income beforehand should make a corresponding adjustment in order to avoid double taxation. Economic double taxation arises, if the same income attributed to two different persons, including related parties, is taxed in two different countries. Owing to the complexity of analysis of the correctness of income attribution to individual countries as well as application of the arm's length principle, Member Countries have reached a consensus as to the interpretation of this principle. This consensus has been provided for in the OECD Guidelines[2] and allows to correctly distribute the rights of Member Countries to impose taxation on income of related parties as well as to avoid economic double taxation.

It should be noted that the arm's length principle has remained unchanged since 1963 although the OECD Guidelines were altered multiple times. Thus, numerous countries refer directly to the OECD Guidelines in order to remain coherent with the changes that are introduced. Owing to the increasing integration of the economies and the simultaneous intensification of the phenomenon of tax avoidance, G20 and OECD Member Countries have undertaken to jointly work out common actions intended to limit the phenomenon of erosion of the tax base of countries and transfer of incomes. As a result, two reports have been published; one was concerned with documentation of transfer prices[3] and the other with important issues concerning transfer pricing[4].

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[1] Model Tax Convention on Income and on Capital (version 2017), http://www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm, website available on 30 October 2018.

[2] OECD transfer pricing guidelines for multinational enterprises and tax administrations, http://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm, website available on 30 October 2018.

[3] Action 13, transfer pricing documentation and country-by-country reporting – Final Report 2015, http://www.oecd.org/tax/transfer-pricing/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm, website available on 30 October 2018.

[4] Action 8-10, aligning transfer pricing outcomes with value creation actions – Final Report 2015, http://www.oecd.org/tax/transfer-pricing/aligning-transfer-pricing-out-

Both reports have been implemented into the OECD Guidelines.

In 2015, Poland as one of the first European States implemented the report on documentation of transfer prices. In line with the intention of the legislator, the second of the reports listed above as well as changes in documentation obligations are to be implemented as part of the changes discussed in this elaboration. Due to the significance of the changes and the necessity to ensure coherence with the OECD Guidelines, changes in regulations will be assessed in terms of their coherence with the OECD Guidelines. The content of the provisions of the law is derived from the government draft act amending the personal income tax act, the corporate income tax act, the tax ordinance act, and some other acts (Sejm's publication Np. 2860) as of 30 October 2018[5].

Since the provisions of the national law on the correctness of establishing transfer prices give rise to economic double taxation between related parties, changes in the regulations both in the context of the aims of the legislator and the possibilities of eliminating economic double taxation will be evaluated.

The regulatory changes under discussion do not offer new instruments for eliminating double taxation. The currently applicable mechanisms allowing to eliminate double taxation are available through the application of the stipulations of ratified international agreements that Poland is a party to. In line with the hierarchy of legal acts, which is established in Poland, ratified international agreements prevail over the provisions of the national law, including the CIT Act[6] and the PIT Act[7]. Currently, Poland is a party to over 80 international agreements on avoidance of double taxation.[8] Moreover, as far as the EU Member States are concerned, elimination of economic double taxation is possible through the application of the stipulations of the multilateral Arbitration Convention agreed among the EU Member States[9]. In other cases, that is, if Poland has not entered into a relevant agreement with a given country, the problem of economic double taxation will not be avoided.

It should be stressed that in order to be able to avoid or eliminate double taxation arising from adjustment of profits of associated entities, the adjustment as well as its amount must meet international standards. Otherwise, the mechanism of avoidance of double taxation will be ineffective since the other country that should make the corresponding adjustment will not be willing to do so, if the adjustment does not follow international standards. As far as the OECD Member Countries are concerned, such a standard is the arm's length principle whose interpretation is a consensus among OECD Member Countries expressed in the OECD Guidelines. The consensus sets the limits within which OECD Member Countries agree to make a corresponding adjustment, if transfer prices are adjusted by one of the contracting countries. That is why our further assessment of the proposals for changes as regards establishing the income of related parties will also be concerned with compliance with the international standard.

The Main Assumptions Underlying Changes

The explanatory memorandum of the proposed amendments to the CIT and PIT Acts presents

comes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm, website available on 30 October 2018.

[5] http://orka.sejm.gov.pl/opinie8.nsf/nazwa/2860_u/$file/2860_u.pdf, website available on 30 October 2018.

[6] Act of 15 February 1992 on corporate income tax (Journal of Laws of 2018, item 1693 as amended).

[7] Act of 26 July 1991 on personal income tax (Journal of Laws of 2018, item 1693 as amended).

[8] https://www.finanse.mf.gov.pl/pl/abc-podatkow/umowy-miedzynarodowe/wykaz-umow-o-unikaniu-podwojnego-opodatkowania, website available on 30 October 2018.

[9] Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/436/EEC), https://eur-lex.europa.eu/legal-content/PL/TXT/PDF/?uri=CELEX:41990A0436&from=PL, website available on 30 October 2018.

the main objectives of the amendments which are to simplify the tax law regarding income taxes and to tighten the income tax system. The need for modifications as regards simplification of tax regulations as well as the need for reducing the bureaucratic and administrative burdens placed on entrepreneurs, especially small and medium-sized ones, were indicated as part of the process of tax law simplification. Whereas tightening the tax system applies to large enterprises (esp. multinational ones) as regards ensuring that the amount of tax is linked to the actual place of generating income.

These objectives are in line with the Strategy for Responsible Development that was adopted by the Council of Ministers on 14 February 2017. Its general framework is determined by the so-called Business Constitution – the Entrepreneurs' law. According to the project promoter, these changes should reflect a partner approach to relations between tax administration and entrepreneurs as expressed in the 3 × P philosophy – a simple, transparent, and friendly tax system (In Polish: "prosty, przejrzysty, przyjazny").

The explanatory memorandum also indicates that through the amendments the Polish tax authorities are to address the OECD transfer pricing "acquis" included in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published in 2017. The project promoter pointed out that the OECD "acquis" will be transposed to the Polish system either directly or indirectly.

Apart from providing general prerequisites, the legislator did not, however, specify which detailed changes in transfer pricing are intended to simplify the tax system and which are aimed at tightening it. All of the detailed amendments that were proposed have been identified as simplifications of the tax law.

The new regulations introduce significant changes to the provisions on transfer pricing. Therefore, they are provided in a separate chapter. Adding a new chapter on transfer pricing requires an introduction of a new network of concepts. Analysis of partially new terms included in the glossary (e.g. the concept of a transfer price or controlled transaction) testifies to the significance of the changes in the existing system of definitions. Additionally, the new regulations are concerned with the application of the arm's length principle, adjustments of transfer prices as well as the provisions of the law regarding the obligation to prepare transfer pricing documentation.

The new regulations introduce previously unknown solutions (such as a safe harbour) into the Polish legal system and the application of such solutions causes the price or an element of the price to be recognized as an arm's length price under the Act. Such solutions are expected to be introduced for loans and low-value-adding-type services. So far taxpayers were required to prepare transfer pricing documentation that contained proof of compliance of the accepted settlements with the arm's length principle. According to the legislator, the new solution is supposed to, on the one hand, ensure that the taxpayer is protected against price being contested by the tax authority and, on the other hand, to release the taxpayer from the documentation obligations in this respect.

The solutions that are being implemented allow – in justified cases, other than the ones specified in the Act – to adopt methods, including valuation techniques, to determine the taxpayer's revenue or tax deductibles derived from controlled transactions, which will enable tax authorities to more effectively verify consistency of the terms and conditions established by related parties with the arm's length conditions.

The new regulations also stipulate introduction of a rule governing adjustments of transfer pricing, which will apply to revenue or tax-deductibles respectively and should be recognized in the year it applies to, provided that all the conditions specified in the provisions of the law have been met.

Furthermore, in the explanatory memorandum, the legislator indicated that the powers of the tax authority to analyse transfer pricing as derived from the current wording of the provi-

sions have been clarified in the implemented regulations. Clarification of the way these instruments function constitutes implementation of the OECD Guidelines as regards preventing tax base erosion and profit shifting.

A detailed analysis of the new regulations reveals a number of inconsistencies between the new proposals and international standards, which creates particular uncertainty as to whether Poland will be able to eliminate double taxation effectively when it occurs. Double taxation that cannot be eliminated is a clearly negative phenomenon in economic relations, which is considered a major limitation to economic growth.

On the other hand, simplifications in transfer pricing may prove insufficient in the context of other regulations of the Act. For example, introduction of simplifications as regards the statutorily acceptable level of transfer prices for low-value services does not solve the problem of limitation of deductibility of tax deductibles incurred in connection with purchase of especially intangible services. The new provisions do not regulate the interconnections between these rules.

The proposed amendments raise a number of doubts as to interpretation, which increases the uncertainty of tax law in Poland.

Imposition of New Obligations on Related Parties

In accordance with the explanatory memorandum, the previous regulations did not sufficiently specify their addressee. According to the project promoter, the wording of the previous regulations does not allow to clearly tell whether transfer pricing regulations can be applied directly by the taxpayers. Whereas the structure of the introduced regulations directly indicates that the addressees of these provisions of the law should be both the tax authorities and taxpayers. Clarification in terms of the addressees of the provisions should allow taxpayers to apply the regulations directly. The intention behind the introduction of the rule that transfer pricing regulations are addressed primarily to taxpayers (and not only to tax authorities) is, first of all, to directly oblige taxpayers to comply with the principle of the arm's length price already at the time of making a transaction.

In consequence of such an approach, the legislator added regulations that impose an obligation on related parties to enter into transactions under the terms and conditions that do not differ from the ones that would be established by unrelated parties[10]. At the same time, the fact that the regulation is also addressed to taxpayers (i.e., related parties) explicitly implies that they are obliged to apply arm's length prices – to the best of their current knowledge and experience – already at the time of entering into a controlled transaction[11].

If it is found that due to the existing links the terms and conditions established by related parties are different from the terms and conditions that unrelated parties would establish and in consequence the taxpayer does not report income (and so incurs loss as well) or shows income lower than would be expected, if the above-mentioned links did not exist, the tax authority is entitled to determine the taxpayer's income or loss disregarding the terms and conditions arising from these links[12].

The change in the legislator's approach towards the addressee of the regulations is also accompa-

[10] Article 11c, section 1 of the CIT Act – Related parties are obliged to set transfer prices in line with the terms and conditions that unrelated parties would establish.

[11] Article 11a, section 1, point 1 of the CIT Act – Whenever (...) a transfer price is mentioned, it refers to the financial outcome of the terms and conditions established or imposed as a result of the existing links, including the price, remuneration, financial result or financial indicator.

[12] Article 11c, section 2 of the CIT Act – If due to the existing links the terms and conditions set or imposed differ from the terms and conditions established by unrelated parties and in consequence the taxpayer reports income that is lower (or loss that is higher) than would be expected if the above-mentioned links did not exist, the tax authority shall determine the taxpayer's income (or loss) disregarding the terms and conditions arising from these links.

nied by the change in the scope and time of commencement of the obligation to adopt the methods set out by the legislator. It follows from the explanatory memorandum that both the tax authorities and taxpayers may make use of the new catalogue of methods in order to verify transfer prices to ensure that the level of the transfer price is the same as the one that would be established by unrelated parties. Simultaneously, according to the legislator, considering given circumstances, the best possible method should be used to verify whether the transfer price is compliant with the arm's length principle, taking into account, among other things, the terms and conditions set or imposed in a relationship between related parties, the availability of information necessary for the correct application of the method, and specific criteria for its application[13].

In consequence, in accordance with the new regulations, the legislator proposed five basic methods indicated in the currently applicable provisions of the law as well as the possibility of using other methods, including valuation techniques. If a different method is selected, the taxpayer is required to justify why none of the five basic methods could be deemed the most appropriate. This regulation is intended to limit the freedom of application of other methods as the five basic ones take precedence.

The explanatory memorandum indicates that the regulation regarding the methods is intended to enable tax authorities to estimate taxpayers' income based on other methods as well, including valuation techniques. The regulations applicable so far enabled tax authorities to estimate income only based on the five methods indicated in the act of law. These methods were placed on an exhaustive list. According to the legislator, such circumstances placed the tax authorities in a more adverse situation compared to the taxpayer who could adopt any method of establishing transfer prices.

The new concept of analysis of transfer prices used by related parties is considerably different from the approach that has been followed so far. In line with the currently applicable provisions of the law, tax regulations do not interfere with the manner of setting transfer prices by related parties. Operating based on the principle of the freedom of the establishment, these entities entered into civil law agreements and one element of such agreements was price. Until 2017 such entities were obliged to present the most important terms and conditions influencing a given transaction when documenting related party transactions. Subsequently, such terms and conditions were analysed by tax authorities and if it had been determined that they were different from the terms and condition set by unrelated parties, the tax authority would have had the right to estimate income of the taxpayer that was a related party. Estimation of income by a tax authority was, however, limited to the use of the statutorily indicated five methods pursuant to the OECD Guidelines. Since the beginning of 2017, related parties have been obliged to supply – as part of their transaction documentation – a test of consistency of the prices set with the ones that would have been established by unrelated entities. The consistency test consists in obliging related parties to verify the transfer prices they established in transactions with related parties with the use of the five methods provided for in the act of law in line with the OECD Guidelines.

The fundamental doubts as to interpretation that arise in this approach were concerned with whether verification of the consistency of the terms and conditions set or enforced by related parties entitles tax authorities to estimate income taking into consideration or disregarding

[13] Article 11d, section 1 of the CIT Act – transfer prices are verified with a method that is the most suitable in given circumstances and selected from among the following ones: comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method, and the profit distribution method. Article 11d, section 2 of the CIT Act – if it is not possible to adopt the methods enumerated in section 1, another method shall be used, including valuation techniques, which is the most suitable under the given circumstances. Article 11d, section 4 of the CIT Act – tax authority uses the method adopted by a related party to determine the amount of income (or loss), unless the adoption of another method is more suitable under the given circumstances.

certain conditions that would not be identified in relations between unrelated entities. Or whether the tax authority should limit its actions to calculating the price only by way of adopting the available tools indicated in the act of law.

Taking into account the international character of the arm's length principle as well as references to the OECD Guidelines[14] indicated in the explanatory memorandum, the changes that have been introduced will be compared to the instructions provided in the OECD Guidelines. These Guidelines serve as a consensus among OECD Member Countries as to the interpretation of the arm's length principle.

The new OECD Guidelines (2017) introduce the requirement of accurately delineating the actual transaction[15]. In order to accurately delineate the actual transaction, it is necessary to identify the economically significant characteristics of such a transaction, which at the same time serve as criteria of comparability[16]. The process of properly delineating the actual transaction is a point of departure for the correct establishment of a transfer price. The process is concerned with determining the characteristics of a transaction, including the terms and conditions, the functions, employed assets, risks taken by related parties, character of the commodity, and economic conditions. These characteristics should be identified at the very moment of entering into a transaction and should make it possible to determine the outcome of using transfer prices that allow to link it to the place of value creation. Identification of the economically significant characteristics of a transaction should be reflected in the local file intended to support the ongoing analysis of transfer prices performed by the taxpayer. Evaluation which transaction characteristics (e.g., terms and conditions of the contract, functions, assets, and risks) are economically significant for a particular transaction is depended on the evaluation made by unrelated entities when analysing the terms and conditions of an identical transaction[17].

In Poland, the new OECD approach has been adopted in the proposal for amendments of the provisions of the law by way of imposition of a new obligation on related parties. Such entities have been obliged to establish transfer prices on an ongoing basis (at the time of making a transaction) based on the terms and conditions that would be set by unrelated entities. However, the obligation formulated in such a way raises doubts both as to the criteria that related parties should apply in order for the transfer price to be set in accordance with the terms and conditions that unrelated entities would establish and as to the very definition of the term – transfer price.

First of all, the proposed stipulations of Article 11c, section 1, of the CIT Act, which impose the obligation, do not define the criteria that related parties should take into consideration when setting transfer prices in line with the conditions that would be established by unrelated entities.

The revised OECD Guidelines from 2017 could be of some help as regards interpretation of this legislative proposal. They stipulate that unrelated entities will compare the transaction to other realistically available options when evaluating the terms and conditions of a potential transaction. Such entities will enter into such a transaction, if they see no alternative offering clearly more advantageous commercial conditions. In other words, unrelated entities will enter a transaction, only if it does not worsen their situation in comparison to other options. Under such circumstances, unrelated entities will take into account any economically significant difference between the realistically available options (such as, e.g., the difference in the level of risk). Therefore, identification of the economically signifi-

[14] The OECD Guidelines as regards transfer prices for tax administrations and international companies.

[15] Action 8-10 Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Report OECD/G20 Base Erosion and Profit Shifting project, p. 1.33.

[16] Action 8-10 Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Report OECD/G20 Base Erosion and Profit Shifting project, p. 1.36.

[17] Action 8-10 Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Report OECD/G20 Base Erosion and Profit Shifting project, p. 1.37.

cant characteristics of a transaction is key for the accurate delineation of the actual transaction[18].

If that was the legislator's intention, it should be expected that such an intention ought to be explicitly expressed in statutory provisions of the law. Imposition of the obligation to set transfer prices just as unrelated entities entails placing considerable burdens on taxpayers, which are related to preparation of analysis of realistically available options in case of each and every transaction. Therefore, imposition of such obligations may not be considered simplification of the system. In this context, the proposal of the legislator expressed in separate provisions of the law, which limits documentation obligations regarding controlled transactions and defers these obligations in time, defeats the legislative purpose, if analysis of the realistically available options needs to be performed at the very time of making each controlled transaction. It clearly arises from the provision of the law as well as from the detailed explanatory memorandum that analysis of the realistically available options would be required by the tax authority at the very moment of entering into a transaction. Since business activity has been significantly burdened with additional economic analyses at the very time of entering into a transaction (when it is not certain if the transaction will be successful and continued), it is necessary for the legislator to consider high significance thresholds and consider when tax authorities might request submission of such an analysis.

A possible solution in terms of fulfilment of the obligation to set transfer prices in line with the conditions that unrelated entities would establish and presentation of realistically available options at the time of making a controlled transaction is to use the methods based on the arm's length principle. These are the methods that allow to run comparative analysis, that is, to make references to the terms and conditions set by unrelated entities. When considering the realistically available options, unrelated entities compare differences between individual options, if such differences significantly influence their value. And so, a controlled transaction is compared to an uncontrolled transaction, for example, with the comparable uncontrolled price method, in order to directly establish the price that parties would agree to, which provides a direct reference to the arm's length alternatives to controlled transactions.

Doubts as to the interpretation of such an application of the methods arise from the legislator's statement – regarding both tax authorities and taxpayers – that the methods serve to verify transfer prices. Which can be interpreted in such a way that at the moment of making a transaction, for the purposes of setting the transfer price the way unrelated parties would, the legislator expects another proof of establishing the economically significant characteristics of a transaction and the realistically available options.

Additionally, the legislator's admission of the possibility of using other methods, including valuation techniques, precludes acceptance of the above interpretation that application of one of the five methods based on comparability could fulfil the obligation to present realistically available options proving consistency of the terms and conditions for setting transfer prices with the terms and conditions set by unrelated entities.

Secondly, doubts as to the interpretation deepen as far as determining the meaning of the notion of transfer pricing is concerned. It should be indicated that the notion of transfer pricing was broadly defined as the financial outcome of the terms and conditions set or imposed as a result of the existing links, including the price, remuneration, financial result or financial indicator. In this context, it is unclear what reasons underlay the legislator's approach to use the provisions of the tax law to impose an obligation on business entities to prove that price, remuneration, financial result or financial indicators, which are non-tax categories, were established based on the terms and conditions that would be set by unrelated entities.

[18] Action 8-10 Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Report OECD/G20 Base Erosion and Profit Shifting project, p. 1.38.

What is more, the definition suggests that the notion of transfer pricing is partially of a pejorative character. This is because the transfer price is a financial outcome that results from the terms and conditions set or imposed due to the existing links. The provisions further suggest that the statement "terms and conditions set or imposed due to the existing links" may refer to the terms and conditions differing or not differing from the terms and conditions that unrelated entities would establish. If the terms and conditions differ from the ones that unrelated entities would establish, the tax authority has the right to estimate. Therefore, the definition becomes looped.

In consequence of the imposition of a new obligation, doubt arises as to what and with what tools will be checked by tax authorities verifying whether the taxpayer has met their obligations.

Transfer Pricing Adjustments

Justification for the interpretation regarding the imposition of a new obligation to establish transfer prices on an ongoing basis in line with the terms and conditions that unrelated entities would establish and based on realistically available options can also be found in the construction of the provisions on adjustments of transfer prices. The draft act introduces new regulations concerning the possibility of making adjustments of transfer prices.

The explanatory memorandum states that the legislator noticed the need to make adjustments of transfer prices at the end of the year. An example of a situation is provided, where following the end of the year and changes in the circumstances significant from the point of view of calculating transfer prices, the total remuneration received by an entity serving limited functions may be not enough to achieve an arm's length level of profitability. Among others, significant changes in market prices for raw and other materials, exchange rates fluctuations, changes in interest rates or significant changes in supply and demand were enumerated as circumstances that could not be predicted at the time of planning transfer prices. The need to adjust a transfer price may also arise from the adaptation of historical data used for the purposes of calculation of a transfer price as their adaptation to the actual data is only possible at the end of the year. A difference then arises from comparison of historical and actual data. The legislator, however, introduced an array of limitations on the possibilities of making adjustments. The taxpayer may make an adjustment of a transfer price, if five conditions are met simultaneously. First of all, the terms and conditions of the taxpayer's controlled transactions throughout the tax year were consistent with the terms and conditions that unrelated entities would have established. The legislator adds in the explanatory memorandum that the best knowledge and experience of the taxpayer are crucial here.

The textual interpretation of this provision suggests that if, in any controlled transaction, a tax authority questions the consistency of a transfer price with the terms and conditions that unrelated entities would set, it may be impossible to make adjustments on any other controlled translation. In the explanatory memorandum, the legislator claims that tax authorities have the right to question an adjustment, if there are bases to conclude that the taxpayer, e.g., used transfer prices that significantly differ from the arm's length level throughout the year on purpose and did not adjust the prices in the meantime.

Secondly, there has been a significant change in the circumstances mentioned earlier. Thirdly, the taxpayer should be in possession of a declaration from the related party stating that the party has made a corresponding adjustment. Fourthly, the related party making the corresponding adjustment is a resident of a country or a territory that Poland has an agreement on the avoidance of double taxation with and there is legal basis for the exchange of information. This, de facto, means that it is impossible to make adjustments in controlled transactions concluded with entities from tax havens (such as Hong

Kong) as well as with entities from the following countries: Brazil, Argentina, Ecuador, Cameroon, Cambodia, Kenya, Colombia, Cuba, Lichtenstein, Madagascar, Nigeria, Peru, Sudan, Venezuela. Of course, these are not countries whose residents have investments in Poland that are significant for the Polish foreign trade. Nevertheless, some investors from Hong Kong and Lichtenstein[19] were put on the list of the biggest foreign investors in Poland and the impossibility of making adjustments of transfer prices may be a huge impediment to their activity. Fifthly, the taxpayer confirms that adjustment of a transfer price has been made in a tax return for the tax year that the adjustment was made in.

Scope Ratione Materiae – Controlled Transaction

In the explanatory memorandum regarding the changes, the legislator indicated that the scope ratione materiae of the detailed regulations on transfer pricing covers any economic operation, including commercial, capital, financial, and servicing one. This intention has been encapsulated within the definition of a new term, that is, a controlled transaction[20].

In line with the legislator's intention, the tax authority should identify the actual course of such an operation on the basis of actual behaviours of the parties. This condition is particularly important when the actual course of a controlled transaction is not consistent with the stipulations of the relevant written agreements or if there are no written agreements governing the controlled transaction. In the explanatory memorandum, the legislator indicated as well that it is intended for the definition of a controlled translation to also cover operations that cannot be colloquially understood as transactions, such as, among others, restructuring operations, cost contribution agreements (CCAs), partnership agreements, cooperation agreements or liquidity management agreements.

Consequently, the legislator excludes a certain group of transactions from the group of controlled transactions. The exempt transactions are controlled transactions where the price or manner of establishment of the price of the transaction item arises from the provisions of the acts of law or normative acts issued based on such provisions. The literal interpretation of the provision might incline one to claim that in accordance with the CIT Act all controlled transactions are thus excluded owing to the legislator's proposal for prices in controlled transactions to be established based on the provisions of the CIT Act.

Secondly, transactions between the Bank Guarantee Fund and a bridge institution or between an entity managing assets and a bridge institution – within the meaning of the act of 10 June 2016 on the Bank Guarantee Fund, the deposits guarantee scheme, and mandatory restructuring – are subject to exemption.

Despite the fact that the obligation to set transfer prices in line with the terms and conditions that unrelated entities would establish was imposed on the taxpayer, the requirement to accurately delineate the actual transaction was only clarified with respect to tax authorities[21]. It is indicated in the explanatory memorandum that tax authorities analyse the terms and conditions of a controlled transaction on the basis of the actual circumstances surrounding the course of the transaction and the actual behaviours of the parties to the transaction in accordance with the

[19] https://www.paih.gov.pl/publikacje/inwestorzy_zagraniczni_w_polsce.

[20] Article 11a, section 1, point 6 of the CIT Act – whenever a controlled transaction is mentioned in this chapter, it means economic operations of the parties as identified on the basis of their actual economic behaviours, including attribution of income to a foreign establishment, whose terms and conditions have been established or imposed as a result of the existing links.

[21] Article 11c, section 3 of the CIT Act – When determining the income (or loss) of the taxpayer in a situation described in section 2, the tax authority takes into consideration the actual course of and the circumstances surrounding the conclusion and the course of a controlled transaction as well as the behaviours of the parties to the transaction.

principle of substance over form. According to the legislator, this allows tax authorities to delineate and examine the tax effects of an actual transaction – and may also serve as basis for a conclusion that a given transaction would not have been made by unrelated entities based on such terms and conditions. That way the legislator's implementation limits a very substantial part of the arrangements covered by the OECD Guidelines of 2017 as regards the principles for determination of the actual transaction.

Revision of the OECD Guidelines in 2017 was intended to provide taxpayers and tax administrations with guidelines to be used in the course of analyses of transfer prices. In order to correctly delineate the actual transaction, its economically significant characteristics or comparability criteria must be identified. Such characteristics may be categorized as follows: the terms and conditions of a contract for a given transaction, the functions performed by each party to a transaction, taking into account the assets employed and risks taken (including delineation of how these functions influence generation of value by the group of related entities), determination of the transferred assets and performed services, the economic environment and market circumstances, and business strategies that the parties to the transaction pursue. All the indicated economically significant characteristics should be provided in the documentation of transfer prices as confirmation of taxpayer's analyses[22].

In the new OECD Guidelines, particular attention was paid to delineation of the actual transaction by way of proper identification and assignment of risk involved in a controlled transaction. The Guidelines provide for the so-called 6-step approach to analysis of risk associated with a controlled transaction, which is intended to ensure correct delineation of an actual transaction[23].

Recharacterizing or Disregarding a Related Party Transaction

The new regulations provide tax authorities in Poland with a wide scope of powers in terms of questioning the legitimacy of a transaction between related parties. If the tax authorities question such a transaction, they may not take it into consideration at all or take into consideration a transaction that they deem appropriate. These entitlements are given to the tax authorities within the framework of the mechanism of recognition. The provisions of the law stipulate that tax authorities may only use the mechanism of recognition, if they demonstrate that in comparable circumstances unrelated entities using reasonable economic judgement would not make a given controlled transaction or would make a different transaction or operation.

In the explanatory memorandum to the draft act, it was indicated that in case it is concluded that in comparable circumstances unrelated entities using reasonable economic judgement would not make a given controlled transaction or would make a different transaction or operation, the tax authority will determine the taxpayer's income or loss, without taking into consideration the controlled translation, and if appropriate – will determine the taxpayer's income or loss based on a proper transaction (recognized based on the examination of the actual circumstances surrounding the transaction and behaviour of the parties). This regulation allows a tax authority to properly recognize an actual controlled transaction (even if it deviates from the transaction indicated by the taxpayer) and potentially replace the controlled transaction with another (proper) one in order to estimate income or loss or disregard the tax outcome of the controlled transaction altogether.

In consequence, as the legislator indicates in the explanatory memorandum, the provision of the law specifies tax authorities' possibility

[22] Action 8-10 Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Report OECD/G20 Base Erosion and Profit Shifting project, p. 1.36.

[23] Action 8-10 Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Report OECD/G20 Base Erosion and Profit Shifting project, p.1.60.

of recognizing under given circumstances that unrelated entities would not enter into a given transaction or would make a different one as well as the possibility of evaluating the tax outcome of the proper transaction exclusively and allows not to take into consideration the tax outcome of a controlled transaction, if unrelated entities would not make such a transaction at all. Other provisions of the law, which limit the tax authorities' possibilities of employing the instruments of recharacterization and refusal to recognize a transaction, indicate two criteria that may not serve as an exclusive basis for applying these instruments, that is, difficulty in verification of a transfer price by a tax authority or lack of comparable transactions between unrelated entities under comparable circumstances. This solution is intended to prevent a situation when a tax authority will "take a short cut" in the face of difficulty in establishing a transfer price, while the adoption of the instruments of recharacterization and refusal to recognize a transaction should not be widespread.

According to the legislator, the provisions in force so far allowed such an approach based on the general arm's length principle. Nevertheless, lack of precise regulations in this respect arouse numerous doubts among taxpayers. The regulation that is being designed is intended to confirm the existence of the possibility that a tax authority may recharacterize or refuse to recognize a controlled transaction and to remove any doubts as to the application of these instruments.

Analysing the stance of the legislator, one should first and foremost refer to the stipulations provided in the OECD Guidelines (2017). Analysis of transfer prices consists in identification of the substance of commercial and financial relationships between related parties and it is intended to correctly delineate the actual transaction through economic analysis of its significant characteristics[24]. The actual transaction is derived from the substance of a written contract and behaviour of the parties to the transaction. Tax authorities should take into consideration and complete the formal terms and conditions provided for in the contract by way of analysis of the behaviours of the related parties and other economically significant characteristics of the transaction. If the economically significant characteristics of the transaction are not consistent with the written contract, then the tax authorities should derive the actual transaction form the characteristics of the transaction reflected in the behaviour of the parties to it. Assignment of risks based on the contract and actual behaviour should be verified taking into account two criteria simultaneously: control of the risk and financial capability of taking the risk. In consequence, the risk transferred to one of the parties to the contract on the basis of the contract may be assigned to a different entity as a result of analysis of the behaviours of the parties to the contract. Therefore, analysis of both the content of the contract and the behaviours of the parties serves as basis for the establishment of the actual substance of the commercial and financial relationships between the parties and proper delineation of the actual transaction[25]. Thus, the OECD Guidelines recommend tax authorities to take any efforts to price the actual transaction that has been correctly determined in accordance with the arm's length principle. Both the taxpayers and tax authorities may use the tools and methods indicated in the OECD Guidelines in order to determine the price. The tax authorities should not disregard an actual transaction or replace it with another one, unless special circumstances come up that are indicated in the OECD Guidelines[26].

Since it is controversial for a tax authority to disregard a transaction and leads to economic double taxation, the OECD Guidelines recommend taking any steps necessary to determine

[24] Action 8-10 Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Report OECD/G20 Base Erosion and Profit Shifting project, p. 1.119.

[25] Action 8-10 Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Report OECD/G20 Base Erosion and Profit Shifting project, p.1.120.

[26] Action 8-10 Aligning Transfer Pricing Outcomes with Value Creation, 2015 Final Report OECD/G20 Base Erosion and Profit Shifting project, p. 1.121.

the actual transaction and carry out pricing of the actual transaction in accordance with the arm's length principle. Disregarding the transaction only because it is difficult to determine the price in line with the arm's length principle is unacceptable.

Analysis of the construction of the Polish government bill allows to conclude that the mechanism of recognition is applicable when under comparable circumstances unrelated entities using economically reasonable judgment would not make a given transaction or would make a different one.

The legislator did not specify how to verify whether unrelated entities would not make a transaction or would make a different one under given circumstances. Two situations that might meet this prerequisite were literally excluded (as the provision of the law excludes these two situations from the catalogue of prerequisites) and they cannot serve as basis for the application of the mechanism of recognition. The two excluded situations are as follows: first, when the authority has difficulty in verification of a transfer price; second, when there are no comparable transactions between unrelated entities under comparable circumstances. Interpretation of this provision inclines to conclude that similar circumstances will be contained in the catalogue of situations that serve as prerequisites for adopting the mechanism of recognition.

However, a simple presentation of the prerequisite along with the exclusions of its applicability raises doubts as to the intention of the legislator. It is difficult to assume that unrelated entities using economically reasonable judgement would not make a transaction or would make a different transaction in a situation where the tax authority would have difficulty in verification of the price of such transaction. Similar is the case with the second exclusion that also arouses doubts, especially the assumption that unrelated entities would not make a transaction or would make a different one in case of the non-existence of comparable transactions between underrated entities.

Whereas analysis of the prerequisites stipulated in the OECD Guidelines allows to notice significant differences in relation to the proposals provided for in the Polish provisions of the law. First of all, a tax authority that is considering disregarding or reclassifying a transaction should first correctly determine the actual transaction between the related parties. Only then a transaction may be disregarded or replaced with a different one, if arrangements relevant for the transaction, which have been analysed taking into account all the relevant aspects, are different from the ones that unrelated entities using reasonable economic judgement would make under comparable circumstances, which makes it impossible to determine the price that would be acceptable for both parties to a transaction considering their appropriate perspective and realistically available options at the time of entering the transaction. A transaction may be recognized to lack commercial reasonableness found in arrangements made between unrelated entities, if a group (that a related party is part of) as a whole is in a worst situation as a result of entering into the transaction than it was before taxation.

Summarizing the guidelines, it should be stressed that the main prerequisite for disregarding a transaction or replacing it with another one is the impossibility to determine the price of the correctly delineated actual transaction between related parties, considering the perspective of both parties as well as realistically available options. It is not possible to determine the shared part having two separate positions of negotiating entities guided by reasonable judgement and advancing their own economic interests.

Thus, analysis of the prerequisites for disregarding or replacing a transaction between related parries shows clear differences between the Polish draft act and the OECD Guidelines. Additionally, considering the Polish legislator's underspecification of the details as regards the indicated prerequisites, serious risk presents itself that as a result of the determination of the Polish tax authorities regarding related parties, economic double taxation will arise and will be im-

possible to eliminate. In effect, the provisions of the law will lead to irreversible consequences affecting the financial condition of the Polish economic entities, which will result in limitation of investment and lower economic growth.

Conclusions

Application of transfer prices for the purpose of transferring income from one related party to another should be deemed an explicitly negative phenomenon. Analysis of the correctness of transfer prices applied by related parties is a complex and multifaceted issue. The provisions regarding transfer prices, which are being introduced in Poland, increase the burden on related parties due to the imposition of new obligations of establishing transfer prices on an ongoing basis in line with the terms and conditions that unrelated entities would establish. Some of them – regarding adjustments of transfer prices, identification of the links among entities or the introduction of instruments bearing the characteristics of a special clause – cause growing concerns regarding the possibilities of eliminating double economic taxation in case of the application of these provisions. What is more, references to an important part of the revision of the OECD Guidelines of 2017 regarding analysis of risk and intangible assets are missing from the draft act. As indicated in the OECD Guidelines, these issues cause the largest problems as to interpretation for both related parties and tax authorities. Ignoring this part of the OECD Guidelines in the new regulations may lead to premature adoption of the "last resort" mechanism, that is, disregarding a transaction or changing its character.

Adoption of new regulations requires that procedures for elimination of double taxation be improved in the context of the perspective of an increase in the number of disputes arising from the application of the new provisions of the law by tax authorities. Handling international disputes over transfer prices by the Polish tax administration is time-consuming and requires considerable involvement. The non-existence of effective procedures and norms for pricing complicated transactions, such as the ones concerned with intangible assets, will lead to international disputes with the administrations of other countries, which can take many years.

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