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COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

Related parties in CCCTB

Meeting to be held on 13 December 2006

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WORKING DOCUMENT

I Introduction and the purpose of the document

1. The main objective of tax provisions concerning transactions between related parties is the fair allocation of income and expenses between the state of residence and the state of source and the prevention of artificial arrangements intended to stop non-commercial shifting of profits and losses between companies. Most MS have tax legislation, which (i) define related parties for corporate tax purposes (ii) provide for rules on pricing of transactions between related parties, and (iii) provide for rules on deductibility of some items paid between related parties, to ensure that profits among related companies are allocated properly.
2. In principle related parties are required to keep conditions made or imposed between them in their commercial or financial relations at arm's length, i.e. not different from those which would be agreed between independent parties. The arm's length principle is the guiding rule and is also incorporated in double taxation conventions. Guidance of how states should apply the arm's length principle have been elaborated by OECD.
3. In CCCTB transfer-pricing will not need to be at arms' length among companies consolidating their profits and losses in the same group. Overall profits and losses of consolidated groups will be allocated amongst members according to an agreed mechanism. However, for relations between CCCTB companies and their related parties which are outside the consolidated group common rules including a common way of applying the arm's length principle will have to be sought. Some discussion of how this issue should be approached has been initiated in the Working Document 'International aspects in the CCCTB' and several MS expressed the view that common rules for these related companies which are not in the same consolidated group is the only way to combat distortions and inefficiencies in the corporate tax area effectively.
4. The purpose of this document is to identify in which situations common rules for related parties will have to be agreed for the CCCTB purposes. The document is structured in four parts: I Introduction and purpose of the document, II Situations to be covered, III Definition of related parties and/or closely held companies, IV Possible consequences. Members of the Group are invited to comment on issues raised or any related issue they find important. For more guidance and to facilitate and structure the discussion some questions are suggested at the end of this document. The document focuses on CCCTB solutions and does not attempt at giving a comprehensive theoretical outline of the topic.
5. The following four scenarios need to be examined when seeking appropriate CCCTB solutions (i) both related parties are companies in CCCTB consolidated in the same group, (ii) both related parties are companies in CCCTB, but not in the same consolidated group, (iii) one related party is a company in CCCTB and the other related party is a company not in CCCTB, (iv) one related party is a company in CCCTB and the other related party is an individual (i.e. by definition outside of the CCCTB). Each of these situations will require a nuanced approach and will have different tax consequences.

II Situations to be covered

(i) Companies in CCCTB and consolidated

6. Intra-group profits and losses will be eliminated so that the arm's length pricing will no longer be required for transactions among companies within the same consolidated group. The method(s) for pricing of intra-group transactions or indeed not having to price at all have to be agreed. Since these will be eliminated the simplicity criterion should play the key role when selecting the most appropriate pricing method for recording the transactions.

(ii) Companies in CCCTB not consolidated

7. This situation will arise when the threshold for consolidation is higher than the qualifying participation for determination of related parties. The two companies may be either in two different consolidated groups or one in a consolidated group and the other taxed as a single company, because the conditions for consolidation have not been satisfied. The arm's length principle is likely to be applied in respect of transactions between such companies and a thin capitalisation rule may also be relevant. Possible consequences should be discussed in detail by the group. This should not create any additional practical problem since the current transfer pricing should have been based on arm's length pricing. How this is applied in practice will have to be the same for both related parties and for all companies in the CCCTB and their related parties.

(iii) One company in CCCTB the other one outside of the CCCTB

8. Similarly as in situation (ii) the arm's length principle will be the basis for transactions between the two companies and thin capitalisation rules would apply. Where two companies are resident in different EU MS the relevant tax treaty provisions will apply. Potential anti-avoidance rules must be consistent with EC Treaty provisions. Where one company is resident outside the EU the relevant tax treaty will apply.

(iv) A company in CCCTB and an individual as a related party

9. Relations between companies and their individual shareholders employed with the same company and/or involved in its management process (hereafter 'employees/shareholders'), are governed by similar general principles, and current tax systems have often developed specific rules to deal with concrete situations. The main purpose is to attribute undistributed income to shareholders and treat amounts paid by companies to them as salaries, interest, pension contributions or other benefits as dividends that are non-deductible for tax purposes at the company level. Currently these techniques often interact with personal income tax provisions, however as the CCCTB will seek solutions at the company side only it will not be possible to introduce specific provisions at personal tax level.

10. If an individual shareholder has overall control over the management and the decision making procedure of the company, their decisions may be influenced by tax implications. For example, payments described as salaries and wages expenses are tax deductible in contrast to dividends. This has been mentioned by CCCTB experts on several occasions and particularly at meetings of the subgroup on Taxable income (SG3). Members of the Group discussed what conditions should be met for tax deductible expenses. Some experts mentioned that various deductions should be limited if they exceed usual or reasonable amounts. They wished to prevent companies from paying higher salaries, pension contributions, interest etc., that are generally tax deductible, to their shareholders (and/or creditors), and at the same time employees of the company instead of profit distributions that are tax non deductible and in principle taxable at shareholders' level.
11. The Commission Services have been convinced that interference in management decisions by tax administrations should be minimised in CCCTB and in general tax administrations should not be able to challenge deductions simply on the grounds that amount are regarded as excessive. In companies where shareholders and executive managers are not the same persons the directors are bound by various control mechanisms, following from other than tax legislation. Special bodies are established to check that management of the company is performed in line with them. It is not the role of the CCCTB to check whether the management decisions were well done and properly checked and approved, etc.
12. The sub-set of related parties comprising companies with a limited number of individual or individual and corporate shareholders is sometimes considered to be particularly sensitive to these tax planning risks. Some MS therefore ring-fence these closely held companies and subject them to a special anti-avoidance rules (as described hereafter).

III Definition of related parties and/or closely held companies

13. Related parties are generally determined by (i) a direct or indirect participation in management, control or capital of another enterprise or by the fact that (ii) the same persons participate directly or indirectly in the management, control or capital. This framework for the common definition of related parties has been laid down by the Article 9 (associated enterprises) of the OECD Model Convention on Income and on Capital.
14. The national legislations give more details of what the direct or indirect participation in the management, control or capital shall mean and the CCCTB will have to as well. The objective is to cover situations where companies and their associates are potentially able to present and/or treat some transactions in a different way than such transactions would be treated and/or presented between independent parties. Many MS lay down the threshold for control that constitutes the control as a basic criterion and the most common threshold is 25% of the

- capital or voting rights. In addition to that companies may also be considered as related if it is proved that the decisive influence can be exercised, which may be determined by circumstances other than qualifying participation in the capital, such as contractual relationships, representation of the same persons in the boards of directors, family links and other forms of decisive influence. Although the OECD gives a framework definition it is currently applied differently in detail in different MS. Under CCCTB a greater level of commonality will be required.
15. The definition of related parties is often extended to relatives of individual shareholders and persons participating in the management (e. g. directors).
 16. If a sub-category of related parties is defined as closely held companies it should cover companies controlled by a limited number of persons having a share or interest in the capital or income of the company or a person who is entitled to acquire share capital or voting rights (and their relatives) who are also directors. Control should be widely defined for this category to cover any kind of control or right to acquire control over the company's affairs as well as the right to the greater part of the share capital, voting rights or assets of the company available on distribution and on winding up. The rights of associates and relatives should also be taken into account in determining whether a person has control. Defining closely held companies would allow the CCCTB to keep the definition of a related party less complex.
 17. In accounting companies are not obliged to keep transactions with related parties at arm's length, however IFRS requires them to disclose all related party transactions and defines 'a related party' and 'related party transaction' for this purpose in IAS 24¹. For an associate a reference is made to the IAS 28, which presumes the investor holding '*directly or indirectly (e. g. through subsidiaries), 20% or more of the voting power of the investee, to have a significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly (e. g. through subsidiaries), less than 20% of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence and gives more guidance for what the significant influence shall mean for the purposes of application of accounting of an investment and application of the equity valuation method*'.

IV Possible consequences

18. In general transfer pricing of transactions between related parties refers to the allocation of profits among the parts of a corporate group. For the group as a whole the after-tax profit of the group is more important than those of its individual members. The prices charged within the group may serve as means of moving funds around the group taking advantage of different tax rates, individual company tax losses, etc. Financial accounting requires accounts for the group as a whole effectively eliminating intra-group transactions, in addition to (in most countries) accounts for each company in the group. In taxation, it is necessary to allocate profits among the respective companies situated in different tax jurisdictions. The arm's length principle is the method commonly agreed and applied by OECD countries and it is provided for both branches and subsidiaries. The basis can be found in the article 9 of the OECD Model. However it will be important to have a common basis for making transfer pricing adjustments in the CCCTB legislation as well.
19. The increased integration of the activities of corporate groups, the growing importance of unique intra-group intangibles and services, and the sophistication of their financing operations mean that application of the arm's-length standard is becoming more difficult. As already mentioned above problems have been addressed in part by the OECD, which has developed, updated and expanded its guidance on this issue. The OECD guidelines represent the internationally accepted norms giving content to the arm's-length principle. However, as mentioned previously, the CCCTB will require a greater level of commonality than the OECD principles provide for so that the same issues are approached in the same way for all companies in CCCTB.
20. Currently MS ensure that companies within the same group (but not consolidated and/or not within the same tax jurisdiction) do not pass on the cash in the form of excessive tax deductible items (for example interest or management fees) instead of non-deductible ones (for example dividends) or the profit in the form of non-arm's length prices. The non arm's length part of tax deductible items is subject to adjustment and therefore made non deductible. They may also be re-characterised as a dividend, referred to below as hidden, constructive or deemed and some systems deny tax relief available for ordinary profit distribution to any re-characterised (constructive) dividends paid between companies. The CCCTB will need to define these for situations (ii) – (iv) in paragraph 5 above.
21. Transfer pricing adjustments on the arm's-length principle have traditionally been viewed as involving price only and not the reconstruction of transactions in the sense of disregarding the nominal transaction between the related parties and substituting another arrangement for tax purposes. The OECD transfer pricing guidelines, while recognizing that adjusting prices of actual transactions is the norm, do permit tax administrations to re-characterise transactions 'where the economic substance of a transaction differs from the form' and where the 'arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving

- in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.¹ .
22. However as mentioned above some states are enacting general provisions in their tax laws directed against tax avoidance, which give powers to reconstruct transactions and also more specific provisions to deal with particular cases. The amounts that do not meet arm's length conditions may for example be considered to be a constructive dividend. As mentioned above constructive dividends in general result from non arm's length transactions between related companies or a company and its shareholders or other related parties in most cases. The constructive dividend is that part of the benefit passed on by the company which is deemed to be excessive. Such payment is made tax non deductible for the company and in most cases subject to similar taxation as ordinary profit distributions for the recipient. Some MS make a clear link between the company and individual income tax, the amount is deductible for the company as long as it is taxable at recipient. Creating such link in the CCCTB would be very difficult. The CCCTB will have to make clear whether the participation exemption should apply to constructive dividends or not.
 23. To achieve the application of the international arm's-length principle in practice, tax administrations generally start with the accounts of the local branch or subsidiary, make the usual adjustments to reflect differences between financial accounting and tax rules, and then make such further adjustments in accordance with the arm's-length principle as necessary. Non-tax considerations may lead to the group preparing its branch or subsidiary accounts on this basis in any event. For management purposes, the group will wish to know the real profitability of its separate parts; local employees may be remunerated in part on the basis of the local contribution to group profit, and local accounting rules will likely require that the financial accounts give a proper view of the profits of the branch or subsidiary. In practice, the tax administration may use simplified methods and various financial ratios that are similar to formulary apportionment in order to test whether the profits reported by a local branch or subsidiary fall within acceptable boundaries. These methods frequently operate as a means of selecting taxpayers for further checking (audit). The use of such administrative methods will not be contrary to tax treaty rules so long as they are being used as a means to the end of establishing the arm's-length price. It will be important to ensure that CCCTB states use common or commonly acceptable practices and methods at the administrative level.
 24. Many systems provide for special rules in case of loans provided between associated companies and loans provided by an employee/shareholder to its company and respective interest (thin capitalisation rules). Thin capitalisation rules examine whether the loan is not in fact a hidden equity, i.e. if there is a disparity between the existing equity and equity needs in the future and/or the debt/equity ratio is smaller than is usual in the comparable business area.

¹ The OECD is currently reviewing the circumstances under which the re-characterisation is appropriate.

Sometimes it is also examined whether the company would be able to get a loan from an independent person under comparable conditions; other states would lay down a fixed debt to equity ratio and make the interest non-deductible when it is exceeded. Additional restrictions may also apply on loans made to shareholders and their associates in some systems.

25. As for relations between companies and individual related parties (paragraph 5 above) payment of various benefits to employees/shareholders that could be in general described as non arm's length would be subject to adjustment. Re-characterisation of any expense incurred by a company when providing benefits or facilities for qualifying shareholders or their associates as a dividend as a presumption, which can be rebutted if the company proves that the transaction and the payment is at arm's length, may be a technique of how to handle the situation (iv) in paragraph 5 above. It is important that only relations with shareholders controlling the company and able to influence the company's management are affected.
26. Another possible solution would be to deal with this issue on the basis of a business purpose test in general, according to which any tax deductible expense is required to be incurred strictly in the company's business in production, maintenance or securing income. An additional anti-avoidance rule restricting deductions on certain types of payments would apply only to a sub-set of related parties qualifying as closely held companies in which these practices are more likely to occur. In practice it would mean that tax administrations could concentrate on the latter situations instead of checking systematically whether the business purpose criteria are met in large companies where the shift of profit distribution into payments to individuals is not likely and the proper management is subject to control by bodies other than tax authorities established for this purpose.
27. Experts will need to consider how, if necessary, to protect against manipulation of a tax base when individuals are involved, particularly whether the same rules and principles should apply to all categories of related parties or whether a separate category of related parties (closely held companies) should be determined. As already mentioned above the latter solution would enable the CCCTB to direct the respective legislation to situations where planning is more likely, and at the same time make the general definition of related parties more straightforward. On the other hand making a distinction between closely held and other companies may create concerns regarding potential discrimination. For some MS the concept may be difficult to accept as it has not been present in their current legislation.

Questions

► *Do Members of the Group agree that as a general rule arm's length principle should apply to transactions between related parties with the exception of companies consolidated in the same group?*

► *How should related parties be defined in the CCCTB? Members of the Group are invited to elaborate on what specific criteria to supplement the general criteria in article 9 of the OECD Model should be laid down.*

► *Do Members of the Group agree that the OECD guidelines and practices, as enhanced by the work of the Joint Transfer-pricing Forum create a sufficient basis for common practices, the CCCTB could simply refer to them, and all MS would effectively mutually recognise each others' practices. Or, do Members of the Group think the CCCTB legislation will need to lay down details of how the arm's length principle shall be applied. If the latter, what additional details should be specified?*

► *Members of the group are invited to comment on what specific consequences (other than the adjustment of the price for corporate tax purposes), if any, they think should be connected with (i) non arm's length pricing between related parties other than those consolidated in the same group or (ii) the mere fact that parties are related, for example special requirements for recording of relevant transactions or disregarding of certain transactions as a rebuttable assumption.*

► *Which categories/ types of payments or transactions would Members of the Group think the CCCTB should define as a constructive dividend (if any)? Should a participation exemption apply to these amounts?*

► *What solutions for thin capitalisation should the CCCTB adopt?*

► *Do Members of the Group agree that the CCCTB should limit some restrictions or tests for deductions to a specified group of companies where there is no clear separation between employee and shareholder. How should such a category of 'closely held' companies be defined and what type of transactions should be affected by this measure? If this category were to be covered by a general definition of related parties how should the definition be structured so that it (i) covered all respective situations and (ii) would not be too complex?*

¹ *Related party: A party is related to an entity if:*

(a) directly, or indirectly through one or more intermediaries, the party:

(i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);

(ii) has an interest in the entity that gives it significant influence over the entity; or

(iii) has joint control over the entity;

(b) the party is an associate (as defined in IAS 28 Investments in Associates) of the entity;

(c) the party is a joint venture in which the entity is a venturer (see IAS 31 Interests in Joint Ventures);

(d) the party is a member of the key management personnel of the entity or its parent;

(e) the party is a close member of the family of any individual referred to in (a) or (d);

(f) the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e);

or

(g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

Close members of the family of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include:

(a) the individual's domestic partner and children;

(b) children of the individual's domestic partner;

and

(c) dependants of the individual or the individual's domestic partner.

Compensation includes all employee benefits (as defined in IAS 19 Employee Benefits) including employee benefits to which IFRS 2 Share-based Payment applies. Employee benefits are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity. It also includes such consideration paid on behalf of a parent of the entity in respect of the entity. Compensation includes:

(a) short-term employee benefits, such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and nonmonetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and postemployment, medical care;

(c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service

benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;

(d) termination benefits; and

(e) share-based payment.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Joint control is the contractually agreed sharing of control over an economic activity.

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement."