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European Commission releases Directive Proposal on Transfer Pricing: A trojan horse?

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On 12 September 2023, the EU Commission released a Directive Proposal on Transfer Pricing (hereafter, the "**Proposal**" or the "**TP Directive**") as part of the package that includes the Directive Proposal on BEFIT which was commented in our previous ATOZ Alert. The Directive Proposal aims at integrating key transfer pricing ("**TP**") principles into EU law with the objective of putting forward common approaches for Member States.

Due to the lack of harmonised TP rules at EU level, Member States enjoy large discretion in interpreting the OECD TP Guidelines including for crucial concepts such as "associated enterprises". The EU Commission points to several issues linked to the complex nature of TP rules including profit shifting and tax avoidance, litigation and double taxation and high compliance costs.

With the Proposal, the EU Commission would like to incorporate the arm's length principle ("**ALP**") and key TP rules into EU law, create a "fast-track" procedure to resolve double taxation, clarify the role and status of the OECD TP Guidelines and create the possibility to establish common binding rules on specific transactions.

The key parts of the Proposal are detailed below.

Incorporation of the Arm's Length Principle

PRINCIPLE

Where the conditions of intragroup cross-border transactions are not at arm's length, they must be adjusted to reflect the terms and conditions that would have been established between independent parties.

The Proposal defines the ALP as an "*international standard that prescribes that associated companies must transact with each other as if they were independent third parties. In other words, the transactions between two* *associated enterprises should reflect the outcome that would have been achieved if the parties were not related i.e. if the parties were independent of each other and the outcome (price or margins) was determined by (open) market forces*"[1].

To ensure that the ALP is applied in a uniform way across the EU, the Proposal includes the definition of "associated enterprise"[2]. Pursuant to the TP Directive an "associated enterprise" means a person that is related to another person who:

- participates in the management of another person by being able to exercise a significant influence over the other person;
- participates in the control of another person through a holding that exceeds 25% of the voting rights;
- participates in the capital of another person through a direct or indirect ownership right that exceeds 25%; or
- is entitled to 25% or more of the profits of another person.

Furthermore, "permanent establishments"[3] are treated as associated enterprises in order to ensure equal treatment. Thus, the internal dealings between head office and permanent establishment should be determined in accordance with the ALP.

TP ADJUSTMENTS

Corresponding adjustments and creation of a 'fast-track' procedure

The TP Directive provides specific rules on the corresponding adjustments when a primary adjustment is made in another jurisdiction. In such case, the Directive requires Member States to ensure that they make a corresponding adjustment so as to prevent the double taxation (i.e. Member States have the possibility to perform such adjustments and do not limit the granting of such adjustments).

In addition to the corresponding adjustment granted in the context of mutual agreement procedures ("**MAPs**"), the Proposal sets out a "fast-track" procedure. Under this procedure, the request introduced by the taxpayer must indicate all factual and legal circumstances necessary to evaluate, under the ALP, the primary adjustment performed in the other jurisdiction and provide a certificate (or equivalent document) attesting the definitive nature of the primary adjustment abroad. After filing the request, Member States will have to declare the request (in)admissible within 30 days.

When double taxation arises from a primary adjustment made in another Member State, Member States would have to conclude the procedure within 180 days from the receipt of the taxpayer's request with a reasoned act of acceptance or rejection. If the corresponding adjustment is not granted under this fast-track procedure, it would not prevent the taxpayer from pursuing a MAP.

[1] Article 3, (1) of the Proposal.

[2] Article 5 of the Proposal: "(1) For the purpose of this Directive, 'associated enterprise' means a person who is related to another person in any of the following ways: (a) a person participates in the management of another person by being in a position to exercise a significant influence over ethe other person; (b) a person participates in the control of another person through a holding that exceeds 25 % of the voting rights; (c) a person participates in the capital of another person through a right of ownership that, directly or indirectly, exceeds 25 % of the capital; (d) a person is entitled to 25 % or more of the profits of another person. (2) If more than one person participates in the management, control, capital or profits of the same person, as referred to in paragraph 1, all persons concerned shall be regarded as associated enterprises. (3) If the same persons participate in the management, control, capital or profits of more than one person, as referred to in paragraph 1, all persons concerned shall be regarded as associated enterprises. (4) For the purposes of paragraphs 1 and 2, a person shall mean both legal and natural persons. A person who acts together with another person in respect of the voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other person. (5) In indirect participations, the fulfilment of the criteria set out in point (b) and (c) of paragraph 1 shall be determined by multiplying the rates of holding through the successive tiers. A person holding more than 50 % of the voting rights shall be deemed to hold 100 % of the voting rights. (6) An individual, his or her spouse or recognised partner, in accordance with the applicable national law, and his or her lineal ascendants or descendants and his or her siblings shall be treated as a single person. (7) A permanent establishment shall be considered an associated enterprise of the enterprise of which it is a part of".

[3] Article 3, (4) of the Proposal: "'permanent establishment' means a fixed place of business, as defined under the relevant bilateral convention on the avoidance of double taxation or, in absence thereof, in national law".

The Proposal also lays down that Member States should grant corresponding adjustments as a result of joint audits or other forms of international administrative cooperation such as multilateral risk assessment programs like the European Trust and Cooperation Approach ("**ETACA**") and the International Compliance Assurance Programme ("**ICAP**") when the relevant tax administrations agree on the determination of the arm's length price and the primary and corresponding adjustments are granted symmetrically for the same amount in all the relevant jurisdictions.

Compensating adjustments

In order to establish a common approach to compensating adjustments[4] (also referred to as "intentional setoffs") within the EU and to avoid litigation, the TP Directive provides the conditions under which Member States should recognise a compensating adjustment, to be interpreted in conjunction with the Commission's 2013 EU Joint Transfer Pricing Forum Report on compensating adjustments.

Common Core Elements for Applying the Arm's Length Principle

TRANSFER PRICING METHODS AND SELECTION OF THE MOST APPROPRIATE METHOD

In line with Chapter III of the OECD TP Guidelines, the TP Directive prescribes five recognised TP methods: the comparable uncontrolled price method[5], the resale price method[6], the cost-plus method[7], the transactional net margin method[8] and the profit split method[9]. No preference is indicated for any of these.

The Proposal further provides that a TP method other than one of the OECD recognised methods may only be applied where it can be demonstrated that: (i) none of the OECD recognised methods can be reasonably applied and (ii) such other method produces a result consistent with the ALP.

The selection of the TP method should always aim at finding the most appropriate method for a particular case. No one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable in a given set of circumstances.

[4] Article 3, (8) of the Proposal: "'compensating adjustment' means an adjustment in which the taxpayer reports a transfer price for tax purposes that is, in the taxpayer's opinion, an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between the associated enterprises".

[5] Article 3, (9) of the Proposal: "the 'comparable uncontrolled price method' means a transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances".

[6] Article 3, (10) of the Proposal: "the 'resale price method' means a transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise; the resale price being reduced by the resale price margin and the result, after subtracting the resale price margin, can be regarded, after adjustment for other costs associated with the purchase of the product, e.g. custom duties, as an arm's length price of the original transfer of property between the associated enterprises".

[7] Article 3, (11) of the Proposal: "the 'cost plus method' means a transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction; an appropriate mark-up is added to these costs, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions; the price, after adding the mark-up to the proper cost base, may be regarded as an arm's length price of the original controlled transaction".

[8] Article 3, (12) of the Proposal: "the 'transactional net margin method' means a transactional profit method that examines the net profit margin relative to an appropriate base, e.g. costs, sales, assets, that a taxpayer realises from a controlled transaction that it is appropriate to aggregate".

[9] Article 3, (13) of the Proposal: "the 'profit split method' means a transactional profit split method that shows the relevant profits to be split for the associated enterprises from a controlled transaction (or controlled transactions that it is appropriate to aggregate) and then divides those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been agreed at arm's length".

ARM'S LENGTH RANGE

The arm's length range must be determined using the interquartile range (being the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables).

In order to minimise disputes and ensure a common approach across the EU, the Proposal further provides that no adjustments can be made by Member States when a result falls within the interquartile range. When the results of a controlled transaction fall outside the arm's length range, tax administrations should make an adjustment to the median of all the results. However, in both scenarios, the tax administration or the taxpayer may prove that different positioning in the range is justified by the facts and circumstances of the specific case.

TP DOCUMENTATION

The TP Directive requires taxpayers to have sufficient information and analyses available to verify that the conditions of its transactions with associated enterprises are in accordance with the ALP and encompassing:

- the identification of the commercial or financial relations;
- the transfer pricing method and its selection;
- the comparability analysis; and
- the determination of the arm's length range.

This mandatory TP documentation would apply to all taxpayers regardless of any revenue threshold. However, the exact content of this TP documentation will be specified by the Commission at a later date.

Further Amendments and Tax Certainty

The provisions of the TP Directive should be applied in accordance with the OECD TP Guidelines. The Proposal refers to the 2022 version of the OECD TP Guidelines and any further amendments to these Guidelines approved by the EU. Hence, the Proposal would establish the principle that the latest version of the OECD TP Guidelines will be binding on all EU Member States. While this is already a reality, it might be a problem when the OECD TP Guidelines are significantly amended and then should apply regarding the past in which such guidance did not exist.

The TP Directive further provides that the EU Council may establish additional binding rules in the area of TP by way of implementing acts.

Conclusion

The TP Directive would require EU Member States to follow the OECD TP Guidelines. However, as all EU Member States are members of the OECD, the OECD TP Guidelines should already be followed by EU Member States. As such, the Proposal should, in principle, not change much.

However, the TP Directive would require mandatory TP documentation, albeit the exact scope of TP documentation requirements would only be specified by the EU Commission at a later stage.

Moreover, the possibility of the EU Council to establish additional binding rules in the area of TP would mean that EU Member States give up their sovereignty in tax matters as it cannot be excluded that far-reaching, binding TP rules might be adopted in the future (which EU Member States have no control over whatsoever).

The proposed 'fast-track' procedure regarding corresponding adjustments would be an additional instrument for taxpayers (in addition to the arbitration convention and the MAP procedures under applicable Directives and tax treaties) to request the tax authorities of EU Member States to align their position in case of TP disputes.

The adoption of the TP Directive would require unanimity within the EU Council. If adopted, the new rules should apply as from 1 January 2026.

Ultimately, while the TP Directive would in essence not change much, it may be (mis)used by the EU Commission to become the authoritative instance for the interpretation of the OECD TP Guidelines in the EU. While this largely failed during several of the State Aid investigations relating to TP (for example, the FIAT and the Amazon State Aid cases), this TP Directive could be used by the EU Commission to strip sovereignty from the tax authorities of EU Member States.

Do you have further questions?

OLIVER R. HOOR
Partner,
International & Corporate Tax
oliver.hoor@atoz.lu
T + 352 26 940 646