



EUROPEAN COMMISSION
DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
Direct taxation, Tax Coordination, Economic Analysis and Evaluation
Company Taxation Initiatives

Brussels, 4th March
Taxud D1/

DOC: JTPF/001/FINAL/2011/EN

EU JOINT TRANSFER PRICING FORUM

REPORT ON SMALL AND MEDIUM ENTERPRISES AND TRANSFER PRICING

Meeting of 10 February 2011

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Report

I. Introduction

1. The Joint Transfer Pricing Forum (JTPF), as part of its agreed work programme, considered the impact of transfer pricing on Small and Medium Enterprises (SMEs). The JTPF background discussion papers on this work may be found on the DG Taxation and Customs Union website including contributions from The Federation of European Accountants and Confédération Fiscale Européenne. This report is the outcome of that work.

II. Background

2. There are around 23 million SMEs in the EU representing 99.8% of all European enterprises. About 5% of those SMEs have associated companies where transfer pricing may be in point.¹ These figures indicate that transfer pricing is not a widespread issue for SMEs in relative terms but may well be in absolute terms. But, where transfer pricing is in point, SMEs face difficulties as a result of their lack of knowledge, experience of the subject and resource availability. The low figure of international intra-group trading at SME level may also reflect that those same difficulties can impede SMEs from engaging in intra-group cross border trading.
3. Tax administrations also face challenges when dealing with SMEs. Administrations need to strike a balance between applying their tax policy in an even handed manner taking into account available own resources and cost benefit considerations and avoiding undue administrative burden and unnecessary tax conflicts for SMEs and among tax administrations. Within the EU there is neither a common definition of SMEs for general tax purposes or specifically for transfer pricing, nor a common treatment of SMEs.
4. Some tax administrations already have specific SME transfer pricing measures in place. Those measures can be broadly categorised as an overall policy approach or specific administrative actions. An example of a policy approach is that of proportionality. This approach revolves around balancing compliance requirements with the SME resources available to meet that compliance requirement. An example of an administrative action is a more slim line transfer pricing documentation requirement for SMEs than that for non-SMEs.
5. The MNE perspective is that they and SMEs often complement each other in EU business operations and each has a vested interest in the efficient operation of the other. But non-SMEs also want to maintain an appropriate 'level playing field' and not be disadvantaged as a result of responses by tax administrations to the needs of SMEs.

¹ 2009 Annual Report on European SMEs (http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/pdf/dgentr_annual_report2010_100511.pdf, page 15)

6. Business recognises that issues like management time and expert tax advisers' costs can cause SMEs to refrain from accessing expert services.
7. The JTPF in its reports on transfer pricing documentation and Advance Pricing Agreements (APA) guidelines acknowledged the need for flexibility when dealing with SMEs and transfer pricing. The documentation report refers to applying "a reasonableness test" and the APA guidelines to "facilitating access" where SMEs are involved.

III. Defining an SME

8. A common definition of an SME for transfer pricing purposes would provide an agreed departure point in facilitating the outcomes and recommendations of this report. A general EU definition for SMEs exists (EU Recommendation 2003/361/EC) but is not widely applied for direct tax purposes by tax administrations. The JTPF made the following observations on the use of a definition.
9. For small Member States applying a particular SME definition could result in even large domestic companies/groups being classified as SMEs. Therefore, special care must be taken regarding the SME definition applied.
10. A definitional approach can influence SME behaviours. It may be a disincentive for some SMEs to grow their business and thereby cross a defined threshold and potentially incur increased costs, administrative burden and lose access to incentives.
11. Similarly, some Tax administrations feel a too prescriptive EU SME definition would not take sufficient account of the make up of a particular tax administration's tax base. For example, if, according to a commonly agreed definition, a large proportion of a Member State's tax base were made up of SMEs that may pose different issues than if SMEs make up only a minority of a tax base.
12. The current different tax administration definitions of SMEs, either for direct tax purposes generally or for transfer pricing specifically, often 'borrow' from parts of the EU definition. The criteria commonly used throughout the EU are: balance sheet value, turnover, and numbers of employees; individual or cumulative transaction values; and some anti abuse rules. The criteria may or may not be applied on a consolidated basis – i.e. at group level. Where tax administrations have not published a SME definition, either for the purposes of a general definition or specifically for transfer pricing, they are invited to consider using criteria already commonly in use.
13. The Forum considers it useful to bring together in one place a description of EU tax administration's SME definitions that are currently in place either for direct tax purposes generally, transfer pricing or both. See annex (DOC: JTPF/001/ANNEX/2011/EN).

Recommendations:

R1. If an EU tax administration is considering defining SMEs for direct tax purposes or more specifically for transfer pricing purposes, it is recommended it considers using

criteria already used throughout the EU. Such an approach will also assist in reducing instances of asymmetry of treatment arising from differing SME definitions.

R2. The recommended criteria in current use consist of: balance sheet value, turnover, numbers of employees; individual or cumulative transaction values. It is recommended that all be measured on a consolidated basis, i.e. at group level.

R3. Definitions currently in use by Member States should be brought together in one place and updated regularly. See annex (DOC: JTPF/001/ANNEX/2011/EN).

R4. A common EU tax definition of SMEs is recommendable and would provide an agreed starting point in the implementation of the findings and recommendations of this report, but it is not realistic to reach a common agreement in the foreseeable future.

IV. SMEs: compliance and transfer pricing

14. In the EU transfer pricing compliance currently means adherence to the arm's length principle in line with Art 9 of The Organisation for Economic Co-operation and Development (OECD) Model Tax Convention. The arm's length principle applies equally whatever the size of a MNE. However, the degree of difficulty in applying it may be greater for SMEs. The OECD Transfer Pricing Guidelines ("TPG") contain explicit acknowledgement of this difficulty in several places. For instance, paragraph 3.80 contains a specific comment in relation to compliance costs for SMEs. The OECD at paragraph 3.83 of the TPG states that "Small to medium sized enterprises are entering into the area of transfer pricing and the number of cross-border transactions is ever increasing. Although the arm's length principle applies equally to small and medium sized enterprises and transactions, pragmatic solutions may be appropriate in order to make it possible to find a reasonable response to each transfer pricing case.

15. This report considers what best practices and recommended guidelines can be discerned from current compliance activity. A useful structure for that examination is to consider pre-audit, audit and dispute resolution activities. Inevitably these rather broad categories will have some overlap.

16. A recurrent theme in tax administrations is that the approach to SMEs should be proportionate to the requirements of the tax administration and the ability of SMEs to meet those requirements. The JTPF supports the principle of proportionality as a sound approach to meeting the needs of SMEs. The JTPF also noted that an approach based on proportionality aligns itself well with the commentary on Chapter IV and V of the OECD guidelines.

Recommendation:

R5. An approach based on proportionality is welcomed by the JTPF. It seems particularly appropriate to balance a tax administration's need to even-handedly apply transfer pricing rules with the burden it might create for SMEs when complying with those rules.

Pre-Audit

17. Tax administrations want to receive and taxpayers want to pay the right amount of tax at the right time. Pre-audit activity is possibly the most effective method to enable taxpayers and tax administrations to achieve voluntary compliance – the most cost effective form of compliance. That objective is best facilitated by good communication, the provision and understanding of relevant information, supplemented by easily accessible specialist advice. Getting this interaction right has a direct impact on the level of voluntary compliance and the level of compliance burden.

Tax administration and SME communication

18. There is an increasing international recognition² that enhancing the relationship between a tax administration and its corporate taxpayers by means of an ongoing dialogue outside an audit is beneficial to both parties. Exchanges will be less confrontational and promote a wider and better understanding of each others perspectives. If an audit were launched, each of the parties would start from a more informed position.
19. It is particularly difficult to build up a communication network with SMEs not least because of their limited resources. SME representative groups provide useful insight to matters of concern to their members. What seems harder to establish is a direct line of communication with frontline SMEs. Tax administrations are encouraged to seek opportunities to work with individual SMEs, representative groups and professional advisors to build or strengthen a local communication network with SMEs. For example, a relatively simple action, as already happens in some tax administrations, is to organise technical workshops. A variety of SMEs are invited to attend to discuss and seek solutions to problem areas and identify best practice. Such events can also be used to consult SMEs on transfer pricing policy initiatives a tax administration may wish to introduce.

Access to information

20. The breadth and depth of information provided to assist SMEs to comply with transfer pricing rules varies between tax administrations. It would be beneficial for both business and tax administrations to be able to access that information. Details of where that information can currently be found are contained in annex (DOC: JTPF/001/ANNEX/2011/EN).
21. The JTPF proposes that the information provided by tax administrations for this report is kept updated. Administrations should consider how best they can establish electronically accessible SME information perhaps either as a dedicated site or as an integrated part of an existing site. The site(s) would detail definitions of SMEs - generally and/or for transfer pricing, as well as any other SME transfer pricing legislation, administrative practice or training material. In addition a contact(s) address for further enquiries can be

² The recent work of the OECD Forum on Tax Administration may be cited as an example.

included. The web pages may also usefully include other non transfer pricing matters relating to SMEs. A list of those web pages will be held on the JTPF website.

Training

22. The possibility of producing some sort of blue print transfer pricing training module for SMEs was debated. To develop this suggestion would require a significant amount of the Forum's resource. Also it was not clear what the additional benefit the JTPF could add over locally produced material. See annex (DOC: JTPF/001/ANNEX/2011/EN).

Certainty in advance of a transaction taking place

23. SMEs often seek certainty that before executing a transaction it will comply with the transfer pricing rules but they may not be aware how that might be done.
24. The mechanism generally used in transfer pricing to meet this need is an Advance Pricing Agreement. The process determines an appropriate set of criteria, agreed between the tax administration and the taxpayer, to establish the transfer price of a future transaction. However, APA rules may contain complexity thresholds or fees that make the process inaccessible or at least less accessible to SMEs. As stated at paragraphs 4.158 and 4.163 of the OECD TPG, “the nature of APA proceedings may de facto limit their accessibility to large taxpayers. The restriction of APAs to large taxpayers may raise questions of equality and uniformity, since taxpayers in identical situations should not be treated differently. A flexible allocation of examination resources may alleviate these concerns. Tax administrations also may need to consider the possibility of adopting a streamlined access for small taxpayers. Tax administrations should take care to adapt their levels of inquiry, in evaluating APAs, to the size of the international transactions involved”. The JTPF has previously issued some guidelines on how best to approach the subject of accessibility and the guidelines state: Tax administrations should use their experience of the problems faced by SMEs to facilitate access to APAs for SMEs where APAs are useful for dispute avoidance or resolution. This wording is intended to encourage a flexible approach when accepting cases into an APA programme.
25. Some tax administrations offer other options to obtain a measure of certainty of tax treatment. A non binding opinion may be given. In that case a tax administration specialist will offer a view on a transaction perhaps confirming that transfer pricing is in point and acknowledging that a suggested OECD methodology is appropriate. This approach falls short of agreeing the actual transfer price. There may be a clearance or rulings system that gives a binding view from the tax administration. The clearance or ruling obtained may be obtained ex-ante the relevant tax return.
26. Measures directed to SMEs and “small transactions” have been identified as some of the most frequently encountered simplification measures.
27. Several commentators suggest that the use of safe harbours will provide a measure of simplification for SMEs as well as saving on administrative resource and reducing compliance burden.

28. To improve clarity and transparency for both SMEs and tax administrations it is recommended that each tax administration sets out what advance certainty procedures are available on transfer pricing, how to access those procedures and the outcomes that can be expected. Information currently available is contained in the annex (DOC: JTPF/001/ANNEX/2011/EN).

Pre-audit recommendations:

R6. To facilitate voluntary compliance Member States should ensure SMEs have access to up to date information and advice. It is recommended that each Member State establishes an electronically accessible point of information site including details of who to contact for further advice. A list of those sites will be held on the JTPF website and links provided.

R7. Member States and the business community should take opportunities to build constructive relations with individual SMEs and their representative groups.

R8. Member States should seek to increase SME awareness of and ability to access processes that enable SMEs to gain certainty in advance of a transaction taking place or it being reported for tax purposes.

R9. Member States are invited to actively develop simplification measures to reduce administrative and SME compliance burden.

Audit

29. At least one Member State takes the view that a policy of exempting most transactions of its SMEs from its transfer pricing rules is a proportionate response. Clearly that approach has advantages in resource savings and certainty of treatment but it may possibly have some detrimental effects on the tax base of a country implementing it, the significance of which would vary depending on the size of the activities conducted by SMEs in such country. But asymmetries of treatment can arise if associates are not similarly exempted in other Member States

30. Other Member States take a less broad based approach when implementing the principle of proportionality. In both the audit and APA processes specific measures are put in place and include: streamlined documentation requirements; provision of relevant information orally; preparation of a limited transfer pricing study by the Tax Administration; Tax administration provides assistance to the taxpayer in preparing comparable data; special measures for long term contracts. More details on these current measures are in the annex (DOC: JTPF/001/ANNEX/2011/EN).

31. The JTPF felt that adherence to the principle of proportionality gave an overall framework with enough flexibility for tax administrations to develop their own specific measures. Tax administrations are encouraged to look at measures already introduced by others and seek opportunities to incorporate them into their own rules as appropriate.

32. It is also recommended that approaches available in one process may have similar benefits in another. Examples of this are tax administration assistance in the APA process by preparing comparable data or a limited transfer pricing report for the taxpayer. That type of assistance would be equally useful in the audit process.
33. Similarly, existing JTPF reports can be usefully cross referenced to this subject. For example, in the report on intra-group services, the process of evaluating an arm's length price was discussed. The report acknowledged that cost benefit considerations are particularly appropriate in low tax risk cases. The report proposes that in such cases it is particularly important that a balance is sought between available resource, compliance burden and the potential level of adjustment. The commentary in the report on narratives and an arm's length charge is also relevant. Emphasis is given in the report on working with a minimum rather than maximum amount of information when evaluating a transfer price. It is suggested that the same emphasis could equally apply when evaluating a SMEs' transfer prices.
34. The subject of documentation related penalties was considered. It would be inconsistent for a tax administration to have a streamline approach to documentation requirements pre-audit but then to impose penalties for the absence of additional documentation required only as a result of an audit, if the taxpayer acted in good faith, relying on the streamline approach, and is not able to supply the required documentation.
35. Concerns were raised that experienced tax administration transfer pricing personnel do not often deal with SME transfer pricing issues. This could lead to a disparity of treatment between SMEs and non-SMEs. Some administrations avoid the potential problems of less experienced officials being assigned to SME transfer pricing work by structural means, for example they have dedicated SME centres dealing with a wide variety of cases but by a relatively small group of people. Other administrations have process systems wherein an internal peer group review of audits take place to ensure consistency. Both approaches are recommended for consideration.

Recommendations:

R10. When considering SME audit approaches, Member States are encouraged to consider the simplification measures already introduced by others and where possible introduce similar measures in their own Member States.

R11. Previous JTPF reports contain useful material on pragmatic approaches to transfer pricing issues. Member States are invited to review those previous reports with a view to drawing on the principles established in those reports that may equally apply in this context.

R12. It would be inappropriate to impose documentation related penalties arising from an audit requirement to provide documentation that was not required pre-audit, if the taxpayer was acting in good faith, relying on the streamline approach, and is not able to supply the required documentation.

R13. Member States should seek to ensure that when SMEs are audited for transfer pricing purposes they receive appropriate treatment. Internal peer group reviews or

structural organization of audit resource are put forward as cost effective means of achieving that objective.

Dispute Resolution

36. Once a transfer pricing adjustment has been made it often gives rise to potential double tax. A claim to relief from that double tax is available under a tax treaty, the EU Arbitration Convention or both. For SMEs the quantum of relief sought is, generally, at the lower end of the scale but the impact on their business is often at the high end of their scale. Additionally, the timescales involved in resolving claims are often disproportionate to the complexity and the amounts involved in a claim.
37. It is suggested that in dealing with SME claims either from their own auditors or from other MS, tax authorities make greater use of their authority to resolve double taxation unilaterally, whether under Article 6(2) of the Arbitration Convention or under Article 9 of the applicable bilateral tax convention.
38. If an adjustment involving a non complex transaction with a relatively low monetary value does need to go through the full MAP or A/C process, it is suggested there is a role for a fast track approach. The JTPF has not detailed the process of such an approach but notes it is likely to involve CAs agreeing to work to much shorter time scales than might be the case in a large complex adjustment. Also the principles underlying the compliance approach and detailed above could equally apply here. For example, taking a decision on a minimum of information; a flexible approach as to how information is supplied; for example, the provision of relevant information orally rather than in formal written position papers. The fast track approach could also be based for instance, in some countries, on a de minimis rule.
39. The need for formal dispute resolution processes may be reduced if the relevant tax administration auditors are in direct communication with each other in the framework of MAP or A/C process to better understand the reasoning behind a particular adjustment, but this communication must not contravene exchange of information rules. A way to achieve such direct contacts may be CA meetings where respective local auditors are discussing certain cases directly with possibly low involvement of regular CA staff but the CAs agreeing finally.

Recommendations:

R14. Tax Authorities are requested to make use of their authority to act unilaterally in resolving transfer pricing double tax in SME cases.

R15. Fast track dispute resolution processes are encouraged in resolving non complex low value SME claims to relief from double tax.

R16. Alternative approaches to dispute resolution including auditor to auditor contact and de minimis limit rules should be explored and implemented by tax administrations where appropriate in the framework of MAP and A/C process.

V. Conclusions

40. The JTPF recognises that SMEs have particular needs in meeting their requirement to comply with transfer pricing rules. The JTPF notes Member States have already implemented some valuable measures in responding to those needs and this report seeks to build on those measures.
41. The findings and recommendations in this report rely on the application of the principle of proportionality backed by a flexible implementation of that principle. The report also suggests how SMEs may be identified so that suggested measures in the report can be effectively targeted.
42. As appropriate the particular needs of SMEs should be taken into account in the future work programme items of the JTPF.
43. At regular intervals the effect of SME measures recommended by the JTPF should be monitored.