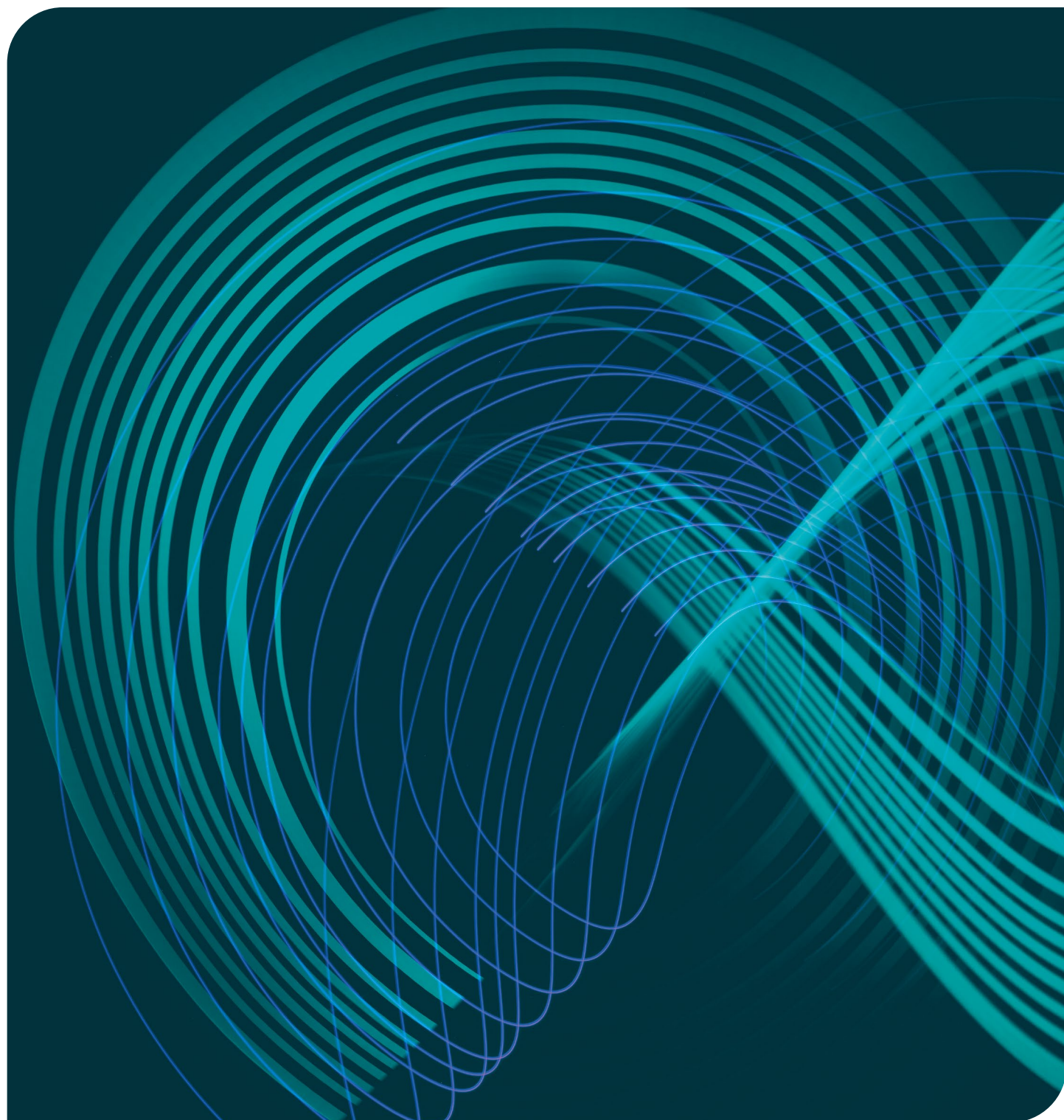




Perspectives on the proposed transfer pricing legislative changes for the European Union



Introduction to the Transfer Pricing Directive

As part of the Business Europe Framework for Income Taxation (“BEFIT”) package, published on September 12th, 2023, a proposal for issuing a European Directive, aimed at harmonising the EU regulatory framework on transfer pricing (“TP Directive”), was issued by the European Commission.

The proposal attempts to create standardised transfer pricing legislation for all of the Member States, basing on the unanimous acceptance of the principles stated in the OECD Transfer Pricing Guidelines (“OECD TP Guidelines”). The expected benefits of such an approach include the reduction of double taxation issues and the simplification of tax controversy, aimed at promoting the competitiveness of the European Single Market.

The OECD TP Guidelines currently provide comprehensive guidance on the application of the “arm’s length principle” for OECD members, including EU Member States, when dealing with transfer pricing both from a taxpayer and a tax administration perspective. Nevertheless, when compared to the domestic transfer pricing law of each Member State, they could be said to be ranked as non-binding recommendations.

According to the European Union Functioning Treaty, the TP law harmonisation process would be implemented through the transposition of the content of the TP Directive on transfer pricing into the domestic law of each EU Member State. This would, therefore, imply that, with the approval of the TP Directive, its principles would assume the rank of primary law, outranking the correspondent content of the OECD TP Guidelines.

Since each EU country’s domestic legal system currently has its own rules on transfer pricing, concerns arise from the eventual harmonization process, which would impose the same – binding – transfer pricing principles for each Member State, leading to potential implementation and coordination issues with current internal regulations.



Other harmonisation projects at a European and OECD level

The BEFIT package also includes a second separate proposal for a European Directive, aimed at setting common rules for computing the tax base of large groups (those within country by country reporting) of companies within the European Union. This additional proposal follows in the footsteps of the OECD's Pillar II and proposes a "simplified approach" for transfer pricing, based on the concept of the "risk framework" of the tested party. For example, this approach recommends that, where the remuneration of a low-risk distributor or a contract manufacturer (jointly characterised as the "tested party") needs to be set, the tested party's profit should be calculated to fall within an arm's length range of publicly available benchmarks. Therefore, the arm's length principle would basically rely on this "compliance framework approach." The framework would, in fact, attribute a specific level of risk to the tested party, based on predetermined elements (e.g. intangible ownership, inventory etc.) which would drive the positioning of its profit within the range. This might be seen as potentially moving away from the arm's length principle as we have known it.

It is worth mentioning that another attempt to reduce tax controversy by creating a unique approach on transfer pricing is currently in progress at the OECD level, within the Pillar I - Amount B project. In December 2022, the OECD/G20 Inclusive Framework published a public consultation paper, which aims at establishing a fixed remuneration for some basic distribution and marketing activities.

The proposed approach on transfer pricing, in the Amount B perspective, is also called the "simplified approach" and consists of the comparison of the profitability of the tested party with a pricing matrix, generated by a data set of approximate arm's length results. The matrix is structured to take into account a set of factors to better target the most appropriate (arm's length) profitability threshold (i.e. operating asset to sales intensity, operating expense to sales intensity and industry).

In contrast to the above mentioned EU Directives, the OECD projects such as Pillar I operate supra - State, so that their approvals would constitute a change to the TP Guidelines, at a non – binding recommendation level.

As noted above, the European Commission and OECD's attempt of creating and harmonizing transfer pricing and arms' length rules and principles are currently being discussed at various levels and currently lead to potentially overlapping situations and uncertainty among the existing proposals.

The EU proposals on transfer pricing could also create transfer pricing inconsistencies between members of worldwide groups within EU countries and those group members in countries which are not part of the single market.

An additional point is that member countries could still retain their own guidelines on transfer pricing documentation, which is not expected to be harmonized within the EU under this Directive.

Summary of the proposed regulations at the EU level

The following table briefly summarises some frequently asked questions on the proposals and sets out commentary on matters relevant to transfer pricing implementation for the affected members of a multinational worldwide group. The questions contrast the expected transfer pricing position from the perspective of both the proposed EU Directive on transfer pricing and the OECD's Transfer Pricing Guidelines.

We will also be adding specific country positions to this table in due course.

Questions	BEFIT: Proposal for Transfer Pricing Directive across the EU	OECD Transfer Pricing Guidelines
Which companies will be legally obliged to implement?	The European Directive, aimed at harmonizing the EU regulatory framework on transfer pricing ("TP Directive") would be applied by all businesses operating within the European Union member states.	The OECD TP Guidelines are recommendations on responsible business conduct applied to multinational enterprises (MNEs) operating in or from the countries that adhere to the OECD TP Guidelines (the OECD members plus Argentina, Brazil, and Chile).
Is it a mandatory requirement or a recommendation?	The application of the TP Directive on transfer pricing would be mandatory . EU member states will be obliged to incorporate the provisions outlined in the directive into their domestic legislation.	The OECD TP Guidelines are non-legally binding principles and standards. In the domestic transfer pricing legislation of some countries, they are brought into law.
What is the related party definition?	<p>The TP Directive proposes a common definition of affiliated enterprise across the EU as a person who is related to another person in any of the following ways:</p> <ul style="list-style-type: none"> • a person participates in the management of another person by being in a position to exercise a significant influence over the other person; • a person participates in the control of another person through a holding that exceeds 25% of the voting rights; • a person participates in the capital of another person through a right of ownership that, directly or indirectly, exceeds 25% of the capital; or • a person is entitled to 25% or more of the profits of another person. <p>Permanent establishments are also considered related parties if the conditions are fulfilled.</p>	<p>The OECD TP Guidelines do not specify a threshold for affiliation.</p> <p>Associated enterprises can be considered, where</p> <ul style="list-style-type: none"> • an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State, or • the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, <p>Permanent establishments are considered related parties.</p>
What is considered to the arm's length price?	The proposal for the TP Directive stipulates that the arm's length range should be the interquartile range and that no deviation could be allowed.	<p>OECD Guidelines do not specify the application of a specific range for the arm's length price range.</p> <p>However, they indicate that if the sample contains comparability defects that cannot be adjusted, the application of statistical tools to narrow the range (e.g. the interquartile range or other percentiles) might improve the reliability of the analysis.</p>

Questions	BEFIT: Proposal for Transfer Pricing Directive across the EU	OECD Transfer Pricing Guidelines
Which point within the arm's length price range should be considered for transfer pricing adjustments?	If the pricing under consideration lies outside the arm's length range, adjustments should be made to the median point in the range.	In an adjustment, any element of the range might comply with the arm's length principle. However, if the range contains comparability defects, it might be appropriate to apply measures of central tendency to determine the point (e.g. median, mean or weighted averages, etc).
Is there any restriction on transfer pricing adjustments?	If the pricing under consideration falls within the arm's length range, no adjustments should be applied.	If the relevant condition of the controlled transaction (e.g. price or margin) lies within the arm's length range, no adjustment should be made.
What types of transfer pricing adjustments could be made?	<p>In line with the OECD TP Guidelines, the proposal determines the following transfer pricing adjustments:</p> <ul style="list-style-type: none"> • Primary and corresponding adjustments (by tax jurisdictions after the company's tax return is filed) Primary adjustments should apply to the increase in a company's taxable profit as the pricing applied in the transactions with a related company was not considered arm's length. The purpose of the corresponding adjustments is to eliminate any double taxation that may arise as a result of the primary adjustment. • Compensating adjustments (by the company before the company's tax return is filed) For tax purposes, the taxpayer declares a transfer price that corresponds to the arm's length price of the controlled transaction. 	<p>The OECD TP Guidelines provide guidance on possible adjustments and also specify the definitions of primary, corresponding, and compensating adjustments.</p> <p>The Guidelines also mentioned a so-called secondary adjustment, whereby some jurisdictions having proposed a transfer pricing adjustment will assert under their domestic legislation a constructive transaction (a secondary transaction), whereby the excess profits resulting from a primary adjustment are treated as having been transferred in some other form and taxed accordingly.</p>

Questions	BEFIT: Proposal for Transfer Pricing Directive across the EU	OECD Transfer Pricing Guidelines
<p>What procedures are available for transfer pricing adjustment between the competent tax authorities?</p>	<p>The proposal in the TP Directive introduces a “fast-track” procedure that should be concluded in 180 days without the need to open a Mutual Agreement Procedure (MAP) when there is no doubt that the primary adjustment is well founded.</p> <p>The Proposal does not exclude the option of initiating a MAP or other forms of international cooperation.</p>	<p>To eliminate double taxation, the OECD introduced the Mutual Agreement Procedure (MAP)</p> <p>The maximum time limit for the MAP procedure is two years from the date when all the required information is available.</p> <p>After the two-year deadline has expired, the person may request in writing that unresolved issues be submitted to arbitration.</p>
<p>How does it define the documentation obligation and the contents of the documentation?</p>	<p>The published proposal does not currently include requirements for transfer pricing documentation.</p> <p>The Transfer Pricing Directive will be supplemented at a later stage and will possibly include the requirements for transfer pricing documentation, as well as the type, content, and language of the documentation and the deadlines for preparation.</p>	<p>OECD Transfer Pricing Guidelines provide requirements for the content and form of the three-tiered approach to transfer pricing documentation recommended for adoption by individual jurisdictions:</p> <ol style="list-style-type: none"> 1. Master File 2. Local File 3. Country-by-Country Report
<p>What methods can be applied to determine the arm’s length price?</p>	<p>The TP Directive confirms that the most appropriate method for determining the arm’s length price should be selected from the five methods included in the OECD TP Guidelines.</p> <p>The proposal for the Directive further specifies that application of any other valuation methods and techniques shall be allowed where it can be reliably demonstrated that none of the above methods is appropriate and the other method chosen is more reliable for determining the arm’s length price.</p>	<p>OECD Transfer Pricing Guidelines states that one of the following five methods should be applied in the first instance for determining the arm’s length price:</p> <ul style="list-style-type: none"> • the comparable uncontrolled price method; • the resale price method; • the cost-plus method; • the transactional net margin method; • the profit split method. <p>Other methods can be applied in justified circumstances.</p>

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