Transfer Pricing Adjustments

(Operational TP, VAT and Customs)

2015
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1. Introduction to Transfer pricing adjustments

a. Price setting and price checking

The OECD Guidelines require that prices in transactions between related parties be set at a level that would have occurred in the same transactions had they taken place between unrelated parties. As a general rule, prices in third-party transactions are set \textit{ex ante} when the transaction is first negotiated. Nevertheless, most documentation studies focus on testing the "arm's-length nature" of transfer prices after the results of the transaction are known. While the OECD Guidelines and the transfer pricing rules of certain countries may place greater emphasis on the arm's-length nature of the price-setting process, tax authorities in these countries nevertheless look at after-the-fact results and insist upon testing after-the-fact results. In terms of formal rules, this appears to vary by tax authority.

Many EU member States' documentation requirements place a substantial emphasis upon documenting projections and expectations, which would suggest a focus on whether prices were set in an arm's-length manner. On the other hand, US rules emphasize the testing of after-the-fact results with little concern for how prices are set.

The EU Joint Transfer Pricing Forum has published in January 2013 a supplementary discussion paper on Compensating/Year-End adjustments\textsuperscript{1} and in May 2013 a draft Report on Compensating/Year-End Adjustments\textsuperscript{2}.

In conclusion, in general terms, we expect that many tax authorities globally will continue to focus on \textit{ex post} results.

The importance of price checking is also relative to the functional analysis of the entity concerned, particularly to its risk profile: the assumption of risk will normally lead to \textit{ex post} outcomes that may be either higher or lower than \textit{ex ante} expectations. Thus, whether it is relatively easy to take risk into account in evaluating \textit{ex ante} expectations, it may prove difficult to test \textit{ex post} results in the case of risk-taking entities.

On the other hand, in the case of a distributor that has been set up as a limited-risk entity, \textit{ex post} results should not deviate much from expected \textit{ex ante} results. If they do, such deviations may be evidence that the transfer pricing policy, in effect, did not work as intended.

In the case of a divergence between the actual and target/budget net margin, the choice of “no true-up”, i.e. not make any adjustment for the current year and only adjust prospectively for future years, seems inconsistent with any characterization of the distributor as "limited-risk" and may give rise to risk. The implementation of a price checking mechanism to achieve an arm's length net operating margin avoids this.

\textsuperscript{1} DOC: JTPF/004/2013/EN
\textsuperscript{2} DOC: JTPF/009/2013/EN
Price setting policy adopted by a MNE for inter-company sales products is based on “resale price minus” method. Any differences in the quantity sold, the sales price, or the operating expenses of the distributor would lead to discrepancies from the target margin.

Any discrepancy between the target margin and the actual realized margin may be reconciled either by adjusting the transfer prices throughout the year or by making an out-of-period adjustment on the tax return. A tax return adjustment creates a book-tax difference for the company operating it.

b. Example

<table>
<thead>
<tr>
<th>Principal/Trading</th>
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<tbody>
<tr>
<td>A</td>
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<tr>
<td>BC</td>
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<tr>
<td>PS</td>
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<td>PC</td>
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<thead>
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<th>Production</th>
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<tr>
<td>A</td>
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<td>BC</td>
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<td>PS</td>
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<thead>
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<th>Distributor</th>
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<tr>
<td>A</td>
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<tr>
<td>BC</td>
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<tr>
<td>PS</td>
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<tr>
<td>PC</td>
</tr>
</tbody>
</table>

A = Activity  
BC = Responsibility Centre  
PS = Price Setting  
PC = Price/Profit Checking

c. Periodic monitoring and TP adjustments

Laufende unterjährige Preisanpassungen nach vorne - Prospective Adjustments

1.1.2013  Q1  Q2  Q3  31.12.2013
Under a periodic-monitoring approach, a tax department tracks and compares actual results with forecasts on an ongoing basis. As a general rule, the longer the forecast period is, the less reliable is the pricing mechanisms. Therefore, reducing the forecast periods by resetting transfer prices periodically during the year helps ensure the results match the transfer-pricing policies.

Obviously, accuracy comes at some cost, since every price reset requires time and resources. Thus companies must evaluate carefully what the "optimal" adjustment period should be. In our experience, the optimal period will differ by company and industry. Companies that operate in very stable and mature industries have stable prices that need only infrequent adjustment, in some cases even less often than once a year. Other companies operate in an environment where prices and costs can change significantly throughout the year, which requires multiple adjustments, on a quarterly or monthly basis.

Other factors influencing this decision will be:

- The size of expected deviations, also on the basis of historical performances of transfer pricing policy adopted; and
- The degree of tolerance accepted by the company for deviations from the stated policy on a year-to-year basis. Even if the general policy calls for results in a range with a median, as it was found by TPA in the updated benchmark analysis, some companies will tolerate results that fall outside that range if the deviations are not too extreme and not systematic, since both the OECD Guidelines and many countries allow transfer prices to be tested on a multi-year basis.

d. Out of period adjustments

\textit{Preisanpassung zum Jahresende – Retrospective Adjustment}

The other approach to ensure that results match the stated transfer-pricing policy is to make year-end adjustments. Such lump-sum adjustments are typically made around or after the last day of a
Generally speaking, companies can also adjust the amount of taxable income to reflect an arm's-length tax result after the financial books are closed for the year, but before the tax return is filed. This creates a book-to-tax difference, which can increase the audit risk for income tax, as well as raise customs/VAT issues. In addition, many countries do not allow after-period adjustments to either the taxable income or the statutory books. Thus, a company may find itself increasing the taxable income of one affiliate without providing an offsetting deduction for the other.

For these reasons, TPA recommends a MNE to operate periodic adjustments, and not out-of-period and/or book adjustments.

Also in consideration of the relevant industry and the following features of A MNE business:

- Limited variance in the sales prices to final customers over the year. This should be the case even whether, in a MNE’s industry, sales prices to final customers are not in the hands of the company; and
- Limited variance in the costs of manufacturing of the products.

We recommend a MNE to monitor (price checking) net margins achieved for the current year in the fourth quarter (Q4) of the year (November) and adjust transfer prices whether needed.

We could understand that IT/accounting system currently adopted by A MNE would allow the company to adjust at that time (Q4) only the inventory values of products but not the impact on P&L of inter-company transactions. Therefore, we would recommend the company to adjust retroactively in Q3 (September, even if this may imply to accept a larger deviation) on the basis of the margin realized on the transactions performed during the first 6-to-8 months of the year, and prospectively (price setting) for the sales of Q4.

Alternatively, whether there is a feeling that adjusting in September will not be enough to ensure results within an arm’s length range, because of limited reliability/availability of data at that period or because of particularly significant price changes occurred after, a manual adjustment could be done in Q4, i.e. by the release of credit/debt notes to subsidiaries.

Final data available at year-end will be utilized for updating the price setting policy for the coming year (as per January, 1st).

e. Experience with TP adjustments in Germany

Germany follows in general the OECD TP Guidelines, which require that prices in transactions between related parties be set at a level that would have occurred in the same transactions had...
they taken place between unrelated parties. Germany has various TP regulations in place.

A periodic-monitoring and adjustment approach (price checking) is necessary in Germany in cases of a price setting policy based on budgets (Administrative principles - Procedures’, issued in April 2005, chapter 3.4.12.6).

Germany has regulations in place, which deal with TP adjustments. The “Administrative principles - Procedures” state in chapter 3.4.12.8:

It is clearly indicated, that the German authorities do accept ex-post TP adjustments only in cases, which follow the following conditions:

- Upfront agreement regarding relevant price setting factors between the involved parties must be in place;
- Ex post adjustments have to be based on conditions and factors, which were in place ex ante;
- A ex post adjustment must be based on uncertainties, which have been in place at the moment of conclusion of the contract / transaction (interest rate European Central Bank or oil price), but not on uncertainties under influence of one of the involved parties; and
- In extraordinary cases exemptions of these general rules are possible if the taxpayer can show and substantiate, that these ex post adjustments would have been made by thirds parties as well.

The German tax authorities have started in 2012 to draft new regulations on a Price setting approach in line with the discussion at the OECD.

f. Discussion of Timing Issues at the OECD (2012)

The OECD has started to discuss the different approaches including an invitation for comments in autumn 2012. The issues are

- Price setting & price/profit testing
- Ex ante pricing vs. post hoc pricing
- Use of hindsight
- Legal vs. economics vs. valuations
- Price adjustment clauses in third party situations?
2. Transfer Pricing Adjustments in Practice

a. Introduction

As a general rule, prices in third-party transactions are set when the transaction is first negotiated. Accordingly, transfer pricing rules of many countries focus on the arm’s length nature of the price-setting process.

How to react when actual financial results differ from those predicted under a certain transfer pricing methodology and are outside of arm’s length range?

OECD Guidelines indicate that prices in transactions between related parties be set at a level that would have occurred in the same transactions had they taken place between unrelated parties.
Prospective or retroactive adjustments?

A company that aims to win market shares and adopts aggressive penetration strategies needs flexibility to manage its contracts with (new) customers. Such a company will likely be in possession of the information/inputs needed for adjusting prices only as the year is coming to the end.

Prospective adjustments only may not lead the company to results targeted; a year-end adjustment will likely be needed. A prospective monthly adjustments system will allow the company less tolerance, but it is administratively more cumbersome.

Year-end adjustments pose additional tax issues.

Bundled or unbundled approach?

The Administrative burden differs generally:

- Bundled approach: maximum
- Unbundled approach: minimum

The German ministry of finance has indicated to prefer generally an unbundled approach.

Some flexibility features

E.g. adjustments system based on “corridors” of ROS for each category of hardware (e.g. between 1.8% and 3% for networks) rather than targeted ROS (e.g. 2.5% for networks). The adjustments will be made only in case the profitability of the tested companies departs from the “corridor”.

PS = price setting (statutory)
PC = profit checking (statutory and/or tax)
→ = prospective adjustments
← = retrospective adjustments
b. **Tax implications**

Local country rules regarding year-end adjustments can vary considerably. For example, German tax authorities may not allow the adjustment:

- if it is not operated on the basis of an agreement which is in place at the beginning of the FY concerned, regulating price setting factors and related adjustments, or
- the company is not otherwise able to show to tax authorities that the same adjustment would have been made by third parties as well (“Administrative Principles - Procedures” 3, Chapter 3.4.12.8)

Many tax authorities may view year-end adjustments as an examination trigger

Some tax authorities view adjustments as non-deductible voluntary contribution or distribution of capital (e.g. Japan) – double taxation issues

c. **Customs implications**

- Goods moved across borders and imported from one customs jurisdiction into another are potentially subject to customs duties (and other indirect taxes, VAT etc)

- Customs duties are generally levied *ad valorem*, and countries have complex regulations for determining the value of imported goods for customs purposes

- WTO members are bound by the WTO Customs Valuation Agreement, requiring, as a general rule, that customs value to be determined on the basis of the “transaction value” (i.e. the price paid or payable for the goods when sold for export to the country of importation) subject to certain prescribed adjustments and conditions

- In a sale between related parties, transaction value eligible only if the price has not been influenced by the relationship between the parties: consistency with arm’s length standard

  Documentation: many countries explicitly stated that a transfer pricing study does not constitute sufficient evidence for validating value of goods for customs purposes.

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3 German Administrative Guidelines “Verwaltungsgrundsätze Verfahren”
• WTO Valuation Agreement does not specifically provide for the treatment of adjustments to transaction value; national legislation will determine the behaviour of respective customs authorities

• An apparent contradiction: the transaction value principle states that the price of the goods “when sold for export to the country of importation” should constitute the customs value

• Customs Co-operation Council (CCC) Secretariat stated that the expression “when sold for export” merely indicates the type of transaction involved and made clear the price review clauses alone should not preclude valuation under a transaction value method

• As a matter of practice, customs authorities tend to view year-end adjustments as directly applicable to the goods imported and part of the price paid for those goods (especially if it is not an occasional adjustment, but a usual practice).

• Companies are typically in a lose-lose situation:
  - For upward price adjustments, customs authorities will generally require the importer to declare such higher amount and pay duty on the difference
  - For downward adjustments, the importer will face problems having customs administration taking account of such rebates (and possibly get refund of duties). As an example, Canadian Customs Act explicitly prohibits to take into account any rebate or other decrease in the price paid after importation (Article. 48(5)(c) Canadian Customs Act).
d. VAT implications (Europe)

(1) Prospective (monthly or quarterly) adjustments:

- Invoices have to be issued meeting all the invoice requirements.

(2) Retroactive (quarterly or year-end) adjustments:

- Retroactive quarterly adjustments result into the obligation to issue credit notes relating to the previous supplies.
- When the credited amounts are with VAT (standard/reduced rate), the credited VAT should be claimed back from the local tax authorities. The credited VAT becomes due by the LDR.
- When the credited amounts are without VAT (in case of intra-Community supplies of goods), the credited amounts have to be accounted for as adjustments on the so-called EC Sales Listing (as from January 1, 2010 called EC Transaction Listing).
- Credited amounts related to intra-Community supplies will in principle result into the obligation to make adjustments to previous submitted Intrastat returns.

TP Software tools (i.e. Hyperion for Transfer Pricing (HTP))

Today’s business environment requires a move from the manual tracking, maintenance and management towards a more software driven solution. Only to the extend your Business Control Framework will allow you to track, maintain and manage your approach global tax /transfer pricing risk through internal software solutions, a ‘real time’ mitigation of these risks can be achieved.

Implementing the Transfer Pricing Control Framework using HTP software allows you to

- Mitigate risk through:
  - Central monitoring and coordination
  - Integrated audit trail
  - Unified tax and finance data repository, centrally consolidated

- Optimize tax return and transfer pricing documentation through:
  - Proactive management of your transfer pricing
  - Financial simulations for any transfer pricing scenario
  - Bottom line impact

- Save operational costs through:
  - Process automation
  - Avoid spread sheet nightmare
  - Reduce consulting fees
The TPA/HTP proposition consists of:

1. Automatic calculation of periodic and Year-end adjustments.
2. Tax planning optimization through Transfer Pricing simulations.
3. Progress status to provide full control to mitigate risk through optimizing your tax return, i.e. “real time tax/transfer pricing planning”.
4. Software is used as supporting tool for your Transfer Pricing Reporting Manager, i.e. limit your need for additional in-house FTEs.

The technical requirements are:

The TPA/HTP platform is fitting multinationals with operations in 10+ countries while having a sufficient level of financial data warehouse in place. However, the platform solution is scalable to multinationals with fewer countries and a less developed financial data warehouse.

The TPA/HTP platform runs using leading Oracle Financial Management (HFM) solution as the main operational transfer pricing and financial database of the solution and can be integrated to almost any ERP system.

For customers who are not yet running Oracle HFM, we can provide a global software offer including Hyperion Financial Management & Hyperion Transfer Pricing. Alternatively, we can support a customized integration project with your existing financial data warehouse.

e. TPA In-house Services

The frequent control of the transfer pricing system within this financial Transfer Pricing Management model, depending on the case monthly, quarterly or semi-annual, requires besides the operative transfer pricing know-how also the knowledge of the existing IT system and especially time-based capacity. It has to be considered, however, how the tasks can be accomplished, internally or externally with the assistance of a consultant.

TPA Global provides the suitable projection: Experienced transfer pricing experts visit you at the date stipulated beforehand (e.g. in the beginning of every quarter), analyses the price and /or margin situation of the past quarter per transaction or per corporation, makes an necessary adjustments for the upcoming quarter and adjusts the TP system according to the policy. Consultation with the responsible person for customs or tax takes place equivalent.

Besides this controlling, the concept provides an additional benefit: Where required, supplementary TP risks as well as chances are detected precociously and the global network of TPA Global is available within 50 countries worldwide if needed.
The consultant of TPA have extensive and long lasting expertise as transfer pricing specialists and are familiar with both sides: Corporation as well as consulting. Regular continuing education concerning present developments domestic and abroad are naturally occur and provide therefore additionally an continuing know-how transfer within the company.

f. TP adjustment manual

The preparation of a TP manual and a global communication of a consistent TP adjustment policy strengthen this policy towards all tax administrations and limit the risks of non-acceptance significantly.

3. TPA’s Recommendations

- Follow the German requirements and implement a periodic monitoring and TP adjustment mechanism;

- Monitor on a quarterly basis (price checking) and monitor net margins achieved for the current year in the fourth quarter (Q4) of the year (December) and adjust transfer prices whether needed.

- Prepare a TP adjustment manual

- Use available software solutions to streamline processes

- Take into account capacity issues and use external capacities
## Appendices

### Appendix A: Country overviews

<table>
<thead>
<tr>
<th>Country</th>
<th>CIT</th>
<th>Customs Duty</th>
<th>VAT (other indirect tax)</th>
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<tbody>
<tr>
<td>Australia</td>
<td>Upward adjustments permitted after year-end. For downward adjustments need to demonstrate there was a binding agreement with foreign supplier acknowledging an adjustment would be made in line with arm’s length principle.</td>
<td>Some cooperation between ATO and ACS. ACS will consider customs valuation adjustments based on APA or TP audit, although only within approved pre-determined range. Taxpayers should consider Valuation Advice (VA) ruling. A VA is valid for five years and indemnifies against customs penalties.</td>
<td>GST will be impacted by adjustments in customs value. ATO requires all customs duty adjustments to be processed through the integrated cargo system (ICS) so GST is adjusted automatically.</td>
</tr>
<tr>
<td>China</td>
<td>Statutory year end adjustments difficult. Upward adjustments to income tax return allowed; currently no procedures for downward adjustments.</td>
<td>Voluntary upward adjustments are possible within three years; downward adjustments not allowed. Customs authorities now beginning to request TP documentation when performing customs audits.</td>
<td>Year end adjustment to an export value may be deemed to be a domestic sale and caught by 17% VAT.</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Adjustments upwards permitted after year-end. Downward adjustments allowed if binding agreement in place with supplier consistent with arm’s length principle.</td>
<td>Customs duty limited to liquor, tobacco and other restricted items; Currently no formal voluntary adjustment/disclosure rules in place.</td>
<td>No VAT applicable.</td>
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<tr>
<th>Country</th>
<th>CIT</th>
<th>Customs Duty</th>
<th>VAT (other indirect tax)</th>
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<tbody>
<tr>
<td>India</td>
<td>Year end adjustments possible prior to close of accounts; upward adjustment to the income tax return also possible but can be difficult in practice.</td>
<td>If there is a change in the method of computation or assumptions or if additional facts are brought to light, the Special Valuations Branch of Customs (SVB) can consider a request by the importer for amendment. This could potentially result in a refund of customs duty as well.</td>
<td>VAT which is leviable on sale of goods would not have any impact on import of goods into India. GST laws which are currently being drafted will be levied on imported goods, with a valuation/adjusted valuation based on the SVB order.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>No formal procedures for self-initiated adjustments</td>
<td>Import value can only be adjusted by the customs official during the importation or at the time of customs audit. Therefore, it is not currently possible to adjust customs valuation based on transfer pricing adjustment.</td>
<td>VAT adjustments only possible based on customs audits.</td>
</tr>
<tr>
<td>Japan</td>
<td>Written guidelines were issued for self-initiated adjustments (TP commissioner’s directive) on October 22, 2006.</td>
<td>Voluntary disclosure system is in place for adjustments; refunds of duty are possible through this mechanism.</td>
<td>A customs valuation adjustment will trigger a consumption tax adjustment on imports (rate currently 5%).</td>
</tr>
<tr>
<td>Country</td>
<td>CIT</td>
<td>Customs Duty</td>
<td>VAT (other indirect tax)</td>
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<tr>
<td>Korea</td>
<td>Adjustment permitted to tax return. Three year limitation on downward adjustment to income.</td>
<td>Voluntary disclosure system in place for upward adjustments</td>
<td>Adjustments based on customs duty revaluations</td>
</tr>
<tr>
<td>Singapore</td>
<td>Adjustments permitted if within range of TP documentation</td>
<td>Customs duty applicable to very limited range of goods; voluntary disclosures are possible although no formal procedures in place</td>
<td>GST adjusted in line with Customs Duty valuation</td>
</tr>
<tr>
<td>Taiwan</td>
<td>Self-initiated adjustments to the median of the interquartile range are allowed under the comparable profits method.</td>
<td>No formal mechanism; however adjustments may be allowed in some cases in practice</td>
<td>As for Customs duty</td>
</tr>
<tr>
<td>Thailand</td>
<td>Adjustments permitted if adequate documentation/agreements etc exist.</td>
<td>Director-General can make refund based on calculation error, provided that such refund shall not be made after two years from the date of importation or exportation.</td>
<td>No formal procedures for adjustment</td>
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<tr>
<th>Country</th>
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<tbody>
<tr>
<td>USA</td>
<td>Adjustments are the normal procedure (profit split methods privileged)</td>
<td>Companies may choose among the following options: 1. Post-entry adjustment (shortcoming: limited time), 2. Administrative protests, 3. Prior Disclosure (limited sanctions; exposure to Sec. 1055A), 4. Customs Reconciliation program (upon authorization). Preferred method for valuation adjustments seems to be the Customs Reconciliation program, allowing the importer to subsequently provide customs authorities with Information (incl. value) not available at the time of entry of the goods. Under the Reconciliation program, the importer would: -- declare a provisional value at the time of entry of the goods; -- complete the declaration at a later date when the information is available, within 21 months from the date of entry.</td>
<td></td>
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**Reference B1:** EU JOINT TRANSFER PRICING FORUM - Supplementary Discussion Paper on Compensating/Year-End Adjustments (January 2013)

**Reference B2:** EU JOINT TRANSFER PRICING FORUM – Draft report on Compensating/Year-End Adjustments (May 2013)
Case study TP / VAT / customs

**ProdCo** (CP+)  **PrincipalCo** (Matchmaker)  **SalesCo** (RSM)

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<tr>
<th></th>
<th>ProdCo</th>
<th>PrincipalCo</th>
<th>SalesCo</th>
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<tbody>
<tr>
<td>TP</td>
<td>30</td>
<td>90</td>
<td></td>
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<tr>
<td>VAT value</td>
<td>30</td>
<td>60 (90-30)</td>
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<tr>
<td>Customs value</td>
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**Remarks**

Market price 100

Variation 1: Year End Adjustment  SalesCo

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<tr>
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<td>30</td>
<td>80</td>
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<tr>
<td>VAT value</td>
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<td>50 (80-30)</td>
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<td>Customs value</td>
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Without VAT adjustment the VAT tax base after the TP adjustment is 10 too high

Total risk 10 * VAT rate

Variation 2: Year End Adjustment  ProdCo

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<tr>
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<th>ProdCo</th>
<th>PrincipalCo</th>
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<tr>
<td>TP</td>
<td>40</td>
<td>90</td>
<td></td>
</tr>
<tr>
<td>VAT value</td>
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<td>50 (90-40)</td>
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<tr>
<td>Customs value</td>
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</tr>
</tbody>
</table>

Without VAT adjustment the VAT tax base after the TP adjustment is 1x10 too low/1x10 too high

Without customs adjustment the customs value is 10 too high

Total risk 20*VAT rate respectively 10*customs tarif