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EU Gateway Publication

# The Transfer Pricing Directive: The Fundamental Changes and Impact on Groups Operating in the EU

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In this EU Gateway publication, we present the fundamental aspects of the proposed Directive on Transfer Pricing and their impact for groups operating in the EU Member States. Each aspect is accompanied by our EU Gateway observations.

- On 12 September 2023, the European Commission published a legislative proposal for a Directive on Transfer Pricing, also known as the “TP Directive”.
- This Directive (if adopted) would **incorporate the arm’s length principle into EU law and EU Member States’ domestic legislation**, harmonize key transfer pricing rules, and create the possibility to establish common binding rules in the EU on specific Transfer Pricing (“TP”) subjects.
- It also looks to **clarify the role and status of the OECD TP Guidelines**.
- The European Commission’s stated **objective** in introducing the TP Directive is to simplify tax rules through increasing tax certainty for businesses in the EU, thereby reducing the risk of litigation and double taxation and the corresponding compliance costs and thus improve competitiveness and efficiency of the single market.[1]

## 1. The TP Directive in a nutshell

The TP Directive is composed only of general provisions, which are based on Chapters I-IV of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“the OECD TP Guidelines”).[2] The scope of the proposal is limited to taxpayers that are registered in, or subject to tax, in one or more EU Member State(s), including permanent establishments in one or more EU Member State(s).[3] Upon the adoption of the Directive, the European Commission plans to introduce further proposals related to transfer pricing. These additional proposals will cover aspects such as the provision of intercompany services (including distribution and marketing services), financial transactions, intangibles, and business restructurings, among others.[4]

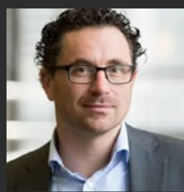
**1** The Proposal for a Council Directive on transfer pricing {SWD(2023) 308-309 final}, Explanatory Memorandum, p. 2, paragraph 4 of the Preamble, available *here*.
**2** OECD (2022), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, OECD Publishing, Paris, available *here*.
**3** Article 2 of the TP Directive.
**4** Article 14 par. 2 of the TP Directive.

## EU Gateway

EU Gateway PwC Netherlands, supported by the robust Dutch Knowledge Centre and the ITS/EUDTG network of EU colleagues, endeavors to offer coordinated assistance to non-EU clients in navigating the intricate EU tax and legal landscape. Furthermore, PwC Netherlands assumes a proactive role in apprising clients of significant EU tax law and EU27 domestic developments through the monthly EU Gateway newsletter, thereby establishing itself as the primary point of contact for non-EU clients and colleagues within the EU.

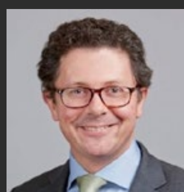
**For comments or questions regarding this EU Gateway publication, please contact:**

**Dr. Vassilis Dafnomilis**
Senior Manager Tax
Tax Knowledge Centre
vassilis.dafnomilis@pwc.com
PwC Netherlands



**Prof. dr. Maarten de Wilde**
Director Tax
Tax Knowledge Centre
maarten.floris.de.wilde@pwc.com
PwC Netherlands

**Bert Middelkoop**
Partner Tax
Transfer Pricing
bert.middelkoop@pwc.com
PwC Netherlands



**Jeroen Peerbooms**
Partner Tax
Transfer Pricing
jeroen.peerbooms@pwc.com
PwC Netherlands

**For market related questions please contact:**

**Jeroen Peters**
Partner International
Tax Services
jeroen.h.peters@pwc.com
PwC Netherlands (EMEA)

**Chahid el Tarrahi**
Partner International
Tax Services
chahid.el.tarrahi@pwc.com
PwC Netherlands (Americas)

**Pieter Janson**
Partner International
Tax Services
pieter.janson@pwc.com
PwC Netherlands (Asia)

**Vincent Voogt**
Partner International
Corporate Tax
vincent.v.voogt@pwc.com
PwC Netherlands (USA)

**Mohammed Allaoui**
Partner International
Corporate Tax
mohammed.allaoui@pwc.com
PwC Netherlands (USA)

The proposal will undergo negotiation by the EU Member States with the goal of achieving the required unanimous approval. This is expected to be a challenging process: early reactions have been mixed, with a negative reaction from Sweden followed by support for the TP Directive from Finland.

However, if approval is obtained, the Directive will come into force as of 1 January 2026.

## 2. Background to the TP Directive

The European Commission sets out its reasons for the proposal in its Explanatory Memorandum. Firstly, it states that although the arm's length standard is reflected in Article 9 (Associated Enterprises) of the OECD Model Tax Convention on Income and on Capital ("MTC") and OECD TP Guidelines, there is no harmonization between EU Member States on either the status and role of the OECD TP Guidelines or the TP rules applied through domestic legislation, leading to complexity and an uneven playing field for businesses.[5] This complexity is said to give rise to a number of other problems, namely profit shifting and tax avoidance, litigation and double taxation, and high compliance costs.[6]

These issues are described by the European Commission as tax barriers for businesses operating in the EU which impede the proper functioning of the single market, ultimately undermining its competitiveness.[7]

## 3. Main aspects of the TP Directive and their impact – our EU Gateway observations

In our view, although the TP Directive currently consists only of general provisions, we have flagged five topics that if implemented will represent a departure from the status quo and the international standard of the OECD TP Guidelines, and have a considerable impact for groups operating in the EU Member States.

### Definition of associated enterprises

The TP Directive aims to implement the arm's length principle by stipulating that "where an enterprise engages in one or more commercial or financial cross-border transactions with an associated enterprise, such enterprise determines the amount of its taxable profits in a manner that is consistent with the arm's length principle".[8] The Directive introduces a 25% threshold (voting rights or participation in the capital or in profits) for companies to be considered associated enterprises.[9] A company can also be considered a related enterprise if it participates in the management, control, capital or profits of an entity.[10] Further, the Directive stipulates that permanent establishments shall be considered associated enterprises of the enterprise of which they are a part.[11]

**EU Gateway observation:** Regarding the proposed 25% threshold, the OECD TP Guidelines do not have such a definition of associated enterprises and instead refer back to Article 9 of the MTC.[12] In practice we see that some countries define associated enterprises using a threshold of 25%, whereas others use 50% (e.g., Italy, France). The transfer pricing practices of business are based on using these definitions to determine whether companies are in scope.

The introduction of the 25% threshold would mean that many companies and their cross-border transactions which were previously not subject to transfer pricing rules will fall within the scope of the TP Directive. Those affected may include joint ventures, investment funds, and entities in the EU Member States which previously applied the 50% threshold. The same can also be said for cases where a company can be determined to participate in the management, control, capital or profits of an entity, regardless of its holding percentage. Groups will need to revisit their transfer pricing policies and make changes to the way they are implemented to ensure they are compliant with the new definition, and the compliance burden for documentation may well increase in some cases.

### Arm's length range

The TP Directive defines the arm's length range used to establish whether the conditions of a controlled transaction are at arm's length as the interquartile range of the results of the uncontrolled comparables.[13] If the results of a controlled transaction fall outside the interquartile range an adjustment is made to the median of all the results, unless it is proven that any other point of the range determines an arm's length price taking into consideration the circumstances of the specific case.[14]

**EU Gateway observation:** This is somewhat at odds with the OECD TP Guidelines, which recommend that in the case where there are a sizeable number of observations, statistical tools that take account of central tendency to narrow the range (e.g., the interquartile range or other percentiles) may be used to enhance the reliability of a comparability analysis.[15]

The OECD therefore does not have a definitive requirement on the use of the interquartile range.

**5** Explanatory Memorandum to the TP Directive, p.2
**6** Explanatory Memorandum to the TP Directive, p. 3.
**7** Ibid.
**8** Article 4 of the TP Directive.
**9** Article 5 par. 1 of the TP Directive.
**10** Ibid.
**11** Article 5 par. 7 of the TP Directive.
**12** OECD TP Guidelines, preface, para. 11.
**13** Article 12 of the TP Directive.
**14** Ibid.
**15** Para. 3.57, OECD TP Guidelines.

Indeed, in paragraph 3.62 of the OECD TP Guidelines, it is stipulated that where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm's length principle. An example of this would be in a CUP analysis, where the high degree of reliability of the comparables would not necessitate the use of the interquartile range.

In addition to this tightening of the definition of the arm's length range, there is also a lack of guidance in the TP Directive for taxpayers on how an arm's length outcome can be determined in situations where a limited number of observations results in difficulty in applying the interquartile range. Further, the Directive does not address the situation where the tax authorities disagree with the benchmarking study conducted by a taxpayer, perform their own analysis. In case that the financial results of a taxpayer are outside of their interquartile range the tax authorities may assert that an adjustment should be made to the median of their interquartile range.

On the whole, the tightening of the parameters for the arm's length range as defined in the Directive is likely to increase the need for effective implementation and monitoring of TP policies by taxpayers to ensure that the tested result falls within the interquartile range.

## Corresponding adjustments

The TP Directive formalizes the process for EU Member States to perform a corresponding (i.e., downward) adjustment, setting out the conditions for such an adjustment and the requirements for the taxpayer's request. The Directive also introduces a fast-track procedure whereby EU Member States are required to ensure that requests from taxpayers for a corresponding adjustment in the event of double taxation due to a primary adjustment made by another EU Member State are concluded within 180 days.[16]

**EU Gateway observation:** The formalization of rules relating to corresponding adjustments will be welcomed by many taxpayers, as will the fast-track procedure to resolve double taxation. The 180-day limit will in many cases represent an improvement on Mutual Agreement Procedures (MAP), which may last much longer depending on the case in certain EU Member States. Further, understanding the impact of the adjustment at an early stage will be critical for calculating other taxes (i.e. Pillar 2 top-up tax, and also possibly the BEFIT tax base). Nonetheless, whether all EU Member States have the resources to process requests so quickly remains to be seen. It is also worth noting that the requirement in the TP Directive is only for EU Member States to conclude the taxpayer's request with a "reasoned act of acceptance or rejection", leaving the possibility that requests may still be rejected and end up going to MAP (and possibly arbitration) at the discretion of national tax authorities.

## Compensating adjustments

A "compensating adjustment" is defined in the Glossary of the OECD Transfer Pricing Guidelines as "an adjustment in which the taxpayer reports a transfer price for tax purposes that is, in the taxpayer's opinion, an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between the associated enterprises". However, compensating adjustments are a cause of double taxation as they tend not to be recognised in all jurisdictions on the grounds that the tax return should reflect the actual transactions. To avoid litigation and establish a common approach to compensating adjustment within the Union, Article 7 of the TP Directive provides the conditions under which EU Member States should recognise a compensating adjustment.

More specifically, the TP Directive gives a list of conditions to be met for year-end adjustments to be made by taxpayers.

The conditions listed in the TP Directive are:

- Before recording the relevant transaction, or series of transactions, the taxpayer made reasonable efforts to achieve an arm's-length outcome.
- The taxpayer makes the adjustment symmetrically in the accounts in all Member States involved.
- The taxpayer applies the same approach consistently over time.
- The taxpayer makes the adjustment before filing the tax return;
- The taxpayer is able to explain why its forecast did not match the result achieved.[17]

**EU Gateway observation:** None of these criteria are included in the OECD TP Guidelines, and their inclusion in the TP Directive will give rise to significant operational transfer pricing challenges for many companies. The first condition assumes that the taxpayer has a TP policy in place that aims to set intercompany pricing on an arm's length basis at the time the transaction is recorded. In our experience, many companies take an ex-post approach to transfer pricing and use year-end adjustments to ensure the tested party ultimately achieves an arm's length result. This requirement will therefore change the dynamic for taxpayers, demanding revisions to internal processes to make intercompany pricing a more proactive exercise. The requirement for taxpayers to show that they have made "reasonable efforts" is another point companies will newly need to address.

In addition, the condition for taxpayers to explain the difference between forecasts and actual results may also cause practical issues as many groups do not prepare forecasts on an entity level.

**16** Article 6 of the TP Directive.
**17** Article 7 of the TP Directive.

## Version of OECD TP guidelines applicable

The TP Directive proposal aims to align primarily with the latest OECD TP guidelines. Recognizing the continuous evolution of these guidelines, and to ensure compliance with their latest version in EU Member States, the European Commission suggested that the procedure outlined in Article 218, paragraph 9, of the Treaty on the Functioning of the European Union (TFEU) should be applicable. This procedure entails the European Commission initiating the establishment of an EU common position for negotiations on amendments to the OECD TP guidelines.[18] Additionally, as per the Explanatory Memorandum, the European Commission may also propose an amendment to the TP Directive in order to reflect an amendment of the OECD Transfer Pricing Guidelines.

**EU Gateway observation:** Adhering to the most recent version of the Transfer Pricing guidelines might pose challenges for EU Member States. The initiation of the process rests with the European Commission, while the Council of the EU (comprising EU Finance Ministers in this case) adopts a common approach on the guidelines. In the event of a common approach, there is, however, a need to consider and balance the interests of all 27 EU Member States, inevitably leading to concessions being made. This aspect of the TP Directive may not easily be accepted by the EU Member States.

## 4. TP Directive: What's next?

At the EU level, the examination of the TP Directive proposal has commenced concurrently with the proposals for a Council Directive establishing a Head Office Tax System for micro, small, and medium-sized enterprises (HOT)[19], as well as a Council Directive on transfer pricing and a Council Directive on Business in Europe: Framework for Income Taxation (BEFIT)[20] EU Member States have initiated the analysis and technical work on these three proposals at the Working Party on Tax Questions (WPTQ) level. In 2023, three WPTQ meetings were convened on this issue during the Spanish Presidency of the Council of the EU.[21]

Going forward, the Belgian presidency of the Council, which began on 1 January 2024, is expected to endeavor towards advancing the negotiations of the TP Directive, among other matters. The discussion on the TP Directive was included in the agenda of EU Council WPTQ meeting scheduled on 12 January 2024.[22]

**18** Article 3 section 18 of the TP Directive.
**19** Proposal for a Council Directive establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU, available *here*.
**20** Proposal for a Council Directive on Business in Europe: Framework for Income Taxation (BEFIT), available *here*.
**21** See ECOFIN report to the European Council, available *here*.
**22** Agenda of next EU Council Working Party on Tax Questions (Direct Taxation),available *here*.

## 5. TP Directive: how do EU Member States view the TP Directive?

Sweden, Finland and the Netherlands have already published their positions on the TP Directive proposal. Naturally, these stances may evolve during the negotiations, but we regard these initial positions as establishing the groundwork, particularly for a Directive that necessitates unanimous approval.

In a press release of 17 October 2023, the Swedish Ministry of Finance stated that Sweden does not approve the proposed TP Directive. According to the release, Sweden disagrees with many of the underlying reasons for the proposed Directive, including the European Commission's claim that differences in interpretation of the transfer pricing rules lead to increased conflict and tax avoidance. In addition, as per the release "The government believes that the differences in EU Member States' interpretation and application of the arm's length principle are overestimated and that the disputes that arise regarding transfer pricing are more often due to different states making different assessments of the circumstances in the specific case. The government also believes that since transfer pricing is applied globally, global solutions are preferable to solutions at EU level, as the latter can mean that new problems arise vis-à-vis third countries." [23]

In a press release dated 26 October 2023, the Finnish government expressed its support to the goals of applying the arm's length principle in a harmonized way. However, the government is not entirely convinced that the TP proposal (as well as the BEFIT and the HOT proposals) will effectively reduce the administrative burden on businesses. Therefore, it is crucial to ensure in further preparations that the proposed Directives do not impose undue administrative burdens on companies or the tax administration.[24] It is also interesting to note that the Finnish Ministry of Finance has opened a public consultation with regard to the national implementation of the BEFIT, HOT and the TP Directive proposals.

The Netherlands has a mixed stance on the TP Directive. While supporting the goals to enhance EU competitiveness and internal market efficiency, and reduce tax-related risks, the Netherlands aligns with the European Commission's view on the suitability of the OECD Guidelines for the arm's-length principle. However, the Netherlands expresses concerns about the proposal's incorporation of the OECD Guidelines into EU legislation, citing potential limitations and uncertainties in interpretation. Additionally, questions arise regarding the proposal's impact on individual EU Member States' positions in OECD transfer pricing meetings and alignment with new OECD Guidelines.[25]

## 6. TP Directive: Continue Monitoring the Developments

It is not yet clear whether the TP Directive will be adopted or the extent to which the current proposal will be revised. If adopted and transposed into the domestic laws of EU Member States, the Directive may well bring more certainty to taxpayers on key transfer pricing issues but also entail stricter requirements that will add to the importance of transfer pricing policies and their implementation. Taxpayers may also have to bear additional costs related to compliance and adaptation to the new rules in the initial phase. Ultimately, the benefits of a more level playing field for transfer pricing in the EU may be enjoyed more by those groups who take a more proactive approach to the operational aspects of their transfer pricing.

We will maintain a close watch on TP Directive's progress and keep you informed through our monthly EU Gateway newsletter.[26]

**23** The press release is available *here*.
**24** The press release is available *here*.
**25** Assessment of the Working Group Beoordeling Nieuwe Commissievoorstellen (BNC) on the TP Directive available *here*.
**26** Subscribe *here* to the EU gateway newsletter.

This publication was created by PricewaterhouseCoopers Belastingadviseurs N.V. and concluded on 10 January 2024. Subsequent developments have not been taken into account unless otherwise stated. This publication does not serve as the official input from PwC on the consultation of the European Commission on the TP Directive.