In spite of the extended regulatory framework, increased knowledge and better tools to solve the transfer pricing equation, Europe has not seen major improvements over the last years for reconciling MNEs and governments on the issue of transfer pricing. Competent authority procedures and the European Arbitration Convention have not been sufficiently efficient in respect of the elimination of double-taxation. Court decisions have been too sporadic, and too diverse in their conclusions, to provide guidance to MNEs and tax administrations. Interpretation of the OECD Guidelines, the standard used in most European jurisdictions, has given too much space to endless discussions between MNEs and tax administrations. Practical cases end up too often in purely arbitrary negotiations.

In that context, the current transfer pricing headlines are of great interest as, looked at from a national level, they confirm these trends observed over the last decade; but on the multilateral level, recent developments (the EU Commission Code of Conduct on Transfer Pricing, debates within the OECD about the Guidelines) can be interpreted as the outline of a new playing field for transfer pricing in Europe.

**Extended regulatory framework**

Most recent transfer pricing developments are in line with observed trends over recent years. First of all (and the different country reports on the issue of Transfer Pricing Review highlight this) the issuance or announcement of specific transfer pricing documentation requirements in European countries has drastically accelerated over the last months. New regulations are effective from 2006 in Denmark\(^1\) and Hungary,\(^2\) and announcements were given for new regulations effective from 2007 in Sweden\(^3\) and Spain.\(^4\) The issuance of APA regulations has also recently accelerated. In France,\(^5\) possibilities for unilateral APAs have been legally formalised and the Czech Republic\(^6\) and Poland will have new APA programmes from 2006.

In line with an accelerated pace of transfer pricing audits in most European countries, the number of applicants to double-taxation relief has increased in the past few years. More than 100 European taxpayers asked for the right to arbitrate unresolved competent authority disputes under the European Union arbitration convention as of December 31, 2005 if their case was not resolved within two years.\(^7\) This shows the extent of work still to be done with respect to competent authorities and European Arbitration convention disputes. So far, only two cases have progressed to the arbitration stage (France/Germany; France/Italy). In recent months the OECD made proposals to improve current procedures, with a proposal for the mandatory arbitration of competent authority disputes;\(^8\) and the possibility granted to taxpayers to seek court relief if they are dissatisfied with an arbitration outcome.\(^9\)
OECD also released a practical manual of mutual agreement procedures. On the courts side, decisions regarding transfer pricing have been rather rare and are in line with observed recent trends. Not surprisingly, courts have in most recent cases stuck to a debate over the burden of proof rather than about the arm’s length nature of the intra-group flows. In other decisions, courts in European countries tackled some of the transfer pricing challenges, without, though, entering into an in-depth debate of the economics of the cases at hand.

In general, the debate focuses on the question of whether compensation should be paid (or received) by the taxpayer, but it very rarely deals with the arm’s length nature of this compensation. Courts in Europe rarely go into the details of the transfer pricing subject, which would require entering into observations about the most appropriate transfer pricing methods to be used, the most relevant profit level indicators or a refinement of the comparability issues. However, it did happen recently in Germany, confirming that Germany is among those countries that is ahead in Europe for transfer pricing policy.

Call for ‘masterfile’
Of particular interest, however, among transfer pricing developments, is the recent communications from the EU and the OECD, which may be interpreted as the sign of a new era for transfer pricing.

The issuance by the EU Commission of a “proposal for a code of conduct on transfer pricing documentation for associated enterprises in the EU”, in November 2005, can be seen as a small revolution. Following the Commission staff working paper “Company taxation in the Internal Market” (issued in October 23, 2001) and the works of the EU Joint Transfer Pricing Forum (JTPF), the code of conduct recommends that MNEs with operations in Europe constitute one pan-EU transfer pricing documentation report instead of a series of different documentation reports by country. According to the Commission, this will achieve more transparency and consistency, and lower the compliance costs for MNEs.

It is likely that this approach will entail some challenges from the MNEs’ perspective, at least for those that opt for the pan-EU approach; providing the full-picture of the European operations of an MNE and explaining both the process for setting prices and its outcomes may well not be an easy exercise at first. Indeed, the ‘masterfile’ should not be seen as the aggregation of local country documentation reports. It has wider implications: achieving transparency and consistency on a continuous basis means that MNEs will be expected to provide economic rationale for their price setting policy, together with the global outcomes of their policy.

In the past, the price setting process or the situation of other group subsidiaries in other EU countries was hardly considered by local tax administrations. As an example, historically, it was not unusual for local documentation reports to use different transfer pricing methods to test the outcome of similar transactions under the same transfer pricing policy. However, functional profiles of the local subsidiaries and economic circumstances would rather imply similar conclusions in terms of method selection.

Another example of past practice relates to the so-called ‘one-sided’ documentation reports. These reports would only address the arm’s length nature of a transfer pricing policy from the perspective of the tested party, without any in-depth analysis of the broader circumstances of the transaction and/or the relationship with the other related transacting party or parties. The emergence of the masterfile concept entails the progressive end of these practices; more generally, it entails the progressive decline of transfer pricing, managed locally, on a case-by-case basis, with low transparency and poor consistency. In the future, with the masterfile, it can be expected that on a pan-EU basis, MNEs will be leaning towards consistency (for instance with the use of one transfer pricing system for all local operations, in cases where circumstances allow this) and will be challenged to justify the arm’s length nature of the price setting process and the outcomes of this policy.

OECD joins the debate
In parallel to the EU developments, in 2006, the OECD issued papers on transactional profit methods and on comparability issues.

In the first paper, the OECD discusses issues related to transaction-based methods, i.e., the Transactional Net Margin Method and the profit splits. In the invitation for comment, the hierarchy of the OECD method is under discussion, as well as the appropriateness of transfer pricing analyses involving the use of different methods, selection of methods in the context of development of intangibles, access to foreign entities’ financial information, and detailed issues related to the practical application of transactional profit methods (for instance, determination of the residual split in the residual profit split method, or determination of appropriate allocation key).
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Even though apparently disconnected, the OECD discussions are complementary to the EU developments, as it attempts to define improved tools for MNEs to manage and defend their transfer pricing, in a consistent and continuous manner. For instance, providing more guidance on profit split methods is all the more necessary since global pan-EU masterfile approaches will certainly lead to two-sided argumentation, which can entail the use of profit split methods. Similarly, it is not surprising that the OECD addresses the issue of access to foreign data or the issue of the most appropriate method to set prices and to test prices.

In that respect, the other paper, dealing with comparability, also demonstrates that the OECD wishes for the achievement of transparency and consistency, in line with the EU developments. It provides draft guidance on comparability issues, including timing, internal comparability, sources of information, selection of comparables and documentation of the search for comparables. It also illustrates its wish to obtain more efforts from the MNEs and from the tax administrations to assess what is ‘arm’s length’. For instance, the OECD considers that ex-ante approaches reflected in the documentation of processes that lead to the establishment of the transfer prices prior to the transactions being undertaken, are “consistent with Article 9 of the Model Tax Convention, which requires a comparison of the conditions made or imposed between the two related enterprises in respect of the transaction”.16

All these developments seem to go in one direction, the emergence of a new, European dimension of transfer pricing. To achieve more transparency and consistency in this new dimension, the commonly-used transfer pricing tools may not be the most appropriate. The time for static and rigid transfer pricing design might be over, as well as the time for the case-by-case management of transfer pricing. Messages both from the EU Commission and from the OECD seem to bring us back to the roots of transfer pricing and to the question ‘what is arm’s length?’.

Reading between the lines of the OECD comments on comparability, the OECD seems to judge that transfer pricing practitioners have deviated from the initial transfer pricing path, the one leading to sustainable interpretations of ‘arm’s length’. As an illustration, in the invitation for comment, the OECD states that “in effect in practice, many tax administrations and practitioners rely primarily on a comparison of prices or margins in order to determine the arm’s length nature of a transaction. It might be worth however noting that:

- A comparison of the conditions surrounding the transaction under review, including price, is needed to justify an adjustment under Article 9 of the MTC.
- Any proposed comparison of prices or margins should be supported with documentation allowing a broader understanding of all the conditions of the transaction being reviewed (hence the importance of the five comparability factors identified in the Guidelines); [...]”17.

In this statement, the OECD insists on the conditions surrounding the transaction to determine what third-parties would have agreed on. The focus on comparability analysis prior to any comparison of margins is very likely to be the OECD response to deviations observed, over the last decade, within transfer pricing practices.18

Conclusion

We observe that it is likely that the new era for transfer pricing will entail the need for consistent and transparent transfer pricing policies, based on an in-depth analysis of ‘what is arm’s length?’, with the help of more robust economic analyses. Improved tools to solve the transfer pricing equation will be required. Among the options available, Relational Arm’s Length (ReAL) Transfer Pricing19 focuses on identifying the relevant circumstances, using a toolset that enables the definition of transfer prices that are consistent both for tax and for business objectives. ReAL Transfer Pricing aims at promoting a symbiotic relationship between transfer pricing and business. In the ReAL Transfer Pricing approach, focus is shifted from testing a ‘stand-alone’ entity (the tested party) to mapping the relative position of entities, involved in a joint process of creating value. More broadly, ReAL Transfer Pricing elevates a MNE’s transfer pricing management, from a compliance and penalty avoidance effort, to an effective management tool, from a tactical device to a strategic contribution. It may well be that this represents the main tool set enabling companies to develop the answers to the questions posed by OECD and face the challenge of developing transfer pricing solutions that meet the requirements dictated by MNE’s risk management considerations.

Notes:
1 In Denmark, tax authorities published final transfer pricing documentation regulations on February 4, 2006 and final guidelines interpreting the regulations on February 6. Regulations are effective for fiscal years beginning January 1, 2006. Documentation should be prepared following either the EU Transfer Pricing Documentation or the local rules. See Danish section of Transfer Pricing Review.
2 In Hungary, taxpayers are facing their first deadline for preparing transfer pricing documentation which for entities with calendar tax years must be ready by May 31 under legislation enacted in 2003.
3 In Sweden, on 20 March 2006, a proposal to introduce rules to prevent tax evasion was submitted to the parliament. New transfer pricing documentation requirements will be introduced. Unless otherwise indicated, if approved, the amendments will enter into force on January 1, 2007. See Swedish section of Transfer Pricing Review.

4 In Spain, the Spanish government on December 30, 2005 published a draft for the future Tax Fraud Prevention Act, which includes a reform of the transfer pricing rules in Spain. The draft Act introduces a taxpayer obligation to prepare documentation that justifies an arm’s length price for transactions between related parties. See Spanish section of Transfer Pricing Review.

5 In France, the Finance Amendment Bill 2005 strengthened the legitimacy of French APAs by inserting a formally legislated APA procedure into the scope of Article L80B of the Tax Procedure Code. French APAs are given a stronger legal basis and unilateral APAs will be granted. In an instruction (Instruction 4 A-11-05 June 24, 2005), situations in which unilateral APAs could be granted have been listed (no APA procedure in the other country involved, a large number of countries involved, limited complexity of transfer pricing issues, transactions involving small- or medium-sized companies).

6 In Czech Republic, the Czech tax authorities have issued on December 22, 2005 a decree that introduces the concept of binding rulings for the determination of prices in inter-related transactions. The Czech APA applies the basic principles and standards of APAs according to the OECD Guidelines.

7 BNA Transfer Pricing Report, EU faces Unresolved Arbitration issues, questions over number of cases, penalties, May 24, 2006.

8 The OECD is circulating a draft proposal for mandatory arbitration of competent authority disputes. Draft programme would provide mandatory arbitration of issues arising from a competent authority proceeding that are unresolved after two years similar to the terms available for European companies under the EU arbitration convention (one difference is that EU convention addresses only TP issues, draft arbitration proposal would include all types of disputes).

9 The proposal has been released by the OECD in February 1, 2006.

10 The OECD released on February 27 a manual on Effective Mutual Agreement Procedure (MEMAP). The proposed Manual would be accessed through an OECD Web site that would be available to the public. MEMAP would dismiss various issues relating to competent authority and where appropriate describe best practices. OECD urges in this Manual suspending collections, interest accruals during MAP proceedings.

11 In its decision September 23, 2005, the Dutch Supreme Court ruled that it is reasonable to reverse the burden of proof for not providing the meeting notes of management and commissioners meetings to the tax inspector; it also ruled that the tax inspector is restricted by the “fair-play principle”. This means that the tax inspector may not use its authority to obtain reports of third-parties from taxpayer, which has the objective to discuss the tax position of the company or to advice the company in its respect. In Sweden, the Supreme Administrative Court gave its decision on February 2006 in the case of Dow Sverige v. Skatteverket (i.e. the Swedish tax agency) concerning the deductibility of certain intra-group fees. The Court ruled in favour of the company as burden of proof is on the tax administration’s shoulders and that management fees policy appears reasonable (indirect allocation and cost + 10%). In France, the French Supreme Court (Cap Gemini, November 7, 2005, n° 266436 and 266438) ruled that, in the lack of comparable uncontrolled transactions, the tax administration did not demonstrate the benefits provided by the French parent to its foreign subsidiaries by not charging a trade mark and logo royalty (whereas an equivalent royalty was charged to the French subsidiary).

12 In France, the French Administrative Supreme Court (Conseil d’Etat, Société Electromécanique du Nivernais, August 10, 2005, n° 275983) ruled in favour of a French company, to which deductibility of a fee paid to its agent based in the Isle de Man was refused, arguing that demonstration was made that the Isle de Man agent contributed to the increase of sales in Italy, and therefore that the 3% commission fee was a fair compensation for services actually rendered. In the above-cited Dutch Supreme Court decision (September 23, 2005), the Court agreed with the tax inspector on the fact that a Principal’s role limited to signing license agreements and financing only some R&D costs is not sufficient to have the Principal owned the group corresponding IP and been entitled to remuneration. In the case at hand, it also appeared that Principal seemed not to have any employee and no control on contract R&D activities.

13 In Germany, the country’s Federal Tax Court April 6 (Case n° I R 22/04, Federal Tax Court, judgment dated 4/6/05) increased the level of comparability that a taxpayer must meet when applying the comparable uncontrolled price method. The case involved transactions between a German distributor that sold household products manufactured by a Swiss parent company. In the case, the court also confirmed the general applicability of the resale price method and, consistent with a series of pervious judgments, held that the maximum adjustment to a taxpayer’s income is measured by the most beneficial extreme of the arm’s-length range of profit level indicators, and not the upper bound of the inter-quartile range. See German section of Transfer Pricing Review, p. xx.

14 OECD, Invitation to comment on Transactional Profit Methods, February 28, 2006.


16 OECD, Comparability: Public Invitation to comment on a series of draft issues notes, May 10, 2006, Section B-z, p. 12.

17 OECD, Comparability: Public Invitation to comment on a series of draft issues notes, May 10, 2006, Section A, p. 5.


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