TRANSFER PRICING APLLIED IN EUROPEAN COUNTRIES

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This paper provides a background discussion of the arm's length principle, which is the international transfer pricing standard that OECD Member countries have agreed and should be used for tax purposes by MNE groups and tax administrations. The paper discusses the arm's length principle, reaffirms its status as the international standard, and sets forth guidelines for its application in a few European countries.

Key words: arm's length principle, transfer pricing, OECD guidelines

1. General Considerations

The role of multinational enterprises (MNEs) in world trade has dramatically increased over the last 20 years. On one hand this role reflects the increased of integration in case of national economies and technological progress, particularly in the area of communications. On the other hand the growth of MNEs generated increasingly complex taxation issues for both tax administrations and the MNEs themselves since separate country rules for the taxation of MNEs cannot be viewed in isolation but must be addressed in a broad international context.

In order to apply the separate entity approach to intra-group transactions, individual group members must be taxed on the basis of ***arm's length principle*** in their dealings with each other. However, the relationship among members of an MNE group may permit the group members to establish special conditions in their intra-group relations that differ from those that would have been established by the group members that have been acting as independent enterprises operating in open markets. To ensure the correct application of the separate entity approach, OECD Member countries have adopted the ***arm's length principle***, under which the effect of special conditions on the levels of profits should be eliminated.

Arm's length principle is the international standard that OECD Member countries have agreed in terms of determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows: where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".

These international taxation principles have been chosen by OECD Member countries as serving the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimizing conflict between tax administrations and promoting international trade and investment.

Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. Transfer pricing issues originally arose in dealings between associated enterprises operating within the same tax jurisdiction. The domestic issues are not considered in this Report, which focuses on the international aspects of transfer pricing. These international aspects are more difficult to deal with because they involve more than one tax jurisdiction and therefore any adjustment to the transfer price in one jurisdiction implies that a corresponding change in another jurisdiction is appropriate.

The authoritative statement of the arm's length principle is described in paragraph 1 of Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties involving OECD Member countries and an increasing number of non-Member countries. Article 9 stated that: "[When] conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would,

but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

In respect of arm's length principle, the contractual terms of a transaction generally define explicitly or implicitly how the responsibilities, risks and benefits are to be divided between the parties. As such, an analysis of contractual terms should be a part of the functional analysis discussed above. The terms of a transaction may also be described in correspondence/communications between the parties other than a written contract. Where no written terms exist, the contractual relationships of the parties should take into consideration the economic principles that generally govern relationships between independent enterprises.

2. Transfer Pricing in Europe

This Chapter is presenting some general consideration in terms of transfer pricing in some European countries, like taxing authority and law, regulations, pricing methods, transfer pricing penalties, documentation requirements, categories of documentation required, deadline to prepare documentation, deadline to submit documentation, statute of limitations on transfer pricing, assessments, return disclosure – related party transactions, transfer pricing scrutiny, advance pricing agreements.

2.1. Austria

Taxing Authority is the Federal Ministry of Finance.

The current Regulations in transfer pricing in Austria are the OECD Transfer Pricing Guidelines. In this country are no statutory provisions dealing specifically with transfer pricing.

In respect with the **priorities and pricing methods allowed** in Austria are no binding rules.

There are no special **transfer pricing penalties**. If inter-company transactions are not carried out at an arm's length price, the tax authorities may consider that the difference should be treated as a hidden distribution of profits. The effect of this is that certain expenses become non-deductible expenses and withholding tax is payable on the deemed distribution, subject to treaty relief.

Is no special provisions in which that consider the **reduction in transfer pricing documentation penalty** that could be gained if the tax payer satisfies certain conditions.

Documentation Requirements should follow OECD guidelines. Taxpayers are advised to maintain adequate supporting documentation justifying their transfer prices, as this can shift the burden of proof to the tax authorities.

In terms of **types of information required** as part of taxpayers documentation there is no specific categories of documents required, but a written transfer pricing contract or other documentation is highly recommended.

The deadline to prepare and to submit transfer pricing documentation is just on time. There are no specific limitations on assessment for transfer pricing adjustments.

The risk that transfer prices are scrutinized during a tax audit are high.

2.2. Belgium

Taxing Authority is Ministry of Finance, Federal Finance department.

Tax law is the Belgian domestic tax law and numerous interpretation circulars issued by the Ministry of Finance.

In respect with **regulations and rulings** in transfer pricing, in Belgium exist the follow provisions:

I. Circulars issued by the Belgian tax authorities mainly make reference to the OECD guidelines.

II. a. Belgian Income Tax Code:

- as from 19 July 2004 the arm's length criteria as determined in article 9 of the OECD guidelines has been implemented in Belgian domestic tax law under article 185 § 2 and with cross-reference in article 235, 2° for non-residents:
- Article 185 § 2 applicable as from 19 July 2004: if conditions are made between two related companies belonging to a multinational group in their commercial or financial relation which differ from those which would be made between independent enterprises, then any profits

> which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Where profits on which an enterprise of a Contracting State have been charged to tax in that State are also included, according to the previous paragraph, in the profits of the enterprise of the other Contracting State and taxed accordingly, and the profits so included are profits which might have been expected to have accrued to the enterprise of the other State if the conditions operative between the enterprise had been those which might have been expected to have operated between independent enterprises dealing wholly independently with one another, then the first-mentioned State shall make such adjustment as it considers appropriate to the amount of tax charged on those profits in the first-mentioned State.

These newly implemented stipulations can, however, only be invoked in case an international procedure for avoiding double taxation has been introduced (for instance a bilateral tax treaty or a EU Arbitration treaty) or a (national) ruling has been filed.

b. Other transfer pricing regulations in Belgian domestic tax law

- Article 26: If a Belgian company grants abnormal or gratuitous benefits to a related entity, the so-granted benefit can be added back to its taxable result, unless the receiving entity has been taxed (in Belgium) on such received benefits.
- Article 79 and 207: The company that receives an abnormal or gratuitous benefit may not deduct tax losses carried forward, investment deductions and dividend received income from the received benefit. As from the financial year 2003 (for companies closing per 31 December 2003) the losses of the year may not be deducted either.

There are no specific **transfer pricing methods** allowed in Belgian domestic tax law. Circulars issued by the Belgian tax authorities mainly make reference to the OECD guidelines.

Also, are no specific penalties **for transfer pricing transactions**. General penalties apply upon assessment of the Tax Inspectors' audit. The Tax Inspectors can reject all or part of the expenses and amend the taxable profits of that year imposing income tax for the extra profits assessed plus penalties (interest) for late payment of tax which can reach 200% of the main extra tax assessed.

In respect with the **reduction in transfer pricing documentation penalty** that could be gained if the tax payer satisfies certain conditions, is no specific regulations.

There are specific **requirements** in Belgian domestic tax law.

Based on the circulars issued by the Belgian tax authorities, general requirements for documents supporting any transaction apply, with reference also to OECD guidelines.

In practice, tax authorities are paying more and more attention to the transfer pricing applied within groups of companies. In this respect, upfront documentation is becoming a necessity in order to substantiate intra-group transactions. The Belgian tax authorities have announced that the absence of documentation may trigger an in-depth transfer pricing investigation.

Types of information required as part of taxpayers documentation requirement. No specific for related parties' transactions or for transfer pricing issues. General rules apply, i.e. written contract (especially for royalties or services with analytical description of services, basis for fees calculation, terms and conditions for transactions, etc), invoices, supporting documentation for payments.

Deadline to Prepare Documentation. Upfront documentation is becoming a necessity in order to substantiate intra-group transactions. **Deadline to Submit Documentation** is upon request of the Tax Authorities.

In respect with **statute of limitations on assessment** for transfer pricing adjustments is not specific for inter-company transactions or for transfer pricing issues, thus general rules apply: According to the Belgian general statutes of limitation, the tax authorities can carry out a tax audit for a financial year up to three years as from the closing date of that financial year (in cases of fraud this period is extended to five years). However, in certain specific circumstances other assessment periods may apply.

Assessments. The assessment year starts 1 January and ends on the following 31 December. The corporate income tax can be assessed until 30 June of the year following the assessment year.

For corporations with an accounting year ended on 31 December, the assessment year is the following calendar year. When the accounting year ends at another date, the tax year is the calendar year in which the accounting year ends.

In the absence of documentation substantiating the intra-group transactions, **the risk** is high that the tax authorities trigger an in-depth transfer pricing investigation.

In accordance with ability that Belgium territory could enter into Tax Authority approved multi lateral or unilateral advance pricing agreements between group companies, the Belgium authorities says that: a preliminary tax ruling can be applied for in order to ascertain the tax regime of the transaction. The timeframe for the tax authorities to deal with the ruling request is set in principle at 3 months, this timeframe can however be changed in mutual consent between taxpayer and tax administration.

During this period the transaction cannot take place if upfront certainty is required. A positive decision will be valid for maximum 5 years.

2.3. Denmark

Taxing Authority is Ministry of Taxation.

Transaction-based preferred over profit based. The **transfer pricing methods** allowed are CUP[176], Resale Price, Cost Plus, Profit Split, TNMM[177].

In Denmark the **documentation requirements** are contemporaneous.

Types of information required as part of taxpayer's documentation requirement are the follow:

- Description of the involved entities
- Description of the type of intra group transactions
- Analysis of the functions and risks undertaken and assets employed by the involved enterprises
- Information about the transfer pricing method applied
- Comparability analysis

Deadline to prepare documentation is by the date for filing the tax return. **Deadline to submit documentation** is on request from the Danish Tax Authorities.

The limitation on a transfer pricing assessment is 1st May in the sixth year after the end of the calendar year replacing the income year.

Is no **advance pricing agreements** regime in place, but Danish tax authorities have entered into a limited number of bilateral APAs

2.4. Germany

The Taxing Authority is Ministry of Finance.

The Tax Law is Gewinnabgrenzungsaufzeichungsverordnung (Tax Ordinance on Transfer Pricing (10/17/2003)).

The current transfer pricing and regulatory provisions. In addition to the main statutory provisions mentioned above, there are draft statements of the Ministry of Finance (10/18/2004) which explain certain details of the transfer pricing. The most important is so called "Gewinnabgrenzungsaufzeichnungsverordnung" (10/17/2003) Principles for the Examination of Income Allocation in the Case of Internationally Associated Enterprises and Other Related Parties

The priorities follow OECD Transfer Pricing Guidelines.

Traditional transactional **pricing methods** are preferable to the transactional profit methods. Profit based methods are not accepted since they are not following the dealing-at arm's length principle.

[176] Comparable uncontrolled price method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

[177] Transactional net margin method examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction. Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods.

The **penalty** is applied if taxpayer fails to submit TP documentation. Regular penalty is calculatea at a percentage of 5 to 10 % of estimated income correction and the minimum penalty is in amount of 5.000 euros. This penalty is also due in a loss situation. The late filing penalty of up to 1 million euros is 100 euros per day of delay..

Penalties may not be imposed if the taxpayer is not responsible for lack of appropriate documentation. A loss situation could lead to a lower rate within the 5 to 10 % margin.

Documentation Requirements: General fiscal code - Gewinnabgrenzungsaufzeichnungsverordnung

Types of information required as part of taxpayer's documentation requirement are the follow:

1. General information on shareholder relationships, organizational and operative group structure, area of operations
2. Description of intercompany transactions (incl. related parties)
3. Functions and Risks analysis
4. Transfer pricing methods analysis
5. Separate documentation of extraordinary transactions

Deadline to prepare documentation is contemporaneous (just on time). For extraordinary transactions the deadline is 6 months after the year end. **Deadline to Submit Documentation** is within 60 days upon tax authority's request.

There is no specific **statute of limitations**. It is accepted that there is no exact transfer price. Thus, a certain range of prices is possible. If the taxpayer can prove that his price is within that range an adjustment is not possible

Assessments are possible according to general adjustment principles normally within four years after filing the tax return, starting with the beginning of tax year after the filing year.

Advance Pricing Agreements are generally available but restricted to 'big' cases, due to German reluctant attitude toward APAs.

Bibliography

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