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# THE EU JOINT TRANSFER PRICING FORUM
# ISSUES FOR DEBATE

## 1. INTRODUCTION AND REMIT

Following its Communication "Towards an Internal Market without tax obstacles – A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities" COM (2001) 582 of 23 October 2001 and after the Council Conclusions of 11 March 2002 welcoming the initiative, the Commission has set-up the EU Joint Transfer Pricing Forum (hereafter FORUM) consisting of an expert of each Member State and 10 experts from business. Representatives from applicant countries and the OECD-Secretariat have been invited as observers**.**

The FORUM should examine the practical problems related to the application of the tax rules on transfer pricing in the Internal Market and more in particular those related to the implementation of the Arbitration Convention.

Without prejudice to the respective competencies of the EU institutions and the Member States, the FORUM should aim to work on the basis of consensus in order to identify possible non-legislative improvements to these practical problems. Where complete agreement cannot be reached, the range of opinion will be reflected in any report.

Considering that the overall objectives of any initiative should be the prevention of double taxation and the reduction of the compliance cost, a more uniform application of transfer pricing tax rules within the EU, should be considered as a way forward. The FORUM should therefore in particular focus on documentation requirements including the scope for reduction of the compliance burden for Small and Medium sized Enterprises (SMEs), the promotion of greater certainty as regards the acceptability of transfer prices to tax administrations and the exploration of the potential for speedier and more streamlined dispute resolution procedures.

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As regards the Arbitration Convention, the FORUM should as a priority look for **pragmatic solutions to improve its practical functioning.** It should, for example, contribute to a common understanding of the procedures to be followed during the interim period when not all Member States have ratified the Convention; the starting point of the two-year period for the first phase of the Arbitration procedure; definitions where they give rise to different interpretations; and details of the proceedings of the second phase of the Arbitration procedure.

Considering the work already undertaken in this field by the OECD and in particular the merits of the "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" which form the fundamental global framework for transfer pricing on the wider international scale, the work of the FORUM should be consistent with and complement these Guidelines and not hamper more global solutions within that particular OECD framework.

Equally, the FORUM shall neither interfere with nor hamper the work undertaken in other institutional groups discussing tax matters such as the Code of Conduct Group, which inter alia is examining the exchange of information between tax administrations on transfer pricing.

The purpose of this note, which is based on the findings of the Commissions study "Company taxation in the internal market" SEC (01) 1681 of 23 October 2001, and in particular its annex 3, is to have an initial exchange of views on the different issues at stake with the aim to prioritise discussions, establish a balanced two year work programme and present a longer term calendar.

It should be noted that the order of presentation of the issues follows the logical sequence of transfer pricing proceedings (compliance, audit, taxation, collection of tax and dispute settlement) but does not prejudge any prioritisation to be decided by the FORUM.

## 2. ISSUES TO BE EXAMINED

As discussed above the main task of the FORUM will be to examine the implementation of the OECD Transfer Pricing Guidelines in the Member States of the European Union and the practical functioning of the Arbitration Convention.

### 2.1 Application of transfer pricing rules within the EU

#### 2.1.1 Documentation requirements

A key issue for transfer pricing is the question of what kind of documentation a group company needs to prepare to demonstrate it has applied the arm's length principle. The OECD Guidelines aim at maintaining a balance between the right of tax administrations to obtain from tax payers as much information as possible to ascertain whether the transfer price is of arm's length, and the compliance cost that any documentation rules imply for the taxpayer. The Guidelines recognise that the tax payer should make reasonable efforts, at the time transfer prices are set, to determine whether the arm's length principle is satisfied, and that tax authorities can expect or require tax payers to maintain documentation to support this. However, the amount and type of documentation required should be in proportion to the

circumstances of each case. In this context the Guidelines introduce the important concept of the 'prudent business manager'. This implies that the process of considering transfer prices should be carried out in accordance with the same prudent business management principles as would govern the process of evaluating any other business decision of similar complexity and importance.

The Guidelines provide a list of items, which are likely to be useful in most cases, and other types of information that will be useful in many cases. Given the specific nature of transfer pricing, i.e. the variety of cases and the different facts and circumstances of each case, the list is not exhaustive. The Guidelines do explicitly mention that enterprises are not required to use more than one transfer pricing method, and also state that there is no requirement for supporting contemporaneous documentation to be prepared either at the time the prices are set or when the tax return is filed (i.e. it is acceptable for it to be prepared only on request from the tax authorities).

Business representatives strongly express the view that the transfer pricing documentation requirements are increasingly onerous and create unduly high compliance costs. Generally, it is said that they often go beyond the requirements which can be met by management accounting, thus creating a substantial and growing compliance cost for businesses (and tax administrations) involved in cross-border activities. It is also maintained that some Member States do not follow the OECD Guidelines and that there are significant differences in documentation requirements between Member States. Member States on the other hand argue that they often are unable to examine transfer prices due to non-compliance of tax payers with documentation requirements.

Documentation requirements overall have increased within the EU in the sense that some Member States either by legislation or by circular letters have introduced documentation rules or tightened existing requirements and it can be expected that this trend will continue.

The mere existence of different sets of documentation requirements (and its potential to expand to over 25) represents an additional burden for a company in one Member State to set-up and/or conduct business with an affiliated company in another Member State, and instead favours domestic investments/transactions. Small and medium-sized enterprises can be particularly hit by these problems. Frequently they are not even familiar with the basic concepts of transfer pricing and do not have the appropriate resources and structures to deal with the problem when they, say, create a first subsidiary abroad.

In this respect, it might be interesting to note that the PATA (Pacific Association of Tax Administrators) including Australia, Canada, Japan and the Unites States, have tentatively agreed on principles under which taxpayers can prepare one set of documentation that will meet the respective transfer pricing documentation provisions of each PATA member country and thus eliminate the need to prepare different documentation for each country. (for detailed information see: www.irs.gov. and click on "Business" in the "contents" area, then choose "International Businesses")

***Would the Forum agree on the development of a common approach (including questions of language) to documentation requirements of which both business and national tax administration could benefit in terms of transparency, reduction of compliance cost (in particular for SMEs) and improvement of taxpayer compliance?***

### 2.1.2 Acceptability of transfer prices to tax administrations

As explained above, documentation requirements and the acceptability of the transfer pricing methodology, including the search for acceptable comparables, are key questions in the determination of arm's length transactions**.**

These factors increase uncertainty of transfer pricing both for business and national tax administrations.

One possibility to overcome this problem are Advance Pricing Agreements, which for the taxpayer are a means to request a binding transfer pricing ruling from the tax administration(s) on the treatment of future transactions involving transfer prices. The disadvantage is that they can usually only be obtained via a lengthy and costly procedure, both for tax payers and tax administrations, which makes them generally useful only for very important cases. More precisely, in the OECD Transfer Pricing Guidelines an APA is defined as: *" an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustements thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time"*

Depending on the number of Member States granting a specific APA, those can be unilateral, bilateral or multilateral. Unilateral APAs do not necessarily prevent double taxation, owing to their domestic scope, and raise concerns about harmful tax competition unless sufficient transparency and exchange of information are guaranteed. As also acknowledged by the OECD, unilateral APAs should therefore be discouraged in contrast to bilateral or multilateral APAs.

Only a few Member States have established formal APA programmes. However, in most other Member States APAs to some extent can be obtained via other general procedures such as rulings and/or under the scope of the mutual agreement procedure of a double taxation treaty. The majority of bilateral or multilateral APAs concluded by EU multinational enterprises (and tax administrations) involve a non-Member State, often the USA. It is worth noting that the OECD transfer pricing guidelines have recently been supplemented with an annex that establishes some common guidelines for operating APAs under Mutual Agreement Procedures in Tax Treaties.

It is generally assumed, that the practical application of APA programmes (or similar instruments) is often more difficult than it might seem from the legislation at first sight. From the point of view of the taxpayer the main concern is likely to be the complex procedures, significant cost and time required. For instance, tax authorities will generally require that the multinational enterprises prepare the same (or even higher) levels of documentation as would be required in "normal" circumstances. Another issue of concern might be the applicability of APAs in certain quickly changing business sectors. Seen from the tax administration side, the

costs and resources required will be the main concern, and for some tax administrations there is also the problem of a lack of experience in dealing with APAs. As a result, APAs are primarily used by large multinational enterprises in cases involving complex issues (e.g. intangibles, cost-sharing etc.) and/or transactions involving significant amounts.

Even if the procedures for entering into bilateral or multilateral APAs – including APAs concluded after Appendix 3 to the OECD Guidelines was issued – might be complicated, costly and time consuming for business (and tax administrations), it seems difficult to avoid this. Thought could therefore also be given to developing simplified administrative procedures in the form of a "mini-APA" available for small and medium-sized enterprises on “de minimis” grounds. Moreover, if tax administrations are to feel confident in agreeing on the transfer pricing method etc. in advance, it is not unreasonable that the process should include certain safeguards and that taxpayers should be asked to provide sufficiently detailed information to enable administrations to form a judgement.

***Against this background, would the Forum support the promotion of the availability of reliable and quick mechanisms for businesses to obtain under reasonable conditions an APA?***

***Is the Forum of the opinion that Member States could benefit from an exchange of best practice in the area of APAs and should the development of a Code of Best Practice be envisaged?***

**2.1.3 Speedier and more streamlined dispute resolution procedures.**

Whereas the examination of the previous issues should result in the avoidance of double taxation, in practice it might be difficult to achieve. It is therefore imperative to have appropriate dispute settlement mechanisms that relieve double taxation as quickly and efficiently and in as many cases as possible, and with the lowest possible costs for business and tax administrations.

Compared to the OECD Mutual Agreement Procedures (MAP) vested in the bilateral double tax treaties, the commitment for timely decisions and the guarantee for relief of double taxation are the two most important objectives which should make the EU Arbitration Convention the prevailing dispute settlement mechanism within the EU.

Under 2.2, the FORUM is requested to examine the possibilities to improve the practical functioning of the existing Arbitration Convention, however this might not be sufficient to achieve the goals as set out in the first paragraph of this section.

In the light of the intention to propose revisions to the Arbitration Convention, announced in the aforementioned Commission’s Communication of 23 October 2001, it might be useful that the FORUM examines other measures and mechanisms that could be introduced in the Convention in order to prevent or relief double taxation.

The Arbitration Convention (like bilateral double tax treaties) does not oblige the tax authorities of a Member State to agree in advance on an appropriate transfer price with the tax authorities of the affiliated company before an income adjustment is made. This procedure would solve most of the mentioned business concerns; i.e. the double taxation itself, the costs of temporarily having to finance the same tax burden twice, business costs of seeking double tax relief etc. However, tax administrations might argue that such a rule would increase their administrative burden, lead to more aggressive tax planning, and require substantial extension of the periods where tax returns are open etc. Since both concerns are valid, the basic idea of prior approval or the agreement on a less stringent and voluntary consultation procedure should therefore be considered in more detail.

The lack of rules on collection or suspension during cross-border dispute resolution, of tax which is due, is another important obstacle to prevent (temporary) double taxation. Although this type of rules exist in most national tax legislations in case of domestic appeal, their absence in EU cross border cases is denying the basic existence of an Internal Market. Whereas instant tax collection could be justified in certain cases when dealing with third countries, the existing EU Treaty network, the Mutual Assistance Directive 77/799 of which the provisions on exchange of information are currently being examined by a subgroup of the Code of conduct group with a view of implementation in the area of transfer pricing and Directive 76/308/EEC on mutual assistance for the recovery of claims relating to certain levies, duties, taxes and other measures , should be sufficient guarantees to secure tax collection in due time.

The Arbitration Convention could be improved so that suspension of tax collection was possible to the same extent as when an adjustment is appealed against to national courts.

Another problem closely linked to the issue of collection of tax liabilities is that of interest charges - or similar supplementary payments - added to those liabilities and interests on tax refunds.

Both problems still constitute an important equity issue for business and in cases involving significant amounts the interest payment might constitute an important loss of cashflow.

***Would the Forum be prepared to examine the possibilities of consultation procedures prior to making adjustments and the problems of suspension of tax collection and interest charges together with other possible measures to avoid double taxation and improve the Arbitration Convention?***

## 2.2 Improvement of the practical functioning of the Arbitration Convention 90/436/EEC

### 2.2.1 The starting point of the three and two year periods

i) Article 6.1 of the Convention specifies that " Where an enterprise considers that, in any case to which this Convention applies, the principles set out in Article 4 have not been observed, it may, irrespective of the remedies provided by the domestic law of the Contracting States concerned, present its case to the competent authority of the Contracting State of which it is an enterprise or in which its permanent establishment is situated. The case must be presented within three years of the first notification of the action which results or is likely to result in double taxation within the meaning of Article 1."

Apparently, different interpretations are given to the notion of "first notification of the action"

Indeed, as "first notification of the action" could be considered a request for additional information from the taxpayer in a case to which the Arbitration Convention applies, the formal communication to the taxpayer of the intention of the tax authority to make an adjustment which could result in double taxation; the formal sending to the taxpayer of the tax audit report or the formal sending to the taxpayer of the tax re-assessment notice.

ii) Business also claims that Member States' interpretations of the starting point of the two-year period of the first phase differs significantly. (Art.7§1 of the Convention) Business also claims some Member States have taken a position that is not in accordance with the EU Arbitration Convention, as they hold the opinion that the two-year period does not start until the other Member State has formally notified that it is not prepared to make a corresponding adjustment.

According to the Commission Services transfer pricing questionnaire only one Member State takes this position, whereas three Member States mention that the two year-period starts when the tax authorities receive a request from the taxpayer. This is also the position of two other Member States which, however, express the view that a request cannot be made until the tax authorities have actually made the adjustment, as no double taxation will occur until this point. One Member State takes the position that the two year period does not start until all necessary information has been provided to the tax authorities. The answers to the questionnaire thus confirm the differing views.

***Does the Forum recognize the need to give more clarification and develop a common approach on these points ?***

### 2.2.2 Interpretation of definitions

According to Article 3 (2) of the Convention any term not defined in the Convention shall, unless the context requires otherwise, have the meaning, which it has under the double taxation convention between the Member States concerned. Examples of terms not defined include "enterprise", "permanent establishment" and when companies are "associated". The Convention as it stands does not therefore

guarantee relief of double taxation if Member States apply a different interpretation of these definitions.

The treaty network between Member States is not complete. In a potential case where there is no double tax treaty between the Member States, it is therefore uncertain whether these terms will be interpreted in line with the OECD model tax convention or according to domestic legislation.

Furthermore, key definitions in the double tax treaties are not always defined in the treaty itself, but refer back to the domestic legislation of each Member State. The term "enterprise" and the question of when companies are "associated" might therefore be defined according to each Member States internal legislation. This lack of definition of "associated" might be problematic as Member States apply different definitions in their domestic legislation and there is a theoretical risk that whereas one Member State under this domestic legislation might consider certain enterprises "associated", another Member State might not and would thus consider the Convention to be inapplicable.

***Although so far there is no concrete evidence that differences in interpretation of definitions has led to the inapplicability of the Convention, would the Forum be prepared to consider this issue for discussion and undertake the development of a practical solution to avoid the inapplicability of the Convention?***

### 2.2.3 Proceedings of the second phase of the Arbitration Convention

Only one Member State seems to have cases that have proceeded to the second (Panel) phase. In its answer to the Commission Services transfer pricing questionnaire this Member State suggested that the arbitration phase should be explained in more detail. Procedures for setting up the advisory commission, in particular the appointing of the chair could be specified. The EU Arbitration Convention includes some procedure rules, e.g. information, business rights to appear or be represented before the advisory commission, costs etc. It is also stated that the advisory committee must deliver their opinion "within 6 months from the date on which the matter was referred to it".

However, there are numerous other unresolved issues, some of which are outlined below. One is the important question of when precisely the 6-month period starts running. The most obvious starting point would be the cut-off date of the two-year period of the first phase, leaving it up to the involved Member States to get the second phase process started quickly. However, it could also be argued that a case cannot be referred to an advisory commission until this has been (finally) established. In that context it should also be noted that the Convention does not include rules on how the advisory commission organises its work**.** For instance who should call for meetings, what notice periods are required, where should the meetings take place, which language(s) should be used, who provides the secretariat of the advisory commission, on what basis should the remuneration for the members of the advisory commission and other expenses be calculated etc. The deadline of 6 months is very tight (but there are no consequences linked to non-compliance), and it therefore seems to be important to establish rules which would improve the likelihood of meeting the deadline.

Moreover, considering that the composition of the advisory commission for each case is different and publication of decisions is not mandatory, the risk of different treatments for similar cases seems apparent. The possibility of establishing a series of precedents in the transfer pricing area seems therefore missed.

***Does the Forum agree on the importance of providing more specific guidance as regards the proceedings during the Convention's panel phase ?***

### 2.2.4 Procedures to be followed during the interim period when not all Member States have ratified the Convention

The Protocol, extending the Arbitration Convention beyond 1 January 2000, has been signed by all Member States on 25 May 1999.

This Protocol provides that the extention of the Convention takes effect the first day of the third month following that in which the instrument of ratification is deposited by the last signatory State.

So far only eight Member States have ratified the protocol. It is unclear why, three years after signing the protocol, so few Member States have succeeded in ratifying the extension of the Convention. Moreover, and in particular in view of the forthcoming enlargement, it is surprising to notice that three Member States have not yet ratified the convention concerning the accession of Austria, Finland and Sweden to the Arbitration Convention.

In practice national tax administrations seem to interprete differently the interim period in which the Convention is not applicable: some Member States distinguish between cases that were submitted until 31 December 1999 and applications that were filed on or after 1 January 2000, certain accept cases without of course initiating the procedure, some refuse to accept cases considering the lack of legal basis, others who have already ratified the protocol seek to implement bilaterally the Convention with other Member States who have also ratified etc.

Whereas Member States should be invited to expedite the ratification procedure, in the meantime companies' and governments' legal certainty should be ensured.

***Would the Forum be prepared to seek for a uniform, pragmatic and transparent solution on how to handle cases, both pending and new, during the interim period?***

### 2.3 Other issues

***Is the Forum of the opinion that considering its remit mentioned under 1, this paper sufficiently covers all issues to be discussed or would the Forum like to add some additional discussion topics?***

## 3. OPERATIONAL CONCLUSIONS

The Members of the Forum are requested to reply to the above questions.

On the basis of the replies, a draft two-year work programme should be established, prioritising the issues and presenting a longer-term calendar.

In function of the outcome of the deliberations, the Secretariat, in close co-operation with the Chairman and the Vice-Chairpersons, will submit for the next meeting of the Forum a detailed work plan.