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The Code of Conduct for the EU's Transfer Pricing Documentation

by Roberto Succio

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FEATURED PERSPECTIVES

The Code of Conduct for the EU's Transfer Pricing Documentation

by Roberto Succio

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Nearly every multinational enterprise group must arrange for a wide scope of services to be available to its members, particularly administrative, technical, financial, and commercial services.

According to OECD transfer pricing guidelines section 7.2.9, the services may include management, coordination, and control functions for the whole group. The cost of providing the services may be borne initially by the parent, by a specially designated group member (''a group service center''), or by another group member. An independent enterprise in need of a service may acquire the services from a service provider that specializes in that type of service or may perform the service for itself.

Similarly, a member of an MNE group in need of a service may acquire it directly or indirectly from independent enterprises or from one or more associated enterprises in the same MNE group, or it may perform the service for itself. Intragroup services often include those that are typically available externally from independent enterprises (such as legal and accounting services), in addition to those that are ordinarily performed internally (such as central auditing, financing advice, or training of personnel).

There is an increasing trend in tax audits that cost allocation systems are challenged and there are significant differences when documentation has to be prepared to justify a certain cost allocation system. During a transfer pricing audit, few issues draw more attention from tax auditors than intragroup services and the compensation paid for them by related entities in the form of management or other fees.

Most taxpayers are not well informed about the nuances of identifying, evaluating, and documenting their intragroup services for transfer pricing purposes. However, that lapse in documentation may invariably lead to large reassessments against the taxpayer as well as subsequent litigation at the tax courts. In essence, as amply demonstrated by a number of transfer pricing litigation cases involving management fees in Canadian and U.S. courts recently,[1] intragroup services are among the most controversial issues in the realm of transfer pricing.[2]

The EU TPD

The EU transfer pricing documentation (EU TPD) does not help in this respect since it only provides an abstract approach on how to prepare documentation.

However, the arm's-length standard holds a taxpayer to a standard no higher, and no lower, than that of the marketplace.

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[1]For a survey of the cases, see R.S. Avi-Yonah, ''The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation,'' 15 *Va. Tax Rev.* 89 (1995), updated version in 9 *Fin. and Tax L. Rev.* 310 (2006); S. Young, ''Ninth Circuit Reversal of Tax Court in *Xilinx* a Major Government Victory, Practitioners Say,'' *Tax Notes Int'l*, June 1, 2009, p. 707, *Doc 2009-11945*, or *2009 WTD 100-1*.

[2]*See* K.T. Boatman, ''A Better Way to Apply Arm's Length Standard to Management Fees,'' *Transfer Pricing*, Vol. 6, No. 26, Apr. 22, 1998, p. 3; M.J. Bitner, R.P. Fisk, and S.W. Brown, ''Tracking the Evolution of the Services Marketing Literature,'' *J. Retailing* (1993), 69, 1, 61-103.

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To find pragmatic solutions to this problem, the EU Joint Transfer Pricing Forum was set up by the European Commission in October 2002. The commission has reported twice on the work of the forum through two communications. The first communication (COM(2004) 297 of April 23, 2004) presented a code of conduct on the convention for the elimination of double taxation (the arbitration convention) to ensure that it would operate more efficiently.[3]

The masterfile should provide a blueprint of the MNE group and its transfer pricing system for all EU member states concerned.

The second communication (COM(2009) 472 of September 14, 2009) presented a code of conduct on documentation requirements for transfer pricing within the EU — the EU TPD. The code of conduct on the EU TPD sets out rules for the amount and type of documentation that member states will request and accept for the purposes of their own transfer pricing rules. The European Commission has appointed 10 private-sector tax experts to participate in the EU Transfer Pricing Forum on business taxation, as well as a chairman of the forum. Together with experts from member states' administrations, the business experts have the task of considering ways of reducing the high compliance costs and eliminating the double taxation that often arise in the case of cross-border intergroup transactions. These problems occur because of disagreements both between companies and tax administrations and between national tax administrations on the pricing of the transactions. The commission made these appointments with the agreement of representatives of the Presidency of the EU's Council of Ministers and of the Union of Industrial and Employers' Confederations of Europe (a European employers' organization). The commission has proposed that member states agree to an EU-wide common approach to transfer pricing documentation requirements.

The EU TPD would consist of two main elements:

- The ''masterfile'' would contain common standardized information relevant for all EU group members of an MNE such as a general description of the business and business strategy, a general description of the transactions involving associated enterprises in the EU, and the enterprise's transfer pricing policy.
- The ''country-specific documentation'' would consist of a set standardized documentation for each of the specific member states involved. Each set of country-specific documentation would contain information relevant to that country only, such as amounts of transaction flows within that country, contractual terms, and the particular transfer pricing methods used.

Without prejudice to the respective spheres of competence of the member states and the Community, the code of conduct concerns the implementation of standardized and partially centralized transfer pricing documentation for associated enterprises in the EU. It is addressed to member states but is also intended to encourage MNEs to apply the EU TPD approach.

In particular:

- member states will accept standardized and partially centralized transfer pricing documentation for associated enterprises in the EU (EU TPD), as set out in the annex, and consider it as a basic set of information for the assessment of an MNE group's transfer prices;
- the use of the EU TPD will be optional for an MNE group;
- member states will apply similar considerations to documentation requirements for the attribution of profits to a permanent establishment as apply to transfer pricing documentation;
- member states will, whenever necessary, take duly into account and be guided by the general principles and requirements referred to in the annex; and
- member states undertake not to require smaller and less complex enterprises (including small and medium-size enterprises) to produce the amount or complexity of documentation that might be expected from larger and more complex enterprises.

The masterfile should follow the economic reality of the business and provide a blueprint of the MNE group and its transfer pricing system that would be relevant and available to all EU member states concerned.

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[3]For literature on the arbitration convention (Convention 90/436/EEC of July 23, 1990, published in the EC Official Journal L 225 (Aug. 20, 1990)), see, e.g., M. Lang and M. Zuger (eds.), *Settlement of Disputes in Tax Treaty Law* (Kluwer Law International, 2002); L. Hinnekens, ''Different interpretations of the European Tax Arbitration Convention,'' *EC Tax Rev.* 4 (1998), at 247; D. Schelpe, ''The Arbitration Convention: its origin, its opportunities and its weaknesses,'' *EC Tax Rev.* 2 (1995), at 68; P. Adonnino, ''Some Thoughts on the EC Arbitration Convention,'' 43 *Eur'n Tax'n* 11 (2003), at 403; O. Rouselle, ''The EC Arbitration Convention — An Overview of the Current Position,'' 45 *Eur'n Tax'n* 1 (2005), at 14; B. Damsma, ''Proposed Changes to the Code of Conduct for the Arbitration Convention,'' 17 *Int'l Transfer Pricing J.* 1 (2010), at 34; M. Züger, ''The ECJ as Arbitration Court in the New Austria-Germany Tax Treaty,'' 40 *Eur'n Tax'n* 3 (2000), at 101.

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It should contain: ''a list of cost contribution agreements [(CCAs)], Advance Pricing Agreements (APA) and rulings covering transfer pricing aspects as far as group members in the EU are affected.'' For the first time ever, we can find in an official document a reference to a list of CCAs as requested documents.

MNEs should undertake to prepare the masterfile in time to comply with any legitimate request originating from one of the tax administrations involved.

On request by a tax administration, the taxpayer in a given member state should make its EU TPD available within a reasonable time depending on the complexity of the transactions. When a taxpayer makes an adjustment in its tax return to its accounts profit resulting from the application of the arm's-length principle, documentation demonstrating how the adjustment was calculated should be available. It may not always be necessary for documents to be translated into a local language. To minimize costs and delays caused by translation, member states should accept documents in a foreign language whenever possible. Regarding the EU TPD, tax administrations should be prepared to accept the masterfile in a commonly understood language in the member states concerned. Translations of the masterfile should be made available only if strictly necessary and on specific request.

The 2010 Report

The report from the June 8, 2010, meeting of the EU Joint Transfer Pricing Forum gives the following definition:

> A Cost Sharing Arrangement (CSA) is a framework between business enterprises (''related parties'' or ''parties'') in an MNE to incorporate a mechanism to share the costs and risks of developing, producing or obtaining assets, services or rights and to determine the nature and extent of the interests of each participant in those assets, services, or rights.

Unfortunately, no definition of services is provided.

The term ''service'' may refer to:

> useful labour that does not produce a tangible commodity, performance of a function, work done, for another or for a community or assistance or benefit given to someone. In essence, a service is performed by one entity for the benefit of another for a specific purpose, does not involve the sale of any tangible or intangible property, and cannot exist independently of the entities involved in the transaction. Services are considered time-dependent and time-important.[4]

An intragroup service is a service usually performed by one member of an MNE group for the benefit of one or more related members of the same group. In some cases, intragroup services may be performed by a parent company or a sister company to one or more related parties. For transfer pricing, those intragroup services become important when they are rendered to related parties located in different tax jurisdictions. The compensation for those services is usually termed management fees or administrative fees, depending on the type of services rendered. They are especially interesting to transfer pricing auditors around the world because they are perhaps one of the most effective means of lowering taxable income by increasing expenses in a particular tax jurisdiction.

> **While intragroup services might be vilified as a tax avoidance vehicle by tax authorities, they can also be an important tax planning tool.**

Hence, while intragroup services might be vilified as a tax avoidance vehicle by tax authorities, they can also be an important tax planning tool, especially if compensation for those services can be adequately justified with the appropriate documentation prepared to fulfill the legislative requirements of the various tax jurisdictions.

A CSA is defined in U.S. tax law as:

> a contract between two or more controlled participants to divide ownership of cost-shared intangibles on a territorial basis, share intangible development costs (IDCs) based on respective shares of reasonably anticipated benefits (RAB Shares), enter into preliminary or contemporaneous transactions (PCTs) to compensate for all external contributions, and exploit the cost-shared intangibles without any further obligation to compensate other participants in the CSA.

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[4]Many topics are involved in the definition of services: the traditional transfer pricing treatment of intangible asset transfers and the treatment of services that relate to the creation of intangible assets (for example, services provided by research centers). These types of services, which do not fall under the ambit of the cost-sharing regulations, are often perceived as granting their providers with material interests in the intangible assets. *See* P. Dau and R. Donnelly, ''Globalization of Intangibles-Based Businesses: Tax Aspects,'' 9 *Stan. J.L. Bus. & Fin.* 1 (2003); G. Ossi et al., ''New Section 482 Services and Modified Intangibles Proposed Regulations,'' 44 *Tax Mgmt. Memorandum* 443 (2003) (suggesting that the services are to be evaluated under the transfer pricing rules of intangibles).

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Furthermore, to have a valid CSA the participants must substantially comply with contractual, documentation, accounting, and reporting requirements.[5]

Common elements in a CSA are detailed in the report as follows:

- A cost-sharing system agreement will have two or more participants.
- Each of the participants should have a reasonable expectation to benefit from taking part in the arrangement.
- Contributions in the arrangement should be in line with the expected benefits for each of the participants individually.[6]
- The potential benefit for the participant is a consequence of being part of the arrangement. It should merely be necessary for the participant to demonstrate an expectation of benefit from the overall arrangement rather than from each individual component of expenditure.
- A CSA also allows for sharing of risks among the participants; hence, even if any individual piece of expenditure under the CSA is deemed to give rise to an unsuccessful outcome, those costs should still be shared.[7]

There will be an allocation key to apportion the shared costs between the parties based on anticipated benefits. The allocation key could, for example, take account of the different scale of the businesses (for example, turnover, number of people, or computers) that would provide an appropriate estimation of the expected benefit of each party. The CSA should set out what costs of each of the parties to the CSA are to be shared, as only costs that relate to the common purpose should be included. This should include direct costs as well as indirect costs.

I think the following considerations should be made.

First, it is important to note the connection adopted by the EU TPD with the OECD transfer pricing guidelines.[8] Paragraph 8.9 states:

> The expectation of mutual benefit is fundamental to the acceptance by independent enterprises of an arrangement for pooling resources and skills without separate compensation. Independent enterprises would require that each participant's proportionate share of the actual overall contributions to the arrangement is consistent with the participant's proportionate share of the overall expected benefits to be received under the arrangement. To apply the arm's length principle to a CCA, it is therefore necessary to determine that all the parties to the arrangement have the expectation of benefits, then to calculate each participant's relative contribution to the joint activity (whether in cash or in kind), and finally to determine whether the allocation of CCA contributions (as adjusted for any balancing payments made among participants) is proper. It should be recognised that these determinations may bear a degree of uncertainty. The potential exists for contributions to be allocated among CCA participants so as to result in an overstatement of taxable profits in some countries and the understatement of taxable profits in others, measured against the arm's length principle. For that reason, taxpayers should be prepared to substantiate the basis of their claim with respect to the CCA (see Section F).

Second, the following quotation from paragraph 8.11 is essential as a reply to the tax administration's claim to disregard the allocation of the CCA contribution when the deal is not successful for one or both of the entities:

> The requirement of an expected benefit does not impose a condition that the subject activity in fact be successful. For example, research and development may fail to produce commercially valuable intangible property. However, if the activity continues to fail to produce any actual benefit over a period in which the activity would normally be expected to produce benefits, tax administrations may question whether the parties would continue their participation had they been independent enterprises.

Note that losses may continue for several years in cases when high-tech products are developed. Also, basic research that may not lead to the development of successful products, but that is necessary for long-term business reasons, may be carried out in the form of a CCA.

Finally, the EU TPD underlines the primary tax benefit for entering into a CSA:

> The IP developed under the CSA is available to all the participants, without the requirement for an additional charge. Any IP that cannot be transferred due to national or legal restrictions should not be the subject of the CSA. In other words, all participants to such arrangement will be considered the owner of their respective interest in the intangibles created, thereby precluding the application of the general transfer pricing

[5] *See* prop. Treas. reg. section 1.482-7(b)(1)(IV)-(VII).

[6] *See* para. 8.9 of the OECD transfer pricing guidelines.

[7] *See* para. 8.11 of the OECD transfer pricing guidelines.

[8] For a detailed analysis, see H. Becker, ''Commentary on Chapter VIII of the OECD Transfer Pricing Guideline,'' 5 *Int'l Transfer Pricing J.* 2, 72 (1998); T.A. Reichert and D.R. Wright, ''Proposed Cost Sharing Regulations: A Departure From Arm's Length?'' 13 *Int'l Transfer Pricing J.* 1 (2006). Note that buy-in arrangements and valuation of contributions at market value are different from the markup of contributions. *See* Becker, *supra* note 8, at 78.

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rules relating to the transfer of intangible property. Consequently, cost sharing is viewed as a practical alternative to cross-border licensing.[9]

Regarding the definition of participant, it is assumed that it is a controlled taxpayer that reasonably anticipates that it will derive benefits from the use of covered intangibles (either from direct use of the intangible or through licensing the intangible), that substantially complies with enumerated accounting requirements, and that substantially complies with enumerated administrative requirements.

For this purpose, all members of a consolidated group that join in the filing of a consolidated return will be treated as one taxpayer. Participation in a CCA is therefore limited to associated parties that reasonably expect to gain a benefit by directly or indirectly exploiting or using the results of a CCA. A similar condition applies under Treas. reg. section 1.482-7(c)(1).

The participation requirement described above reflects a fundamental change from the requirement as first promulgated. Originally, only a controlled taxpayer that used or reasonably expected to use the covered intangible in the active conduct of its trade or business could qualify as a participant. A taxpayer was considered to actively conduct a trade or business only if it carried out substantial managerial operational activities itself or supervised the conduct of such activities by another. This requirement was dropped following a substantial amount of criticism by taxpayers who rightly pointed out that there are sound business reasons for transferring intangibles to entities that do not conduct an active trade or business, as defined in the regulations. If a controlled taxpayer that is not a participant renders assistance to the research and development undertaken under a qualified CSA, that taxpayer must be compensated.

The Amount of Contributions

Contributions under CCAs must be consistent with what an independent enterprise would have agreed to contribute under comparable circumstances.[10]

This means that contributions should be in proportion to anticipated or received benefits, estimating the share of benefit expected to be obtained by each participant and allocating contributions in the same proportion.[11]

Common techniques are:

- To directly estimate the additional income generated (for example, projected sales of a new product or income from licensing a new process),[12] or estimate costs saved by each participant as a result of the CCA.
- To use prices charged for similar assets or services (a quasi-comparable uncontrolled price method, probably difficult in practice).
- To use an indirect method, an allocation key (for example, based on sales, units used, capital invested, gross or operating profit, units produced or sold, number of employees). The appropriateness of an allocation key depends on the nature of the CCA activity and the relationship between the participants. Sales is an appropriate key if all participants are expected to have a similar increase in net profits, and all of them do business at the same market level (for example, manufacturing). Units used, produced, or sold may be an appropriate key if the participants exploit the intangible concerned in the use, production, or sale of similar products under comparable economic conditions. Gross or operating profit from the activities in which the intangible concerned is exploited is an appropriate key if the intangible is fundamental to carry on the activity.
- To estimate the share of benefit expected to be obtained by each participant and to allocate contributions in the same proportion.[13]

A proper CCA should provide for possible adjustments to reflect changes in relevant circumstances with an impact on shares in benefit. When actual results differ considerably from projections, tax authorities may adjust a participant's contribution.

Regarding the valuation of a contribution, the problem arises when contributions are made by assets or administrative assistance to a CCA. The OECD transfer pricing guidelines suggest a case-by-case approach, leaving open the use of costs or of market prices to determine the value of such contributions. Costs may be appropriate when services are contributed; replacement cost when tangible property is made available; and market prices if valuable know-how is contributed.

Balancing payments may be necessary to correct contributions if the proportionate share of the overall contributions of one or more participants is not consistent with its share in the overall expected benefits. Those payments increase the costs of the payer and reduce the costs of the receiver.

Costs of intangibles development include operating expenses other than depreciation and amortization plus charges for the use of tangible property provided.

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[9] A.M. Dodge and W.G. Shapiro, ''Planning Opportunities Under the Final U.S. Cost Sharing Regulations,'' 5 *Int'l Transfer Pricing J.* 2, 86 (1998).

[10] *See* para. 8.8 of the OECD transfer pricing guidelines.

[11] *Id.* at para. 8.19.

[12] *Id.* at para. 8.21.

[13] *Id.* at para. 8.19.

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The individual contribution shares of participants are a proportion of the above costs plus balancing payments received minus balancing payments made. Intangible property provided is accounted for separately through arm's-length buy-in payments.

A 20 percent safe haven is available to cope with difficulties in anticipating benefits. If the difference between projected and realized benefits from the arrangement is 20 percent or less, the projections are not considered unreliable.

Conclusion

In the latest of a short but drawn-out series of cases, the European Court of Justice has delivered a judgment that clarifies the position of transfer pricing rules within the EU. The decision in the most recent case, *SGI v. The Belgian State* (C-311/08), was delivered in January 2010. (For the text of the ECJ judgment, see *Doc 2010-1509* or *2010 WTD 14-11*.) This decision confirms that applying the arm's-length principle (or something akin to it) brings within the framework of European law legislation that might otherwise be a breach thereof, provided that important conditions are met. Transfer pricing rules that treat cross-border transactions (within the EU) differently from domestic transactions are likely to be regarded as a breach of European law, but rules that apply the arm's-length principle will be justifiable provided that the two proportionality tests are met.

In those cases, taxpayers should be entitled to challenge the application of the rules on transactions within the EU (and in some cases outside the EU if a common EU parent company involved is located there).

A CCA can be a reasonable solution to prevent controversies and to raise a defense in case of a tax audit. The new EU document is an important step toward an effective European common definition of the content and requirements of a CCA. ◆

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