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INTERNATIONAL TRANSFER PRICING AND THE EU CODE OF CONDUCT

Clemens Buter
University of Applied Sciences Koblenz (Germany)

Abstract

International transfer pricing concerns the prices charged between associated enterprises across national borders. Associated enterprises, also known as related parties, are enterprises that control each other either directly or indirectly by means of capital participation. International transfer pricing decisions have to be made, for instance, when a mother company delivers goods, services or intangibles to its foreign subsidiaries, particularly when it receives them from its affiliates. The tax rates on company profits differ from country to country. In the EU member states the tax rate differential on company profits range between 10 % in Bulgaria to about 35 % in France. Such tax rate differentials encourage associated enterprises to set transfer prices that shift profits from high-tax to low-tax countries in order to reduce the overall tax burden for the whole Multinational Corporation. No country can allow its tax base to suffer because of international transfer pricing. It is therefore necessary to set up guidelines in order to avoid arbitrary pricing. The OECD member countries have agreed that international transfer prices shall be determined according to the "Arm's Length Principle". The "Arm's Length Principle" is an important element of the tax jurisdictions in EU member states. In order to reduce bureaucratic burdens imposed on Multinational Corporations operating on the European Common Market the European Commission has proposed an EU-wide common approach to transfer pricing documentation requirements. This EU Code of Conduct on transfer pricing documentation (EU TPD) shall help to prevent Multinational Corporations with affiliates in different EU Member States from taking a country-by-country documentation approach. This article describes economic implications of international transfer pricing. Furthermore it classifies and compares the possiblities to determine an „arm's length price" according to the OECD Guidelines 2010. Based on empirical data concerning the actual taxes on company profits in EU member states the article shows that the EU Code of Conduct on transfer pricing documentation (EU TPD) can only be an intermediate remedy towards an inevitable tax harmonization in the European Union.

Keywords: EU Transfer Pricing Documentation, OECD Transfer Pricing Guidelines 2010, Compliance costs, Masterfile documentation, Country-specific documentation, EU Code of Conduct, Associated enterprise, "Arm's Length Principle", Multiple tax jurisdiction, Related party trade, "Global formulary apportionment", Harmonization requirements.

Introduction

The economic backbone of the European Common Market is the innercommunity trade. More than 60 % of German foreign trade is with EU member states. In smaller countries such as Belgium, the Netherlands and Lithuania, this proportion is even higher.[1] A large part of innercommunity trade is based on trade relations between associated enterprises operating in the Common Market. Associated enterprises, also known as related parties, are enterprises that control each other either directly or indirectly by means of capital participation.

International transfer prices are the prices being charged for cross-border transactions between associated enterprises (see figure 1). Such international transfer pricing decisions have to be made for instance when a parent company delivers goods, services or intangibles to its foreign subsidiaries, respectively when it is receiving them form its affiliates.

In the European Union the tax systems of the member states are not harmonized yet. Because of this the tax rates on companies' profits differ from country to country. In EU member states the tax rate differential on companies` profits ranges between 10 % in Bulgaria to about 35 % in France.[2] Such tax rate differentials encourage associated enterprises to set transfer prices that shift profits from high-tax to low-tax countries in order to reduce the overall tax burden for the whole Multinational Corporation.

No country can allow its tax base to suffer because of international transfer pricing.[3] It is therefore necessary to set up guidelines in order to avoid arbitrary pricing. The tax administrations of EU member states have to control international transfer pricing decisions according to the predominant internationally agreed guideline, which is the "Arm's Length Principle". In order to control international transfer pricing decisions, tax administrations request detailed documentation concerning the international intra-group transactions.

Compliance costs are the costs of a taxpaying corporation for the documentation of information and data requested by tax authorities in different member states.[4] In order to reduce bureaucratic burdens and therefore the compliance costs imposed on Multinational Corporations operating in the European Common Market the European Commission proposes an EU-wide common approach to transfer pricing documentation requirements. This EU Code of Conduct on transfer pricing documentation (EU TPD) shall help to prevent Multinational Corporations with affiliates in different EU Member States to take a country-by-country documentation approach.

This article describes the latest developments concerning international transfer pricing regulations in the European Common Market. It also pinpoints the existing trade-offs between the necessity of transfer pricing documentation and the increasing administrative burden and compliance costs of the taxpaying corporation.

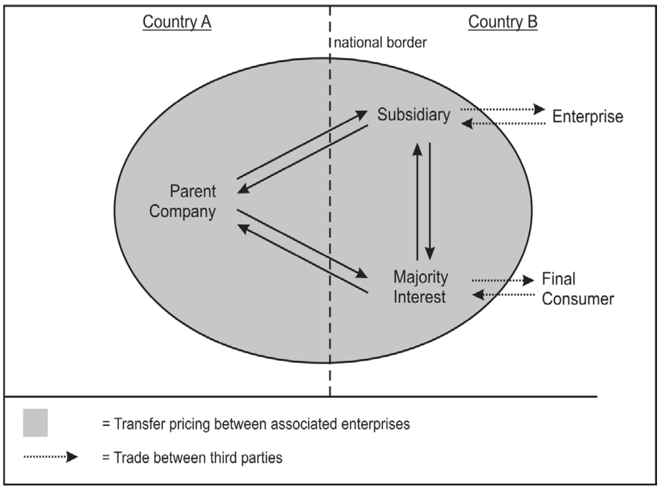

Figure 1. Related Party Trade and International Transfer Pricing
Source: Büter Clemens (2010) Außenhandel – Grundlagen globaler und innergemeinschaftlicher Handelsbeziehungen, p. 122, Berlin Heidelberg.

The second part of this article considers the OECD Transfer Pricing Guidelines 2010. It briefly illustrates the "Arm's Length Principle" and its theoretical alternative, the "Global Formulary Apportionment". Furthermore it describes the five basic methods for the determination of an "Arm's Length Price". The third part of this article deals with the "EU Code of Conduct", namely the proposed documentation requirements in order to control related party transactions in the European Common Market. The article ends with some critical conclusions concerning the practicability of the "Arm's Length Principle" and the administrative limitations of the "EU Code of Conduct" for the European Common Market.

OECD Transfer Pricing Guidelines 2010

The "Arm's Length Principle"

The OECD Transfer Pricing Guidelines were first released in 1995. The latest revision took place in 2010. The OECD Transfer Pricing Guidelines 2010 are more detailed and contain practical suggestions for the comparison of the transaction conditions between associated enterprises and transaction conditions between third parties.

The tax jurisdictions of EU member states have adopted transfer pricing rules which are similar to the OECD guidelines. The predominant transfer pricing rule is the "Arm's Length Principle"[5]. It is the international consensus for the determining of cross-border transfer prices[6]. The "Arm's Length Principle" is defined in Article 9 of the OECD Model Tax Convention.

> "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."[7]

An "Arm's Length Price" is a price which a purchaser has to pay for the delivery of goods, services or intangibles under the conditions of perfect competition.[8] In other words an "Arm's Length Price" would be the result of supply and demand in a particular market. That's why it is also called "market-based pricing".

Arm´s Length Pricing

	Country A		Country B
Sales	100.000,- EUR	Export	120.000,- EUR
Cost of sales	80.000,- EUR		100.000,- EUR
Profit	20.000,- EUR		20.000,- EUR
Corporate tax rate	5.000,- EUR		7.000,- EUR
Country A 25%			
Country B 35%			
Net profit	15.000,- EUR		13.000,- EUR

Autonomous Transfer Pricing

	Country A		Country B
Sales	120.000,- EUR	Export	120.000,- EUR
Cost of sales	80.000,- EUR		120.000,- EUR
Profit	40.000,- EUR		0,- EUR
Corporate tax rate	10.000,- EUR		0,- EUR
Country A 25%			
Country B 35%			
Net profit	30.000,- EUR		0,- EUR

Figure 2. "Arm's Length Pricing" and "Autonomous Transfer Pricing"
Source: Büter Clemens (2010) Außenhandel – Grundlagen globaler und innergemeinschaftlicher Handelsbeziehungen, p. 124, Berlin Heidelberg.

International transfer pricing can also be the result of an autonomous negotiation between the associated parties. In this case the international transfer prices shall serve certain purposes. They can particularly be used to allocate profits and liquidity between associated enterprises across national borders.

International transfer pricing is a special decision problem within the international price policy of a Multinational Corporation.[9]

As seen in figure 2 the associated enterprise in Country A sells goods to its subsidiary in Country B. On the basis of an "arm's length price" the seller in Country A delivers the goods for 100.000, - € to its subsidiary in Country B and receives a profit of 20.000, - €. In turn the subsidiary in Country B sells the goods for 120.000, - €. Both enterprises make a profit of 20.000, - €. The corporate tax rates differ between Country A and Country B. The overall net profit of the associated enterprises sums up to 28.000, - €.[10]

Under an autonomous transfer pricing agreement the objective would be to minimize the tax burden in the high tax Country B and to shift the profit to the low tax Country A. As a result of this the associated enterprise in Country A would deliver the goods to its affiliate in Country B for 120.000, - €. If the subsidiary in Country B sells the goods for 120.000, - € it would ultimately receive no profit. Thanks to the "autonomous transfer pricing" agreement the overall net profit for the associated enterprises is higher that it was under the "arm's length pricing" arrangement. It sums up to 30.000,- € instead of 28.000, - €.[11]

The "Global Formulary Apportionment"

A theoretical alternative to the "Arm's Length Principle" is seen in the "Global Formulary Apportionment". A "Global Formulary Apportionment" would mean to split the entire profit of the associated enterprises on a consolidated basis regardless of their location.

For the application of the "Global Formulary Apportionment" three prerequisites have to be fulfilled[12]:

1. The tax unit has to be determined. Which subsidiaries and branches of the associated enterprise belong to the global taxable entity?
2. The global profit of the taxable entity has to be determined. Which accounting system should be used for the profit measurement?
3. A formula to allocate the global profits of the taxable unit has to be established. What should be the basis of the formula and who shall decide on it?

The application of the "Global Formulary Apportionment" as a realistic alternative for the "Arm's Length Principle" is rather controversial. The most significant concern with the "Global Formulary Apportionment" is seen in "the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation. To achieve this would require substantial international coordination and consensus on the predetermined formula to be used and on the composition of the group in question"[13].

Such a level of international cooperation is seen to be unrealistic in the field of international taxation. So far OECD member countries do not consider the "Global Formulary Apportionment" as a practical alternative to the "Arm's Length Principle".

Determining a Transfer Price

The OECD and the European Commission clearly favour the "Arm's Length Principle" as opposed to the theoretical alternative of the "Global Formulary Apportionment". The crux of the matter concerning the "Arm's Length Principle" is to determine an appropriate "arm's length price". This "arm's length price" is than be compared to the actual price setting for the related party trade.

The OECD guidelines contain five methods for the determination of an "arm's length price". These methods are classified into two categories, namely the Traditional Transaction Methods and the Transactional-Profit Methods. The Traditional Transaction Methods include the Comparable Price Approach, the Resale Price Approach and the Cost-plus Approach[14]:

- The Comparable Price Approach compares the price for goods or services transferred in a related party transaction to the price charged in an independent transaction in comparable circumstances. It is the most direct evaluation of whether the arm's length principle is complied with.[15]
- The Resale Price Approach is useful where a product that has been from a related party is resold to an independent party. The resale price has to be reduced by the resale price margin. The remainder amount is seen to be an arm's length price of the original transfer between associated parties.[16]
- The Cost-plus Approach is based on the costs incurred by a supplier in a controlled transaction. An appropriate gross mark-up is added to this cost in order to calculate the arm's length price of the transaction.[17]

The Transactional-Profit Methods are using the profit from a controlled transaction as an indicator of whether the transaction was affected by conditions that differ from those that would have been made by independent enterprises in comparable circumstances. The Transactional-Profit Methods recommended in the OECD guidelines are the Transactional Net Margin Approach and the Profit Split Approach[18]:

- The Transactional Net Margin Approach examines the net profit achieved by an associated enterprise to those achieved by comparable independent parties. The main difference between the Transactional Net Margin Approach and the Resale Price and Cost-plus Approach is that the former is focused on the net margin instead of the gross margin of a transaction. The lack of comparable data is seen to be the main weakness of the Transactional Net Margin Approach.[19]
- The Profit Split Approach involves two steps. Firstly the total profits arising from the arrangements of the associated enterprises have to be identified. This combined profit is then split by reference to the relative contributions of the associated enterprises in the transactions. The Profit Split Approach can be helpful when the transactions between associated enterprises are very much interrelated and can't be evaluated separately.[20]

According to the OECD the Traditional Methods are preferred. Nevertheless the Traditional Methods always require comparable data. In case highly comparable data is given the most preferred Traditional Method is the Comparable Price Approach.[21]

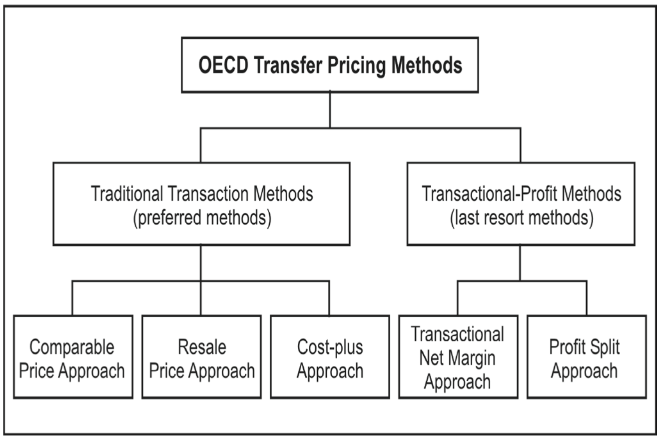

Figure 3. OECD Transfer Pricing Methods
Source: According to: OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, p. 63 f. and p. 77 f.; OECD Publication 22nd July 2010

Generally the possibility of manipulation of cross-border transfer prices increases with the complexity of the market conditions.

Taking into account the unique characteristics of international commodity markets, intragroup services and other intangibles being traded between associated enterprises the "Arm's Length Principle" is a fairly theoretical approach.[22]

The EU Code of Conduct

The "Transfer Price Documentation" Concept

In order to reduce bureaucratic burdens on associated enterprises operating in different EU member states, the

European Commission has proposed a Transfer Pricing Documentation Code of Conduct (EU TPD).[23] This proposal was approved by the European Council on 27th June 2006. The EU TPD is not a Community law but a proposal. EU member states are therefore not obliged to introduce transfer pricing documentation according to the EU TPD concept. Nevertheless the existing Code of Conduct should encourage EU member states to implement the EU Transfer Pricing Documentation approach.

“The EU TPD is designed to establish a balance between the tax administrations right to obtain from a taxpayer the information necessary to assess whether the taxpayer's transfer pricing is at arm's length and the compliance costs for the tax payer.”[24]

The EU TPD Concept consists of two main elements:[25]

1. The “masterfile” contains common standardized information for all EU group members of an associated enterprise. It mainly comprises a general description of the business and of the transactions in the EU.
2. The “country-specific documentation” includes documentation for each of the specific EU member states involved. It contains more detailed information for the specific country, such as contractual terms and the transfer pricing methods used.

An associated enterprise that opts for the EU TPD Concept should generally apply this approach to all its associates in the European Union.

„The EU TPD should cover transactions (i) between associated enterprises resident in the EU and (ii) between an enterprise resident outside the EU and an associated enterprise resident in the EU. It should not cover transactions between associated enterprises of the same group resident outside the EU. In other words: at least one of the enterprises must be resident in the EU.“[26]

The existing EU TPD is a data-framework for the compilation of requested information for the fiscal authorities concerning the business transactions between the group companies and the pricing methods applied. So far it is an open question whether it is sufficient for the taxpaying corporation to lay down the facts for determination of the inter-company prices being fixed, or whether it is necessary to provide evidence for the justice of the transfer prices according to the “arm's length principle”.

It is unquestionable that the EU TPD needs further development. To this end more detailed proposals and concepts are being discussed. This work is mainly done by the EU Joint Transfer Pricing Forum (JTPF). Currently the Joint Transfer Pricing Forum is particularly discussing the treatment of inter-company services as well as possibilities to reduce the overall compliance costs for associated enterprises operating in different EU member states.[27]

Implementation Problems

Currently transfer price documentation requirements in EU member states range from no requirements to rather extensive requirements in a few member states.[28] The existing EU TPD is just a non-legislative proposal of the European Commission which has been approved by the European Council.[29]

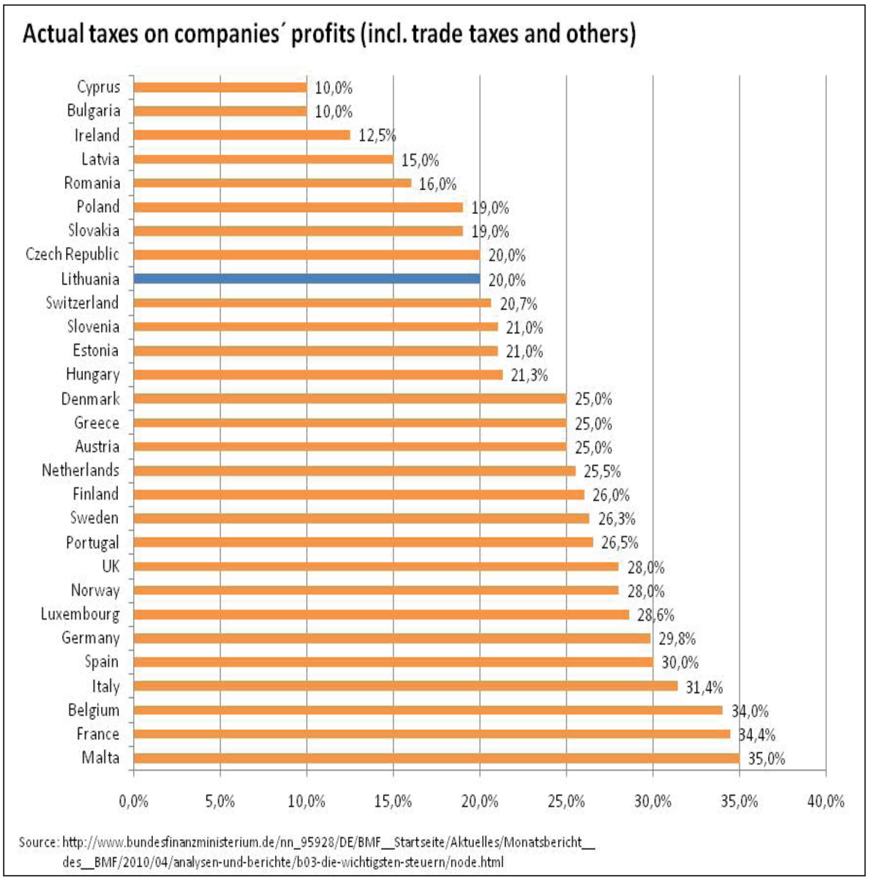

Figure 4. Actual taxes on companies profits (incl. trade taxes and others)
Source: www.bundesfinanzministerium.de (2010)

It is not mandatory for associated enterprises operating on the European Common Market to make use of the EU TPD approach. In the worst situation such a Multinational Corporation would have to prepare different sets of transfer price documentation for each EU member state involved.

Furthermore the scale of the tax rate differential on companies' profits gives a strong incentive for associated enterprises operating in the EU Common Market to shift profits to low-tax EU member states.

In figure 4 the actual taxes on companies' profits of most European Countries are shown. These statistical figures were calculated by the German Ministry of Finance (Bundesfinanzministerium) for the fiscal year 2010.

The actual tax rates on companies' profits take into account the standard corporate tax rates and adjust them to country-specific differences concerning the taxable base and further tax particularities.[30]

The statistical figures reveal a huge tax rate differential on companies` profits in EU member states. The tax rate differential ranges from 10 % actual taxes on companies` profits in Cyprus and Bulgaria to 34.4 % in France and 35 % in Malta.

The concept of the common market means the elimination of obstacles to the free movement of goods, services, persons and capital. Fiscal disharmony in the European Union leads to the fact that cross-country transfer pricing decisions are not only based on market requirements but are ultimately influenced by tax considerations. An efficient resource allocation can hardly be reached under these conditions.

Conclusions

International transfer pricing refers to the practise of pricing among the subsidiaries and affiliates of the same corporate family located in different countries. International transfer pricing can serve as a means to shift profits from high-tax to low-tax countries. In order to avoid such arbitrary pricing decisions the OECD member countries have defined the „Arm's Length Principle", which is an important element of the tax jurisdictions of EU member states.

The tax jurisdictions of EU member states have to control international transfer pricing decions according to the „Arm's Length Principle". Therefore they request a lot of information and data form the taxpaying corporations. In oder to reduce the administrative burdens imposed on Multinational Corporations operating on the European Common Market the European Commission has proposed an EU-wide common approach to transfer pricing documentation requirements.

The articel shows that the EU Code of Conduct on transfer pricing documentation (EU TPD) can mitigate the administrative burdens for the taxpaying corporations operating on the European Common Market. Nevertheless the EU Code of Conduct on transfer pricing documentation (EU TPD) can not be the solution to the arbitrary pricing problem. The tax rate differential on company profits between EU member states is to big. It encourages Multinational Corporations to shift profits from high-tax EU member states to low-tax EU-member states. Therefore the EU TPD can only be an intermediate remedy towards an inevitable tax harmonization in the European Union.[31]

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