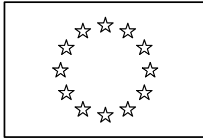

EUROPEAN COMMISSION
DIRECTORATE-GENERAL TAXATION AND CUSTOMS UNION

Direct Taxation, Tax Coordination, Economic Analysis and Evaluation
Unit D1 Company Taxation Initiatives

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EU JOINT TRANSFER PRICING FORUM

FUTURE WORK PROGRAM.

BUSINESS CONTRIBUTIONS ON:

- **IS THE PROTECTION OF A (EU) TAXPAYER TO DOUBLE TAXATION SUBJECT TO LIMITATION?;**
- **COMPENSATING ADJUSTMENTS AND YEAR END ADJUSTMENTS;**
- **SECONDARY ADJUSTMENTS, A RISK OF DOUBLE TAXATION WITHIN THE EU.**

Meeting of 26 Octobre 2010

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IS THE PROTECTION OF A (EU) TAXPAYER TO DOUBLE TAXATION SUBJECT TO LIMITATION?

I. Introduction

1. It is provided in paragraph 1 of the introduction to the OECD Model Tax Convention on Income and Capital ("OECD MTC") that the harmful effects of international juridical double taxation on the exchange of goods and services and movements of capital, technology and persons are so well known that it is hardly necessary to emphasize the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.

2. From paragraph 3 of its introduction it subsequently follows that the main purpose of the OECD MTC[1], is to provide a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation.

3. From this perspective it is not a surprise that the European Commission in its explanatory memorandum to the proposal for a council directive on the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises[2] notes in relevant part "that double taxation arising from the situation in which one country's tax authority increases the profits of an enterprise but the profits of the associated concern that is its partner in the transaction are not correspondingly reduced, may well give rise to distortions both in the conditions of the competition and in capital movements of a kind that would otherwise not exist." The Commission then continues with the important remark that "such consequences are not acceptable within the Community, because they directly affect the operation of the common market".

4. Furthermore, it is noteworthy that the Commission expresses its view towards the means of how to ensure that "such double taxation" would not affect the operation of the common market[3]: "In order to be sure of suppressing such double taxation it is necessary to provide that where tax authorities concerned do not reach agreement, the case will be submitted to a commission which will have to settle it. (…). The Commission (…) thinks it is essential to make certain that a decision will be taken definitely removing double taxation in every case".

5. Although the abovementioned proposal for a directive was not adopted, the idea to reduce and avoid double taxation was subsequently laid down in the Arbitration Convention ("AC").

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[1] Although the title of the Model Convention, unlike the 1963 Draft Convention and the 1977 Model Convention, no longer includes a reference to the elimination of double taxation it does not mean that elimination of double tax no longer is key to the Model Convention. From paragraph 16 of the Introduction it follows that "In recognition of the fact that the Model Convention does not deal exclusively with the elimination of double taxation but also addresses other issues, such as the prevention of tax evasion and non-discrimination, it was subsequently decided to use a shorter title which did not include this reference".

[2] Submitted by the Commission to the Council, CCM (76)611 Final, Brussels, 25 November 1976

[3] See paragraph 5 explanatory memorandum proposal for a council directive on the elimination of double taxation in connection with the adjustment of transfers of profits between associated Enterprises.

6. This paper explores whether the OECD MTC and/or the AC allows room for the suggestion that the protection of a taxpayer against double taxation could be subject to a(ny) limitation. This question arose when discussing the treatment of triangular cases in the context of the AC. Since the type of triangular case at stake is different from what one in the international context normally would describe as a triangular case the next section will describe the type of triangular case subject to the discussion briefly before continuing and elaborating on the topic of this paper.

II. Subject triangular case

7. The AC analysis of triangular cases that is the subject of review and this analysis is based on the determination that resolution of double taxation (resulting from a primary adjustment in one state party to the AC) regarding a transaction between two associated enterprises, both of which are resident in States party to the AC, would result in not-at-arm's length profit margins/prices for the functions performed by the enterprises in the other state as a result of the pricing of a *third* associated enterprise transaction this enterprise is involved in and which enterprise is located in a third State (not being an EU Member State and not being party to the AC).

8. An example within this context can be described as follows. Company C sources raw materials outside the EU and is located outside of the EU. This company manufactures parts/components. Company C is associated with Company B which is located within the EU. Company B serves as the European warehousing/assembly entity of the group. Furthermore, there is a third associated enterprise – Company A – located within the EU. Company A serves as the European distributor and makes sales to unrelated parties in the EU market. The pricing of the intercompany transactions between Company C and B, respectively Company B and A is based upon pan-European benchmarks.

9. Company A is audited and the tax authorities propose a transfer pricing adjustment because they are of the opinion that instead of the range of benchmarked comparables as proposed by Company A (Pan European) a range of benchmarked domestic comparables should have been used. As a consequence the operating profit margin of company A is adjusted since it falls outside (below) the range suggested by the tax authorities.

10. The adjustment suggested by the tax authorities in State A would require a corresponding adjustment at the level of Company B to avoid economic double taxation. The tax authorities in State B agree with the proposed adjustment by the tax authorities in State A. However, if the corresponding adjustment would be made in its full extent the consequence would be that the remaining operating profit margin of Company B would fall outside the range of benchmarked comparables; i.e. Company B no longer would receive an arm's length consideration for the activities it has performed. That is, the consideration would no longer fall within the ranges established by the Pan European benchmark.

III. OECD Model Tax Convention

11. As already noted, the purpose of the OECD MTC is to provide a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation. In order to achieve this goal the OECD MTC determines the respective rights to tax of the State of source and of the State of residence.

12. In the case of a number of items of income and capital, an exclusive right to tax is conferred on one of the Contracting States. The other Contracting State is thereby prevented from taxing those items and double taxation is therefore avoided. In the case of other items of income and capital, the right to tax is not an exclusive one, however.

13. Based upon the aforementioned line of thinking income and capital may be classified into three classes, depending on the treatment applicable to each class in the State of source or situs:
    - income and capital that may be taxed without any limitation in the State of source or situs,
    - income that may be subjected to limited taxation in the State of source, and
    - income and capital that may not be taxed in the State of source or situs.

14. From the description above it follows that by determining which State has the right to tax one in essence will prevent double taxation to happen. Although this principle is rather logic and from a cursory view does not seem to be that complex, difficulties nevertheless can arise. For that reason the OECD MTC also contains a procedure for resolving difficulties arising out of the application of the convention in the broadest sense of the term[4]; i.e. the so-called "mutual agreement procedure".

15. An in-depth description of how the mutual agreement procedure actually works goes beyond the scope of this paper and readers are referred to the Commentary on article 25 of the OECD MTC. This paper will focus on parts of the commentary as far as they are relevant for the scope of this paper.

16. In this respect reference is made in the first place to the remark in paragraph 9 of the Commentary on paragraphs 1 and 2 of article 25. It is specifically noted here that "(…) the procedure applies to cases (…) where the measure in question leads to double taxation which it is the specific purpose of the convention to avoid."

17. Furthermore, the paragraphs, 10, 11 and 12 are relevant for the scope of this paper and for that purpose are copied. From paragraph 10 it follows that "Article 25 also provides machinery to enable competent authorities to consult with each other with a view to resolving, in the context of transfer pricing problems, not only problems of juridical double taxation but also those of economic double taxation, and especially those resulting from the inclusion of profits of associated enterprises under paragraph 1 of Article 9". The Commentary then continuous with stating that "the corresponding

[4] Commentary article 25 OECD MTC, par. 1

adjustments to be made in pursuance of paragraph 2 of the same Article thus fall within the scope of the mutual agreement procedure, both as concerns assessing whether they are well founded and for determining their amount".

18. The Commentary in paragraph 11 then continues with noting that if "the bilateral convention does not contain rules similar to those of paragraph 2 of Article 9 (as is usually the case for conventions signed before 1977) the mere fact that Contracting States inserted in the convention the text of Article 9, as limited to the text of paragraph 1 - which usually only confirms broadly similar rules existing in domestic laws - indicates that the intention was to have economic double taxation covered by the Convention. As a result, most Member countries consider that economic double taxation resulting from adjustments made to profits by reason of transfer pricing is not in accordance with - at least - the spirit of the convention and falls within the scope of the mutual agreement procedure set up under Article 25.

19. From paragraph 12 of the commentary it subsequently follows again what the instruction is towards dealing with double taxation. "(…..) it follows that even in the absence of such a provision (*i.e. article 9(2)*), States should be seeking to avoid double taxation, including by giving corresponding adjustments in cases of the type contemplated in paragraph 2. Whilst there may be some differences of view, States would therefore generally regard a taxpayer initiated mutual agreement procedure based upon economic double taxation contrary to the terms of Article 9 as encompassing issues of whether a corresponding adjustment should have been provided, even in the absence of a provision similar to paragraph 2 of Article 9. States which do not share this view do, however, in practice, find the means of remedying economic double taxation in most cases involving *bona fide* companies by making use of provisions in their domestic laws."

20. Setting aside the issue that the mutual agreement procedure of article 25 only requires from the competent authorities to *endeavour* to resolve the case the thrust of the aforementioned paragraphs is that it is certainly the purpose of a Convention to avoid double taxation.

21. Having concluded that it is the purpose of a Convention to avoid double taxation, the question subsequently arises whether this has to take place under all circumstances. In this respect the Commentary on article 1, paragraph 7 is instructive. From paragraph 7 it follows that the "principal purpose of a double taxation convention is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons". Paragraph 7 subsequently continuous by noting that it "is also a purpose of tax conventions to prevent tax avoidance and evasion".

22. From the perspective of preventing tax avoidance and evasion the following two fundamental questions are discussed in the commentary of article 1:

- whether the benefits of tax conventions must be granted when transactions that constitute abuse of the provisions of these conventions are entered into;
- whether specific provisions and jurisprudential rules of the domestic tax law of a Contracting State that are intended to prevent tax abuse conflict with tax conventions.

23. With respect to the second question the Commentary states that for many States any abuse of the provisions of a tax convention could also be characterized as an abuse of the provisions of domestic tax legislation in which respect the question arises whether the provisions of a tax convention may prevent the application of domestic anti-abuse provisions. In this respect the commentary notes that "to the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them[5]".

24. For States preferring to view some abuses as being abuses of the convention itself the commentary notes that "these States (…) consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions[6]".

25. In conclusion the commentary on article 1 states "it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into. Noting that the wording used references "the" convention, it may be assumed that the scope of such abuse should be limited to or solely regards the convention that is being invoked.

26. Moving again to the commentary on article 25, one can also find some language regarding what might be referred to as the "improper use of the Convention" as discussed in the above paragraphs.

27. Paragraph 26 of the commentary on article 25 notes that "some States may deny the taxpayer the ability to initiate the mutual agreement procedure (…..) in cases where the transactions to which the request relates are regarded as abusive". In this respect it is interesting to note that the commentary continuous with "in the absence of a special provision, there is no general rule denying perceived abusive situations going to the mutual agreement procedure (…). The simple fact that a charge of tax is made under an avoidance provision of domestic law should not be a reason to deny access to mutual agreement. However, where serious violations of domestic tax resulting in significant penalties are involved, some States may wish to deny access to the mutual agreement procedure. The circumstances in which a State would deny access to the mutual agreement procedure should be made clear in the Convention."

28. In conclusion it seems clear that the Commentary suggests that only in case of serious violations of domestic tax resulting in serious penalties a State might reconsider its position but in the other situations the purpose of the convention remains the elimination of double tax. This conclusion seems to justify the presumption that in principle in all other cases the OECD MTC suggests that the States concerned should attempt to eliminate double taxation. However, before exploring whether the subject situation, i.e. the application of the arm's length principle in a so called triangular case situation, might be one where, given the specific circumstances of the situation the reward for the functions performed by the taxpayer would prevail over the

[5] Commentary article 1, paragraph 9.2
[6] Commentary article 1, paragraph 9.3

question whether the pricing of the relevant intercompany transactions would be at arm's length, this paper first will describe the intention of the AC.[7]

IV. Arbitration Convention

29. The issuance in 1976 of the Directive concerning Mutual Assistance by competent authorities in the field of direct taxation in which amongst others a system for the Exchange of Information was introduced did feed the expectation that the number of double taxation cases in the EU Member States would increase dramatically.[8] This fear for an increasing number of double taxation cases resulted in the submission by the EC Commission to the European Council of a proposal for a council directive of the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises.

30. As most of the Member States disagreed with the proposal for an Arbitration Directive (some Member States did not want to give up their tax sovereignty, others did not want to refer these cases to the European Court of Justice) the Directive was not adopted. Instead the suggestion made in 1978 by The Netherlands to conclude an arbitration convention based upon article 220[9] of the EC treaty was embraced. The key difference between a directive and a multilateral convention is that in the latter case the EU Member States maintained their tax sovereignty.

31. Furthermore, in principle the European Court of Justice ("ECJ") has no jurisdiction to interpret and enforce provisions of a convention. Technically a convention is not subject to Community law, albeit that more recently the ECJ decisions do indicate that treaties should not be interpreted contrary to or in violation of Community Law, and it is argued that double taxation in and of itself may be an obstacle to trade in the Common Market[10].

32. The scope of the AC compared to other conventions is rather limited, as it only applies to transfer pricing cases. On the other hand, since the AC also allows access for permanent establishments located in participating EU Member States to the competent authority process one could say that its scope is broader than conventional treaties.

33. However, the uniqueness of the AC does not lay in the fact that it can be considered as a *lex specialis* under treaties. Rather, the uniqueness lies in the fact that it requires competent authorities fully to resolve a case submitted to them. If full avoidance of double taxation[11] has not been achieved within a period of two years, the case is to be handed over to an advisory commission to resolve the case and obtain full avoidance

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[7] The situation referenced is the one where, without the corresponding adjustment the functions performed by the domestic taxpayer would be compensated with an arm's length reward, however, the (in principle correct) corresponding adjustment would have such an impact on the consideration for the functions performed that it would no longer they would be rewarded at arm's length unless the pricing of the 3rd intercompany transaction would be adjusted.

[8] See explanatory memorandum proposal for a council directive on the elimination of double taxation in connection with the adjustment of transfers of profits between associated Enterprises.

[9] Currently article 293 of the EU Treaty

[10] *Lankhorst-Hohorst GmbH v. Finanzambt Steinfurt*, 12 December 2002, C-324-00

[11] Article 14 AC defines full avoidance as: a) the profits are included in the computation of taxable profit in one state only; or b) the tax chargeable on those profits in one state is reduced by an amount equal to the tax chargeable to them in the other state.

of double taxation within a six-month time period[12]. Subsequent the competent authorities have to implement the ruling of the advisory commission or provide an alternative solution for full avoidance of double taxation within another six-month period[13].

34. From the above it follows that the process under the AC has two stages. In the first stage the competent authorities of the Member States concerned have the possibility to eliminate the double taxation. The process applicable to achieve this goal is similar to the mutual agreement process as described in article 25 of the OECD MTC.

35. According to article 6(1) AC, a taxpayer (enterprise) may present its case to the competent authority if he is of the opinion that "the principles set out in article 4[14] have not been observed". When looking at the language used the flow and thrust of the article is similar to article 25(1) OECD MTC.

36. Article 6(2) AC subsequently instructs the competent authority to whom the case has been presented that if it is of the opinion that the complaint is well founded and that it cannot solve the issue itself, it shall endeavor to resolve the case by mutual agreement with the other competent authority concerned. Again the language used and the thrust of it is similar to article 25(2) OECD MTC.

37. The second phase of the process is described in article 7 AC. In so many words if the competent authorities fail to reach an agreement to eliminate the subject double taxation within a two year timeframe, they will have to set up an advisory committee charged with delivering its opinion on the elimination of double taxation in question.

38. It would go beyond the scope of this paper to elaborate on how the process described in the previous paragraphs exactly works. Within the scope of this paper however it is the question whether the AC offers the competent authorities concerned a possibility *not* to entertain the mutual agreement procedure or abstain from establishing the advisory commission.

39. Article 8 of the AC provides the competent authorities with such a possibility. According to this provision the competent authority is not obliged to initiate the mutual agreement procedure or to set up the advisory commission in the event that the enterprise confronted with the transfer pricing adjustment (as a consequence of that adjustment) also is liable to a serious penalty.[15]

40. In conclusion, like the OECD MTC the AC contains the possibility not to entertain the procedure that would solve the double taxation. The situations in which this would be allowed can be considered as rather similar to the one applicable under the OECD MTC. In both cases the liability to a serious penalty (and/or abusive practices) in relation to the subject issue raised under the (applicable) convention is seen as a justification for the competent authorities concerned to refrain from entering into a process to solve the double taxation.

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[12] See articles 7 and 14 AC

[13] See articles 11 and 12 AC

[14] Article 4(1) AC contains the definition of the arm's length principle

[15] Article 8(2) AC provides the same possibility in the event that one of the enterprise concerned simultaneously is also subject to a legal or administrative procedure with a view to ruling that the enterprise confronted with the transfer pricing adjustment (as a consequence of that adjustment) also could be liable to a serious penalty

41. Furthermore, as a preliminary conclusion at this point it can be noted that for as well the OECD as the EU the reason for eliminating double taxation can be found in the wish to have adequate measures that counteract possible negative impact on economic development which could be caused by double taxation.

42. The key difference between the two systems is that the AC requires that double taxation is resolved while the OECD MTC instructs the competent authorities to endeavor to resolve double taxation.

43. Going back to the subject question "whether the OECD MTC and/or the AC contain any suggestion that the protection of a taxpayer to double taxation would be subject to any limitation" it can be concluded that both contain the possibility to not entertain the procedure that would resolve the double taxation. These possibilities are subsequently defined (rather narrowly) as being the liability to a serious penalty in relation to the subject issue. No other justification is provided for the competent authorities concerned to refrain from entering into a process to solve the double taxation.

44. The basic idea of eliminating double taxation appears the leading thinking behind the OECD MTC and AC. Access to the process can only be denied in case of abusive cases, a qualification that should not be applied too easily or loosely. Moreover, once entered into the AC process - again except in a possible abusive case - the instruction to the Member States concerned is to resolve the double taxation.

45. Having drawn this conclusion the paper continues to explore whether in the subject triangular case application of the arm's length principle might support another view towards this conclusion.

V. Application arm's length principle

46. From article 6 AC it follows that in the event an enterprise is of the opinion that because of an action (i.e. adjustment) of a tax administration in one Member State the principles laid down in article 4 AC no longer would be observed (i.e. would result in economic double taxation), this enterprise may present its case to the competent authority in the other Member State concerned with the request to solve the double taxation.

47. Article 4(1) AC describing the principles basically contains the definition of what can be considered the subject taxpayers (i.e. the associated parties) and the definition of the arm's length principle both of which are also laid down in article 9(1) OECD of the MTC. Not observing the principles laid down in article 4 could regard the question of whether or not the definition of what is a related party has been correctly applied and the question whether the arm's length principle has not been correctly applied. For the subject question only the latter is of relevance.

48. Having drawn the conclusion that it basically regards the question whether or not the arm's length principle has been applied correctly, it becomes key to identify first whether there is any guidance on how to apply this principle.

49. The explanatory memorandum of the proposal for a council directive on the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises is silent on how this principle is to be applied. This is not such a big surprise if one realizes that this proposal was submitted to the Council in 1976 while the first OECD report providing guidance on the application of the arm's length principle was published in 1979.

50. However, in later documents, the Code of Conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises published in 2006 it is noted in paragraph 3 that "the arm's length principle will be applied, as advocated by the OECD".

51. This reference to the OECD made in 2006[16] can only be understood as a reference to the explanation regarding the application of the arm's length principle as laid down in the OECD transfer pricing guidelines for multinational enterprises and tax administrations ("OECD TPGL") as published in 1995 and its subsequent updates.

52. From the preface to the OECD TPGL it follows that the ever increasing globalization of multinational enterprises ("MNEs") presents increasingly complex taxation issues. At a policy level countries need to reconcile their legitimate right to tax the profits of a taxpayer based upon income and expenses that can reasonably be considered to arise in their territory with the need at the same time to avoid the taxation of the same item of income by more than one tax jurisdiction. The practical application might lead to problems; i.e. difficulties with obtaining information located outside its own jurisdiction[17].

53. Having referred to these difficulties, the preface notes that OECD Member Countries have chosen the separate entity approach in conjunction with the application of the arm's length principle as serving the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation[18].

54. Having recognized that the establishment for tax purposes of appropriate transfer prices is one of the most difficult issues that has arisen in the context of taxation of MNEs, the preface notes that "these guidelines are intended to help tax administrations (…) and MNEs by indicating ways to find mutually satisfactory solutions to transfer pricing cases[19]".

55. Further of importance is the remark in the preface that the guidelines are primarily intended to govern the resolution of transfer pricing cases in mutual agreement procedures[20]. However, member countries are also encouraged to follow these guidelines in their domestic transfer pricing practices[21].

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[16] And confirmed in the revised code of conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises published in 2009

[17] See preface OECD TPGL paragraph 4

[18] See preface OECD TPGL paragraph 7

[19] See preface OECD TPGL paragraph 15

[20] See preface OECD TPGL paragraph 17

[21] See preface OECD TPGL paragraph 16

56. Finally noteworthy is the statement[22] that “in seeking to achieve the balance between the interests of taxpayers and tax administrators in a way that is fair to all parties, it is necessary to consider all aspects of the system that are relevant in a transfer pricing case”. Although this statement in isolation might perhaps be interpreted as opening a door for tax administrations towards arguing for protection of their interests, on reflection this sentence has to be seen in the light of the allocation of the burden of proof relative to the determination of the arm’s length value of the subject transaction and not as an option to limit access to avoidance of double taxation.

57. In conclusion the preface does recognize that for both taxpayers and tax administrations the establishment for tax purposes of appropriate transfer prices is one of the most difficult issues that has arisen if dealing with the taxation of MNEs. Having recognized this when allocating the burden of proof one has to seek a balance between the interests of taxpayers and tax administrations in such a way that it is fair to all parties. No suggestion is found in the preface that would support the conclusion that the protection of a taxpayer to double taxation would be subject to any limitation. Moreover, from the statement “both competent authorities are expected to take a cooperative approach in resolving mutual agreement cases” one might even expect the opposite.

58. How to apply the arm’s length principle would go beyond the scope of this paper. However, with respect to the subject question reference is made to paragraph 3.9[23]. in this paragraph one of the leading principles towards a proper application of the arm’s length principle has been stated, i.e. “ideally, in order to arrive at the most precise approximation of fair market value, the arm’s length principle should be applied on a transaction-by-transaction basis.”

59. Having made this statement it is also recognized in the same paragraph that in practice there often will be situations in which separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis.

60. To illustrate the issue a number of examples are provided; i.e. long term contracts for the supply of commodities or services; rights to use intangible property; pricing of a range of closely-linked products when it is impractical to determine pricing for each individual product or transaction; licensing of manufacturing know how and the supply of vital components to an associated manufacturer. With respect to these examples it is recognized that “it may be more reasonable to assess the arm’s length terms for the two items together rather than individually.”

61. The above examples in principle only regard transactions between two associated parties, however, and do not envisage a consecutive series of transactions in a supply chain including more than two associated enterprises. Paragraph 3.9 however, also refers to a situation in which more than two associated parties are involved; i.e. “the routing of a transaction through another associated enterprise”. In this respect it is noted that “it may be more appropriate to consider the transaction of which the routing is part in its entirety, rather than consider the individual transactions on a separate basis.”

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[22] See preface OECD TPGL paragraph 18

[23] Reference is made to paragraph in OECD TPGL version as of July 22, 2010. In the previous version it was paragraph 1.42

62. The next case in which reference is made to a transaction between more than two associated enterprises regards paragraph 2.33[24]. In this case reference is made to "a case where there is a chain of distribution of goods through an intermediate company". In that case it is suggested that "it may be relevant for tax administrations to look not only at the resale price of goods that have been purchased from the intermediate company but also at the price that such company pays to its own supplier and he functions that the intermediate company undertakes." This example describes a situation that somewhat resembles the situation of the example provided to illustrate the triangular case situation under the AC.

63. With respect to this situation paragraph 2.33 of the OECD TPGL notes that "[T]here could well be practical difficulties in obtaining this information and the true function of the intermediate company may be difficult to determine. If it cannot be demonstrated that the intermediate company either bears a real risk or performs an economic function in the chain that has increased the value of the goods, then any element in the price that is claimed to be attributable to the activities of the intermediate company would reasonably be attributed elsewhere in the MNE group, because independent enterprises would not normally have allowed such a company to share in the profits of the transaction".

64. From the above it follows that the OECD TPGL appreciate that in a situation in which more than two associated enterprises are involved it might be difficult to come to a correct assessment of the arm's length terms and conditions. The OECD TPGL - except for the suggestion of possibly looking at the transactions together - remain however silent on how this could work out in practice but certainly do not infer to exclude or limit the possibility to get access to avoidance of double taxation in those circumstances.

65. Therefore, the question arises whether the above would provide any support towards the subject question that the protection of a taxpayer to double taxation would be subject to any limitation.

66. The situations described in the OECD TPGL regard situations in which it might be difficult to correctly determine the market value. However, the simple fact that it could be difficult to correctly apply the arm's length principle can simply not be sufficient of a reason for denying a taxpayer access to a process that is especially established to solve double taxation arisen because of the action of one of the tax administrations involved.

67. The fact that it is recognized that it is difficult to make a proper assessment of the arm's length terms; i.e. accepting that it well might be that mistakes can be made, seems, on the contrary, a reason for the authorities concerned to entertain a process that would eliminate double taxation.

VI. Conclusion

[24] Ibidem; in previous version TPGL it was paragraph 2.26

68. This paper looked at the question whether in so called triangular cases under the AC there would be any support for the view that the protection of a taxpayer to double taxation would be subject to any limitation.

69. From the analysis it appears that but for the situation of abusive cases (as a result of which one of the enterprises involved would be liable to a serious penalty) there seems to be no justification for not entertaining the mutual agreement procedure and/or the establishment of the advisory commission.

70. This conclusion seems entirely consistent with the purpose of the establishment of the AC: protecting the proper operation of the Common Market by trying to eliminate factors that might affect such a proper operation. Economic double taxation arising out of transfer pricing adjustments is defined as such a factor and considered to be not acceptable[25].

71. The application of the arm's length principle itself under the AC should be in line with the guidance provided by the OECD. The OECD recognizes that transfer prices are significant for both taxpayers and tax administrations since they determine in large part the income and expenses and therefore taxable profits of associated enterprises in different jurisdictions.

72. Furthermore, the OECD recognizes that for tax purposes the calculation of the proper transfer price is one of the most complex international tax issues for taxpayers and tax administrations alike. Therefore, when allocating the burden of proof in order to determine the market value in a transfer pricing case one has to achieve a balance between the interests of taxpayers and tax administrations in a way fair to all parties. However, no suggestion is made towards limiting the elimination of double taxation in case of possible difficulties in determining the transfer price between two countries, or in case a third country might somehow be responsible for this difficulty.

73. In conclusion there seems to be no justification whatsoever for the view that the OECD MTC and/or the AC contain any suggestion that the protection of a taxpayer to double taxation would be subject to any limitation other than in abusive cases. Any suggestion that the protection of the domestic tax base in other than abusive case might prevail over the elimination of double taxation therefore needs to be rejected, to avoid a general escape clause for countries to live up to their treaty obligations. This view is also supported by the statement in the Code of Conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises that "[T]he arm's length principle will be applied, as advocated by the OECD, without regard to the immediate tax consequences for any particular Member State."

74. Finally, upon establishment of the EUJTPF (then referenced as the Forum) in 2002, it was provided in relevant part that: "considering that the overall objectives of any initiative should be the prevention of double taxation and the reduction of compliance cost, a more uniform application of transfer pricing rules with the EU should be considered as a way forward." By supporting an interpretation that the arm's length principle may trump and limit the avoidance of double taxation pursuant to the AC in

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[25] See explanatory memorandum proposal for a council directive on the elimination of double taxation in connection with the adjustment of transfers of profits between associated Enterprises.

triangular cases, the EU Member States seem to distance themselves from this objective.[26]

[26] Doc: JTPF/003/2002/EN, at page 1.

COMPENSATING ADJUSTMENTS AND YEAR END ADJUSTMENTS

1. The issue: inconsistent treatment amongst EU Member States of handling compensating adjustments or uncertainty as to how to treat these adjustments

In the field of transfer pricing, companies tend to benchmark their transactions and target an operating profit margin for their functions performed, risks assumed and assets used. In practice, whether a company operates at arm's length is usually reviewed based on the profit margins of a company's overall activities for the year or of those of its business lines rather than on a review of the actual individual transaction prices. If, towards year-end or after year-end, it appears that the actual profit margins reported are inconsistent with the margins determined by an underlying benchmark, companies may need to (or wish to) assure that they report margins in accordance with the benchmark. In order to do so, adjustments are in order to compensate for the under-reported or over-reported margins and to assure that the company reports margins that are at arm's length.

For the purposes of this specific discussion, the term compensating adjustment refers to adjustments that are made *after* intercompany transactions have taken place and that serve to align a(n) (deemed) incorrect transfer price with the arm's length price. It should be noted that these adjustments may take place in the final quarter of the fiscal year or alternatively after the fiscal year. For purposes of this discussion, the scope of compensating adjustments is restricted to those that are initiated and made by the taxpayer itself, either through an actual payment from one Group Company to another, or through a bookkeeping entry in the financial records of the relevant entities involved.

Compensating adjustments may be required inter alia because:

A) The preliminary results of a company (or its business line) of a fiscal year are not in line with budgeted results for that fiscal year;

B) The preliminary results of a fiscal year are not in line with (the median of) a pre-determined arm's length range applicable to the company (or its business line) for that fiscal year;

C) The actual (entire) result of a of a company (or its business line) of a fiscal year are not in line with budgeted results for that fiscal year;

D) The actual (entire) result of a fiscal year are not in line with (the median of) a pre-determined arm's length range applicable to the company (or its business line) for that fiscal year;

E) The company has been granted a government subsidy (based on employees employed or location in a certain region) provided it reports a certain profit margin for the fiscal years to which the subsidy applies, and the preliminary or actual results are lower than the (minimum) profit margin required.

It should be noted that the cause of any discrepancies between budgeted and preliminary results or actual results can be the result of many, and often entirely legitimate, business events or market circumstances. To name a few:

(i) economic environmental changes;
(ii) decreased sales volume or price (within the scope of responsibility of the entity);
(iii) increased (operating) expense levels(within the scope of responsibility of the entity);
(iv) new or overlooked transactions, etc.

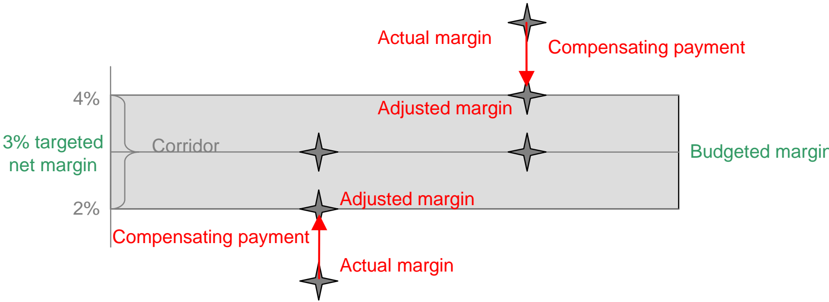
In issue is how compensating adjustments ought to be made, in order to make them acceptable and not raise unnecessary transfer pricing or other exposure. In practice, we see many different ways in which compensating adjustments are implemented:

(1) There are occasions where an aggregate lump-sum payment is made from company A to B, often presented as a year-end adjustment, that serves to get the company back into the benchmarked margin range;
(2) In other occasions, expenses may be recharged or allocated out, to increase profitability;
(3) Sometimes, new service charges may be suggested (i.e. marketing support payments), to reduce excessive margins.

The essence being that there appears to be no strict rule on how compensating adjustments must be made, other than that for tax purposes, the respective parties report the appropriate arm's length taxable amount.

The figure below assumes a targeted (and budgeted) net operating profit margin of 3%, within a range of 2%-4% .If the actual margin is outside this range, action may need to be taken to get the operating profit back into the range.

Figure 1: Compensating adjustments and Transactional Profit Methods



As taxpayers are trying to avoid transfer pricing related assessments and audits, there is an increased focus on making sure the MNE's individual entities operate at arm's length and report profitability consistent with benchmark studies conducted for transfer pricing purposes. As a result, tax directors want to know whether they should take immediate action if operating profit margins falls outside the benchmarked range of results, and if so, what action should be taken.

Timing of adjustments: Before year-end

For example, a discount could be applied to remaining transactions within the year, to get the total operating profit margin within the range, or a lump sum payment could be made to get that result (one-time adjustment). Furthermore, in issue is what the character of such a payment would be. In some countries, the requirement seems to be that the only way to adjust the operating profit margin is to adjust each and every transaction in that year to get to the requisite result, rather than making a one-time aggregate lump-sum payment that serves as adjustment. In addition, in some countries, an adjustment is only allowed, if the contractual arrangement between parties provides in relevant part that there is authority to do so.

Timing of adjustments: post-year-end

If the discovery of the aberrant margins is made at or after fiscal year-end, it may be that a post-year-end adjustment is no longer allowed. In other countries, such may be allowed for

tax purposes as long as the tax return has not been filed, but the inconsistency with the financials of the company will need to be reported/disclosed (as such triggering potentially and additional review).

Finally, in certain situations, countries accept a multiple-year analysis, to determine whether an adjustment is required. As benchmark studies tend to focus on a range of years (3 or 5 years) it makes sense to review whether the taxpayer falls outside the range on a multiple-year analysis (as opposed to adjudicating the issue based on a one-year analysis only), and if such is not the case, it may be that no adjustment is required for the one-year aberration

The form and the timing of adjustments have relevance for and impact on the likelihood of tax authorities accepting them, but these aspects may also trigger VAT and customs consequences, even though they are usually merely hypothetical transactions that solely serve the purpose of having the company comply with arm's length requirements.

Considering the different –and uncharted- approach towards compensating adjustments within the European Union, it would seem that MNEs doing business within the European Union could greatly benefit from an overview of whether compensating adjustments are allowed in the respective EU Member States and if so, in what form. In other words, what requirements apply to make these adjustments acceptable in what countries? Treating compensating adjustments differently in different countries makes it problematic for taxpayers to assure compliance, as these adjustments generally solely serve to get the company to be in compliance with its transfer pricing requirements and transfer pricing report, but it also complicates issues for the competent authority staff that may have to be involved to assist with getting avoidance of double taxation when countries apply different rules and interpretations.

Proposal:

Given the above, the Business Members would like to make the following proposal to the Members of the Joint Transfer Pricing Forum:

A. Can we discuss at the coming meeting whether there would be benefit in having an overview of the respective EU Member Country policies towards obtaining a better understanding and more acceptance of these so-called compensating adjustments and if such adjustments are generally deemed acceptable, which requirements will have to be complied with?
B. Can we discuss the topics/issues that should be addressed in a questionnaire to be sent to the respective EU Member States? A sample questionnaire is concluded in the annex to this paper for discussion purposes;
C. Can we get the Secretariat to develop the proper questionnaire for this survey?
D. Can we collect and also discuss the response to the questionnaire at the 3d meeting in 2011 in order to be able to work towards having a document and deliverable that provides guidance for taxpayers on how compensating adjustments are treated within the EU and amongst the respective EU Member States?

Annex

This Annex provides an overview of some of the main issues/aspects regarding compensating adjustments. It would be beneficial, if each of these aspects can be addressed from a country perspective

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A. Which types of adjustments are possible/accepted in your jurisdiction? Please discuss:

e.g.

- Aggregated level
- Product/service level (transactional)
- Group of products/services (basket) level
- Combination of the above

B. What triggers them and when are they considered legitimate for tax purposes?

Please discuss, e.g. deviation from the median of the range, falling outside the range etc.

C. Timing of adjustments.

Please discuss when is possible to carry out the adjustments and how to carry them out (procedural aspects).

- During the year
- Before year-end
- After year-end but before closing books
- After closing books but before filing tax return
- In the tax return
- After filing tax return

D. How are compensating adjustments characterized for direct tax purposes in your jurisdictions?

How are the compensating adjustments treated for corporate income tax purposes and what is the risk of the adjustments being reclassified?

E. Do you encounter the occurrence of compensating adjustments?

Please discuss whether upon audit the disclosure of compensating adjustments is often noted/reviewed/encountered.

F. VAT and Customs issues.

Please discuss how adjustments should be classified and treated for VAT/Customs purposes. Discuss both general aspects as well as procedural aspects.

G. Contractual issues and documentation issues.

Please discuss whether compensating adjustments should be explicitly provided for in an intercompany agreement.

Furthermore, please discuss whether adjustments should be separately addressed in documenting a transfer pricing policy.

H. Adjustments vs intentional set-offs

The OECD Guidelines describe intentional set-offs as “a benefit provided by one associated enterprise within the group that is deliberately balanced to some degree by different benefits received from that enterprise in return.” (reference can be made to paragraphs 1.60 to 1.64 of the Guidelines for a more extensive discussion on intentional set-offs).

In other words, in some circumstances it may be the case that two or more associated enterprises, by offsetting the respective unbalanced positions related to transactions undertaken between them, may implicitly “adjust” the respective results.

Are intentional set-offs are allowed and under which circumstances, in your country.

Please also discuss what procedural aspects should be undertaken in order to proceed with intentional set-offs (e.g. timing issues, reporting issues, contractual arrangements etc.).

SECONDARY ADJUSTMENTS, A RISK OF DOUBLE TAXATION WITHIN THE EU

see the PDF document