Transfer pricing in the Faroe Islands

This guide comprises a generalized description of the transfer pricing legislation in the Faroes. Further, it describes the obligation to disclose information on intercompany transactions and document intercompany prices and terms - also known as the documentation requirement.

The guidance refers to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010-edition, hereinafter "the OECD Guidelines". Chapters of the 2010 edition were last updated in 2015 with the reports "Aligning Transfer Pricing Outcomes with Value Creation" and Guidance on Transfer Pricing Documentation and Country-by-Country Reporting". The updates were published on the 10 July 2017 with the 2017-edition of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

According to the arm's length principle in paragraph 37 a in the national Tax Act (Skattalógin – hereinafter "SL") related parties are supposed to apply prices and terms in their commercial or economic relations as had they been made between independent parties.

The arm's length principle

The arm's length principle in national law is described in SL paragraph 37 a. According to paragraph 37 a following taxpayers fall within the scope of the provision:

1. legal entities controlled by foreign individuals or legal persons;
2. individuals or legal entities with control over legal persons;
3. legal entities within the same group as other legal persons;
4. individuals or legal entities with permanent establishments abroad;
5. individuals or legal entities, which are considered a foreign individual or legal person with a permanent establishment in the Faroe Islands.

Please refer to SL paragraph 37 a, subsection 1.

Taxpayers associated with legal persons in SL subsection 1, no. 3 refers to cases where the same group of owners controls several legal entities. In this context, there is *control* when the taxpayer directly or indirectly or with related parties jointly owns more than 50% of the shares or capital in the company or controls more than 50% of the votes.

Individuals and legal entities are deemed foreign, if they are domiciled in Denmark, Greenland or another foreign country, referring to the provisions of a tax treaty.

The obligation to disclose all information regarding all controlled transactions and to fulfil the documentation requirement in SL paragraph 118 a, applies to the same group of taxpayers as the arm's length principle in paragraph 37 a.

Legal persons

The term *"legal person"* includes estates of deceased persons and various companies provided that these are liable to pay tax in the Faroe Islands in accordance to SL paragraph 1 or 2. The scope of SL paragraph 1 extends to "*kommanditfeløg*", which is a company structure where the participants as a minimum comprise a "*komplementar"*, who is personally liable for any obligations of the company and a "*kommandist",* which's responsibility is limited to the invested capital. Furthermore, the legal person is required to liable pay tax.

Permanent establishment

A permanent establishment is a fixed place of business through which the business of an enterprise wholly or partly is carried on.

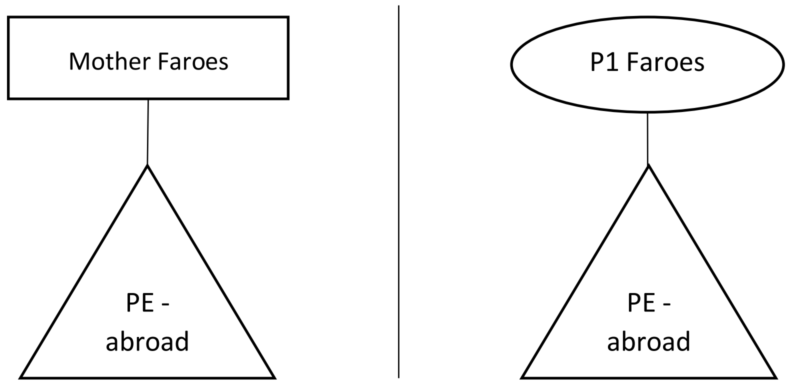
SL paragraph 37 a, subsection 1, no. 4 and no. 5 applies to taxpayers with permanent establishments abroad and foreign individuals and legal persons with permanent establishments in the Faroe Islands.

Owners or co-owners carrying out or participating in business activities or "samløgumenn" or "samútgerðarmenn", that are liable to pay tax in the Faroe Islands in accordance to SL paragraph 2, subsection 1, (d) are within the scope of SL paragraph 37 a.

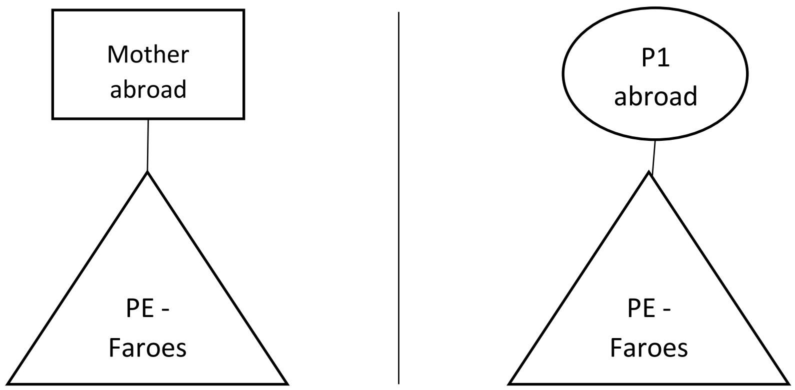
Please note that SL paragraph 37 a applies to the foreign individual or legal entity that is liable to pay tax in the Faroe Islands in accordance to SL paragraph 2, subsection 1, (d) and not the permanent establishment.

Thus, the scope of the provision includes foreign trusts and associations when these have a permanent establishment in the Faroe Islands.

Examples



The example above illustrates the scenarios where Faroese taxpayers have permanent establishments abroad.



The example above illustrates the scenarios where foreign taxable entities have permanent establishments in the Faroe Islands.

Permanent establishment in the Faroe Islands

SL paragraph 2, subsection 1, (d) and paragraph 2 subsection 3 outline when a permanent establishment is established in the Faroe Islands.

In assessing whether an establishment constitutes a permanent establishment as provided for in SL paragraph 2, subsection 1, (d) and paragraph 2 subsection 3 the term should be interpreted in accordance to the relevant tax treaty, which is further described in the OECD Model Tax Convention on Income and on Capital. According to the Convention article 5, the term *"permanent establishments"* means:

a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop, and
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Building sites or construction or installation projects also constitute permanent establishments in accordance to SL paragraph 1, subsection 3, provided that the duration of the plans last more than 30 days. This is also the case for activities relating to planning, control, advisory and personal assistance in relation to the mentioned plans.

According to article 5, subsection 4, the OECD Model Tax Convention on Income and on Capital does not include:

a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

Place of management

Foreign companies, trusts and such may be liable to pay tax to the Faroe Islands in accordance to SL paragraph 1, subsection 1, provided that the place of management is in the Faroe Islands, disregarding which country the entity is registered in.

The arm's length principle in SL paragraph 37 a applies to companies, trusts and such that are liable to pay tax in the Faroe Islands in accordance to SL paragraph 1, subsection 1.

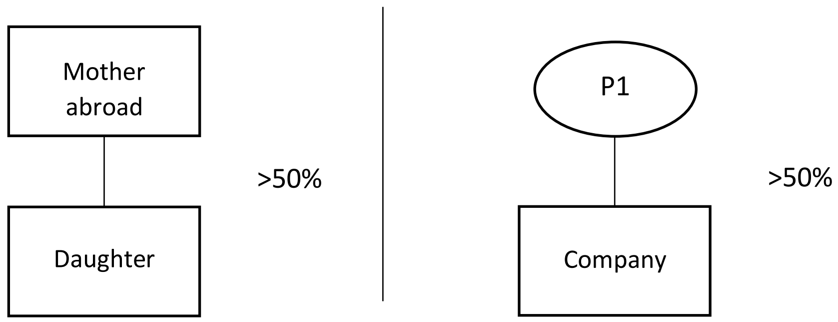
Control in SL paragraph 37 a

Control in accordance to SL paragraph 37 a has a taxpayer, who

- directly or indirectly owns more than 50% of the shares or capital; or
- directly or indirectly controls more than 50% of the votes.

Direct control

Following examples illustrate that a legal entity or individual is required to hold more than 50% of the shares or capital or control more than 50% of the votes in the company in order to have direct control.



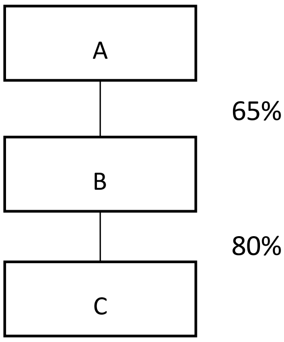
1. if the mother owns more than 50% of the shares or capital; or
2. if the mother owns more than 50% of the votes.

1. if an individual owns more than 50% of the shares or capital; or
2. if an individual owns more than 50% of the votes.

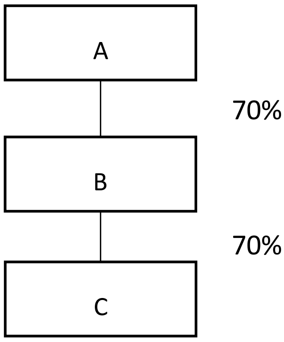
Indirect control

An individual or a legal entity indirectly controls a legal entity if the person in question owns the legal entity through a holding company. In relation hereto, it is important to make a distinction between control via ownership or via voting rights.

Ownership



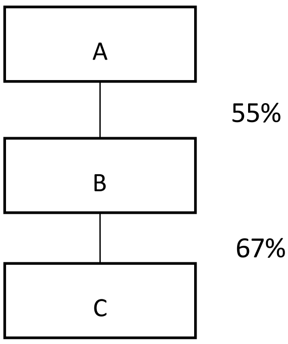
A controls C, as the company owns 52% of the capital in the company (65%*80%),



A does not have a controlling interest in C, as the company's portion of the company's capital only comprises 49% (70%*70%).

Voting rights

When there is indirect control via voting rights, A must either independently or through other companies over which A exercises control, be in charge of more than 50% of the voting rights in C, or jointly with other legal entities within the group control more than 50% of the votes.

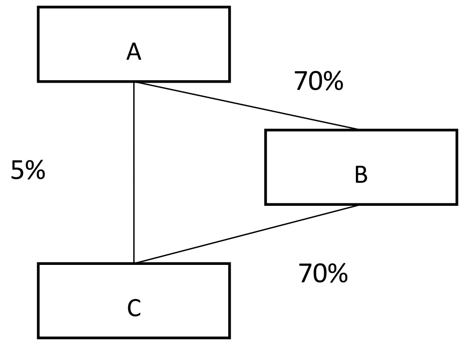


As A controls 55% of the votes in B, A exercises direct control over B. B controls more than 67% of the votes in C, and thus, has direct control over C. Hence, A indirectly controls C via voting rights.

Control – direct and indirect

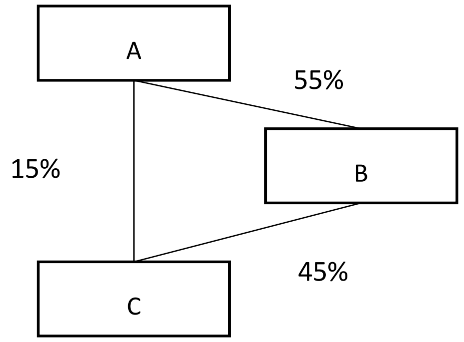
According to SL paragraph 37 a, an entity can be deemed to have control via a combination of direct or indirect control, including both ownership and voting rights.

Ownership

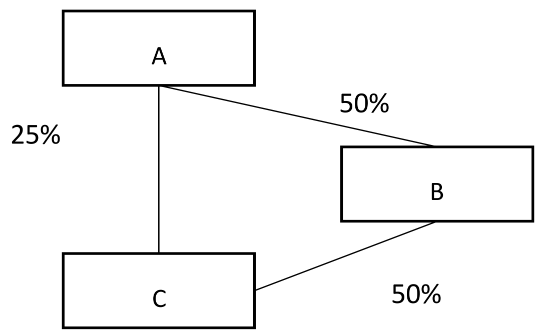


A holds 70% of the capital in B and 5% in C. B holds 70% of the capital in C. Hence, A indirectly owns 49% of the capital in C via B. Further, A directly owns 5% of the capital in C. As a result A owns 49% + 5% = 54% of C and consequently controls C.

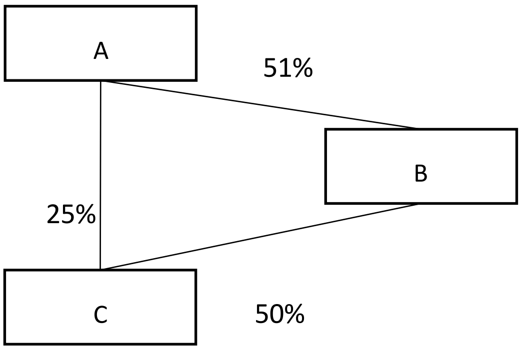
Voting rights



A controls 55% of the voting rights in B, and B controls 45% of the voting rights in C. As a result A indirectly has 45% of the votes in C as well as A directly has 15% of the votes in C. Consequently, A controls a total of 45% + 15% = 60% of the votes in A. Thus, A indirectly controls C.



A controls 50% of the votes in B, which is not more than 50% and consequently, A does not control B. As a result, A holds 25% of the votes in C.

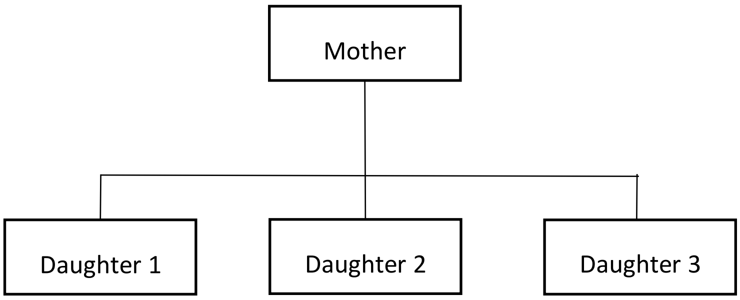


A holds 51% of the votes in B and controls B. B holds 50% of the votes in C. As a result, A holds a total of 25% + 50% of the votes in C. Thus, A controls C.

Member of a group with other legal entities

Taxpayers in the same group as a legal entity fall within the scope of SL paragraph 37 a, subsection 1, no. 3. Taxpayers in the same group as a legal entity, refers to the case when a group of owners control several companies. The term “*control*” should be read in the same way as *control* mentioned in previous sections.

For instance, the sister companies 1, 2 and 3 in the figure below, are in the same group. Moreover, the daughters are in the same group as the mother as it controls the daughter companies.

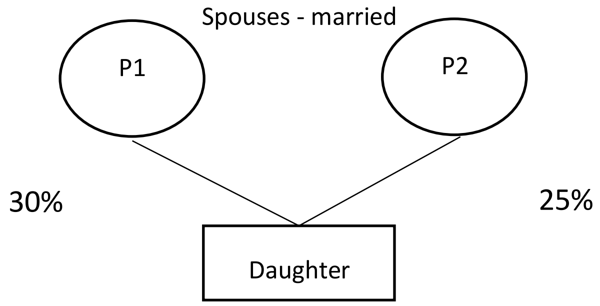


Individuals

Individuals covered by the scope of SL paragraph 37 a often comprise shareholders, members of co-operatives or self-employed business people.

The scope of *control* in the provision does not include control over individuals. Thus, an individual can only be covered by SL paragraph 37 a in accordance to paragraph 37 a, subsection 1, no. 2, 4 and 5.

Example:



P1 owns 30% and P2 owns 25% of the shares of Daughter. In total, the married couple jointly owns 55% of the shares exceeding the 50% threshold, as a married couple is considered related within the spirit of the law. Referring to paragraph 37 a, subsection 2 intercompany transactions between parties such as the ones in the example above are covered by paragraph 37 a and 118 a in SL.

Commercial and economic relations within the scope of SL paragraph 37 a

According to the preparatory works to paragraph 37 a in the SL, economic and commercial relations comprise all types of economic and commercial relations including e.g. services, lending services, transferals of goods and transferals of intangible assets for managerial purposes.

Consequently, the scope of paragraph 37 a covers all types of commercial and economic relations. Examples include, but are not limited to:

- purchase of goods and other current assets;
- sale of goods and other current assets;
- income from services, including management fees, and cost sharing;
- expenses from services, including management fees, and cost sharing;
- rental and leasing incomes;
- rental and leasing expenses;
- incomes deriving from intangible assets;
- expenses related to intangible assets;
- financial incomes;
- financial expenses;
- subsidies received, including waivers of loans;
- subsidies given, including waivers of loans;
- other incomes; and
- other expenses etc.

Related parties

The definition of the term *"control"* states, that it is to be interpreted as "the taxable entity directly or indirectly or with related parties jointly owns more than 50% of the shares or capital or controls more than 50% of the voting rights in the company." Please refer to SL paragraph 37 a, subsection 2, sub-paragraph 2.

Nevertheless, neither SL paragraph 37 a, nor the preparatory work to paragraphs 37 a and 118 a elaborate further on the scope of the term: *"related parties"*. However, the law on Taxation of Capital Gains (Kapitalvinningsskattalógin – hereinafter KVSL) paragraph 13, subsection 4 contains a definition of individuals and entities considered related to these, within the meaning of the provision. In assessing whether there is control or not, shares owned by following persons should be included:

- legal entities within the same group, including sister companies, please refer to paragraph 37 a subsection 2, 3. point;
- shareholders and persons related to them, refer to KVSL, paragraph 13, subsection 4; and
- companies, trusts and such, which the taxpayer controls due to ownership, articles, agreement or a joint management agreement.

When assessing whether an individual controls another legal entity, shares and voting rights held by relatives and trusts, and companies, which the individual controls, should be included.

According to KVSL paragraph 13, subsection 4 related parties of the taxpayer include spouse (by marriage), parents, grandparents, children, grandchildren as well as spouses of the mentioned persons and potential estates of any of these persons, should they be deceased. Adopted children, stepchildren and foster children are to be considered as biological family ties.

SL paragraph 118 a

The obligation to disclose all information regarding intercompany transactions, paragraph 118 a, subsection 1

According to paragraph SL 118 a, subsection 1, all taxpayers covered by paragraph 37 a, subsection 1 are required to stipulate the type and volume of their commercial and financial relations with related parties in accordance to paragraph 118 a, subsection 1 and paragraph 37 a, subsection 1. Regarding the scope of SL paragraph 37 a, please refer to the examples of commercial and economic relations provided for above.

The form S25.04 070316 below is an appendix to the tax return, which also contains guidance specifying how the form should be filled in. (The Form is only available in Faroese).

6. Aðrar upplýsingar

6.1. Er felagið umfatað av skattalógini §§ 37a og 118a?	☐ Ja	☐ Nei
6.2. Eru handilsligu/fíggjarligu handlarnir, sbrt. skattalógini § 37a, í inntøkuárinum størri enn kr. 500.000?	☐ Ja	☐ Nei
Um ja, frágreiðing:		
6.3. Hevur felagið skuld sbrt. skattalógini § 37b, sum er størri enn 1 mill. kr. og er lutfallið millum skuld og eginogn størri enn 4:1?	☐ Ja	☐ Nei
Um ja, frágreiðing:		
6.4. Hevur góðkendur grannskoðari hjálpt til við at seta upp skattskylduga inntøku?	☐ Ja	☐ Nei
6.5. Hevur felagið fingið eftirgivið skuld í árinum?	☐ Ja	☐ Nei
6.6. Er skuld umløgd til partapening í árinum?	☐ Ja	☐ Nei
6.7. Hevur felagið keypt ella selt virksemi í árinum?	☐ Ja	☐ Nei

Note that taxpayers are required to disclose any commercial or financial relations that they might have with related parties. However, they are not required to disclose the documentation for the intercompany pricing when filing the tax return.

Under point 6.2 in the Form the taxpayer has to state the name of the related entities with which the taxpayer has transacted, as well as the volume of the trades.

Documentation requirement and what it should contain

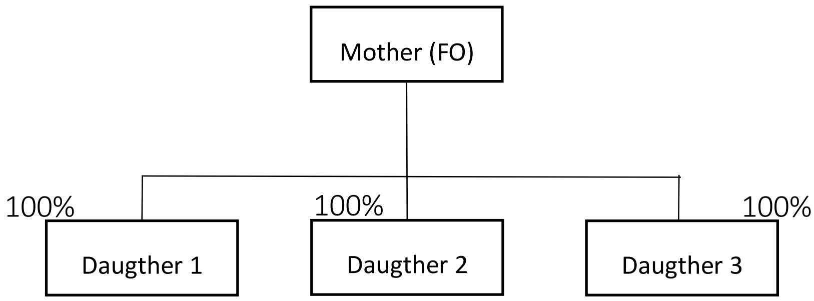
According to SL paragraph 118 a, subsection 4, the entities falling within the scope of the provision are required to produce and keep written documentation, which describes the pricing and terms in commercial or financial transactions with related parties.

The documentation requirement in SL paragraph 118 a applies to the same group of entities as the arm's length principle in paragraph 37 a. The material must be of such quality that it can serve as a basis for an assessment of whether the prices and terms are in accordance to the arm's length principle. The preparatory work to the provision does not say much as to what such documentation should include.

The scope of the documentation is dependent on the complexity of the taxpayer and the related parties that are parties to the transactions within the wording of paragraph 37 a. Moreover, the scope of the taxpayer relies on the taxpayer's business activities and the related parties. Thus, it is not possible to give a general description of what information should be submitted to TAKS.

On the other hand, an analysis under the arm's length principle generally requires information about the associated enterprises involved in the controlled transactions, the transactions at issue, the functions performed information derived from independent enterprises engaged in similar transactions or business etc. please refer to OECD Guidelines edition paragraph 5.17. The articles might be relevant too.

- To get an understanding of the business, it can be relevant to give an outline of the business;
- In order to get an overview of the group and shareholders the documentation should include a legal chart, which specifies the percentage held by each owner. If any agreements on voting rights exist these should be submitted. Find an example of a legal structure below:



- The documentation has to provide a description of how the group is organized and where these units are placed geographically;
- The documentation shall include a general description of the commercial activities;
- The documentation should include sales and operating results from three years preceding the transaction/s;
- Further, it should include a description of historical changes and possible restructurings and changes in functions and risks carried as well as an explanation of potential losses;
- Moreover, the documentation should include a general commercial or industry conditions affecting the taxpayer may also be relevant. (5.22)

If TAKS finds it necessary, TAKS can ask the taxpayer to elaborate further on the items listed above.

Commercial or financial relations falling within the scope of SL paragraphs 37 a and 118 a

- Transactions that, due to volume, are deemed insignificant, should not be analysed further. Taxpayers are however, required to disclose transaction type and transaction volumes for all intercompany transactions, significant and insignificant. Note that transactions exceeding 500,000 DKK must be disclosed on the corporate tax return, which is part of the obligation to disclose. That is not to say that individuals and enterprises should not keep documentation supporting intercompany pricing of transactions lower than the threshold.
- The documentation should contain information regarding transaction type. Further, the parties to each transaction must be specified as well as the transaction volumes. View an example below:

Transaction: Sales of goods	Buyer	Seller	Price
Goods	X	y	200,000
Total			200,000

Transaction: Loans	Borrower	Lender	Price
Loan	X	y	200,000
Total			200,000

- Further each transaction type must be described with regard to:
    - characteristics of property or services;
    - functional analysis, taking into account assets used and risks assumed;
    - contractual terms;
    - economic circumstances; and
    - business strategies.
- An outline of potential cost sharing agreements may also be relevant.

Comparability analysis

- The comparability analysis together with the information mentioned above forms the basis for an assessment of the pricing principles applied to the transactions in question, in order to determine whether these are arm's length.
- The comparability analysis must include a description of the pricing of the transactions as well as an explanation as to why the elected transfer pricing is in accordance with the arm's length principle and why the elected transfer pricing methods are considered most appropriate.
- The documentation must include intercompany agreements to which the taxpayer is a party.

The transfer prices are supposed to be determined based on the information readily available at the time of the transactions. Please refer to Chapter V in the OECD Guidelines. The chapter was updated with the report "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting."

Transfer pricing methods

OECD Guidelines Chapter II describes different methods to determine and verify arm's length prices and these can be used as guidance in determining transfer prices and terms as well as describing and analysing documents required in SL paragraph 118 a, subsection 4.

For further information on the transfer pricing methods, please refer to Chapter II in OECD Guidelines.

Traditional transaction methods

- CUP method (Chapter II, Part II, Section B)
- Resale method (Chapter II, Part II, Section C)
- Cost plus method (Chapter II, Part II, Section D)

Transactional profit methods

- Transactional net margin method (TNMM) (Chapter II, Part III, Section B)
- Profit split method (Chapter II, Part III, Section C)

When determining an arm's length price or assessing whether transfer prices are in accordance to the arm's length principle it does not suffice to choose one of the mentioned methods and apply it to all transfer prices. The reason being that prices heavily rely on the functions performed, the assets used and risks assumed for each transaction type.

Thus, the most appropriate transfer pricing method should be determined for each transaction, considering the functions, assets and risks. Please refer to Chapter II, section 2.2 in OECD Guidelines.

OECD Guidelines in general

OECD Guidelines provides guidance on the application of the arm's length principle. The principle is the international consensus governing the evaluation of transfer prices among associated enterprises.

On 23 May 2016, the OECD Council approved the amendments to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("Transfer Pricing Guidelines"), as set out in the 2015 BEPS Report on Actions 8-10 "Aligning Transfer Pricing Outcomes with Value Creation" and the 2015 BEPS Report on Action 13 "Transfer Pricing Documentation and Country-by-Country Reporting".[1]

The specific changes introduced in the Transfer Pricing Guidelines by these Reports are as follows:

- The current provisions of Chapter I, Section D of the Transfer Pricing Guidelines are deleted in their entirety and replaced by new guidance.
- Paragraphs are added to Chapter II of the Transfer Pricing Guidelines, immediately following paragraph 2.16.
- A new paragraph is inserted following paragraph 2.9.
- The current provisions of Chapter V of the Transfer Pricing Guidelines are deleted in their entirety and replaced by new guidance and annexes.

[1] http://www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm

- The current provisions of Chapter VI of the Transfer Pricing Guidelines and the annex to this Chapter are deleted in their entirety and replaced by new guidance and annex.
- The current provisions of Chapter VII of the Transfer Pricing Guidelines are deleted in their entirety and replaced by new guidance.
- The current provisions of Chapter VIII of the Transfer Pricing Guidelines are deleted in their entirety and replaced by new guidance.