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A Critical Analysis of the European Commission's Directive Proposal on Transfer Pricing

by Oliver R. Hoor

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by Oliver R. Hoor

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In this article, Hoor examines the European Commission's Directive Proposal on Transfer Pricing and evaluates its purpose and potential.

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I. Introduction

On September 12 the European Commission adopted a Directive Proposal on Transfer Pricing.[1] This proposal is part of the package known as Business in Europe: Framework for Income Taxation (BEFIT).

While the Directive Proposal would integrate key transfer pricing principles into EU law, BEFIT aims to introduce a common set of rules for EU companies to calculate their taxable base that would be aggregated at BEFIT group level and subsequently reallocated to the individual companies based on formulary apportionment.

The Directive Proposal attempts to integrate the arm's-length principle and some fundamental transfer pricing principles included in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP guidelines) into EU law. It would further create a new procedure for ensuring corresponding adjustments, require certain transfer pricing documentation, clarify the role and status of the OECD TP guidelines, and create the possibility to establish common binding rules on specific transactions. If adopted by the EU Council, the Directive Proposal would enter into force on July 1, 2026.

This article provides an overview of the Directive Proposal, considers its purported purpose, and analyses its numerous issues.

[1] European Commission, Proposal for a Council Directive on Business in Europe: Framework for Income Taxation (BEFIT), COM(2023) 532 final (Sept. 12, 2023).

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II. Content of the Directive Proposal

A. Overview

According to article 1, the Directive Proposal lays down rules to harmonize transfer pricing rules of EU member states and to ensure a common application of the arm's-length principle within the EU.

The transfer pricing rules would apply to taxpayers that are registered (or subject to tax) in one or more member states, including permanent establishments in one or more member states.[2]

B. Transposing OECD Guidance Into EU Law

1. Overview

The OECD TP guidelines reflect the consensus of OECD member countries toward the application of the arm's-length principle as provided in article 9(1) of the OECD Model Tax Convention (OECD-MC). The arm's-length principle is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by MNE groups and tax administrations.

The arm's-length principle requires that, for tax purposes, the terms and conditions agreed upon by related parties in their commercial or financial relations should correspond to those that one would have expected in transactions between unrelated parties. When the terms and conditions agreed upon in controlled transactions differ from the arm's-length standard, tax administrations may, for tax purposes, perform transfer pricing adjustments.

2. General Definitions

Article 3 of the Directive Proposal includes several definitions of basic terms like the arm's-length principle, arm's-length range, primary adjustment, corresponding adjustment, comparable uncontrolled price method, resale price method, cost-plus method, transactional net margin method, profit-split method, and controlled transaction.

All these definitions are consistent with those in the glossary of the OECD TP guidelines.

3. Application of the Arm's-Length Principle

Article 4 of the Directive Proposal advocates for applying the arm's-length principle in commercial or financial cross-border transactions with associated enterprises. When these transactions do not adhere to the arm's-length principle, EU member states should perform transfer pricing adjustments to restate arm's-length conditions.

These basic rules are consistent with the guidance provided in Chapter I of the OECD TP guidelines (see section B thereof).

It is interesting that the related BEFIT initiative relies on formulary apportionment to allocate profits among EU members of a multinational group. Here, the OECD TP guidelines state that formulary apportionment should not be confused with the transactional profit methods discussed in Chapter II, Part III of the OECD TP guidelines, and formulary apportionment should not be the standard applied for the allocation of profits among different members of a multinational groups (see Chapter I, section C).

Hence, the BEFIT initiative would be inconsistent with the OECD TP guidelines that the Directive Proposal claims to foster.

4. Associated Enterprises

Article 5 of the Directive Proposal defines what is to be understood as an associated enterprise. It refers to a person who is related to another person in any of the following ways:

i. a person participates in the management of another person by being in a position to exercise a significant influence over such other person;

ii. a person participates in the control of another person through a holding that exceeds 25 percent of the voting rights;

iii. a person participates in the capital of another person through a right of ownership that, directly or indirectly, exceeds 25 percent of the capital; or

iv. a person is entitled to 25 percent or more of the profits of another person.

This guidance is largely consistent with the definition in the OECD TP guidelines, albeit the

[2] *Id.* at article 2.

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latter does not determine any shareholding threshold. It is questionable whether a threshold of 25 percent, as mentioned in the Directive Proposal, is appropriate to classify transactions as controlled transactions because the other shareholders should generally have no interest in shifting advantages to a 25 percent shareholder.

Further, permanent establishments are treated as associated enterprises to ensure equal treatment. Thus, the internal dealings between head office and PE should be determined in accordance with the arm's-length principle. This is consistent with the guidance provided in the 2010 OECD report on the Attribution of Profits to Permanent Establishments (released July 22, 2010).

5. Identification of Commercial and Financial Relations

Article 8 of the Directive Proposal states that member states shall ensure that arm's-length principle application starts with the identification and accurate delineation of, on the one side, the commercial and financial relations of the associated enterprises and, on the other, the actual transaction or transaction between the associated enterprises.

This is consistent with the guidance provided in Chapter I of the OECD TP guidelines (see section D thereof).

6. Transfer Pricing Methods

Article 9 of the Directive Proposal reminds that the arm's-length price charged in a controlled transaction between associated enterprises may be determined based on:

a. the CUP method;

b. the resale price method;

c. the cost-plus method;

d. the transactional price method; or

e. the profit-split method.

Moreover, EU member states should allow the application of any other valuation methods and techniques if none of these methods are appropriate or workable in the circumstances of the case, and such other method provides for a more reliable estimate of the arm's-length result than the standard methods.

This is consistent with the guidance provided in Chapter II of the OECD TP guidelines.

7. The Most Appropriate Transfer Pricing Method

Article 10 of the Directive Proposal provides that the arm's-length price should be determined using the most appropriate transfer pricing method to the circumstances of the case. Here, the respective strengths and weaknesses of the transfer pricing methods and other aspects should be considered.

This is consistent with the guidance provided in Chapter II of the OECD TP guidelines (see section A thereof).

8. Comparability Analysis

According to article 11 of the Directive Proposal, EU member states shall evaluate whether a controlled transaction produces an arm's-length result by comparing the conditions of the controlled transaction with the conditions that would have been set if the associated enterprises were independent and had undertaken a comparable transaction under comparable circumstances (that is, the comparability analysis).

Here, the Directive Proposal points to the comparability factors, like (i) the contractual terms of the transaction, (ii) the functions performed by each of the parties to the transaction (taking into account assets used and risks assumed), (iii) the characteristics of the property transferred or the services provided, (iv) the economic circumstances of the parties and the market in which the parties operate, and (v) the business strategies pursued by the parties.

An uncontrolled transaction is deemed to be comparable to a controlled transaction if either of the following conditions are met:

i. none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or

ii. reasonably accurate adjustments can be made to eliminate the material effects of these differences.

These basic principles are consistent with the guidance provided in chapters I and III of the

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OECD TP guidelines (see, in particular, paragraph 1.36 in Chapter I and section A.6 in Chapter III).

9. Determination of the Arm's-Length Range

According to article 12 of the Directive Proposal, when applying transfer pricing methods produces a range of values, the arm's-length range is determined using the interquartile range of the results of the uncontrolled comparables.

More precisely, the interquartile range is the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables.

While no tax adjustments should be made by EU member states when a result falls within the interquartile range (unless it can be proven that a specific different positioning in the range is justified by the specific facts and circumstances), if the results of a controlled transaction fall outside the arm's-length range, an adjustment should be made to the median of all the results (unless it is proven that any other point of the range determines an arm's-length price considering the specific circumstances).

This is consistent with the guidance provided in Chapter III of the OECD TP guidelines (see section A.7 thereof).

10. Compensating Adjustments

Article 7 of the Directive Proposal states that compensating adjustments in the form of year-end adjustments initiated by the taxpayer should be accepted if certain conditions are met.

This is consistent with the guidance provided in Chapter III of the OECD TP guidelines (see section A.3.2 thereof).

C. Corresponding Adjustments

1. Article 6 of the Directive Proposal

According to article 6 of the Directive Proposal, when a primary adjustment is made, EU member states shall ensure that a corresponding adjustment is made to prevent double taxation if the following conditions are met:

i. the EU member state that was requested to perform the corresponding adjustment agrees that the primary adjustment is consistent with the arm's-length principle both in principle and regarding the amount;

ii. the primary adjustment results in the taxation of an amount of profits in another jurisdiction on which the associated enterprise in the EU member state requested to perform the corresponding adjustment has already been subject to tax in that EU member state;

iii. if a third country jurisdiction is involved, a tax treaty is in force to prevent economic double taxation.

The Directive Proposal would set out a "fast-track" procedure. Under it, the request introduced by the taxpayer must indicate all factual and legal circumstances necessary to evaluate, under the arm's-length principle, 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, EU member states will have to declare the request (in)admissible within 30 days.

When double taxation arises from a primary adjustment made in another EU member state, they would have to conclude the procedure within 180 days from receiving 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 mutual agreement procedure.

The Directive Proposal also states that EU member states should grant corresponding adjustments as a result of joint audits or other forms of international administrative cooperation like multilateral risk assessment programs (for example, the European Trust and Cooperation Approach and the International Compliance Assurance Programme) when the relevant tax administrations agree on the arm's-length price and both the primary and corresponding adjustments are granted symmetrically in all the relevant jurisdictions.

The Directive Proposal would further subject downward adjustments to the following conditions:

i. the downward adjustment is consistent with the arm's-length principle both in principle and regarding the amount;

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ii. an amount equal to the downward adjustment is included in the profit of the associated enterprise in the other jurisdiction and taxed in both the EU member state and the other jurisdiction (subject to double taxation); and

iii. the EU member state that requested to perform the downward adjustment has communicated to the tax administration of the relevant jurisdiction the intention to perform a downward adjustment providing all the factual and legal circumstances necessary to evaluate the downward adjustment under the arm's-length principle.

So, downward adjustments would be conditional to effective taxation (i.e., inclusion of deemed income in the tax base) in the other jurisdiction.

2. Existing Legal Remedies

European companies may already rely on existing remedies provided in tax treaties (concluded by their residence state) and, in an EU context, on the EU Arbitration Convention and EU Directive 2017/1852.

This raises the question: Would another procedure to claim corresponding adjustments advance legal certainty for businesses in a meaningful manner?

After all, one of the conditions for a corresponding adjustment is that the EU member state that was requested to perform the corresponding adjustment agrees that the primary adjustment is consistent with the arm's-length principle both in principle and amount. However, this is frequently the key issue for disputes in transfer pricing matters; tax authorities have no incentive to agree to tax adjustments to their disadvantage.

a. MAP Under Tax Treaties

Article 25(1) of the OECD-MC grants taxpayers a right to raise issues relating to the appropriate application of a tax treaty with the competent authorities of their residence state.

If that state is not able to satisfactorily resolve the issue, article 25(2) and (3) of the OECD-MC foresee that the two competent authorities will endeavour to reach a mutual agreement that eliminates the taxation asserted by the taxpayer not in accordance with the treaty.

When unresolved issues have prevented the competent authorities from reaching a mutual agreement within two years, article 25(5) of the OECD-MC provides that the issues preventing resolution will, at the request of the taxpayer that presented the case, be solved through an arbitration process.

However, the arbitration provision in article 25, paragraph 5 of the OECD-MC has only been included in the 2008 update to the OECD-MC and is therefore not yet included in every bilateral tax treaty.

b. EU Arbitration Convention

In an EU context, companies may further rely on the EU Arbitration Convention,[3] which establishes a two-phase procedure to resolve cases of international double taxation resulting from transfer pricing adjustments (i.e., upward adjustments).

The scope of the EU Arbitration Convention is, however, restricted to transactions between enterprises resident in different EU member states. The EU Arbitration Convention is not applicable for non-EU enterprises, even if they are doing business through a PE situated in an EU member state.

The EU Arbitration Convention provides for mandatory arbitration when EU member states cannot reach mutual agreement on eliminating double taxation within two years of the initial submission date in one of the competent authorities of the EU member states involved.

Following this two-year period, an advisory commission is convened (by the competent authorities) which must deliver an opinion within a six-month period.

Thereafter, the competent authorities may either adhere to the opinion of the advisory commission or benefit from an additional six-month period to seek another agreement to eliminate double taxation. If the competent authorities do not reach an agreement within six months, they must conform to the opinion of the advisory commission.

[3] Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/436/EEC).

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c. EU Directive 2017/1852 — Resolution of Tax Disputes in the EU

Since July 1, 2019, Council Directive 2017/1852 of October 10, 2017, on tax dispute resolution mechanisms in the EU applies and brings, according to the European Commission, a significant improvement to *resolving tax disputes* because they ensure that businesses and citizens can resolve disputes related to the interpretation and application of tax treaties more swiftly and effectively.

The Council Directive rules also cover issues related to *double taxation* which may occur when two or more countries claim the right to tax the same income or profits of a company or person. This can happen, for example, because of a mismatch in national rules or different interpretations of the transfer pricing rules in a bilateral tax treaty.

A MAP is an administrative procedure between the competent authorities of EU member states engaged in resolving a tax dispute. The time limit of the Council Directive for a MAP is two years, or three years if this is extended on a justified request by a competent authority.

If the dispute is not resolved with a MAP between competent authorities, the taxpayer can request to set up an advisory commission. The advisory commission is composed of the competent authorities of the EU member states in dispute and three independent persons (one of whom acts as the chair). These people are drawn from a purpose-compiled list to which they get nominated by EU member states in accordance with the Council Directive.

The competent authorities sitting in the advisory commission must agree on rules of functioning that provide details on the procedure. Overall, this instrument seems to resemble the EU Arbitration Convention.

D. Transfer Pricing Documentation

According to article 13 of the Directive Proposal, EU member states shall ensure that a taxpayer has sufficient information and analysis available to verify that the conditions of controlled transactions are consistent with the arm's-length principle and should at least encompass the following elements:

- 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.

Article 13(2) of the Directive Proposal states that the Commission shall be empowered to adopt delegated acts, in accordance with article 18 of the Directive Proposal, to further supplement these rules.

According to article 18 of the Directive Proposal, the power to adopt the delegated act referred to in article 13 shall be conferred on the European Commission, subject to the conditions articulated in article 18 of the Directive Proposal.

Seemingly, article 18 of the Directive Proposal suggests that additional powers regarding transfer pricing documentation requirements would be shifted from EU member states to the European Commission.

Chapter V of the OECD TP guidelines is dedicated to providing guidance regarding transfer pricing documentation. In the 2017 revision of the OECD guidelines, Chapter V was replaced by new guidance on transfer pricing documentation developed by the OECD as part of their work on action 13 of the base erosion and profit-shifting project.

The guidance sets out a three-tiered approach toward transfer pricing documentation, including a master file, a local file, and country-by-country report (all three reports are collectively referred to as the country-by-country reporting package).

Considering the above, it is questionable whether additional transfer pricing documentation requirements may be necessary.

E. Developing Binding EU Transfer Pricing Rules

According to article 14 of the Directive Proposal, the EU Council may lay down further rules, consistent with the OECD TP guidelines, on how the arm's-length principle and the other provisions in Chapter II of the Directive Proposal are to be applied in specific transactions to ensure more tax certainty and mitigate the risk of double taxation.

More precisely, those specific transactions or dealings that might be governed by additional guidance from the EU Council are the following:

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a. transfer of intangibles assets or rights in intangible assets between associated enterprises, including hard-to-value intangibles;

b. the provision of services between associated enterprises, including the provision of marketing and distribution services;

c. cost contribution arrangements between associated enterprises;

d. transactions between associated enterprises in the context of business restructurings;

e. financial transactions; and

f. dealings between the head office and its PEs.

It is interesting to note that the OECD TP guidelines already include specific guidance on all these topics (except for guidance on dealings between the head office and its PEs which have been extensively covered in the Attribution of Profits to Permanent Establishments report).

With the latest release of the OECD TP guidelines back in January 2022, the guidance included is consistent with all post-BEPS transfer pricing standards:

- Chapter VI provides guidance on transfer of intangibles assets or rights in intangible assets between associated enterprises, including hard-to-value intangibles;
- Chapter VII provides guidance on the provision of services between associated enterprises, including the provision of marketing and distribution services;
- Chapter VIII provides guidance on cost contribution arrangements between associated enterprises;
- Chapter IX provides guidance on transactions between associated enterprises in the context of business restructurings; and
- Chapter X provides guidance on financial transactions.

Why would the EU Council release guidance competing with the explicit OECD TP guidelines, which is the result of years, if not decades, of negotiations between OECD member states (and the European Commission, which takes part in the work of the OECD) when this competing guidance would need to be consistent with the OECD TP guidelines? Notably, any competing guidance would create legal uncertainty for businesses.

III. Purpose of the Directive Proposal

The explanatory memorandum of the Directive Proposal details the purported purpose of this initiative.

Accordingly, "the rationale of this proposal derives from the fact that almost all Member States are also members of the OECD and therefore committed to follow the OECD principles and recommendations."[4] On this basis, one might ask why the European Commission does not simply remind EU member states to adhere to the OECD TP guidelines as the authoritative standard for the interpretation and application of the arm's-length principle.

However, it is stated that "despite the political commitment by the majority of Member States, the status and role of the OECD TP guidelines currently differs from Member State to Member State. In addition, at the level of the Union, transfer pricing rules are currently not harmonized through legislative acts, although all Member States have in place domestic legislation that provides for a common approach to the basic principles. Yet, this is not fully aligned."[5] Nevertheless, EU member states have sovereignty in tax (and therefore transfer pricing) matters and no requirement exists to fully harmonize transfer pricing rules beyond adhering to the OECD TP guidelines (that largely harmonize the transfer pricing framework in EU member states).

Here, the explanatory memorandum states that "the fact that each Member State enjoys large discretion in interpreting and applying the OECD Transfer Pricing Guidelines gives rise to complexity and an uneven playing field for businesses."[6]

As an example, the explanatory memorandum mentions the control criterion that has been set at

[4] Directive Proposal, *supra* note 1 at 2.

[5] *Id.*

[6] *Id.*

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25 percent in the Directive Proposal, whereas some EU member states apply a threshold of 50 percent shareholding. However, in practice, the question arises whether a transaction with a 25 percent shareholder would, by default, not be an arm's-length transaction because the remaining shareholders likely wouldn't have an interest to shift advantages to a minority shareholder.

While the explanatory memorandum complains that different control criteria "translates into businesses facing tax uncertainty, high compliance costs as well as frequent, time-consuming legal disputes leading, amongst others, to considerable amounts of legal fees and creating barriers to cross-border operations and high risks of double and/or over-taxation,"[7] complexity, legal uncertainty and compliance costs did not seem to be a major concern for the European Commission when adopting countless tax initiatives over the last decade.

The explanatory memorandum further points out that "the risk of double taxation and over-taxation for businesses operating cross-border leads to a lack of tax certainty due to possible tax disputes between tax administrations of different Member States in cases where they take different views in relation to the treatment of a specific transaction within their corporate tax system."[8]

It is further stated that "in a continuously more globalised and competitive world economy there is an increased need for more tax certainty in the Single Market."[9] According to the European Commission, even unilateral tax rulings (i.e., advance pricing agreements when transfer pricing matters are concerned) would not eliminate the risk of tax disputes and possible double or overtaxation. The author greatly appreciates this consideration for taxpayers.

The explanatory memorandum mentions further problems that are allegedly the result of transfer pricing rule complexity and their different implementation in the national law of EU member states:

- First, it is stated that transfer prices can be easily manipulated to shift profit and be used in the context of aggressive tax planning schemes. This statement comes as a surprise because the OECD TP guidelines have been significantly revised (some chapters have been entirely replaced) following the work of the OECD on BEPS actions 8-10 and 13. One might assume that transfer pricing outcomes should be consistent with value creation.
- Second, it is stated that transfer pricing is more subjective than other areas of direct and indirect taxation and, for this reason, sensitive to disputes because tax administrations do not always share a common interest and interpretation. This may result in litigation and double taxation. Indeed, as stated in paragraph 1.13 of Chapter I of the OECD TP guidelines, "it should also be recalled at this point that transfer pricing is not an exact science but does require the exercise of judgement on the part of both the tax administration and taxpayer." However, this cannot be an argument to harmonize the domestic tax laws of EU member states beyond adherence to the OECD TP guidelines.
- Third, the explanatory memorandum mentions double taxation and high tax compliance costs related to transfer pricing as problematic.

According to the European Commission, these tax barriers for businesses impede the proper functioning of the single market and hamper the prospect for achieving its potential efficiency gains, undermining the competitiveness of the single market.

Therefore, the Directive Proposal "aims at simplifying tax rules through increasing tax certainty for businesses in the EU, thereby reducing the risk of litigation and double taxation and the corresponding compliance costs and thus improve competitiveness and efficiency of the Single Market."[10]

While it is correct that businesses would welcome legal certainty in tax (and transfer pricing) matters, incorporating a few basic principles included in the OECD TP guidelines

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.* at 3.

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(fundamental principles that should not be disputed by tax administrations of EU member states) would likely not achieve this objective.

According to the explanatory memorandum, tax certainty would be achieved by:

i. incorporating the arm's-length principle into Union law;

ii. harmonizing the key transfer pricing rules;

iii. clarifying the role and status of the OECD TP guidelines; and

iv. creating the possibility to establish, within the EU, common binding rules on specific transfer pricing subjects within the framework of the OECD TP guidelines.

Finally, the explanatory memorandum discloses that the Directive Proposal would provide a gradual development of common and consistent approaches among EU member states' tax authorities for the interpretation and application of transfer pricing rules through incorporating the arm's-length principle into EU law and clarifying the role and status of the OECD TP guidelines.

This is very revealing. Could it be that the true intention of the European Commission is to gradually become the authoritative body for interpreting the arm's-length principle in the EU?

IV. A Critical Review of the Directive Proposal

The Directive Proposal raises several concerns that are addressed in this section.

A. National Sovereignty of EU Members at Stake

The corporate tax laws of EU member states vary from one state to another against the backdrop of the structure and focus of each respective economy. EU member states have the freedom to adopt different tax policy choices to set the right incentives for their economies. However, the interpretation of the arm's-length principle is (at least in theory) not subject to much variation as most, if not all, EU member states adhere to the OECD TP guidelines.

Member states' national sovereignty over tax matters (including transfer pricing) is a fundamental principle of the EU. Therefore, when it comes to important decisions in this field, unanimous agreement by all EU member states is required.

While there have been several attempts by the European Commission to move to a qualified majority voting (in which measures can be approved by a minimum number of EU countries, representing a minimum share of the EU population), these attempts have failed so far.

In the author's view, moving to qualified majority voting in taxation would undermine the competitiveness of the EU because it would diminish the pressure on national authorities to pursue efficient and competitive tax policies, resulting in higher taxation across the EU.

The Directive Proposal would undermine national sovereignty over (transfer pricing) tax matters through a backdoor because it would largely replace domestic tax laws with EU transfer pricing rules over which individual EU member states would have limited control. Instead, adopting the Directive Proposal would elevate the European Commission to the authoritative body regarding the interpretation of the arm's-length principle. EU member states would further have limited control over future transfer pricing developments initiated by the European Commission (e.g., adoption of additional transfer pricing rules to be applied in specific transactions).

B. Absence of a Need for the Directive Proposal

The Directive Proposal would introduce into EU law some of the fundamental principles included in the OECD TP guidelines. However, all but four EU member states[11] are members of the OECD and should adhere to the organization's TP guidelines (the four EU member states that are not members of the OECD should likely accept transfer pricing that is consistent with the OECD TP guidelines).

The latest revision of OECD TP guidelines was released on January 20, 2022, and includes a new Chapter X with transfer pricing guidance on financial transactions, drafted as a follow-up on the BEPS project.

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[11] Bulgaria, Cyprus, Malta, and Romania are not members of the OECD.

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The 2017 revision of the OECD TP guidelines resulted in some major changes, including the replacement of the chapters on (i) transfer pricing documentation and (ii) transfer pricing aspects of intangibles. All these changes followed the work of the OECD on the BEPS project from September 2013 until October 2015.

Notably, four of the 15 BEPS actions are focused on transfer pricing and related documentation requirements:

- action 8, focusing on intangibles;
- action 9, focusing on risk and capital;
- action 10, focusing on other high-risk transactions; and
- action 13, focusing on transfer pricing documentation.

The stated purpose of the work of the OECD was to ensure that transfer pricing outcomes are aligned with value creation. The 2017 revision of the OECD guidelines reflects the wording provided in the final report on actions 8-10 (aligning transfer pricing outcomes with value creation) and the final report on action 13 (transfer pricing documentation) released in October 2015.

Consequently, the current version of the OECD TP guidelines is consistent with all post-BEPS transfer pricing standards and should be followed by OECD member states (and beyond). How could there be a need for additional transfer pricing guidance?

C. Absence of a Legal Basis for Directive Proposal

The alleged legal basis of the Directive Proposal is article 115 of the Treaty on the Functioning of the European Union, which stipulates that legal measures under that provision shall take the legal form of a Directive. However, the EU's competences are governed and limited by the principles of subsidiarity and proportionality if the Directive Proposal is imperative for the functioning of the internal market.

1. The Principle of Subsidiarity

The aim of the principle of subsidiarity is to guarantee a degree of independence for a lower authority in relation to a higher body or for a local authority in relation to central government. Therefore, it involves sharing powers between several levels of authority, a principle which forms the institutional basis for federal states.

When applied in an EU context, the principle of subsidiarity serves to regulate the exercise of the Union's nonexclusive powers. It rules out EU intervention when an issue can be dealt with effectively by member states themselves at central, regional, or local level. The EU is justified in exercising its powers only when member states are unable to achieve the objectives of a proposed action satisfactorily and added value can be provided if action is taken at the EU level.

Here, the European Commission claims that "the cross-border nature of the problem at stake requires a common initiative across the single market. Since transfer pricing is of inherent cross-border nature, it can only be tackled by laying down legislation at Union level. This initiative is therefore in line with the subsidiarity principle, considering that individual uncoordinated action by the Member States would only add to the current fragmentation of the legal framework for transfer pricing and fail to achieve the intended results. A common approach for all Member States would have the highest chances of achieving the intended objectives."[12]

2. The Principle of Proportionality

Further, the envisaged measure must comply with the principle of proportionality. Accordingly, a measure must not go beyond what is required to ensure the minimum necessary level of protection for the internal market.

Here, the European Commission considers that the "envisaged measures do not go beyond the minimum necessary level of protection of the Single Market and are therefore compliant with the principle of proportionality."[13]

3. Assessment

The European Commission only has a legal basis in article 115 of the Treaty to the extent that (i) the Directive Proposal is imperative for the functioning of the internal market, and (ii) it adheres to the principles of subsidiarity and proportionality.

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[12] Directive Proposal, *supra* note 1 at 7.

[13] *Id.*

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Regarding the need of the Directive Proposal for the internal market to function, the European Commission claims that the cross-border nature of transfer pricing requires legislation at the EU level because individual, uncoordinated action by EU member states would only add to the fragmentation of the transfer pricing legal framework.

This is an interesting conclusion considering that the interpretation and application of the arm's-length principle has been detailed in comprehensive OECD TP guidelines (and other reports) that have resulted from thorough negotiations between OECD member states (and the European Commission that takes part in the work of the OECD).

However, it is questionable whether this initiative, which would merely implement some of the fundamental principles included in the OECD TP guidelines into EU law, is necessary for the functioning of the single market.

Further, implementing a new procedure for corresponding adjustments, in addition to the existing three instruments, may fall short of its objective for the same reason the other instruments may not efficiently ensure corresponding adjustments in a timely manner: because the EU member state that was requested to perform the corresponding adjustment must agree that it is consistent with the arm's-length principle both in principle and as regards the amount.

It is unclear how the development of binding EU rules on topics that have already been covered in comprehensive OECD guidance (that should not be contradicted by potential new EU transfer pricing rules) could improve the situation.

Member states have sovereignty in tax matters, which cannot be undermined through invoking article 115 of the treaty. In the author's view, the European Commission should have no authority to intervene in transfer pricing matters.

However, it comes as no surprise that the explanatory memorandum of the Directive Proposal reaches the conclusion that this initiative is compliant with both the subsidiarity and proportionality principles.

V. Conclusion and Outlook

The promise of the Directive Proposal on transfer pricing is less disputes, faster dispute resolution, a harmonized transfer pricing landscape, and more legal certainty for businesses in the EU. However, as it stands, it might be used — or rather misused — by the European Commission to become the authoritative instance for interpreting the arm's-length principle and the OECD TP guidelines in the EU.

While this largely failed during several of the European Commission's state aid investigations concerning transfer pricing (for example, the Fiat[14] state aid case), this Directive Proposal could be used by the European Commission to strip sovereignty in tax matters from the tax authorities of EU member states.

Instead, a measured approach to achieve the purported purpose of the Directive Proposal would be to reinforce that EU member states should adhere to the OECD TP guidelines and to emphasize, and potentially revise, the existing legal remedies to corresponding adjustments to improve their effectiveness.

The Swedish Ministry of Finance published its position on the Directive Proposal;[15] after an overall assessment, the Swedish government is opposed to the proposal and believes that it has clear shortcomings in accuracy and proportionality based on the stated purpose. The Swedish government believes that the differences in EU member states' interpretation and application of the arm's-length principle are overestimated and that the disputes that arise regarding transfer pricing are more often because different states make different assessments regarding the facts and circumstances of a specific case.

Ultimately, it remains to be seen whether all governments of EU member states will agree unanimously to this initiative of the European Commission. While it seems unlikely given the obvious shortcomings of this Directive Proposal, time will tell. ■

[14] *Fiat Chrysler Finance Europe v. Commission*, joined cases C-885/19 P and C-898/19 P (CJEU 2022).

[15] Swedish Ministry of Finance, "Factual Memorandum Concerning the Proposal for a Council Directive on Transfer Pricing, COM(2023) 529" (Oct. 17, 2023).

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