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Directorate-General for Taxation and Customs Union
SPA3 08/015
B-1049 Brussels
Belgium

Via online submission

RE: Proposed Transfer Pricing Directive

Dear Sir or Madam:

On 19 September 2023 the European Commission ("Commission") issued a proposal for a Council Directive on transfer pricing ("Proposed TP Directive"). The Proposed TP Directive is part of a package known as "Business in Europe: Framework for Income Taxation" ("BEFIT"), which will integrate key transfer pricing principles into EU law. The Commission requested stakeholder input on the Proposed TP Directive no later than 3 January 2024. On behalf of Tax Executives Institute, Inc. ("TEI"), I am pleased to respond to the Commission's request for input.

About TEI

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 56 chapters in Europe the Middle East & Africa ("EMEA"), North and South America, and Asia. TEI, as the preeminent association of in-house tax professionals, worldwide, has a significant interest in promoting sound tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our over 6,000 individual members represent over 2,800 of the leading companies in the world.

TEI Comments

TEI's feedback on tax policy initiatives is driven by four principles that we believe underly all tax policy around the world: clarity, consistency, predictability, and dispute resolution/avoidance. In our feedback regarding the Proposed TP Directive, we considered the following objectives:

- Increasing tax certainty;
- Multilaterally implementing consistent tax rules;
- Simplifying transfer pricing compliance and reducing the tax compliance burden;

- Meaningful data transparency; and
- Effective dispute prevention and resolution.

We commend the Directorate-general Taxation and Customs Union ("DG TAXUD") for measures that further these policy goals, and, in particular, the efforts to unify the Member States around a standardized transfer pricing approach and practical solutions effectively benefiting tax authorities and taxpayers.

The Proposed TP Directive would introduce a much-welcomed effort to harmonize, simplify, and reduce the compliance burden and, as important, a much-welcomed framework to simplify and accelerate the prevention and resolution of cross-border transfer pricing disputes across EU Member States. However, we believe the additional steps below are necessary to further improve administrative simplicity, support the effort of Member States to streamline their transfer pricing processes, and provide tax certainty benefits for tax administrations and taxpayers.

For these reasons, TEI recommends the DG TAXUD consider the points below. We trust our comments will allow the DG TAXUD to, collaboratively with the business community, work towards the effective adoption of a consistent set of guidelines by the Member states, which are adopted by and enforced by local law.

<u>Comments Addressing Articles of the Proposed TP Directive</u>

Article 1: Subject matter

Article 1 states in its entirety: "*This Directive lays down rules to harmonise transfer pricing rules of Member States and to ensure a common application of the arm's length principle within the Union*."

TEI believes harmonising transfer pricing rules across members states is a laudable goal. One item that should be clarified is whether the directive adopts a "dynamic" or a "static" interpretation of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD TP Guidelines"). For example, suppose there is an intercompany transaction in year 2025; the corresponding return is filed in 2026; and there is an assessment in year 2027. Assume that in 2026 the guidelines change in a manner relevant to the intercompany transaction. Does the TP Directive deem the "old" (2025) or the "new" (2026) guidelines applicable to transaction?

From the reading of Article 3 (18), definition of "OECD Transfer Pricing Guidelines", we infer that a dynamic approach would be adopted, yet that is not entirely clear. This is often a topic of controversy, and we recommend it be clarified.

Article 3: Definitions

Article 3(1) of the Proposed TP Directive defines the "arm's length principle" for purposes of the Directive. Since almost all EU Member States are OECD Members, it would be advisable to make direct reference to the definition contained in Article 9 of the OECD Model Tax Convention on Income and

Capital ("OECD Model") and have a common definition that is also recognized by non-EU Member states.

Article 3(4) of the Proposed TP Directive defines permanent establishment ("PE") as "*a fixed place of business, as defined under the relevant bilateral convention on the avoidance of double taxation or, in absence thereof, in national law . . . .*" This definition differs from other definitions of a PE, including that set forth in Article 10.1 of the OECD's Pillar Two GloBE Model Rules and the PE definition set forth in Article 5 of the OECD Model. There are therefore at least four definitions of a PE a taxpayer may be faced with:

1. The Member State definition in domestic law;
2. The OECD Model definition;
3. The Proposed TP Directive definition; and
4. The Pillar Two GloBE definition.

This will, of course, end up causing conflict and lead to disputes between taxpayers and tax authorities, as well as among tax authorities. We strongly recommend the EU harmonise the PE definition and reduce the uncertainty about when a taxpayer's activities give rise to a PE. TEI welcomes the opportunity to work with the DG TAXUD on this topic.

Article 3(18) of the Proposed TP Directive references the OECD TP Guidelines for certain purposes. Could Members States make reservations in respect of the OECD TP Guidelines under the Proposed TP Directive in domestic law? And if so, how would this work in practice? For example, a Member State may make reservation in OECD Commentary, the Commentary will then apply in EU through the Proposed TP Directive, will the reservation therefore also apply?

Article 5: Associated enterprises

The Proposed TP Directive's Article 5 addresses "Associated enterprises." The definition of an "associated enterprise" reads in part as "*a person who is related to another person in the following ways: (a) a person participates in the management of another person by being in a position to exercise a significant influence over the other person . . . .*" We strongly recommend clarifying what "significant influence" means as the Proposed TP Directive includes no further detail and Members States may therefore differ significantly in their interpretation of this phrase. Ideally, this part of the definition of associated enterprise would be removed.

The other definitions of associated enterprise in Article 5 require one person to have 25 percent of the voting rights, capital, or profits of another person for the two persons to be associated enterprises. This definition differs from the definition of associated enterprises in both the proposed BEFIT directive and under OECD Pillar Two. TEI recommends aligning the definitions.

Article 5(7) of the Proposed TP Directive considers a PE to be an "associated enterprise" of the enterprise of which it is a part. This raises the question of whether the general transfer guidelines apply (because a PE is an associated enterprise) or if the profit attribution report of the OECD does (because a PE is a PE)? This should be clarified.

Article 6: Corresponding adjustments

Article 6 addresses when corresponding adjustments are required of a Member State to prevent double taxation when another Member State makes a primary adjustment. TEI welcomes the effort to provide tax administrations and taxpayers with a framework that could significantly reduce lengthy disputes and improve tax certainty.

We also recommend the Proposed TP Directive further address the implications resulting from the interaction of (i) the application of the corresponding/compensating adjustments and the principles contained in Article 3.2.3 of the Pillar Two GloBE Model Rules (arm's length requirement for cross-border transactions) and (ii) the impact on GloBE adjustments where advanced pricing agreements or bilateral advanced pricing agreements are signed or adjustments derived by tax audits are made.

Article 6.3 of the Proposed TP Directive sets forth a process by which a taxpayer may request a corresponding adjustment in one jurisdiction regarding a primary adjustment in another jurisdiction. Under Article 6.3.(a)(ii), as part of such a request the taxpayer must "*provide a certificate (or equivalent thereof) attesting the definitive nature of the primary adjustment abroad . . . .*".

A taxpayer will likely be able to provide a certificate if the primary adjustment is concluded following an audit. However, primary adjustments may be concluded outside the context of an audit as well, for example, as a result of a cooperative compliance process or of a self-assessment in the tax return. In this case, a certificate may not be present, yet the primary adjustment would be sustained via the final tax assessment. However, even in that case, it is possible that not all Member States agree that there was a final assessment (e.g., an assessment may become final if the statute of limitations lapses).

Article 6.3.(d) provides "[i]*n the case of acceptance* [of the taxpayer's request], *Member States shall communicate to the tax authority of the other relevant jurisdiction the recognition of the corresponding adjustment*."

Should the denial of a corresponding adjustment also be communicated, especially if the counterpart is in the EU? The answer, presumably, is that Arbitration Convention / Mutual Agreement Procedure is still open for the taxpayer, but that does not take away the fact that two administrations (in/out the EU) have come to a different conclusion, based on same principle / guidelines.

Article 7: Compensating adjustment

Regarding compensating adjustments, Article 7(a) requires taxpayer to have, inter alia, "*made reasonable efforts to achieve an arm's length outcome*" before a compensating adjustment initiated by the taxpayer is accepted. TEI believes the term "reasonable efforts" is too vague, could lead to uncertainty, and could be challenged/interpreted differently by tax authorities. We therefore strongly recommend including objective criteria, in the directive or in separate mandatory guidance, defining "reasonable efforts."

Moreover, the Article does not distinguish between upward and downward adjustments and considers only income statement adjustments, and not adjustments made directly in the tax return. In practice, multinationals rely on two main categories of compensating adjustments:

(i) those recorded in a taxpayer's books of account and subsequently settled in cash; and
(ii) adjustments made on the taxpayer's tax return – often referred to as "tax-only" adjustments – often as a last resort to bring taxable income to an arm's length level when the adjustments can no longer be processed in the taxpayer's books and records for various practical reasons.

It is unclear if both adjustments are in the scope of Article 7. TEI recommends the final directive provide guidance on this matter and welcomes clarifying that compensating adjustments, bilaterally self-assessed in the tax return, would also qualify for the purposes of Article 7.

Article 7(b) provides another requirement for a taxpayer initiated compensating adjustment to be accepted, stating that the taxpayer must "*make [] the adjustment symmetrically in the accounts in all Member States involved . . . .*" However, nothing is said about how this requirement impacts cases where the adjustment involves non-EU jurisdictions. TEI applauds this approach and recommends exploring applying Article 7 to Treaty / non-EU situations as well.

Finally, several TEI members have indicated that transfer pricing adjustments are made not just once in the form of a true-up after year end, but several times throughout the year (e.g., quarterly retrospective transfer pricing adjustments). The reason for the multiple adjustments is to maintain compliance with transfer pricing rules throughout the financial year, as well as to minimize the total amount of the year-end adjustments. The adjustments are periodically booked in the accounting records and settled between the associated enterprises. TEI strongly recommends clarifying how these adjustments would be considered in the light of the Proposed TP Directive. Would they fall under the definition of compensating adjustments or would they be outside this definition as they are strictly speaking not "year-end adjustments"?

Article 12: Determination of the arm's length range

Regarding the determination on an appropriate arm's length range, Article 12.4 provides that "*if the results of a controlled transaction fall outside the arm's length range, an adjustment is made to the median of all the results . . . .*" This differs from the OECD TP Guidelines, which provide that "*where the range comprises results of relatively equal and high reliability any point in the range satisfies the arm's length principle . . . .*". Some EU Member States have implemented an approach similar to the OECD into their domestic law.

It is unclear why the EU would apply a different approach than the OECD taking into account that most of the time the choice of a specific position within the range is based on allowing comparability issues to be considered, as opposed to the median, which usually assumes that there are no such comparability issues.

Practical aspects of transfer Pricing

The Commission's initiative to harmonize the transfer pricing documentation by laying down "*common templates, setting linguistic requirements, defining the type of taxpayer to abide by these templates and the timeframes to be covered*" (Article 13.2) is a much-welcomed improvement to the consistency of the transfer pricing requirements across the EU.

TEI strongly recommends the Commission to consider working on 2 other areas:

- To harmonize the benchmarking criteria used in the single market, for example the acceptance of EU comparable companies (opposed to domestic comparable companies).

- To harmonize the filing requirements, penalty protection and, if feasible, the penalties applicable to the non-preparation, non-filing or non-compliance with the transfer pricing report requirements.

Other Comments

TEI strongly recommends implementing a dispute prevention and resolution mechanism that aligns the tax treatment of transfer pricing adjustment with that of VAT and Customs duties for the reasons discussed below.

Consistency with the EU VAT Directive

The Proposed TP Directive would codify the OECD TP Guidelines as EU law, including the aforementioned transfer pricing adjustments. The EU VAT Expert Group, however, advised in 2018 that any such adjustments should be outside the scope of the VAT. However, there is no harmonization among Member States in this regard, as some treat these as outside the scope of VAT, some as retrospective price adjustments, and some as a separate supply. Since most of these adjustments are cross-border, it is impossible to report these transactions properly without creating mismatches in the VAT Information Exchange System. TEI recommends the EC use the finalization of the Proposed TP Directive to implement the recommendations of the VAT Expert Group on harmonization.

Consistency with the Union Customs Code ("UCC")

The UCC provides a hierarchy for determining the customs valuation to be applied to imported goods (this valuation method/hierarchy is based on WTO rules). The hierarchy is as follows:

1. The transaction value method;
2. The transaction value of identical goods;
3. The transaction value of similar goods;
4. The deductive method;
5. The computed method; and
6. The fallback method.

The Court of Justice for the European Union ("CJEU") has held that the UCC does not include a legal basis for valuing products subject to customs duties based on transfer pricing principles, which may include year-end adjustments. That is, the CJEU held that valuation methods allowing for retrospective adjustments (such as transfer pricing methods) are not acceptable for EU customs valuation purposes. However, many taxpayers use transfer pricing valuations when calculating customs duties. TEI recommends the EC amend the UCC to allow transfer pricing valuations consistent with the OECD TP Guidelines for customs purposes under the UCC. This would ease the compliance burden on taxpayers as well as conform the UCC to current practice.

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TEI appreciates the opportunity to comment on the Proposed TP Directive. TEI's comments were prepared under the aegis of its EMEA Direct Tax Committee and were led by Ralf Thelosen of Citco. Should you have any questions regarding out comments, please do not hesitate to contact Mr. Thelosen at rthelosen@citco.com or Benjamin R. Shreck of TEI's Legal Staff at bshreck@tei.org or +1 202 464 8353.

Respectfully submitted,

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