



Universidade do Minho
Escola de Direito

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Transfer pricing and the arm's length principle in the

European Union law and domestic law

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ABSTRACT

At the present moment, the majority of cross border transactions take place between related enterprises. Transfer pricing has grown and constitutes one of the core issues on the tax agenda of multinational enterprises.

Under this framework, the so-called arm's length principle is the universal method used for tax purposes in order to allocate profits between related enterprises operating in different countries. This standard has become accepted both internationally and within the EU. In the EU, the legal challenge against the transfer pricing rules is found in the Treaty provisions which refer to the fundamental freedoms laid down in the Treaty on the Functioning of the European Union.

Although, this principle has been targeted by many critics. It has been argued that it does not take into consideration the interrelation and integration existent between related parties and is of difficult administrative application. Notwithstanding these shortcomings, the fact is that this principle is rather flexible and effective in the majority of the cases.

Several US federal states apply formulary apportionment instead of separate accounting as in the arm's length principle. In fact, this formulary apportionment method does not share the same flexibility of the arm's length principle, however its main advantage lies on the consideration that related business groups are integrated and interdependent.

The question that remains is whether formulary apportionment can be the solution for the problems posed by transfer pricing. Thus, since the interaction of national tax systems often leads to over-taxation and double taxation, with heavy administrative burdens and high tax compliance costs for businesses, the idea of adopting common corporate tax rules emerged in the European arena. Therefore, the Commission published a proposal directive to implement a Common Consolidated Corporate Tax Base. This paper focuses on this new EU transfer pricing framework. This Project comes across as a highly sensitive issue that generated heated debate in the academic, political and business arena since it represents a radical departure from traditional taxing principles and could fundamentally change the way multinational groups are structured throughout Europe.

KEYWORDS: transfer pricing, arm's length principle, formulary apportionment, CCCTB

RESUMO

No presente momento, a maioria das transações transfronteiras ocorre entre empresas relacionadas. A problemática dos preços de transferência assume hoje um papel central na agenda fiscal das empresas multinacionais.

O princípio da plena concorrência é o método fiscal utilizado, a nível internacional bem como no seio da União Europeia, na distribuição dos lucros entre empresas coligadas, que operam em diferentes países. No entanto, este princípio tem sido alvo de muitas críticas. As críticas apontadas centram-se na não consideração na inter-relação e integração existente entre essas mesmas partes relacionadas além da sua difícil aplicação prática administrativa. Apesar das desvantagens, o facto é que este princípio é bastante flexível e eficaz na maioria dos casos.

Em vários estados federais, como por exemplo, nos Estados federais dos EUA, recorre-se ao método do fracionamento global, em vez do método da contabilidade separada, aplicável segundo o princípio da plena concorrência. Na verdade, apesar de não partilhar da mesma flexibilidade, a sua principal vantagem baseia-se na consideração dos grupos de empresas como negócios relacionados integrados e interdependentes

A questão que se coloca é se a aplicação do método do fracionamento/repartição global pode ser a solução para os problemas colocados pelos preços de transferência, ao nível da União Europeia. Uma vez que a interação dos sistemas fiscais nacionais muitas vezes leva a uma dupla tributação, bem como a pesados encargos administrativos e elevados custos de conformidade para as empresas, a ideia de adoptar regras fiscais corporativas comuns surgiu no cenário europeu. Neste contexto, a Comissão publicou uma proposta de Diretiva para uma base de tributação de acordo com uma base comum consolidada. O presente artigo centra-se neste novo quadro dos preços de transferência da União Europeia. Este projeto surge como uma questão altamente sensível, gerando um acalorado debate no âmbito académico, político e empresarial pois representa uma ruptura radical com os princípios tradicionais de tributação susceptível, por isso, de mudar fundamentalmente a forma como os grupos multinacionais estão estruturados na União Europeia.

PALAVRAS-CHAVE: preços de transferência, o princípio da plena concorrência, método do fracionamento global, CCCTB

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ABBREVIATIONS

ALP- Arm 's Length Principle

CCCTB Common Consolidated Corporate Tax Base

C+- Cost Plus

CUP- Comparable Uncontrolled Price

EC European Commission

ECJ European Court of Justice

ECOFIN- Economic and Financial Affairs Council

Ed- Edition

EU European Union

FA- Formulary Apportionment ff-

Following

Ibidem- in the same place

Idem- same author, same title, different page

MNEs- Multi-national Enterprises

Nr- number

OECD Organisation for Economic Cooperation and Development

RPM- Resale Price Method

Parag- Paragraph

PE-permanent establishments

PP- Pages

PSM- Profit Split Method

SA- Separate Accounting

SME- Small and Medium Enterprises

TNM- Transactional net Margin

TFEU - Treaty on the Functioning of European Union

TUE–Treaty of European Union

UN- United Nations

US- United States

VAT- Value Added Tax

Vol- Volume

UN United Nations

"Between the idea and the reality, Between the motion and the act Falls the shadow

(TS Elliot)

Introduction

The development of the economies and the increasing globalization, make the companies, in order to respond to market demands, expand their activities, either to new businesses areas, or to new geographical locations. Therefore, due to the globalization phenomenon, the movement of concentration, with the constitution of new types of complex company structures, dominates the whole economic life.

In fact, the dramatic expansion of the international trade and the development of new business strategies converted the world into a large global market. In connection with that, companies have been using complex networks of subsidiaries and branches (e.g: permanent establishments) in order to proceed the most of their operations. In fact, the establishment of multinational companies, passed from a sporadic phenomenon to a usual and generalized behaviour.

The Multinational Enterprises (MNEs) pose special problems. Under an economic language MNEs can be defined as a single firm operating under unified direction. In legal terms, they consist of many (sometimes thousands) of affiliates constituting a corporate group. Cross border transfers (of goods, services or finance) between these affiliates are internal to the firm but, to the State, they appear as international transactions of trade or investment.

This new reality causes a dramatic impact in the theme that should be approached – the transfer pricing. International transfer pricing deals with those intra-group transactions where the open market regulator is absent. The concept and definition of transfer pricing is relevant both for business – from the perspective of managing a MNE, without accurate transfer prices, the company would not be able to identify those parts of the enterprise performing well and those performing less so – and for tax purposes – the determination of the correct transfer price is likely to be the main determinant of how the tax base of MNEs is divided between jurisdictions in which they operate. There are many reasons why enterprises charge transfer prices on goods and services – and transfer pricing deals with the charged price among associated enterprises established in different countries for their inter-company transactions. Since non-independent associate companies set the prices, it implies that prices do not reflect an independent market price.

The main goal for a MNE is to maximize its overall profit so, thus, it would try to allocate profits to a low tax country and losses to a high tax country. Therefore, transfer pricing mechanism is the tool that corporations use in order to avoid high taxation in certain countries. The fact is that globalization of the world economy, the mobilization of production factors and tax competition has forced tax administrators and legislators to seek new sources of revenue. Consequently, this represents a major warning sign for tax authorities concerned with the fact that multinational entities use transfer prices on cross border transactions in order to reduce taxable profits in their jurisdictions. This has resulted in tax avoidance rules and in an intensified inter nation struggle for the tax revenues of MNEs.

Background

Twenty years ago, transfer pricing was regarded as a specific subject only available to a few number of specialists. Although, currently, due to its growing use and overuse in commercial transactions among related parties, it has become a major tax issue either to legislators, tax authorities and taxpayers (especially for MNEs and for Small Medium Enterprises - SMEs). The fact is that transfer pricing represents a very important subject, since the great majority of cross border trade that occurs in the world is among related enterprises¹ and, insofar, this practice determines the allocation of income among different tax jurisdictions arising from related party transactions. This has led to the rise of transfer pricing regulations and enforcement, making transfer pricing a major tax compliance issue.

Hence, the question is how the right to tax should be divided among the different countries. As a rule, MNEs are taxed separately by the countries in which they operate on the basis of the income produced in each jurisdiction ("source taxation"). In these terms, they must have separate accounts for business units in each country (separate accounting-SA) attributing each item of expenses and revenues to each business unit on the basis of the universal accepted standard of the arm's length pricing (ALP) that is of comparable or estimated prices for similar markets transactions between unrelated enterprises.

¹ Hubert Hamaekers, "Arm's length – How long?" (2001) 2 International Transfer Pricing Journal 2 30, 39.

Purpose of our work

This globalized economy generated a new business landscape with new players, where the theme of transfer pricing practice is becoming increasingly important. Consequently, the change on these international business operations forces us to reflect about the present regime of the transfer pricing, especially in the European Union framework, which will be our object of study.

In the European Union (EU), taxation is, for the MNEs, an important factor in their economic strategic decision when faced with the diversity of extremely different tax regimes among Member States. Associated with this diversity of tax systems, the prices established between associated enterprises situated in different Member States, namely the transfer pricing that are practiced, may create obstacles to the free functioning of the internal market and, therefore, have been, as we will see, subject of several studies by the European Commission. In fact, the current rules and regulations regarding transfer pricing set in Europe appear to be an obstacle to the Internal Market.

In the present study, we will look at the concept of transfer pricing under separate accounting (SA), which is based on the arm's length principle. It can be anticipated that the SA entity approach causes some disadvantages for the enterprises due to the fact that it does not automatically allow the offsetting of losses in one country against the profits in another. Notwithstanding, for a great majority of MNEs these shortcoming is compensated by the ability to exploit the opportunities for international avoidance, especially through "tax havens"² and "offshore secrecy systems"³. These "tax havens" and "offshore secrecy system" have now

² This term is not a legal concept and, therefore, almost every work dealing with it faces the practical impossibility of clearly defining tax havens (tax Paradise in French, or tax oasis in German) since there is a little consensus related to the semantics of the term. While tax haven are widely understood to be jurisdictions pursuing policies of tax privileges, the majority of the publications attempt to narrow down this definition or emphasize either the end objective of such policies or the methods or the methods they utilize. For example, the Black Law Dictionary, defines tax havens states as the "country that imposes little or no tax on profit from transactions carried out in that country". Sometimes, within the main definition several criteria interfere with each other and even the common division of tax haven on the basis of, for example, their policies towards income taxation turns out to be by no means universal-Orlov, Mykola, "The concept of tax haven: a legal analysis", Intertax, Volume 32, issue 2, Kluxer law International.

³ The phenomenon of 'Offshore is not either a legal concept although it has been an important catalyst in the transformation of the international system. By providing a haven for routing global flows through the use of artificial persons and transactions, offshore has helped to dislocate the

become one of the biggest obstacles to tax fairness, as well as the biggest facilitator of corruption and crime since there are strong evidence that MNEs make extensive use of these opportunities. Despite facing increasing problems in dealing with the heightened scrutiny of their transfer prices by tax administrations ⁴ the fact is that, part of MNEs strongly refuse to accept the possibility of shifting to unitary taxation, since it would threaten tax avoidance. ⁵

The priority of the EU has been the elimination of obstacles, namely tax obstacles, to the free movement of goods, workers, services and capital in order to consolidate the EU internal market. Currently, there are twenty-eight different tax systems- consequently the enterprises operating in different tax jurisdictions must determine their profits in each legal tax jurisdiction by applying the “arm’s length principle”. This may raise complex issues regarding transfer pricing and significant costs in complying with taxes and accounting rules which vary from one Member State to another. As a starting point, it is assumed that the different tax rates applicable to profits of the companies belonging to the same "group", performing a great number of activities in different Member States, cause great tax obstacles to the functioning of the internal market. On the other hand, the existence of different tax rates areas or privileged taxes regimes is responsible for international business competition, that triggers loss of tax revenue by the Member States.

Considering this background, the controversy concerning the current framework for transfer pricing in the European Union is of crucial importance: does this mechanism maintain its efficiency or is it time to face that it has collapsed? Can, in this scenario, the arm’s principle keep

international state system, and induce its substantial reconstruction, Sol Picciotto ., “Offshore, the State as legal fiction”, Mark P. Hampton and Jason P. Abbott (eds.), *Offshore Finance Centres and Tax Havens, The Rise of Global Capital*, (Macmillan 1999), 43-79

⁴ Desired objectives of tax policy (to fulfill the collective needs) can only be achieved only when it is properly administered ny the Tax Administrations. Failure in appropriately administering the tax laws allows tax evaders to thrive. This defeats the purpose of a fair tax policy and threatens the canon of equity and public interest.

⁵ Tax avoidance and tax evasion are pervasive in all countries and tax structures are undoubtedly skewed by this reality. Given the structure of the tax system and enforcement process, taxpayers are faced with opportunities to reduce their tax payments, or expected tax payments. The classic distinction between avoidance and evasion is due to Oliver Wendell Holmes and the main distinctive characteristic of tax evasion is illegality. In practice, of course, there are many gray areas where the dividing line is not clear, and sometimes the tax authorities may inappropriately characterize particular cases, Joel Slemrod and Shilomo Yitzhaki, “ Tax Avoidance, Evasion and Administration”, in Alan J. Auerbach and Martin Feldstein (Eds), *Handbook of Public Finance*, [vol. 3, Chapter 22, 2002], Elsevier Science BV

following the same line? Is still this principle suitable for a region such as the European Union? Maybe it is time to accept that traditional transfer pricing control under the arm's length principle is in crisis in the European Union.

Due to the increasing economic integration in the EU it seems normal to look at how other integrated economic areas, for instance, federal states, have solved transfer pricing issues and the questions related to the attribution of profits among related enterprises.⁶ Does the general, economic, political and legal reasoning against the arm's length standard require the introduction of global or regional profit consolidation for corporate groups accompanied by a formula apportionment (FA) of the tax base? Inspired by the US example and even prior to the tax reform proposals by the European Commission (2001), McLure/Weiner⁷ raised the question whether a formula apportionment, which is, alongside the SA, another method of determining the geographic source of income, should be implemented in the EU. In fact, one option is to leave the "traditional" transfer pricing device and move towards a realistic alternative such as consolidation and formula apportionment. Although, as we will study, whether FA would solve some problems that characterize SA/ALS, it suffers from problems of its own.⁸ A great step taken in this direction in the European Union panorama was the European Commission draft directive on the Common Consolidated Corporate Tax basis (CCCTB).⁹ However, due to the fact that consensus related to this proposal is quite remote;¹⁰ this requires a close approach of transfer pricing in the Internal Market of the European Union.¹¹ Thus, our study is an answer attempt to the following question: *what is the actual framework of transfer pricing within the European Union, and its relation with domestic law? Where does this lead us?*

⁶ The states of the United States that impose corporate income taxes and the provinces of Canada have long employed FA.

⁷ Charles E. McLure; Jr and Joann M. Weiner "Deciding whether the European Union should adopt formula apportionment of company income" (2000) *taxing Capital Income in the European Union, issues and Options for Reform*, Oxford University Press Oxford 243-293

⁸ *Idem* page 258.

⁹ European Commission, "Proposal for a Council Directive on a Common Consolidated Corporate tax base (CCCTB), COM(2011) 121/4.

¹⁰ It cannot be underestimated the political and the administrative problems of shifting to a new system

¹¹ Monica Erasmus-Koen, "Common Consolidated Corporate tax base: a "fair share" of the tax base?" (2011) 18 *International Transfer Pricing Journal* 237, 240.

Outline

The thesis will begin with the study of the transfer pricing concept, and the arm 's length principle as the main criterion governing transfer pricing practice. In this part I, I will also be looking at the reasons why this topic represents an important theme in the current tax framework, namely which questions it raises nowadays. This will be followed by a brief description of the historical evolution of both concepts, analyzed either in the international sphere and at an European level. Afterwards, in part II, the current situation of transfer pricing in the EU will be presented, by looking at the role played in this field by the ECJ. In part III, it will be identified the most problematic issues of transfer pricing, namely the difficulties involving the application of the arm 's length principle in a domestic and at an European level. Subsequently, in part IV, it will be studied the formulary apportionment method (a solution already tested in the USA and other federal States) as an alternative to the Arm 's length principle, as well the EU approach to the formulary apportionment. In part V, I will deal with possible solutions to the identified problems, by discussing whether a formula apportionment method or the CCCTB proposal (as a concretion of the formulary apportionment method) is a realistic solution to transfer pricing issue in EU individual countries. I will conclude with an analysis of the topic at hand. Finally, there will be some concluding remarks.

Key terminology

Before advancing to our main subject of study, it is important to follow the reasoning of Stefan Mayer¹² and define some concepts to which I will resort throughout our study, with the purpose of facilitating a clear understanding of the terminology that will be used.

“Allocation” is used as the most general term, referring to any method of attributing profits to jurisdictions in cross-border situations. “Specific allocation” means the allocation of specific items of income to any jurisdiction, the allocation of non-business profits to the commercial domicile of a group or the *situs* of a specific asset (real property).

“Apportionment” refers to the application of some kind of fraction to distribute an aggregate income spread across border among different jurisdictions. “Formulary apportionment” or “formula apportionment” (hereinafter FA) denotes a method where a predetermined formula including factors such as the value of all assets employed in the business, payroll paid, number of employees, turnover or expenses, is used to apportion income among jurisdictions. Formulary apportionment can be limited to the profits of separate legal entities or be applied to the total profits of international groups of companies. Under FA, a common tax basis is calculated and divided among the host countries in accordance with the given apportionment factors.

“Consolidation” generally refers to situations where the profits and losses of separate legal entities are added so that an automatic loss offset takes place, but intragroup transactions are not necessarily ignored.

¹² Stefan Mayer, *Formulary Apportionment for the Internal Market* (Volume 17 in the Doctoral Series, 2009) 5 and ff

PART I - The principle of Transfer Pricing

1 - The transfer pricing concept

The concept of transfer pricing, accepted both internationally and within the European Union, is the universal method of determining the right pricing to be used among related parties and, therefore, is used by the Organization for Economic Cooperation and Development (OECD) and by the United Nations Tax Committee (UN) and also in the tax treaties concluded by the governments.

The structure of transactions within an MNE group (with its component parts such as companies, also called “associated enterprises” in the language of transfer pricing) is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. Thus, a large and growing number of international transactions are no longer governed entirely by market forces, but by forces which are driven by the common interests of the entities of a group. In such a situation, it becomes important to establish the right price, called the “transfer price” for intra-group, cross-border transfer of goods, intangibles and services.

“Transfer pricing” refers, therefore, to the general term for the pricing of cross-border, intra-firm transactions between related parties. These transactions are also referred to as “controlled” transactions, as distinct from “uncontrolled” transactions between companies that, for instance, are not associated and can be assumed to operate independently (“on an arm’s length basis”) in reaching terms for such transactions

Transfer pricing- the pricing policies and practices that are established when physical goods as well as services and intangible property are charged among associated business entities ¹³⁻ is traditionally used in international tax law as the principal method for allocating income between jurisdictions. Since they determine the income of both parties involved in the cross-border transaction, the transfer price tends to shape the tax base of the countries involved in cross -border transaction.

¹³Andrew Lyner and John Hasseldine, *The International taxation system* (1^o ed., Kulxer Academic Publishers 2002) 159

As afore described, MNEs represent a substantial fraction of the global trade and industry. Therefore, a challenge that they have to face is the articulation decision process among their several subsidiaries, located in different countries. Consequently, some can argue that transfer prices are frequently deployed in order to separate complex decisions among different decision makers, by delegating responsibilities among different agents.

In addition to this coordination function, transfer pricing is also used for tax purposes, namely as a device of international tax planning. In fact, taxable group profits are, many times, allocated among the participating companies by adjusting transfer prices. Therefore, MNEs frequently shift their profits to low tax legislations in order to reduce the group's overall tax burden. In other words, it can be said that the transfer pricing mechanism is a tool often used by corporations to avoid high taxation in certain countries.¹⁴

Transfer pricing is based on the closely related fundamental principles¹⁵ 1) companies with permanent establishments or affiliated companies in other countries¹⁶ have to compute the profits of the different units on the basis of separate accounts (separate entity approach) and 2) for goods and services exchanged by them, prices have to be charged as if they were among independent persons (arm's length principle). In relation to the first condition, it is important to notice that there are certain differences between the treatment of permanent establishments and subsidiaries but, notwithstanding this fact¹⁷, the "*functionally separate entity*" approach adopted by the OECD¹⁸ further gives an equivalent treatment to permanent establishments and to

¹⁴ To illustrate it, look at the following example: the branch of a multinational company builds a car at a real costo of 30,000€, soldo n the market at a price of 50,000€. In a high tax rate, for instance, 30%, the manufacturing comany should pay a price of 6,000€ (20,000€ pf profit X 30%). I order to avoid the payment of taxes in the producing country, the subsidiar sells the car for 40,000€ to another branch (located in a more relaxed tax área) that will ut the product on the market. In this country, the corporate tax rate is of 10%. This means that the income tax of the companies group will be 4,000€ (10,000€ X 30% + 10,000€ X 10%), achieving a significant saving of resources. In other perspective, for the producing country, this situatio creates a significant loss of revenue-, George Matei and Daniela Pirvu, "Transfer pricing in the European Union" (2011), No (557), vol. VIII, Theoretical and Allied Economics, 99, 101

¹⁵ Both rules and standards provide a framework that is, in theory, sufficient for resolving a particular issue in a legal dispute. But as we are using the term, a "principle" only provides guidance for the interpretation or application of a rule or standard. Principles by themselves do not resolve legal issues.

¹⁶ It is important to note that in domestic /shareholding relationships in many countries the arm's length principle also applies and this is particularly relevant whenever the parties are covered by different tax regimes (as an example, when the shareholder is tax exempt or the ring-fencing, for tax purposes, of petroleum exploration and exploitation in the United Kingdom- See Hamaekers (supra note 1)

¹⁷ A critical approach about this treatment can be seen on Robert Couzin, "The OECD Project: Transfer Pricing meets Permanent Establishment" (2005) 53 Canadian Tax Journal 401, 408

¹⁸ Report on the Attribution of Profits to Permanent Establishments (2006)

subsidiaries. In fact, according to François Vincent¹⁹, a concern for the tax authorities has been *“(...) to maintain a level playing field with respect to the use of a branch or a subsidiary to carry on business in a given jurisdiction. It only makes sense to apply the same principle in both situations, and the arm’s length principle was selected”*.

The main reason why companies started to use transfer pricing is to help identifying which parts of the enterprise are not performing well, to escape double taxation when repatriating profits and, ultimately, to reduce tax.²⁰ Despite the recognition that intra group companies frequently try to minimize their costs through the manipulation of transfer prices, the fact is that this is not always like this, since the leaders of those companies may also have reasons to carry on their management in normal market conditions and mimic their intra group relations, the open market schemes.²¹

1.1 The evolution of transfer pricing: a brief history

For over 70 years, the allocation of income to establishments located in different countries but belonging to one “group” has been an internationally discussed issue. The concept of permanent establishments was introduced in tax treaties and in domestic tax legislation in order to guarantee that non-resident taxpayers would pay their fair share of tax in any jurisdiction in which they carried on business through a fixed basis. Initially, the concept was limited to the existence of a fixed basis, but then it evolved towards the inclusion of other situations, such as the use of a dependent agent or the operation of a construction site.²²

1.1.1 The OECD Transfer Pricing Guidelines

The Fiscal Committee of the League of Nations started its work in 1930 with an analysis of legislation and administrative practices of 35 countries about this. The analysis was taken by

¹⁹ François Vincent “Transfer pricing and Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Split (Just Don’t say Formulary Apportionment)” (2005) 53, n° 2 Canadian Tax Journal/ Revue Fiscale Canadienne 409, 41

²⁰ Rohatgi, R, *Basic International taxation* (Volume II – Practice, 2nd ed, Taxman Allied Services 2007) 239

²¹ Hubert Hamaekers “Can free Negotiation of prices within a multinational enterprise serve as an Arm’s length standard” (1997) vol.4 n°1, International Transfer Pricing Journal 2, 4

²² See Vincent (supra note 14)

Mitchell B. Carroll²³, an adviser to the US Treasury and later chairman of the Fiscal Committee and the topic of his research was the allocation of income to local establishments of foreign enterprises. In the countries investigated, the primary system that has been adopted in order to allocate profits to local establishments of foreign enterprises was the separate accounting method.

Carroll also found that a total approach, called empirical method and later referred as the presumptive taxation was used in the cases where the authorities had grounds to consider that the declaration of income based on the accounts of an enterprise was insufficient or false. In these cases, there was an estimation of the income based on the income of similar enterprises in the concerned country.

Another method discovered was the formulatory apportionment, applied in Spain and Switzerland and used as a second method in most countries at the time. According to this method, the income of the establishment concerned was calculated on the basis of the total income of the whole enterprise or on the basis of the joint income of the local establishment and the related establishment abroad, through the application of a formula consisting of certain factors, such as assets, turnover, and payroll.

Under this framework, in 1933, the Fiscal Committee drafted a multilateral treaty on the allocation of business profits which, in its Article 3, established the profit allocation on the basis of the “independent enterprises” principle, apparently a new term for the separate accounting or separate entity approach which was “dealing at arm’s length”. This was the first time that this term was used in draft legislation. In 1946, in the last meeting of the Fiscal Committee, held in London, a new model treaty was again elaborated. Article VI of the Protocol of the London model established the independent enterprise approach for profit allocation by referring to the arm’s length principle in this context. Furthermore, the empirical methods, re-called as presumptive, and the formulary apportionment, were categorized as the second and third methods

²³ Mitchell B. Carrol was responsible to analyze the taxation of business income in 35 jurisdictions, which culminating in the 1933 report entitled taxation of Foreign and national Enterprises (“Taxation of Foreign and National Enterprises”, Vol. I, League of Nations, No C. 73. M.38.1932.II.A; Vol. II, League of Nations Document No C.425.M.217.1933.II.A; Vol. III, League of Nations Document No C.425(a).M.217(a).1933.III.A; Vol. IV: Methods of Allocating Taxable Income ; League of Nations Document No C.425(b).M.217(b).1933:ii:A and Vol. V: Allocation Allocation Accounting for the taxable income of industrial enterprises, League of Nations Document No. C. 425(c).1933.III.A *apud* Wittendorff J, *Transfer pricing and the arm’s length principle in international tax law* (Kluxer Law International 2010) 89

respectively. It seems that the latter method was (correctly) not looked upon by the drafting committee as having a relationship with the arm's length principle.

The work of the Fiscal Committee of the League of Nations was pursued by the Fiscal Committee of the OECD, established in 1956, later referred as the Committee on Fiscal Affairs of the OECD. In 1960, a report that included a draft article on the profit allocation attribution to permanent establishments and related companies was published, which was later converted into Article 7 of the OECD Model Convention of 1963. The empirical/presumptive method for the determination of the profit, found in the London model, has not been incorporated in the OECD Draft and Model Conventions of 1963 and later versions. In relation to the formulary apportionment, it has been included as a secondary method in relation to permanent establishments (article XV, § 4, later Article 7, paragraph 4 OECD Model Convention). The 1963 Commentary on article 9 was very brief and the 1977 update of the OECD Model made no substantive changes to the Commentary except for some comments on the new article 9 (2). In 1992 the Commentary was updated (in order to take into account the conclusions of three OECD reports issued after 1979) but no substantive changes have been made to the Commentary on article 9 (1). Since then, a direct link was established between the 1979 OECD Report and the Commentary on article 9, making the report an integral part of the Commentary.

Both the OECD Transfer Pricing Report of 1979 and the OECD Transfer Pricing Guidelines of 1995²⁴ rejected the global formulary apportionment as a method for profit allocation within the multinational enterprises.

1.2 The arm's length principle

The arm's length principle is the method recommended by the OECD which, in its Model Tax Convention on Income and Capital, has adopted the arm's length standard in article 7^o, related to the business profit, and article 9^o, on associated enterprises²⁵. Since 1979, the OECD has developed practical guidance for the implementation of the arm's length principle. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (thereinafter

²⁴ Organization for Economic Cooperation and Development, Transfer Pricing Guidelines for Multinational Enterprises and tax Administrations (Paris: OECD, 1995)

²⁵ Model Tax Convention on Income and Capital, OECD Committee on Fiscal Affairs, 1992, Updated as of 1th September 1995.

OECD TPG) are continuously revised and updated with new guidance in order to deal and manage with the enormous changes and challenges posed by an increasingly globalized economy. In fact, this principle has been subject of five OECD reports in 1979, 1984; 1995 and 2010.²⁶ The last update particularly took account of the revision of the guidance on comparability and profit methods and the new guidance on the transfer pricing aspects of business restructurings.

In fact, the OECD TPG, released in 1995, was the culmination of the efforts made by the international tax community in order to review the existing standard and adapt them to the modern business world. The OECD Transfer Pricing Guidelines²⁷ made it clear that the concept of transfer pricing should not be confused with tax fraud or tax avoidance even though transfer pricing transactions may be used for these purposes.²⁸ Since transfer pricing may also have other purposes than tax avoidance, fiscal authorities should not automatically determine that companies with cross border activity are trying to manipulate profits. Especially, because it is not easy to establish the price market in a precise way. In this context, the Fiscal Affairs Committee of the OECD created a set of rules in order to reduce the risk of misunderstanding or abuse concerning the taxation of some operations in groups of companies, by adopting the so called arm's length principle.

Alongside article 9^o of the OECD Model Double Tax Convention²⁹ article 9^o of the UN Model Treaty of 1980 also regards the arm's length principle as its basic standard.

The arm's length principle, established in article 9^o of the OECD Model Tax Convention,

²⁶ Report 1979 of the OECD Committee on Fiscal Affairs; Transfer Pricing and Multinational Enterprises, Report 1984 of the OECD Committee on Fiscal Affairs, Transfer Pricing and Multinational Enterprises. Three taxation issues, and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Report of July 1995 with supplements.

²⁷ The OECD Guidelines are, as their title suggests, merely guidelines and, therefore, most countries have developed their own transfer pricing rules and methodologies. For example the European Union, which constitutes our main object of study, has moved to a completely different framework in order to resolve some of the problems related to comparable transactions, Eduardo A Baistrocchi "Transfer pricing in the 21th century: A Proposal for both developed and developing countries" (2005) University of California *apud* Nerissa Haskic "The Arm's Length Principle and the CCCTB: Solutions to transfer pricing issues for individual countries and the European Union?" (2009) vol.19 issue1 article 6 Revenue Law Journal 1,3

²⁸ Michelle Markam, "Transfer pricing of intangible assets in the US, the OECD and Australia: Are profit-split methodologies the way forward?" (2004) University of Western Sydney Law Review 8,55

²⁹ It is important to highlight that this article 9^o is the base for the most bilateral tax treaties involving OECD member countries and for an increasing number of non-members when dealing with transfer pricing.

is framed in this way: *“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”*. In paragraph 2 of article 9, the corresponding adjustment is established, in practice undertaken as part of the mutual agreement procedure, by mitigating or eliminating double taxation. A transfer pricing adjustment can be defined as the recognition, for tax purposes, of the actual transaction and the assignment of income among associated enterprises. In contrast, a transfer price of the transaction is the adjusted price, which includes the profits of one enterprise in the profits of an associated enterprise. The first, involves a pure redistribution of profits among taxpayers, namely, the increase in the profits of one taxpayer is balanced by the decrease in the profits of the other. Therefore, a transfer pricing adjustment means either an income which will be imputed (whenever the transfer price is below the arm’s length principle) or can also result in an income that will be reduced in the case transfer price exceeds the arm’s length price.

In this context, OECD Member States have concluding some agreements to consent adjustments for tax purposes whenever the correction of distortion is needed and, thereby, guarantee the effectiveness of the arm’s length principle.

The wording of article 9(1)^o of the OECD Model and the Commentary do not disclose their main purpose, although, this analysis of paragraph 11 of the commentary of article 25^o of the OECD Model indicates that the reason for inserting the provisions like article 9(1)^o in a treaty is to cover , within its scope, economic double taxation.³⁰ This is also suggested by its relationship with articles 7(1)³¹ and article 8^o of the OECD Model and its strategic location: among these distributive articles.³² In addition to this main purpose, it also aims the prevention

³⁰ Article 9^o is concerned with economic double taxation caused by transfer pricing adjustments (in the absence of taxpayer identity). The basis of such double taxation may be a legal or factual nature: legally caused economic taxation may be due to the application of different allocation norms in domestic tax laws of the contracting states; factually caused economic double taxation may arise due to the disagreement of the contracting states in relation to the facts applicable to a specific allocation norm applied by both states and it may be resolved by the mutual agreement procedure in article 25. Differently, article 7^o of the OECD Model governs international juridical double taxation of business profits

³¹ One difference is that article 9^o (1) governs the taxation of an item of income between two taxpayers whereas article 7 (1) governs the taxation of an item of income of one taxpayer.

³² Article 9(1)^o provides for a quantification of income between associated enterprises to which the contracting states are ascribed taxing rights according to the genuine distributive articles- determines the amount of business profits from transactions between associated enterprises

of tax evasion and tax avoidance as well as an equitable inter-nation allocation of taxing rights³³(although it does not govern the allocation of the taxing rights of the contracting states over a specific income category).

In relation to the domestic law, the fact is that contracting states may rely on domestic law as the authority to levy taxes since, generally, tax treaties do not broaden taxing rights- these rules are normally known as the “golden rule”. Therefore, the right to make adjustments granted to the Contracting States must rely on the authority provided by domestic law. In this sense, tax treaties normally function by restricting the taxing rights under domestic tax law.³⁴By accepting this reasoning, i.e, that the arm’s length principle has restrictive nature, we are forced to conclude that the arm’s length principle is a treaty obligation.³⁵

1.2.1 - Why the ALP?

Under this framework, the question that can be raised is: **why have the OECD member countries favoured the arm’s length principle rather than other methods?**

The OECD answer stands in the simple reason that this principle provides, in a broad way, similar tax treatment for multinational enterprises, together with the efficiency that this standard is supposed to work in the great majority of the cases.³⁶ In fact, the recognition of this principle as a high value in itself is also reflected in the 2010 update of the OECD Transfer Pricing Guidelines where worldwide acceptance of this principle was proudly showed. This can be easily demonstrated by the reformulation of the wording of its article 7^o of the Model Tax Convention where the expression “separate and independent” rather than “distinct and separate” can be now found, reinforcing the idea of a full competition principle. Furthermore, it was removed, from the text of article 7^o, the possibility of opting for another approach, once allowed in paragraph number 4 – the Report and the Commentary to the current article 7^o are explicit in what

³³ OECD Transfer Pricing Guidelines, Preface, paragraph 7.

³⁴ Although, as paragraph 4 of the commentary on article 9^o highlights, the fundamental question whether article 9 (1)^o is of a restrictive or an illustrative nature is not consensual among the OECD countries.

³⁵ Taxing rights of each Treaty country are based on their respective domestic legislation and may be limited but not expanded by the Treaty- Jens Wittendorff “The Transactional Ghost of Article 9 (1) of the OECD Model (2009) Bulletin for International Taxation 107, 110

³⁶ The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Report of July 1995 with supplements Chapter 1.7, et seq.

concerns its exceptionality and inadequacy.³⁷

According to the OECD, the ALP expresses an international consensus-it must be faced as the most effective way to combat transfer pricing .In recent years many developing countries have introduced or strengthened arrangements for combating tax avoidance, including abusive transfer pricing. However, the fact is that the great majority of poor developing countries do not have the resources to apply the complex and time-consuming checks on transfer pricing demanded by the OECD approach. In this sense, the majority of them, for example Brazil, China, India, and South Africa had serious difficulties in applying the ALP, namely in what regards the finding of suitable comparables. In fact, this is now enormously time-consuming for both tax administrations and taxpayers.

Notwithstanding the merits referred above, the fact is that the OECD is also conscious about the shortcomings of this principle. One problem normally pointed out, that we will study in more detail, is its insufficiency related to the separate entity approach, which may not always be suitable to the economies of scale and the interrelation of the diverse activities carried on by integrated businesses. A main disadvantage derived from the type of transactions that are concerned: some related enterprises might undertake what independent enterprises would not.³⁸ Consequently, this creates a difficulty in the application of the arm's length principle in some cases due to the lack or insufficient evidence of the conditions that would be established among independent enterprises. As François Vincent³⁹ pointed out: *"therefore, taxpayers, their advisers and tax authorities are left trying to reconstruct, from largely dissimilar transactions or entities, what arm's length parties have done in similar circumstances"*. It is true that transactional methodologies seems to be the most direct way to determine transfer pricing. However, the difficulty is to find identical transactions which can be compared to the one in question. These problems are particularly relevant in what concerns intangible items, since there is simply no comparison.

³⁷ Paragraph 41 of the Commentary to article 7^o, *maxime in fine* and paragraph 72 and followings of the Report.

³⁸ In the case of impossibility to estimate the profit potential of an intangible, it may be sure that the independent enterprise does not want to sell it. On the contrary, in a transaction of this kind is undertaken by a multinational enterprise group, there isn't the same risk since the profit stays within the overall group's profit.

³⁹ See Vincent (supra note 14, 410)

And the aforementioned author continues to say that ⁴⁰ taxpayers need, by definition, to be able to determine the tax payable in order to pay that tax. In the same way, tax authorities need to be able to determine the tax payable in order to properly administer the tax system. The needs of both parties are thus convergent. Unfortunately, it is the standard set by the arm's length principle that creates a systematic impreciseness in its application. Although, there are other downsides that can be appointed to the application of this principle, as we will study in more detail in the specific part related to the problems concerning the application of the arm's length principle.

1.3 Transfer pricing methods of the OECD

To determine the ALP, OECD TPG recommends various methods to establish whether the conditions imposed by parties are consistent with the ALP. According to the OECD guidelines, there are five different methods for determining the transfer pricing which can be categorized into two main groups: the traditional methods based on the analysis of the transaction (named a "Transactional Traditional Method") and the method based on the analysis of the profits(the "Transactional profit Methods). The difference between them is that the transactional traditional methods are based on comparing prices whilst the transactional profit are sustained by the comparison between transactions among related enterprises and among unrelated entities taking into consideration the profit of that transfer.

1.3.1 Traditional Transaction Methods

There are three subtypes in this group: the comparable uncontrolled price method (CUP), the resale price method (RPM) and the cost plus method (C+). According to the OECD, these methods provide the most direct way to establish whether an ALP has been used and are, therefore, preferable to the others. In terms of priority, and according to the OECD TPG, the first method to be applied is the CUP, followed by the RPM and, ultimately, by the C+. ⁴¹ Even when it is not possible to proceed to the application of these traditional methods, there are some other methods that can be used. ⁴²

⁴⁰Ibidem

⁴¹ The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Report of July, 1995, with supplements, Chapter 2.1 et seq.

⁴² The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Report of July, 1995, with supplements, Chapter 2.48 et seq.

a) *The Comparable Uncontrolled Price method*

The CUP method compares the price charged for the service or goods transferred in a controlled transaction to the same service or goods in an uncontrolled transaction under comparable circumstances (identical or similar goods or merchandises, in comparable amounts, at the same point in the chain of production and distribution and in comparable conditions of payment or delivery). It takes into account the market value and, in order to determine that value it is necessary to establish an internal comparison of prices, by comparing the prices agreed among the entities affiliated with the prices agreed among independent enterprises for comparable transactions. An example is when a company is selling the same goods to an affiliate as to an independent entity, in the same geographic zone and under almost the same conditions. It is also necessary to analyze the external comparison of prices by comparing the prices agreed among independent enterprises for comparable transactions. The differences of price that can be found may be evident that financial and commercial relations with the related enterprises are not at arm's length. Although, even when the conditions are not identical the method can still be used if one of the two conditions is met (1) none of the differences between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or (2) reasonable accurate adjustments can be made to eliminate the material effects of such differences. This method is the most direct to use and therefore preferable to all other methods.

The difficulties associated with this method are related to the difficulty regarding the identification of the comparable transactions⁴³. In fact, there are some examples that can be appointed, namely when the products involved are not similar in nature, quality or novelty. Another problem concerns the characteristics of the markets: not always are they comparable in terms of size. Another shortcoming can also be added: the financial conditions and the currency that often vary and are dependent on the financial integration of the parties. Lastly, another feature which can manipulate the application of this method is the advertisement associated with the goods in question, that can be incorporated in different trademarks and also the dissimilarity

⁴³ Initially, the debate centred on whether comparable profit methods (CPM) is consistent with the arm's length principle and how frequently it is likely to be applied. The problem with the CPM approach is that it is often inaccurate because it fails to deal with the underlying reasons for the profitability of a corporation. Consequently, it was suggested that CPM should be used, if at all, only as a method of last resort and perhaps only in clearly abusive cases: however, there was no discussion of what might be a workable definition of abusive cases-Richard H. Weise, R H, *Representing the Corporation: Strategies for Legal Counsel* (13, Tax Notes, Aspen Publishers 1993), 1380

of the intangible property with the sale. Notwithstanding these demerits, the fact is that this method is reliable to the cases of the selling of the same product among independent enterprise and it is made the same way as if in between two related parties. ⁴⁴

b) The Resale Price Method

Under the RPM, the market price is determined by the resale price of the products and services to independent parties, less the distributing costs and a profit rate, i.e, the RPM compares the gross margin. Sometimes, it also requires the adjustments of other costs associated with the purchase of the product (eg: customs duties). This method takes into consideration some factors such as the circumstances that occurred during the period of the initial purchase and resale, including those concerning the changes in the market as the costs, exchange rates and inflation; the changes in the situation and the level of use of the goods, the technological changes in a specific field and, lastly, the exclusive right of the reseller to sell certain goods or rights that may have some effects on the decision on a change in the price margin. The reminiscent of that reduction and adjustments can be taken as the arm's length price for the original transaction among the related enterprises.

This means that the method begins with the price at which a product has been purchased from an affiliated and that is resold to an independent enterprise. The gross margin of the controlled transaction is compared with the gross margin of the uncontrolled transaction to see if the first transaction is covering its selling and other operating expenses as well as making an appropriate profit. According to the OECD TG the method is probable most useful when it is applied to marketing operations, i.e, the reseller does not add any substantially value to the product and this is because in these situations it is easy to determine an appropriate resale price margin.

This method may use the transactions sold in comparable uncontrolled price in order to

⁴⁴ It can be took as an example the case of an independent enterprise which sells unbranded coffee beans from Colombia of a similar type, quality and quantity as those sold between two related enterprises and that these two transactions occur about the same time, in the same phase in the production chain and under similar circumstances, this method can be applied with effectiveness. Otherwise, if a Colombia unbranded coffee beans had sold unbranded Brazilian coffee beans, is necessary to check if these differences will have a material effect on the price. If the answer is positive, it would be necessary to make some adjustments. On the contrary, if a reasonable adjustment is not possible, the efficiency of the CUP is reduced and might be necessary to use and combine the other methods. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Report of July, 1995, with supplements, Chapter 2.11

determine the reasonable profit margin that a reseller earns on the items purchased but, like in the CUP method, the transactions have to be comparable. The distinction is that here the differences among the products are tolerable in a broader way since it is less likely that this would have a material effect on the profit margins comparing to what they do on the price. ⁴⁵In sum, it can be said that the application of the RPM is targeted to the cases where the reseller gives a relatively low value to his products. In this context, the reasoning for the purposes of the RPM is the following: the greater the value added to the performance of the reseller, the harder the determination of the appropriate resale margin becomes. ⁴⁶Another specificity to be taken into account is the case where the reseller, via trademarks or trade names, contributes substantially to the creation or maintenance of intangible property associated with the product, since these activities, performed by him, will have some effects on the margin of the resale price. This is so because there are some resellers who, as agents, just perform minimal services, rather than others who assume the ownership and also the full burden associated with the advertisement, marketing, distribution and guarantee of the products. It is also important to add that the RPM normally has some variations depending on the existence or non existence of exclusive rights to resell the goods by the reseller. ⁴⁷

c) The Cost Plus method

According to the cost plus (C+) method, in order to determine the normal market price, it is necessary to take into consideration the increase of the main costs with a profit rate similar to the activity field of the taxpayer. So, the starting point is the supplier's cost for the property in a controlled transaction operated by a related purchaser. Then, an appropriate cost plus mark-up are added to this cost, reaching the appropriate profit in terms of the functions performed and the market conditions- this price is the arm 's length of the original transaction.

This is a method which is more effective in the cases where semi-finished goods are sold among related parties; whenever joint facility agreements or long term buy and supply arrangements or even when the controlled transaction at stake concerning the provision of

⁴⁵ The OECD Transfer Pricing and Guidelines for Multinational Enterprises and Tax Administrations, Report of July 1995 with supplements, Chapter 2.15 et seq.

⁴⁶ For example, the cases of loss or transformation of the identity of the goods, due to the incorporation into a more complex product, before the resale.

⁴⁷ The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Report of July 1995 with supplements. Chapter 2.22 et seq.

services exists. Like in the RPM, the adjustments that might take place shall take into account the material differences that influence the cost plus mark-up earned in the controlled and uncontrolled transactions. The fact is that the adjustments under the C+ method are fewer than under the CUP method.⁴⁸

The main difficulty regarding the application of the C+ concerns the calculation of the costs since it is based upon a comparison of the mark up on cost obtained by the controlled supplier of goods or services with the mark up achieved by one or more uncontrolled companies on their costs with relation to comparable transactions. Another important point to consider are the differences in terms of level and types of expenses related to the functions performed and risks assumed by the parties or transactions that will be compared. In addition, also the accounting practice must be regarded, once it reflects a difference in the controlled transaction and in the uncontrolled transaction, adjustments should be made in order to guarantee that the same type of costs are used in each case particularly. In case of variation of the accounting standards there are three basic costs for an enterprise.⁴⁹ Another problem can also be pointed out namely, the allocation of some costs between the supplier and the purchaser due to the limitation of costs requirement to those of the supplier of goods or services, which should be based on the functions performed by the respective parties.⁵⁰

1.3.2-The transaction based on profit method

These methods are to be used when the traditional transactions are not applicable or as a

⁴⁸ An example of the C + Method: company A sells toasters to a related company and that company B sells irons to an independent distributor. The profit margin in selling basic toasters and irons are about the same in the small industry. But if the C + method is applied, the profit margin compared in the two transactions is the difference between the selling price by the companies to the distributors and the costs of manufacturing the product. In the case of company A (being more efficient in the manufacturing process and, consequently, has lower costs) an adjustment must be made - the OECD Transfer Pricing Guidelines for Multinational enterprises and tax Administrations, Report of July 1995 with supplements, Chapter 2.33 et seq.

⁴⁹ Namely the direct costs of producing a product such as the cost of raw materials; the indirect costs of production (the costs of a repair department that services equipment used to produce different products) and costs of the operating expenses of the enterprise as a whole (administrative expenses).

⁵⁰ The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Report of July 1995 with supplements. Chapter 2.36 et seq.

supplement to them. The OECD TG states that there are only two methods that satisfy the arm's length principle: the profit split method (PS) and the transactional net margin method (TNM). Other profit methods could be used only if they are consistent with the guidelines overall. Transactional profits methods examine the profits that are generated from the affiliates. The profit arising from a controlled transaction can be used as a relevant indicator of whether the transaction can be said to be made at arm's length.

d) The Profit Split Method

According to the OECD TG, the PS method is good to use where transactions are very interrelated, no comparables exist and therefore the traditional transaction methods cannot be used. In the first place, the method determines the profit to be split among the parties (the net profit margin achieved by a person from one or more transactions with affiliates and also the margin obtained by this same person in transactions with entities that are independent) and secondly it splits the profit on an economic valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length. One positive side of this method is that it does not directly rely on closely comparable transactions.

e) The Transactional Net Margin

The TNM method is based on comparison of the profitability of enterprises in a controlled transaction as to those in an uncontrolled one. By using this method, it will be provided an estimation of the profit achieved by affiliated organizations from one or more transactions and laterly sharing these profits among the affiliated organizations proportionally with the profit that would be obtained if organizations were independent. Therefore, the profits would be divided by estimating adequately the revenues and the costs incurred as a result of one or more transactions by each organization and they should reflect the activities operated, the risks taken and the assets utilized by each one of the affiliated parties. The strengths of this method are that the net margin is not affected by transactional differences and the net margins are often more tolerant to some functional differences between controlled and uncontrolled transactions. Although, the fact is that the TPM should be used only under exceptional circumstances, namely

when there is a lack of information or when this is insufficient for the application of one of the traditional methods of transfer pricing.

After this brief summary, the question that can be raised is: how can the most adequate method regarding the transfer prices be established? The answer should regard some aspects in order to choose the best method to be used. Therefore, the methods must be, in general, the closest to the circumstances in which the prices, subject to free competition, are established : in comparable markets in terms of trade and suitable to the circumstances that involve the individual case (such as the type, the condition, the quality and degree of novelty of the goods, the type of merchandise/goods transferred; the market conditions in which the goods are used, consumed, treated, processed or sold to independent entities; the activities and stages of production and distribution of entities involved; the clauses enshrined in the contract in terms of obligations, payment terms, discounts, guarantees, the burden of the risk; special conditions of competition).

PART II- The Transfer Pricing in the European Union

1 - General Background

In fact, the peculiar structure of the international community, relying on the coexistence of a plurality of sovereign tax policies, defines the specificity of international tax law as a reasonable complex model of legal pluralism, interconnecting supranational perspectives with national law of the States.

By analyzing the content of the constitutive treaties of the OECD⁵¹ and of the European Union, it can be concluded that both international organizations pursue similar goals. Nevertheless, the EU goes a little bit beyond in its objectives since its Member States (either the originating States and also those which only later had adhered to it), assumed their commitment in promoting all the efforts in order to achieve the convergence of their economies.

On this background, and in the light of an increasingly global business world, where multinational enterprises play a prominent role, in order to attain this goal, the European Union became aware of the need to put into place a monetary and economic Union, including a single currency, which aims the economic and social progress of its peoples, by taking into consideration a sustainable development, inside the framework of the internal market realization condensed by the four freedoms- of goods, workers, capital and services.⁵²

In fact, this single internal market of the EU has to be faced more as a global market once it has to compete in a large competitive landscape of economies- either consolidated or emerging economies. In this context, the EU recognizes that it must work in the sense of not being overcome by the other economies of all over the world, if it wants to continue to be competitive in the international markets. Therefore, the EU concluded that it was necessary to

⁵¹ From the analyze of the articulate of the Convention which implemented the Organization for the Economic Cooperation Development, signed by the founders States, in Paris, on 14 December 1960, there are clear the goals that the OECD to achieve, available at <http://www.oecd.org/document/44/0,3343,fr_2649_201185_1915884_1_-1_1_1,00html>, accessed 12th August 2013>

⁵² The four freedoms established in the Treaties-free movement of persons (article 45° TFUE); free movement of services (article 56° TFUE); free movement of goods (article 28° TFU); free movement of capital (article 63° TFUE) are composed by two basic principles. The first to be remarked is that they grant the right to cross the borders of Member States. The second is, as it was already mentioned, the prohibition of discrimination in terms of nationality or origin. The fact is that these two elements are based in one basic principle: the balance between the sovereignty of the Member States and the interest of the Community in the progress towards the formation of the internal market. Thus, the ECJ has to accept that these freedoms cannot be faced as absolute.

establish some conditions in order to enhance a more favourable business spirit environment, namely, the reduction of expenses related to bureaucracy (by the administrative simplification) in order to help Europe developing a true spirit of entrepreneurship. This factor is clearly associated with the accomplishment of the internal market and, thus, the priority of all the 28 Member States is to eliminate all the real and potential barriers which may create barriers to the trade of services and goods.

In relation to the integration of the single market, it was agreed that the strategy should be based on the abolishment of the differences in relation to the legislation of the Member States, in order to eliminate all the barriers concerning the freedom of movement. In fact, the States realized that these difficulties affect all the economic agents; nonetheless, these obstacles were more visible in those which have smaller dimension-namely the SMEs. Therefore, these factors were impeditive to these enterprises; which could not, effectively, exercise their activity and, thus, benefit from the openness and freedom that the European market provided. In this way, they were persuaded of not performing their activity in any other Member State.

Within the barriers that can be referred, the fiscal barriers are the obstacle that causes a larger number of negative effects. This situation is so due to the existence of several different tax regimes as many as the number of Member States that integrates the European Union. The notable diversity of national approaches to taxation constitutes an additional difficulty to the economic agents that they must overcome in order to expand their activities beyond borders. Consequently, the larger the European Union is, the greater tax barriers will be, namely in what concerns direct taxation, which is susceptible of discourage the MNE of developing their business activities along borders.

In fact, since the establishment of the European Economic Community through the Rome Treaty in 1957, tax harmonization has long been one key point on the complex debate within the European community arena, and has been considered as a core element for the implementation of the internal market. After the adoption of the Lisbon Strategy, the Commission realized that a new EU policy approach on taxation was needed: it could no longer be faced as a single isolated act but rather integrated in the wider EU policies and objectives. Bearing this in mind, and since the interaction of national tax systems often triggers over-taxation and double taxation, imposing heavy administrative burdens and high tax compliance costs for businesses , the idea of adopting

a common corporate tax rules emerged in the European scenario (this topic will be addressed in more detail in part V of the present essay).

2- The evolution of transfer pricing and the arm ' s length principle in the European Union

The European Union recognizes the merit of the work carried out by the OECD. Although, the different interpretations given to the transfer pricing principles – especially by the Guidelines- turned its application very difficult, by creating additional costs either for tax administrations and to the enterprises that operated commercial transactions. Therefore, the EU has proposed to take harmonization measures at the level of the interpretation of the applicable principles in the field of transfer pricing.⁵³

At the European level, it is more precisely article 4^o, paragraph 1 of the Arbitration Convention of 1990 which embodies the arm's length principle. In fact, in the European Union framework, which is our principal object of study, the legal defiance against the transfer pricing rules is based on the Treaty provisions, which constitute the European Internal market, in particular the fundamental freedoms set up in the Treaty on the Functioning of the European Union (thereinafter TFUE).⁵⁴

In 2002, the European Commission created the EU Joint Transfer Pricing Forum, with the goal of approaching and harmonizing the rules related to transfer pricing, practiced in the Member States, through the creation of non binding normative provisions of easy workability. Its main purpose is to, in addition to the attempt of solving some transfer pricing problems, reformulate the Arbitration Agreement⁵⁵ (which expired in December 1999 due to the lack

⁵³ Helena Freire, "Perspectiva Internacional", in Gloria Teixeira and Duarte Barros (eds), *Preços de Transferência e o caso português* (Vida Económica 2004) 455

⁵⁴ The relevance of transfer pricing within the European Union can be demonstrated by the correlation between the level of taxation on profits and the profitability of affiliated organizations. For example, in Germany, by analyzing the situation of the foreign corporations with subsidiaries, it can be found that an increase of corporate tax rate in the origin country by 10 percentage points triggers an increase on subsidiaries profitability- artificially generated through transfer pricing- with a half percentage point-Weichenrieder Alfons, "Profit Shifting in the EU: evidence from Germany" (2007), CESifo Working Paper, nr 2043, 21

⁵⁵ The legal support for the Arbitrage Convention lies on article 220^o of the Rome Treaty. This rule establish the following: Member States shall negotiate between each other, for the benefit of their nationals, the abolition of double taxation within the community.

ratification of the extension protocol ⁵⁶) encourage the signature of prior agreements concerning transfer pricing, and help the standardization of the requirements regarding the documentation of the transfer pricing in the Member States and, even the creation of the measures to avoid double taxation. The full application of the Convention requires the improvement of the arbitration procedure, namely in what concerns the beginning and term of the deadlines, costs, place to carry on the meetings. The whole process demands also more transparency in what concerns the way of a more active participation of the taxpayer. In relation to the Previous Agreements of Transfer Pricings, they allow, prior to the performance of related activities, the definition of a set of appropriate criteria (namely the method to be used, the elements to set the comparison and the adjustments to be introduced, the main requirements concerning the future evolution) in order to determine the applicable transfer price for those operations, during a determined period of time.

In April of 2004, the European Commission proposed a Code of Conduct in order to eliminate double taxation in cross border cases of transfer pricings. The proposed text would ensure a more efficient and uniform application of the existing rules and would define the procedural rules.

2.1 The role of the European Court of Justice

Since the EC Treaty has come into force, the Commission considered the fiscal questions; however, in the early stages of developments, the efforts were concentrated on indirect taxation. ⁵⁷

In terms of direct taxation, this is an area that is under the competence of the Member States; however, they are bound to act in accordance with the community law. In fact, it can be said that the intervention in this area is based on three different points. Firstly, it derives from the general articles of the Treaty, which allows the Council to develop initiatives aiming at the

⁵⁶ The Convention was no longer applicable since January 2000. However due to the celebration of a Protocol on 25th May 1999 among the 15 member states determining that the agreement would remain in force for more five years and was automatically renewed for five consecutive years until one Member State objected such extension, at least five months before the expiration of the five years period. The Convention was not thus in force between 1 January 2000 and November 2004, but even so, it is considered to be in effect given the retroactive effect of the protocol. Currently the Convention has a bilateral application between Member States that had ratified it

⁵⁷ The first proposal related to corporate taxation in the European Community was the Report of the Fiscal and Financial Committee in the ECC Reports on tax Harmonization, [1963], International Bureau of Fiscal Documentation.

promotion of the internal market, such as article 115° TEU (ex- article 94° TEC) and article 352 TFUE (ex-article 308°). In what concerns the second legal basis, the community action has its focus on the general prohibition of discrimination based on nationality –article 18° TFUE (ex-article 12° TUE) and in the freedom of establishment prescribed in article 49° TFUE (ex- article 43° TEC) and article 54° TFUE (ex-article 48° EC). In fact, these provisions were the main responsible for the development of the direct taxation by the European Court of Justice (ECJ). Lastly, the third basis for the community intervention in the field of direct taxation are those provisions related to state aid and ruled in article 107° TFUE (ex-article 87° TEC) and article 109° TFUE (ex-article 109° TEC).

As a result of the few developments due to the (lack) of coordination between the Commission and the Council, the case law of the European Court of Justice has been playing an important role in what concerns the harmonization of the corporate law in the European level.

The ECJ, as the guardian of the law in the community integration process, is the institution that many enterprises appeal, whenever they consider that their activities are being harmed by the national tax legislations of the Member States due to the disrespect of the fundamental principles of the TCE, namely, the non discrimination principle based on the grounds of nationality and the freedom of movements of goods, persons, services and capital.

The ECJ, dealing with a growing number of corporate taxation cases in situations involving the exercise of fundamental freedoms granted by the TFUE, came to safeguard the freedom of establishment and capital movement over the attempts of national tax authorities to protect their corporate tax bases.

Especially since 1986, the ECJ has been dealing with questions related to the exercise of the right of establishment, with the freedom of rendering services and the freedom of movement of capitals.

2.2 The Jurisprudence of the ECJ concerning Transfer pricing

As Schön pointed out⁵⁸, only a few times the European Court of Justice was asked to decide, in its cases concerning direct taxation, about transfer pricing rules. Although, lately, this

⁵⁸ Wolfgang Schön, “ Transfer pricing, the Arm ´s length principle and European Union Law”, in Isabelle Richelle, Wolfgang Schön and Edoardo Traversa (eds), *Allocating Taxing Powers within the European Union* (Max Planck Institute for Tax Law and Public Finances vol II 2013 73, 75

picture seem to have changed, due to the existence of more substantial ECJ decisions regarding the compatibility of transfer pricing rules, namely the application of the ALP, with the foundations of the internal market. The ECJ gradually pursues the conciliation between transfer pricing rules and the requirements of the fundamental freedoms and, in this regard, it can be taken as examples the “*Lankhorst-Hororst*”⁵⁹ case of 2012, the “*Test Claimant de Gestion*”⁶⁰ case and the “*SGI*”⁶¹ case. This last judgement can be faced as the first true transfer pricing case in essence where the Court⁶², following the reasoning of the Advocate General⁶³, defended the ALP as a means to ensure the balanced allocation of taxing powers and as an instrument to fight abusive arrangements. Therefore, this deliberation can be considered as the confirmation of the applicability of the ALP standard in a broad way, for that reason it has been received, as the author aforementioned pointed out, with enthusiasm by international tax experts, who regarded this as evidence that interaction between treaty law and European tax law is still possible. This reasoning is not unanimously accepted, though, on the opposite side, it can be argued that this ECJ systematic approach, by not taking into consideration the specificities of a multinational firm, has transformed the EU transfer pricing control: it has moved it to a place where the ALP will gradually be eroded and will have to be replaced by another model.⁶⁴

It must always be borne in mind, that transfer pricing rules, particularly, the ALP, has a double sided nature: as the first step, it guarantees the allocation of profits to companies and to PE, and, in the second place, the attribution of taxing rights to the involved countries. This is of crucial relevance regarding the compatibility of transfer pricing rules with the requirements of the Internal Market. Meantime, tax treaties and European Law, prevent the risk of double taxation, by enforcing the obligation of the other involved country to provide to a compensatory adjustment.

2.2.1 The adoption of the ALP as part of the avoidance test

It has been defended by the ECJ doctrine along the years that the exploration of the

⁵⁹ Case C-324/00 of 12th December 2002, *Lankhorst-Hohorst GmbH vs Finanzamt Steinfurt* [2002], ECR I-11779

⁶⁰ Case C-524/04 of 13th March 2007, *Test Claimants in the Thin Cap Group Litigation vs Inland Revenue* [2007] ECR I-2107

⁶¹ Case C-311/08 of 21st January 2010, *Société de Gestion Industrielle (SGI) vs Belgian State* [2010] ECR I-487

⁶² *Idem*, paragraph 65-69.

⁶³ Advocate General *Kokott*, opinion delivered on 10th September 2009, paragraph 67-73.

⁶⁴ Schön, see supra note 53, 78

differences between tax systems is not contrary with the EU law. In the light of this reasoning, the risk of tax avoidance has never been considered, by the Court, as a justification for the existence of a tax disposition regarding the protection of tax revenues. In addition, it defended that the mere presence of a transnational element can not presume, *per se*, tax avoidance.

Although, this position has been changing lately, with the introduction of a number of nuances in its case law, thus, the current post crisis scenario has stimulated this slow shift of direction of the ECJ case law, towards a higher protection of tax revenue interests of the EU Member States. This race to the top of anti avoidance measures had also occurred in the US, with the codification of an anti avoidance rules.

In fact, a common feature of the ECJ jurisprudence of the past five years is the concern with the protection of tax revenues (which, as we will see, is in line with the CCCTB proposal). In fact, the Court's reasoning since the *Marks & Spencer* case⁶⁵, has been more flexible, by accepting arguments hovering around the allocation of tax revenues whenever they are closely linked to tax avoidance. This new case law defends that the restriction on a fundamental freedom may only be justified when tax planning is against the allocation of taxing rights among EU Members.⁶⁶ This means that a simple loss of tax revenue by a Member State, implying a gain in another, only constitutes a controllable situation by the losing Member in the case of a duly loss which is against the given allocation of taxing rights.

In this light, it can be said that the ECJ has turned back to its starting point- the allocation of taxing rights in the European Union.⁶⁷ Although, this line of reasoning suffers of some weaknesses which can jeopardize its application, namely the fact that EU members do not always have similar rules concerning the conditions to tax, namely, who should tax, what can be taxed, how and in what extent. The acceptance, by the ECJ, of the balanced allocation of taxing powers is equivalent to defend that the jurisdiction shopping for tax purposes is not always

⁶⁵ Case C-446/03 of 13th December 2005, *Marks & Spencer plc v. Commission of Customs & Excise* [2005] ECR-I-10837.

⁶⁶ Opinion of the Advocate General Kokott in her conclusions for OyAA, delivered on 12th September 2006 (Case C-231/05 of 18th July 2007 ECR I-6373, in paragraph 63) and opinion of Advocate General Geelhoed in the *Test Claimants* case conclusions, delivered on 29th June 2006 (Case C-524/04 of 13th March 2007), *Test Claimants in the Thin Cap Group Litigation vs Inland Revenue* [2007] ECR I-2107, paragraph 75).

⁶⁷ Violeta Ruiz Almendral "Tax Avoidance, the "Balanced Allocation of Taxing powers" and the Arm's length Standard: an odd threesome in need of clarification", in Isabelle Richelle, Wolfgang Schön and Edoardo Traversa (eds), *Allocating Taxing Powers within the European Union*, (Max Planck Institute for Tax Law and Public Finances vol II 2013 131, 156

allowed. Recently, this raises another problem, related to the amount of tax revenue that should be addressed to a determined State. Maybe this is an issue that does not belong to the international tax law, mainly concerned with the amount of tax revenue that is entailed to a country according to the origin location of the tax bases, but rather an EU law problem, since it is here that the revenues and expenses are linked.

In fact, the latest ECJ doctrine links the justification of tax avoidance to the balance allocation of taxing powers and the ALP. This solidly settled link between the ALP and tax avoidance, is even partially established by the EU legislation (for example, article 80° of the VAT Directive) and the ECJ case law. In fact, the Council of European Union, in its Resolution of 8th June 2010 on coordination of the Controlled Foreign Corporation and Thin Capitalization, has adopted the arm's length standard as the third anti avoidance yard stick on the problems of applying anti abuse clauses to transnational transactions. Despite this, the fact is that this standard is often criticized and, fundamentally, this principle is a measure to ensure fair competition and not to prevent anti avoidance. The introduction of the ALP as a guideline to the anti-avoidance test is, therefore, confusing since this principle is not a device created to control tax avoidance but, instead, it must be seen as an instrument that guarantees the balanced and correct allocation of profits among the countries and, therefore, a factor used in order to promote a correct competition. In addition, it must be noted that the tax avoidance must not be confused as tax arbitrage-jurisdiction shopping so, therefore, it can even be questioned if this ALS approach took by the Court is compatible with the accepted notion within the OECD.

The recognition of the ALP by the ECJ corresponds, in fact, to the acceptance of the role of the international tax law even if, as is often defended⁶⁸, the Court does not always understand the logic that is behind the OECD-MTC. Recently, the difficulty that can be pointed out is the non correspondence between, on one hand, the international tax regime and its underlying logic with the ALS as a crucial integrant part of it, with the aims and objectives of the EU law, on the other. This constitutes the main problem regarding the ALP adoption by the ECJ in order to decide which anti avoidance measures are compatible with the EU law.

⁶⁸ M. Lang, "Double Taxation and EC Law", in Avi-Yonah, R.S. J.R. Hines Jr and M. Lang, *Comparative Fiscal Federalism. Comparing the European Court of Justice and US Supreme Court's Tax Jurisprudence* (Kluwer 2007) 17, 33

By assessing the ultimately changes, it results from the ECJ case law that the restrictions on the freedoms established in the Treaty can be justified on the grounds of public interest, such as the need to prevent tax avoidance, alternatively or cumulatively, with the need to guarantee a balanced allocation of taxing powers among the Member States, as long as they fulfil the proportionality requirement in relation to such objectives and they prevent tax avoidance regarding “wholly artificial arrangements”. At this respect, it can be highlighted another problem related to the ECJ reasoning regarding tax law: namely the doctrine of the “wholly artificial arrangements”. The question that can be posed in this regard is: what does this mean for the application of the ALP under the auspices of the fundamental freedoms? According to the ECJ position, with its core focus on the “commercial rationality”, any transfer price that can be defended on the grounds of efficiency considerations within the firm, must be also recognized and accepted by the tax administration. This is so because the application of the ALP within the EU has been restricted to the fight against “artificial arrangements” in an abusive way. Although, the fact is that this concept, alongside suffering from a lack of definition, on one hand (the Court does not clarify in what circumstances should determine it), on the other, it does not take into account the different types of economic activities, for example, it compares a holding entity to a traditional enterprises with personnel and premises. It seems evident that tax administrations tend to face any deviation from the ALP as an effort to manipulate the tax base, but on the other hand, from a business approach, there is also ample evidence that large scale deviations from the ALS can be a result from valid economic and business considerations.

Despite the undeniable importance of the role played by the ECJ in the corporate tax harmonization in the European Union, it must be borne in mind that, due to the fact that it only responds to specific solicitations, its performance does not allow a systematic standardization of the application of the corporate tax and does not obey to a strategic action plan. In addition, not always do the Member States implement, in their own legal systems, in a fast and voluntary way, the alterations, that, according to the ECJ case law, are necessary to their own legal dispositions

2.3 Preliminary Conclusions

It can be said that the result of this ECJ case law and the EU law framework, limiting the discretion in relation to taxation issues, is the “price to pay for integration”. But the fundamental

issue related to this is not the integration in itself but rather the asymmetric integration model which does not contain the taxation powers themselves but includes a number of limits that surround the taxing powers of the Member States. In fact, the most remarkable aspect is that the Court has empowered itself with the capacity of strike down Member State measures in an arena where the EU institutions are not allowed. The fact is that this situation not only occurs in the taxation field but also in the economic and budgetary policy, namely on debt and deficit limits and currency, creating dissonances that are hard to resolve.

Another problem is that, at the present, in some circles of Europe and even more in the United States⁶⁹, transfer pricing is regarded as a completely obsolete and erratic device, with the arm's length standard embattled, either at a conceptual, political and legal level. As we will explain in the subsequent section, the ongoing debate turns around the compatibility of the arm's length standard with the rationale that supports the existence of large firms.⁷⁰

⁶⁹ Susan C. Morse, "The Transfer pricing regs a new edit " (2013) vol.40., Pepperdine Law Review, available on <http://digitalcommons.edu/plr/vol40/iss5/13>, accessed 25th September, 2013

⁷⁰ Adam Biegalski, "The Arm's length principle. Fiscalism or Realism" A few reflections", (2010), 38 Intertax 177

PART III-Transfer pricing and the problems it entails

1 - General Background

Multinational companies operating in several countries have to be competitive in the markets in which they operate so that they can succeed in the business world and meet the expectations of their shareholders, focused on achieving profits and dividends of their invested capital.

The tax burden that MNEs have to support is faced as a cost of their activity and the fact is that this cost will be higher or lower, depending on the pressure that each home State exercise over its taxpayers through its own tax legislation, for example, by creating standards that increase or decrease the tax base. In the end, these taxes revenues serve the financial needs of each State and, insofar, the different tax burden imposed to the companies can be seen as the exercise of the sovereignty of each State ranging from one State to another. Subsequently, in order to minimize such taxes costs, MNEs have two alternatives that can be used either isolated or jointly, the relocation of that enterprises or the relocation of benefits, via the indirect transfer from one State with high tax pressure to another with lower tax pressure, technique that typically corresponds to transfer pricing. This indirect transfer works as tax planning, in a concrete level: the prices agreed between the associated enterprises differ from those which would be applied if they were treated as unrelated relations, by using the universal OECD standard - the arm 's length principle.

It is clear that this indirect transfer of benefits not only happens at the level of the so-called "tax havens" since these transfers also occur in the States where their tax systems allow real gains in the cost of the taxation, either via real effective taxes rates, or by the rules used in the determination of the taxable income, or by taking advantage of the gaps in the tax legislation or by the non application of withholding taxes.

Thus, it can be easily concluded that the multinationals can, via linked operations, and in order to reduce the group 's real effective taxes burden, transfer, in an indirect way, the profits of integrated companies through the manipulation of the transfer pricings among those parts. At

this point, it is perfectly understandable that the reference to the phenomenon of transfer pricing has a negative nature, most of the times it reflects the prices practised for the goods, services or another type of transfer among related enterprises, and which deviate from the prices practised in the normal market which have, as its main goal, the indirect and hidden transfer of corporate profits, with the evident purpose of tax avoidance. When fixing their transfer pricings, the enterprises want not only the correct allocation of resources among the related enterprises, but also, the optimization of their tax burden, searching the maximization of their net profits

Thus, when facing transfer pricing it must be borne in mind the presence of three conflicting interests at stake, namely: the interest of the group in maximizing their income, the interest of the States with higher tax burden in not losing taxes revenues and the interests of the States with lower tax pressure in attracting the investment of the MNEs.

2- The transfer pricing in the light of domestic law

Notwithstanding, transfer pricing can not only be faced as anti avoidance rules but it is also important to look to the rationality that underlies the tax systems, which had specifically created these provisions against these abusive arrangements. According to this, it can be said that the actual transfer pricing standards are aimed at to guarantee that the allocation of taxing rights, as established in the substantive provisions of domestic tax codes and other relevant tax legislation of the involved countries, are also applied in cross border business activities among independent parties and within a corporate group under common control, where, for example, one related enterprise is located in a foreign jurisdiction. Therefore, in order to understand the logic that underlies the transfer pricing rules, it must be taken into account the international general rules respecting the allocation of taxing rights in terms of business profits. The difficulty here concerns the diversity of provisions which, furthermore, is not always uniform in its separation between the taxing rights that are allocated to the state of residence of the corporate taxpayer and the allocation of taxing rights attribute to the state of source of the corporate profits⁷¹. The fact is that this reveals great relevance since, in fact, there is a relevant line dividing the business profits that are taxed in the country of residence and the business profits deriving

⁷¹ For a tax policy analysis of these rules see: Michael Lang/Pasquale Pistone/Josef Schuch/Claus Staringer (Ed.), *Source versus Residence: Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives*" (The Hague: Kluwer 2008).

from a permanent establishment or subsidiary that are taxed in the country of source.⁷²

Despite the use of some techniques (for example, used by the source state in order to extend the scope of territorial taxation, for instance, by levying withholding taxes on interest and royalty payments or by the introduction of the concept of a service-PE) the fact is that they do not modify the general framework of the international taxation of business profits- which depends, on one hand, on the allocation of these business profits to the parent company or head office and, on the other hand, to the allocation of these profits to the subsidiary and permanent establishment⁷³Just one parenthesis: tax revenues are not independent of tax rules and the resulting burdens. In fact, lower tax rates on capital may correspond to higher tax revenues as long as the investments flow in and employment rises.⁷⁴

Thus, the transfer pricing rules are applied in order to define a set of rules capable of providing the division of the tax base between the parent company and the subsidiary (or several subsidiaries) and between the head office and the permanent establishment (or several permanent establishments). From here we can design the transfer pricing legal structure: in first place, transfer pricing provisions, namely the arm's length principle guarantee the allocation of profits to companies and to permanent establishments. In second place, it can be added that this allocation of profits to individual business entities is translated into the allocation of taxing rights to the involved countries.

⁷² In order to illustrate it can be taken the case of a business entity which acts as a supplier of goods and services to a customer located in another country. According to the general principle the country of residence of the supplier is entitled to tax the profit earned by these sales of goods/services. In the same sense, when the business entity grants a loan or licenses out intellectual property to a borrower or a licensee located in another country, the general principle prescribes that that the interest and royalty payments deriving from these loan and license agreements are taxed in the country of residence of the borrower and the licensor. In relation to the source state, it can tax the profits that are related to a permanent establishment or which are connected to a local subsidiary within the corporate group.

⁷³ For our case it is important to note that these allocation rules are also applicable, without any modification, to the sales and services, licenses and loans performed between related group companies.

⁷⁴ It sounds like a paradox but it happens, for instance, MNEs might use transfer prices to shift profits from lower tax countries to higher tax countries, for example, in order to benefit from certain tax incentives in the high tax country. To prove the success of this theory, it can be taken as an example the Irish economy since the middle of the 1980s which had low rates of corporate income tax substantial inward direct investment and high employment and income growth- Stefano Micossi, Paola Parascandolo, Barbara Triberti, "Efficient Taxation of Multinational Enterprises in the European Union", Paper prepared for the Symposium on *La tassazione dell'impresa multinazionale nell'Unione europea*, Università di Siena, 24-5 January 2003, available on <<https://www.coleurope.eu/eco/Papers/BEEP%205.pdf>> accessed 20th August 2013

3- The transfer pricing problems at the European Union level

The preservation of the freedoms established in the TUE and TFUE (formerly TCE) and developed by the community law can, due to its direct applicability and supranational value override the Members States' necessity of creating, developing and structuring their own tax systems. This illustrates the existent dichotomy between, on one hand, the faculty and capacity that each Member State has in elaborating its tax regimes, namely concerning direct taxation, that are submitted to its own rules, *maxime*, constitutional impositions of each Member State which imply the accomplishment of certain demands, for example, the one that stems from the equality principle, how to divide internally the tax burden, the proportionality principle and tax justice and, on the other, the capacity of each Member State in negotiating the international Conventions to avoid the Double Taxation.

It is broadly recognized that the taxes systems that each Member State creates in a specific moment are the reflection of political options that each of them lives in each of the political cycles, which are, undoubtedly, in connection with the existing global economy. In fact, every time a State experiences an economic difficulty, this is automatically reflected in its taxes system to be used as a political weapon in order to overcome those problems.⁷⁵

From a taxation point of view, as we referred, tax legislation is still a national responsibility since cross border transactions are taxed according to unilateral tax laws⁷⁶ or bilateral double taxation treaties⁷⁷ which address the right to tax corporate profits. In the European Union, the allocation of group profit problems deriving from joint operations has been solved by the acceptance of transfer prices based on the arm's length which means that they

⁷⁵ For instances, the subprime crisis in the US is a reflection of this, with all the consequences in the international financial sector, by binding the States in acting directly in their own financial systems in order to obtain liquidity to the called "real economy", namely by using the taxes systems as a damping devices of the globalized effects of the economy. This also illustrate why the Sates are intransigent in what concerns the abdication of their veto right. It is important to note that the tax competence, essentially the direct taxation, is held by the Member States, which exercise it at the Council level and by unanimity and, therefore, never had abdicated of their veto right.

⁷⁶ Usually the country's tax jurisdiction is some mixture of residence and source based taxation.

⁷⁷ Tax Treaties are a mechanism to coordinate taxing rights in order to prevent double taxation arising from the overlap of residence and source jurisdiction. Whenever two countries enter into a Tax Treaty with each other they agree to mutually modify the exercise of their respective taxing rights to prevent double taxation.

must reflect prices that non-related parties should agree upon. Although, the fact is that the business economics of the multinational firms grant taxpayers good reasons to use transfer prices which divert from those engaged by independent parties. Therefore, the assumption that usually normal group transfers match transfer prices among independent parties in the open market can be easily rebutted and tax authorities must be aware of their potential misuse. In the enterprises groups that are taxed according to an organic form, as if they were a single company, the transfer pricing tax problems do not arise. Although the major concern is related to the differences regarding the incidence of taxes and especially their rates among the several Member States as well as the disparities between the economic and financial situations of different enterprises within a Member State. The consequence of this is that the provisions of services and the trade of goods within the same group will have significant implications concerning the tax situation of the all group- and, before this, in the rational organization of the group. In this context, also the application of the “arm’s length principle” that underlies the control of the transfer pricing is becoming more difficult.

In terms of a political perspective, the attentions should rest on the growing of the tourism tax. Insofar, the adhesion of mid European countries to the European Union, caused the emerging of large tax rate differentials and, consequently, the erosion of tax revenues of high tax legislation countries should consider that transfer pricing, as a mechanism created by domestic law, constitutes a key factor of the governments tax policy, many times faced as an alternative to increase tax revenue. Insofar, the domestic problems normally associated to the legal regime of the transfer pricings, more specifically, the concept of special relations and common control ⁷⁸, the burden of proof that the tax administration and the taxpayer have to bear, depending on the legislative technique used, are, naturally, maximized at a European level. Therefore, even if a specific transfer pricing regime fits a specific country, its effects may not be the same whenever it has to deal with 28 different countries and different tax systems. It must be considered that,

⁷⁸ It can be advanced that most of the proposals to create a tax system that encompasses EU operations limit that system to the boundaries, or the “water’s edge” of the European Union. The term “water’s edge” derives from the practices in the US States, of while California’s practice may be the most well known, of restricting the application of combined reporting to certain corporations (or parts of corporations) that have income that is subject to federal income taxation. Although, the “water edge” concept” can be defined in many ways- Joann Martens Weiner, “The European Union and Formula Apportionment caveat emptor” (2001) International Bureau of Fiscal Documentation 380, 384

notwithstanding the existence of Transfer Pricing Guidelines, released by the OECD, as we already noticed, the transfer pricing interpretation varies from one State to another. This lack of uniformity increases the importance of transfer prices as tax planning and carries, in addition to the problems associated with the articulation of the domestic regime with community law, the risk of potential double taxation since the taxpayer, in his transactions with another territory may have to, due to the different regulations, bear additional costs in order to comply with the transfer pricing rules that are in force.

4- Problems when assessing the Arm ' s length principle

The societies, the companies and markets are increasingly more integrated, not only by the formation of regional markets but also through globalization in general. Thus, it seems difficult to find comparable transactions among independent enterprises, especially since such transactions are confidential, not easily unveiled either for the Tax Authorities or for the competitors. Therefore, the application of the arm's length principle requires a great amount of data in order to establish the comparison between transactions and activities among related enterprises and the transactions and activities of independent enterprises. This constitutes a costly administrative burden and time consuming imposed both to tax administrations and to the taxpayers in case significant numbers or types of cross borders transactions exist. Regarding this it can be mentioned, on one hand, the ex ante compliance cost, as the result of the efforts of calculation of transfer prices of the individual transactions at arm's length and the ex post compliance costs, on the other, primarily based on the documentation requirements of transfer pricing at arm's length.

Another problem that must be pointed is related to the uncertainty element that revolves around the ALP, and that the enterprises have to face whenever, for example, two countries compute different transfer prices for the same transaction. In this light, the outcome of transfer pricing cases is not predictable, which certainly maximizes the problem of uncertainty.

On the other hand, the products and services are becoming more specialized and less comparable- they are plus non-materialized and little known. A significant portion of the relations among groups deals with intangibles (like patent, trademarks, know how) which are of difficult

evaluation.

It can also be argued that the principle of the arm's length requires an independence that goes against the rationality of the groups. Indeed, the enterprises belonging to the same group are not independent from one another. Insofar, from the group's perspective, it is often difficult, if not impossible, to apply an "independent" price to an enterprise of the group. As HAMEKERS outlines ⁷⁹, the essence of the arm's length principle is not the comparability of prices and results, but *dealing* with each other as independent parties would do. ⁷² Paraphrasing the same author, *"according to a number of economists the arm's length principle is contrary to economic reality. It starts from the fiscal myth that every subsidiary and permanent establishments within a group is a separate entity which conducts trade under free-market conditions with entities in the group"*. And the author continues, *"the essence of an MNE, however, is the potential to act as one entity in the world market and so to gain competitive advantages"*. In fact, it is this essence of multinational and national groups which grants a competitive advantage, by acting in the market as a single entity and thus obtaining high benefits from this operation, rather than if they operated under the arm's length principle. This is so since the groups' company acts as the organ of a unitary body. Besides this, there are some costs that do not exist outside the related group companies. Therefore, it is often difficult to determine which part of the expenses of the headquarters can be allocated to each of the companies of the group. Therefore, the assumption that dependant parties of such multinational firms are required, by tax law, to behave as independent parties is like to ignore the whole point of organizational economics. The transfer pricing that occurs inside an integrated firm chasing business models largely diverges from the outcome that arises in the outside market operations.

Another shortcoming is related with the e-commerce: the taxation of profits based on the physical presence in a certain jurisdiction becomes inadequate. To this extent, the criterion of the permanent establishment is inappropriate according to the possibilities that the e-commerce, the internet and the communications technology position papers provide to data transmission, online shopping, etc. The OECD committee has already published several tax documents regarding the permanent establishments in the light of the electronic commerce, which can explicitly reflect the difficulties that this topic raises.

⁷⁹ Hamaekers, see supra note 1, 22

Furthermore: despite basing its international guidelines in the arm's length principle, the fact is that, within the OECD framework there is no express global definition of the arm's length principle nor is it applied uniformly. Notwithstanding the reference to "associated enterprises" in article 9° of the Convention, the fact is that this is often inadequate in the resolution of disputes arising from certain transactions since it requests that the Contracting States attain an agreement on what is an acceptable arm's length price to be paid for the transfer. Furthermore, another key element of the Article, namely the concept of "associated enterprises" is not expressly defined in the article aforementioned or in the Convention. The fact is that the precise meaning to be given to this concept many times just appears after the taxpayer acts and probably as a result of the interpretative work provided by the courts.

4.1 Problems when assessing the Arm ' s length principle- in particular at the EU level

In relation to the (difficult) application of the arm ' s length principle in the European Union, and by taking into consideration the Court ' s approach to this topic, some lack of consistence can be pointed out. As afore studied in section 2.2 of our study, by analyzing the ECJ case law it is visible that the Court subscribed the position that the arm ' s length standard, resulting from the business performance of independent enterprises under competitive conditions, shows exactly how the normal intra group operations are undertaken.⁸⁰ According to this reasoning, the allocation of resources that a group adopts is made as if that allocation was carried on outside the firm and subject to the conditions of the open market. Although, the main objection that can be highlighted to this is that it does not correspond to reality. In the line of what we have already noticed, the economic rationality that an enterprise must pursue does not match with this standard. This is due to the fact that enterprises, namely large scale integrated multinational firms, own their existence mainly to how they organize their own production and distribution, which cannot be attained in the open market.

5- Critical Approach

It can be said that the present EU framework does not provide a sufficient allocation of taxing rights among countries, notwithstanding the valid interest that the involved states have in

⁸⁰ Case C- 524/04 of 13th March 2007, "*Test Group in the Thin Cap Litigation*", ECR I-2107, Advocate General *Geelhoed*, delivered on 29th June 2006, Case C-324/00 of 12th December 2002, *LANKHORST-HOHORST GmbH v Finanzamt Steinfur* [2002] ECR I-11779, paragraph 35.

taxing business profits generated in their territory. In fact, whenever two companies within a group enter a cross border transaction and divert from the arm 's length standard, the reduction of the profit of the domestic company implies the corresponding increase of the profit of the foreign company. According to the current transfer pricing view, the allocation of taxing rights corresponds to the allocation of profit to the domestic company⁸¹, although this is not always true.⁸² In fact, the rules and principles established in the internal market do not forbid the taxation of the foreign company in relation to the extra profit generated from the related party transaction. In this context, what is important to rethink are the rules regarding the international tax allocation of business profits in order to grant the States the possibility to exercise a limited tax jurisdiction over foreign group companies which get profits due to the interaction with local group companies. The result of this would be the disengagement of the allocation of taxing rights from the allocation of profits to group companies, which, in a long term, would lead to the non intervention of the ECJ and the modification of double taxation treaties.

In relation to the application of the arm 's length principle, and as we had noted along our study, there are several differences between independent enterprises and group enterprises that cannot be underestimated: the last are based on hierarchies and not on markets, as well on long term contracts rather than one punctual transaction, they also bet on investments with large sized structure and rely on durable trust relationship between members of the same corporate group. Insofar, this common control characteristic, as a feature shared by the group companies, is many times faced, by the tax authorities, as a suspicious element. Although this is a key aspect that must not be disregarded, since it consist the success element, every time an atomistic market cannot achieve an efficient result. From here, some conclusions can be derived, which differ from the ECJ 's opinion: the competitive conditions do not govern the contractual interaction among companies belonging to the same group. Instead, in these cases, where there is high specific investment involved, the "bilateral monopoly" which triggers completely different results in comparison to the relationship among independent firms must be applied.

⁸¹ Under a comercial view, this profit belongs to the foreign company but in terms of tax policy this profit has to be taxed in the country where the subsidiary resides.

⁸²If a foreign parent company derives an extra profit from the territory where the subsidiary is located (business reasons induce the domestic company to accept pricing at marginal cost from the foreign parent company), in a commercial perspective this profit belongs to the foreign parent; but according to a tax policy view, this profit must be taxed where the subsidiary is resident. However, is perfectly possible, since it not impeded by the rules and principles governing the european internal market, to tax the other company (foreign related party) on the extra profit arising from the related transaction.

From this point of view, it can be said that the commercial rationality of transfer prices within enterprises must follow its own rationality, namely, to pursue the reasons of why the founders of the firm have gathered together a hierarchical and integrated entity in order to compete with the operation of competitors in the open market. This way, the economic rationality of related party transactions is not linked to the arm's length pattern.

In this context, it is certain that, from an economic perspective, transfer prices for intra group transactions are not linked with the arm's length standard related to market prices. As Schön⁸³ shows, by citing a business research tool some decades ago, the base for intra firm optimal transfer pricing is the "marginal cost" rather than the "market price"⁸⁴, position that has been strengthened by economic research on incentives destined to alleviate the shortcomings frequently faced by the organization. In the light of the aforementioned, it can be said that, from a business point of view, transfer pricing entails the optimization of the internal production by the use of incentives: on one hand, the corporate headquarters pursue the increase of the overall efficiency of the firm and, thus, the overall profit of the company, on the other hand, the managers of the sub representation intend the increase of the part of the overall profit allocated to them. There is no doubt that, in order to optimize the internal production, there are several variables that must be taken into account such as the specificity of investment, the existence of property intangibles, the relation between the domestic and the outside market. It is not well established if the promotion of the efficient behaviour depends on the use of the marginal cost, historical cost, real or notional market prices. In this sense, it can be said that the transactions involving related parties cannot be presumed as if they were performed on an arm's length basis since the requisite conditions of competitive, free market dealing may not exist. Taking this into account, it is clear that the ECJ position, by assuming that the arm's length price is connected with the economic rationality of an intra group transaction, cannot be accepted.

Insofar, this principle has to be taken as a legal concept which pursues the equality of

⁸³ Schön, see supra note 53, 108

⁸⁴ The structure of MNEs within an MNE group is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. Thus, a large and growing number of international transactions are no longer governed entirely by market forces but by forces which are no longer governed by the common markets of the entities of the group. MNEs are global structures which may share common resources and overheads from the perspective of the MNEs these resources need to be allocated with maximum efficiency in an optimal manner with the MNEs being an integrated structure with the ability to exploit international differentials and to utilize economics of integration not available to a stand alone entity, so transfer prices within the group are unlikely to be the same prices that unrelated parties would negotiate. When associated enterprises deal with each other their commercial or financial relations may not be directly affected by market forces but may be influenced by other considerations.

treatment between group companies and independent companies. This is not a commercial concept since it fails the accomplishment of the efficiency requirements within a firm. This justifies why the application of the arm's length principle has been targeted at multiple discussions in the tax world, with the business experts claiming a different configuration of the transfer prices for a given firm.

In relation to the purpose of our work, it is important to note which consequences can derive from the remarks aforementioned. According to the jurisprudence of the ECJ, with its main focus on the economic rationality, any transfer price can be commercially accepted if grounded on the efficiency considerations within the firm. In this sense, they must also be accepted by the tax authorities. In the EU framework, the ECJ has limited the scope of application of the arm's length principle to the fight against abusive artificial arrangements. Although, and as it has been explained, large scale deviations from the arm's length principle can be justified in the view of a business approach, and it does not always have to be regarded as a way of manipulating the tax base. This means that the accomplishment of the arms' length principle does not have to be fulfilled by the transfer pricing rules, since that legal assumption can be easily rebutted.

PART IV- The Formula Apportionment

1 - The unitary taxation approach

For many tax experts, the unitary approach makes more sense than the SA, applicable under the ALP. In fact, even during the 1930s when the “separate entity” approach was first agreed internationally to deal with transfer pricing it was recognized that in practice national authorities should rather check the firms’ overall so to guarantee a fair split of the total profits allocated to affiliates. Since the 1990’s techniques that already go towards unitary taxation can be found: in US States, for example, it had already been successfully implemented; European Union has currently prepared a proposal for adopting it. Under unitary taxation MNEs would be taxed not according to the legal forms that their tax adviser create for them, as is currently the case, but, instead, by a genuine economic substance of what they do and where they do it. This would be far more legitimate and simpler to implement than the current system. The present international tax system deals with MNEs as if they were separate entities operating in different countries. This reflects a weak coordination between tax authorities and allows “separate accounting” approach a tremendous scope to MNEs shift their profits around the globe in order to suit their tax affairs. The basis of the Unitary method is that each MNEs must prepare a Combined Report covering the whole of the corporate group engaged in a unitary business

1.1 Formulary Apportionment method concept

The apportionment method rests on the difficulty of attributing income by source in a satisfactory way. The theoretical background relies on the assumption that certain business elements fairly reflect the measures of the tax to be attributed to a particular state. Traditionally, the formula used in the US is the so called “Massachusetts formula” where the elements are sales, payroll and assets (real and tangible personal property), weighed by state-specific incidence factors and average. The question that can be raised in this context is whether this formula apportionment method, used, for example, among the States in the US, can be faced as an alternative to the arm’s length principle within the European Union. As Antonio Russo ⁸⁵ questions: would this mechanism be effectively, politically and economically viable and would clearly obtain the desired effects of reducing profit shifting through transfer pricing, curbing tax

⁸⁵ Antonio Russo, “Formulary Apportionment for Europe:Na analysis and a Proposal” (2005) Intertax, 33, Issue 1, Kluxer Law International 2, 3

competition among Member States and creating a more favourable tax regulatory environment for Europe based enterprises?

Under FA, the net income of corporations doing business in more than one country (or a group of related companies) is divided among the countries where the corporation's (or group) operates. For instance, we can choose to use payroll and sales (at destination), weighed equally in order to apportion income.⁸⁶ The formulary apportionment method can be applied by common ownership, or only to commonly owned corporations in an integrated set of economic activities.

1.2 The EU approach to formula Apportionment

In 1992 it was released a report, named Ruding Report⁸⁷, examining the question whether a formula apportionment method could be an alternative to the arm's length in what concerns the taxable income from companies acting within the Community space. In the light of the Committee position, the apportionment method can be used as an option whenever a single country has a separate and local tax jurisdiction. At the time, the Committee has advanced some disadvantages concerning the apportionment formula in the Community. In the first step, it can be argued that this requires a high level of integration, namely, a common currency, a common company law, common accounting standards and common experts in tax administrations. The second disadvantage: it might apportion profits to countries where they were not earned. Thirdly, this would imply the renegotiation of all tax treaties between Member States and possibly with third countries in order to change the arm's length method to a formula apportionment method. A fourth point, if the formula apportionment were used within the community space, on one hand; and the arm's length method outside the Community, on the other hand, this could make the resolution of double taxation disputes harder. In addition, this might trigger some problems whenever tax administrations have to apply two separate standards to a transaction involving more than one Member State and a third country. Bearing this in mind, the Committee concluded that a reconsideration of the arm's length method, to the formula apportionment, would not be desirable in the future. This was justified by the necessity of a higher level of integration among

⁸⁶ If the corporation, or the group, had 50% of its payroll in each of two countries but made 70% but made its sales in country A and 30% in country B, the corporation would pay on 60% of its income to country A and on 40% of its income to country B (60% is the average of 50% and 70%; 40% is the average of 50% and 30%).

⁸⁷ Report of the Committee of Independent Experts on Company Taxation, Commission of the European Communities, March, 1992.

Member States which, at the time, had not been achieved yet.

Although, the question whether formulary apportionment could be a solution to the problems brought about transfer pricing persisted along the years. In fact, due to all the problems associated with the application of the ALP, the idea of adopting common corporate tax rules emerged in the European arena. Therefore, the Commission published a directive for a proposal for a Common Consolidated Corporate Tax Base. This Project comes across as a highly sensitive issue that generated heated debate in the academic, political and business arena since it represents a radical departure from traditional taxing principles and could fundamentally change the way multinational groups are structured within Europe. This topic will be addressed in detail in part V of our essay.

1.3 The arm ' s length principle vs a formula apportionment: main differences

In fact, both methods reveal great differences between them.⁸⁸

As we already have the opportunity to see, the ALP, originating from the US system, is deeply rooted in the European taxation way of reasoning in the case of intra group transactions on multiple levels: OECD's level, UE's level and purely domestic level. The ultimate goal is to achieve an attribution of fair shares of tax to different jurisdictions in cases where one part of an enterprise delivers goods, services or know-how to another part of that same enterprise that is located in another country.

In what concerns the FA, it pursues the determination of the geographic source of corporate taxable income based on a predetermined formula, rather than using separate accounting. Therefore, by employing this formula, the tax liability does not concern the profits actually earned in a particular jurisdiction but the profits generated throughout the group of

⁸⁸ In contrast to a tax system based on separate accounting and arm's length pricing, under formulary apportionment, companies do not attempt to calculate the income of the affiliated entities of the corporate group. Instead, the corporate group first combines (or, consolidates) the income of each of its operatives into a single measure of taxable income. The group then uses a formula to apportion the income to the various locations where the group conducts its business. This formula is generally the share based on of business activity in a location to the total business activity in all locations.

jurisdictions.

One important advantage that can be addressed to the ALS is related to its international acceptance: it may even constitute an international custom and, therefore, international law (which is obviously a huge obstacle against the introduction of a formula apportionment method).⁸⁹ Another merit is that it seems to work effectively in the majority of the cases, together with the possibility of making adjustments, which reveals great importance in what concerns the avoidance of double taxation. It is true that, by using the formula apportionment, the interrelations occurred in a business group are also considered, although, since it constitutes a predetermined formula, it does not share of the same flexibility of the arm's principle. Contrary to SA/ALP, the FA is not interested in the precise determination of the origin of the income, since through the formula the attribution of income is allocated to many jurisdictions. The consequence is that this could trigger arbitrary and unreasonable results, reflecting a fundamental problem regarding the application of FA: it is based on an implicit assumption that profitability, compared with whatever factors appear in the apportionment formula, is uniform across related companies operating in different jurisdictions. Even if this assumption is politically accepted in the US, it may not be accepted within the EU, since this requires a higher economic convergence. In addition, another downside can be appointed: often, under FA method, there is a distortion of the geographic attribution of income which normally occurs when income cannot be clearly be identified with a particular location.

In addition, the fact is that the formula apportionment requires the achievement of agreements between the countries involved and tax administrations, concerning the factors to be taken into account. Thus, this formula treats each dollar of payroll, property and sales (the mostly used factors) as if they produce the same amount of income or an equal quantity of product. The FA assumes that each unit of a particular apportionment factor, for example, each unit of labour cost or of sales, of a given taxpayer is equally productive of income on average, whenever it is located and whatever the use made of that labour or capital is. The fact is that the validity of this assumption cannot be taken as such namely in the case of the property factor and, especially, in

⁸⁹ Weniger P, *Formulary Apportionment of Corporate Group Income to the EU Member States* (Dissertation), 53, 169 et ff

the case of payrolls and sales since, according to the economic theory, in a long term, international capital flows lead to the equalization of marginal returns to capital, but this does not imply either that average returns are equalized in the long run or that marginal returns are equalized in the short run. If an uniform application of the formula to all industries simplified the process, although, it could create inequities and distortions. Insofar, this means that specific industries demand a special formula. And in that case, the use of different formulas by components of a conglomerate company operating in industries would imply the determination of the boundaries of the industries and even the application of the ALS, or some kind of a hybrid formula, in order to split the income among industries.

By assuming this, it can be said that this method requires much more comparable economic and taxing conditions than the arm's length principle. The companies are asked to fulfil combined reports which create an administrative burden to the companies whenever there is a variation of the accounting principles and the currency in the involved jurisdictions. This constitutes one of the main reasons why the formula apportionment method is, in the majority of the cases, used in areas where there is some homogeneity, such as in the federal states.

To sum up, some can argue that the fundamental problem of the FA is that it is not based on a theoretical foundation and, therefore, it is inherently arbitrary. Therefore, while the ALS may trigger some conceptual and practical problems, the FA suffers from a lack of rational economic basis which interferes with the required political consensus, essential to the adoption of universal rules.

1.4 The formulary apportionment conceptual shift

As pointed out in part I, the OECD regards the ALP as the most accurate method in the determination of the taxable income. In this background, the non arm's length principle method, as the formulary apportionment, is rejected by the OECD.⁹⁰ Notwithstanding the recognition of its greater administrative advantages, higher certainty for the taxpayer and adequacy to the economic reality⁹¹, FA cannot be regarded, in the light of the OECD reasoning, as an appropriate form of profit allocation. The OECD justifies its position grounded on the high complexity associated to the implementation of this system, alongside the arbitrary nature of this formula,

⁹⁰ OECD TPG 2010, MN 1.32

⁹¹ OECD TPG 2010 MN 1.19

which does not take in consideration the market conditions.⁹²

In fact, if the EU moves to a FA/UC method, there are some crucial issues that should, primarily, be taken into consideration. First of all, it is necessary to resolve some technical issues, such as the definition of the unitary business (which combination has to be employed)⁹³, the choice of the apportionment formula (with all the political implications), and how to measure the factors.⁹⁴ In abstract the fact is that formula apportionment implemented on a firm by firm basis can trigger the same tax fraud opportunities on transfer prices as well as separate accounting. If wide variations in tax rates continue to occur, it would be inadvisable to adopt FA: it must require the combination of firms in the engagement in a unitary business, since the conceptual problems and the temptation for income shifting would be too great. In this sense, the formula should be uniform across Member States which might require that tax competition among jurisdictions should be supervised in order to avoid “beggar thy neighbour” tax policies among Member States.

A greater co-operation in tax administration will also be needed but the main problems are, especially, political. A FA system based on micro economic factors will probably witness enormous political difficulties in being agreed upon and effectively implemented due to the different economic interests of the Member States. For example, in the EU we have some countries whose economy is predominately based on manufacturing activities whereas there are others in which the services industry are more important; some countries invest in research and development or in the exportation of intellectual property rather than others which are net importers of intellectual property. The fact is that these disparities can cause a non consensus in the determination of the apportionment factors that should be included in the formula. Also within this second part, and as aforementioned, it is the most problematic question, regarding

⁹² OECD TPG 2010, MN 1.25

⁹³ This reveals great importance related to the inclusion of crucial factors: it is not clear if it must be included just one company or the tax base is also extensible to the subsidiaries and affiliates, where some may be wholly owned and controlled as a part of a business rather than others which are independent, or if this covers all subsidiaries all over the world.

⁹⁴ This constitutes one of the most difficult questions to solve. In first place, this would imply the achievement of agreements by all the Member States concerning the definition of the unitary business. Even if there were reached a consensus concerning the non extensibility of the apportionable tax base to subsidiaries non resident in the EU territory with no connection to the EU, the problem is that, on another hand, an in order to avoid manoeuvring through transfer price, controlled and integrated subsidiaries and affiliates locate within the EU must be included. In the USA, and according to the Supreme Court, this definition is related to the interdependence, integration and interrelation that occur between the parts of the business group involved. However, and as can be seen through the US example, this concept of business unitary is not the same in every federal states since it differs from state to state.

the factors which are going to be used and what weight should be given to them, since this has a significant impact on the States revenues. Following the US example, it demonstrates that the differences in the formulas applied in the different States are relatively small, however, it must be noted that the EU does not share the same homogeneity among its Members. The fact is that there are huge cultural, historical and linguistic differences within the EU that do not exist within the US. One important point: the citizens of the EU do not recognize their own interests as the interests of the EU in the same way as the citizens of the US, and this means a potential risk of protectionism of the Member States and the prevalence of self interest ideas which could be determinant in the choice of the factors by the Member States and the weight that is granted to these factors. This can turn the achievement of the agreement a very hard task by demanding a great deal of consensus and cooperation among Member States. Reaching an agreement on the common factors would imply an equal interpretation by the Member States of those provisions. Thus, this could even imply the creation of a kind of central administration, as the existing Multistate Tax Company in the US, in order to deal with the uniformity of the rule. The non existence of a body like this could provoke a high risk of divergence in the allocation of those provisions in the different Member States. In relation to the interpretation, the ECJ could be in charge of this subject, in order to avoid the risk of controversy that would occur if every single court of each Member State would be responsible for this task.

Another condition that this would imply is the need for agreements concerning relief provisions (as the included in the UDITPA).⁹⁸ Since the formula apportionment method deals with a formula that is predetermined this means that, contrary to the arm's length principle, it cannot take into consideration the particular circumstances and facts related to a particular case. In addition, as it uses different factors, this might create double taxation situations, and thus, the agreements about corresponding adjustments, similar to those related to the arm's length principle, are essential.

Furthermore, it would also be the need to harmonize the accounting standards within the EU as far as possible. If there is a lack of uniformity regarding accounting, namely the reconciliation of inventory methods, depreciation formulas, and inter alia, this would constitute a very hard task to the business group to fulfil a combined report of all their affiliated firms,

⁹⁸ The Acronym UDIPTA means Uniform Division of Income for Tax Purposes in the United States of America

engaged in the unitary business but located in a different Member State. The fact is that the creation of a common currency in the EU and the more general application of the IASC principles⁹⁶ show that this area has been in progress in the EU and represents a problem easily surmounts if a formula apportionment enters into force.

1.5 Formulary apportionment as the alternative to ALP?

According to James H. Hines Jr “ *formulary methods are typically defended as pragmatic compromises, representing imperfect alternatives to the current, arguable flawed system of separate accounting*”.⁹⁷In fact, notwithstanding the referred advantages of the ALP system, many of them can be rebutted. A crucial point that cannot be overlooked is that ALP suffers from one fundamental problem: it only works under perfect conditions, which means that all the (parts of) enterprises involved are forced to work together in good faith. Furthermore, it seems needless to refer that the “*real*” business world in no way reflect this premise of perfect conditions. This is due to the need for profit maximization which eventually leads to the aforementioned undesired profit shifting towards low-tax jurisdictions. Thus, the administrative burden on both sides, either to the business part as to the tax authority, has increased significantly. In fact, the treatment that the ALP method gives to business transactions constitutes one particular disadvantage and works as an argument in favour of the application of the FA/UC. In fact, an area where FA has an edge over ALP is that it aims the reducing compliance and administrative costs both for tax administrations and taxpayers, when applied to a group of companies.

In fact, the application of the SA may, in some cases, be the better solution: but it depends on the industry at stake. For instance, it may be suitable for industries in which market prices are readily available, where the interconnected relations between the enterprises are not a crucial factor or where a member of a group of companies generates taxable income and does not share these resources with other group members that integrate it. In this light, It must be recognized the conceptual impossibility of applying the ALS when facing some economic interdependence or whenever the goods or services are not transferred in a market transaction. In fact, whenever economic interdependence is at stake, FA could resolve some difficulties

⁹⁶ International Accounting Standards Committee

⁹⁷ James R. Hines Jr, “Income Misattribution under Formula Apportionment” (2010) 54(1) European Economic Review , available on <<http://www.nber.org/papers/w15185.pdf>>, accessed 10th October 2013, 2

related to transfer pricing that contaminate SA/ALP: for example, in case of application to corporate groups, FA would turn “tax havens” ineffective. In fact, the ALP is criticized due to its incapability of capturing the positive effect (meaning higher profits) due to the economies of scale and scope of large multinational enterprises. The larger the multinational enterprise is, the higher the probability of less accurate income allocation based on transfer pricing becomes.

In fact, another advantage of the FA is related with the transactions among members of the water-edge group⁹⁸, using transfer prices. They cannot be manipulated in order to shift the income to low-tax jurisdictions within the EU. Just one parenthesis: the limitation of the income to be apportioned by the formula would be that of a unitary group determined, through the application of SA/ALP, to be earned within the EU. In fact, the water’s edge can be defined in several ways and might include all affiliates of a unitary business that are resident in the EU or that are doing business within the EU. The water’s edge group would generally exclude the income and operations of all affiliates that did not do business within the EU (and, therefore, would not be included in a worldwide unitary group).

In addition, there must also be remembered the shortcoming concerning the intangible assets, that does not occur if applied the FA. As aforementioned, the ALP should help find fair transfer prices for intra-group or dealings. The fact is that, in what concerns the transactions of intangible assets, such dealings would not often occur with an independent enterprise at all. Needless is to say that, many times, these intra-group transactions are the reason for the existence of multinational enterprises and the way to develop unique intangible values in the first place. Therefore, this means that, especially regarding intangible assets it is very hard to determine an arm’s length price or even impossible to do so due to the lack of comparability between the transactions among independent enterprises. Furthermore, the structural elements

⁹⁸ A few US States have applied unitary combination on a word-wide basis which means that, in order to calculate profits subject to taxation by the State, they have combined the income and factors of foreign enterprises, such as parents, subsidiaries and sister corporations, with those of domestic entities with which they are deemed to be unitary. This is justified by necessity of determine accurately the income of the entity operating in the state, by including in the combined report of the in-state entity the activities of foreign affiliates that are part of the unitary business, even from those that do not carry any activity in the US. Since word-wide unitary combination is a controversial topic, a water’s edge limitation seems a more reasonable approach for the EU at this time, which is constitute by a more diverse group of countries than US, which already have substantial economic integration.

of a multinational enterprise are most of the times so closely linked, turning impossible the attribution of individual profit shares based on transfer prices.

In brief, it can be said that the main objection to the introduction of a FA is its simplification. ⁹⁹As already noted, contrary to the SA/ALP, the FA does not even try to identify the real source of the income. In this light, it is reasonable to accept the arguments defending that this can trigger some inaccuracy, but, on the opposite side, it can be said that is, actually, this feature which turns FA as an alternative to the ALP. The FA method tries to establish a compromise between theoretical accuracy and radical simplification and feasibility.

At the EU level, the adoption of a formula apportionment method, as long as it promotes the common market, would be an area under the competence of the EU that would guarantee its accordance with the Community law and the TUE ad TFUE Treaty. In relation to its compatibility with the provisions concerning non discrimination and the fundamental freedom, there is no risk of infringement as long as the Member States do not use different factors or grant different weights that could conflict with those provisions.

Maybe the most reasonable solution is to operate systems based on FA and SA accounting side by side (in fact, in many jurisdictions that use the FA different formulas according to the specificities of the industry at stake are employed: if a given corporation is more active in more than one industry, its income shall be divided among these activities). On the other hand, if formulas are applied to the income of unitary businesses and a given corporation group is engaged in more than one unitary business the separate accounting must be used in order to determine the income of each of the businesses.

In my personal opinion, moving towards a unitary basis, coupled with a principle basis of apportioning their tax liability, could grant to the international tax system a closer alignment with economic reality, and, thus, greatly improve its effectiveness and legitimacy. Although not without

⁹⁹ FA may not be an accurate indicator of a company's profits since it reduce the problem to a common denominator and may not apportion income accurately among the jurisdictions,

its own difficulties, these are minor when compared to the difficulties that it would eliminate. Since it is based on the assumption that the income of a firm is earned by the firm as a whole, the unitary approach does not attempt to identify or quantify how much of it could be earned by any of the component parts. Instead, income is apportioned by a formula using factors which quantify the actual geographical location of its activities reflecting the real economic activities in each place where they occur.

I think that formula apportionment is of great importance in the EU framework, as it may constitute an alternative to the arm 's length principle, although it cannot be assumed as the only choice for Europe, but rather as one within an array of options. For example, aiming at equal tax rates in the EU may represent another device for the prevention of the manipulation of transfer prices. In the case of uniformity of the tax rates, the companies would not have any interest in changing the source of income for tax purposes.

In this way, the solution for the EU must pass to increasing integration and uniformity as far as possible in order to achieve a fair and foreseeable taxation of corporate income.

Summing up, the introduction of a formula apportionment requires, in order to work efficiently, the integration of an economic area and great cooperation among States. The question that can be raised is whether the EU has already reached the level of integration required. The EU is not a federal State as the US and this could work as a big barrier to the shift from the arm 's length principle to a formula apportionment method in the EU.

In the light of the afore referred, the CCCTB, as a form of consolidation of a FA method, must be seen as a radical departure from the traditional ALP concept and, consequently, can cause structural effects on the way MNEs are organized within the EU. This is the topic that we propose to deal in the subsequent section.

PART V – Latest Developments

The CCCTB: solutions to transfer pricing issue in EU individual countries

1-Preliminary Background

In October 2001, the European Commission embraced a strategy for the future company tax policy in the European Union dealing with “*the fundamental concept of a common company taxation system in the form of a consolidated corporate tax base for the Internal Market.*”

¹⁰⁰According to the Commission, enterprises should, in long term, be able to reach a consolidated corporate tax base with cross-border loss relief under a single set of tax rules for their EU activities. Each of the four methods presented generally provides for consolidated taxation with formula apportionment for a long-term goal: Home State Taxation (HST), Common Consolidated Base Taxation (CCBT); a European Union Corporate Income Tax (EUCIT); and a Compulsory Harmonized Tax Base. Each system has its own benefits and drawbacks – some options may be more politically feasible than others, while others may be more economically or administratively practical than others. However, each of the methods generally provides a way for EU companies to calculate their EU group income on an EU-wide basis. Except for certain variations of EUCIT, each method also uses a formula to allocate the tax base to the Member States.

In short, we can summarize the options for obtaining a consolidated base taxation in the European Union in the following way:¹⁰¹

- According to the Home State Taxation (HST) EU companies would have the option of

¹⁰⁰ The main obstacles relating to corporate taxation were listed with the aid of a panel representing employers’ and employees’ organizations and other economic stakeholders, namely, the coexistence of 27 different systems; transfer pricing issues (documentation and double taxation/arbitration); the general lack of cross-border loss-offset; the fact that existing directives do not enough eliminate tax obstacles; double taxation problems and the inadequacies of bilateral agreements; the obstacles to reorganization and restructuring. For further details, see Common taxation in the Internal market, SEC(2011), 1681, 23 October 2001.

¹⁰¹ Weiner J M, “European Union- The European Union and Formula Apportionment caveat emptor” (2001) International Bureau of Fiscal Documentation 380, 383

computing their income for their operations located in various Member States participating in the home state tax system according to the company income tax rules of the member state where their headquarters are located (the “home” state). Under the notion of “mutual recognition” a Member State hosting investment from another member state participating in the system would agree to accept the tax rules of the home state for determining the tax base in the host member state. A different set of tax rules would apply in the EU depending on the tax base in each home state. Home state tax authorities would administer their particular home state tax system. Profits would be allocated to member states participating in the system using a common formula, where they would be taxed at local rates. Profits would be determined under current national systems for non-participating Member States.

- Under the Common Consolidated Base Taxation, (CCCTB) EU companies would have the option of calculating their income for their operations located in various Member States according to a new common EU tax base. This EU tax base would operate in parallel with existing national rules. The same set of tax rules would apply throughout the EU. The Member State where the company was headquartered would administer the common EU tax base. Profits would be allocated to all member states using a common formula, where they would be taxed at local rates.

- The European Union Company Income Tax (EUCIT) established a new EU tax base that would be developed and would operate in parallel with existing national rules. It would be optional for companies. In one form, this system could create a “federal” EU tax and a single tax authority could administer the tax, with revenues funding EU institutions and activities, or, the member states could administer the EU company income tax.

- In what concerns the Compulsory ‘Harmonized Tax Base’ (CHTB), a single EU tax base and tax code would replace national company tax systems. This EU tax system would apply to all enterprises in all Member States and the national company tax systems would disappear. Member states could administer the tax so there would be no need to create an EU-level tax

As mentioned above, these proposed methods appeared as a possible solution to the problem regarding the arm ‘ length framework. Although, the CCCTB was as *“the only systematic*

*way to address underlying tax obstacles*¹⁰² existing in companies that have associated enterprises in several countries within the internal market. Formally, the establishment of this new framework began in 2004 and in 2008 all the 27 Member States participated in a workgroup in order to create a legislative proposal for an optional directive, released in 2011¹⁰³. Up to now the proposal is still pending from the outcome of further discussions among the head of states in the Council of the European Union. The main goal of the CCCTB is the creation of economic efficiency within the internal market with all the benefits arising from it, due to the reduction of the effective tax rate, the compliance of only one set of rules and the elimination of transfer pricing and double taxation within the CCCTB.

1.1- The new CCCTB proposed scheme

This new CCCTB is the object of a Proposal from the European Commission, dated from March 16th 2011 for a Council Directive, which was released with the main purpose of tackling some major fiscal impediments to growth in the Single Market.¹⁰⁴

On a *prima facie* analysis, this European apportionment mechanism is an ambitious project, by using a complex sharing formula yet flexible when it comes to its application. Although, this is not a Commission innovation since it takes, in its attempt to reach the above mentioned goals, full use of the experience non-European tax legislations providing for formulary apportionment such as Canada and the United States. In this sense, one of the most sensitive topics the European Commission had to address in the development of the CCCTB was the uniform apportionment formula. One advice that can be taken from the US experience is that more uniformity is recommended for a European system of FA. The US formulary apportionment system suffers, for example, from different tax base definitions, differences in the scope of enterprises subject to formulary apportionment and, as shown, differences in the formulas themselves all of which result in higher administrative and compliance costs, proneness to tax avoidance, situations of double taxation or double non taxation and lead to an overall unnecessary complex system. Thus, in many experts' opinions, the uniformity of the apportionment formula has a greater priority than a sound economic justification.

¹⁰² The European Commission, Common Tax base (2008), available on http://ec.europa.eu/taxation-customs/taxation/company_tax/common_tax_base/index-en.htm, accessed on 1th September 2013

¹⁰³ COM(2011) 121/4, Proposal for a Council Directive on Common Consolidated Corporate Tax Base (CCCTB).

¹⁰⁴ See the Explanatory memorandum to the Proposal, paragraph 4

The Factors that must be chosen in the apportionment formula is of high importance since they determine the distribution of the tax base across jurisdictions. In the case of a more labour intensive country, it will receive a larger share of profits from the labour factor. Therefore, the apportionment mechanism may be regarded as a key factor, highly influential to both states and multinationals.

It can be said that, finally, Formulary Apportionment was taken into consideration. In its definition, the Commission followed W. Hellerstein description ¹⁰⁵by taking this FA as a method for determining the corporate tax base of a single company or group of associated companies attributable to a Member State by reference to a formula that assigns a proportionate share of the company or associated companies corporate tax base to the state by reference to a factor or factors that reflect (or are deemed to reflect) the underlying income-producing activities within the state.

As above referred, the main priority purpose of the CCTB is the elimination of tax obstacles to corporate cross-border activity in a single market with a view of enhancing the effectiveness of the internal market. In fact, in the light of the aforementioned, some ECJ rulings increase pressures for tax harmonization at the EU level and strengthened the determination of certain EU Member States to go ahead with proposals form Common Consolidated Corporate Tax Base.

As explained in its Explanatory memorandum, the Proposal is in accordance with the principle of proportionality and subsidiary, falling within the scope of article 115^o of the TFUE ¹⁰⁶ which stipulates those legal measures to approximate Direct tax legislation which shall vest the legal form of a Directive. Since it deals primarily with cross border issues, it requires a common approach at the Union level, namely, its approval by unanimity.

First of all, it should be clarified that this Proposal does not involve the harmonization of the tax rates since this matter continues to be a subject reserved to the tax sovereignty of the

¹⁰⁵ Walter Hellerstein "The Case for Formulary Apportionment" (2005) vol. 3 International Transfer Pricing Journal 105

¹⁰⁶ Without prejudice to Article 114, the Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.

Member States and, therefore, under the competence of the national tax legislator. The Proposal does not intend to interfere in the tax revenues of each Member State and, therefore, the impact on the distribution of the tax bases among EU Member States has been assessed. In addition, it should be noted that the harmonization of the tax base will not interfere with financial accounts.¹⁰⁷The principle associated to this method is suggested by the word “consolidated”, which is the heart of the project.¹⁰⁸In fact, this consolidation method represents the main advantage of the CCCTB scheme, benefit that is also recognized by the industry. The consolidated tax base is only shared when it is positive. A negative consolidated tax base would be carried forward at group level and be set off against future consolidated profits. Subsequently, the tax base so attributed will be taxed in the Member States where the relevant subsidiaries (or permanent establishments) are resident (or located) at the domestic corporation tax rate. Summing up, on the basis of this single tax return, the consolidated tax base of the entire consolidated group is determined. This consolidated tax base is subsequently attributed to each of the respective entities (or permanent establishments) and not between member states, in each tax year, on the basis of a formula for apportionment that will make the object of the analysis.

As illustrated above, according to the CCCTB, EU resident companies with permanent establishments in at least two Member States would be able to gather their taxable income and only have to comply with one set of rules.¹⁰⁹ This system of common rules for computing the tax base can also be applied by EU-located branches for third-country companies.¹¹⁰In abstract this could eradicate many of the existing intra community transfer price difficulties, permit cross border loss compensations and facilitate many operations that involve international restructuring

¹⁰⁷ Member States will continue to have their national rules on financial accounting and the CCCTB system will introduce autonomous rules specific for the determination of the tax base of the companies.

¹⁰⁸ To explain each of the individual elements of CCCTB. Cmon_ One single set of rules that could be applied across the EU: Consolidated-Consolidation means adding up all the profits and losses of a company/ group of companies from different member States to arrive at a net profit or loss for the whole of its activity in the EU. This would then be used to decide the final taxable base of the company or group. For example, a CCCTB group consists of companies A, B, C and D. Companies A and B have revenues equal to € 10 million each; Company C has revenue equal to €5million; Company D has a loss equal to €8 million. The consolidated tax base for this group is A + B+ C-D= € 17 million. Corporate- elating to the taxation of companies. Tax Base- the amount of a company’s profit that will be taxed. The tax base is calculated as: the company’s revenues, minus the amount that can benefit from tax exemptions and deductions such as wages and depreciation. Each Member State has a different set of rules for calculating this tax base. For example, Member State A may allow assets to be depreciated over 10 years while Member State B might allow depreciation only over 5 years. Or Member State A might allow all entertaining expenses to be deducted from profits whereas member State B might not. A single EU tax base would mean that companies only need to do their calculations in line with one set of rules.

¹⁰⁹ Commission Non-Paper to Informal Ecofin Council, September 2004: 2^a Common Consolidated EU Corporate Tax Base, [2004], p1

¹¹⁰ CCCTB Task Force, *Working paper No 60 – CCCTB : Possible elements of the sharing mechanism*, (2007), European Commission Working Group

and avoid double taxation.¹¹¹ In short: the common fiscal framework provides for the standardization of rules for the determination of each company's (or branch's) individual tax results, the consolidation of those results whenever there are other group companies and the apportionment of the consolidated tax base to each eligible Member State.

This CCCTB is an optional scheme to the entire EU cross-border corporate group in order to determine the tax base according to new common rules and, therefore, the consolidation and set-off of profits and losses respectively earned and incurred in different Member States. This optional nature will be available for companies of all sizes. Of course that for Member States, the introduction of an optional system will mean, to tax administrations, the management of two distinct tax schemes.¹¹²

The application of a uniform set of rules within the EU requires the existence of only one tax administration. Thus, under the CCCTB, the one-stop-shop system will be implemented and according to it a company opting for the CCCTB application will not be subject to the national corporate tax arrangements concerning the tax matters regulated by the common rules. In the same sense, a company that does not opt for the system provided by the CCCTB Directive will continue to apply the national corporate tax rules.

The proposal provides a set of rules regarding company taxation, by indicating who can opt (the subjective scope of application, by determining the concept of eligible companies -article 2; the concept of qualifying subsidiaries -article 54^o; how to calculate the taxable base- the principle "all in, all out" in article 55^o, and the functioning of the consolidation. In addition, it also establishes some anti-abuse rules, the definition of the sharing of the consolidated base and how

¹¹¹ Ibidem

¹¹² Whereas the Commission proposed a CCCTB which would be optional, Parliament (on 19th April 2012) proposes a CCCTB that becomes compulsory after a brief transition period, two years after the introduction of the CCCTB, five the CCCTB system becomes applicable to European companies and European cooperatives which by their nature operate across borders; 5 years after the introduction of the CCCTB, the CCCTB system becomes applicable to all companies except SMEs; and when the time comes for the Commission to assess the application of the directive, consideration must be given to whether it is desirable, worthwhile or necessary also to make the CCCTB system compulsory for SMEs and if appropriate draft a proposal for amending the directive and proposed changes, which were approved in full on April 19 by Parliament, were released in a Report on the proposal for a CCCTB on March 28, 2012. In fact, the existence of two parallel systems, due to the optional system will force tax administrations to manage two distinct tax schemes (the CCCTB and their national corporate income tax). Maybe this feature could attract more companies, although, the fact is that, for those which are already established, which practice manageable transfer pricing, this could mean a high compliance risk and administrative costs. In fact, the enterprises which generate more profit through transfer pricing are those which, in an optional system, maybe would not chose to be taxed by a global method. It can be contra argued that being shaped as an optional system represents the most proportionate answer to the identified problems, and maybe this feature could attract more companies, by not forcing the companies which do not want to go abroad to bear the unnecessary benefits.

the CCCTB must be implemented according to the “one-stop-shop” approach.

1.1.1 Key concepts

The operational profile of the CCCTB is based on three important concepts, to know: the already mentioned “one stop shop” (which means that the taxpayer is in contact with only one tax administration during all the process); the principal taxpayer (it would normally be the parent company if the resident is a Member State, which will be under the obligation of ensuring relevant administrative requirements) and the principal tax authority (which will be the tax administration of a member State where the principal taxpayer is resident for tax purposes- in the case of non EU resident taxpayer, the principal tax authority will pay the administration tax for the location of a permanent establishment).

However, the main concept is the “sharing mechanism”- a mechanism which, in essence, has many similarities with the formulary apportionment¹¹³ but constitutes a *sui generis* apportionment mechanism. Firstly, it consists in a rather complex sharing mechanism, although flexible ¹¹⁴ enough in its application in order to be adapted to specific situations or avoided in particular circumstances. In this light, the CCCTB provides an exceptional principle- a safeguard clause- that must be applied whenever the outcome of the apportionment does not fairly

¹¹³ Various possibilities for sharing have been considered by Commission Services, varying from macro-based apportionment based on factors such as gross domestic product or national VAT basis to micro-based apportionment. Reference documents such as Working Paper 47 dated 17 November 2006 (The mechanism for sharing the CCCTB, available on <http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ccctbwp47_sharing_mechanism_en.pdf>, accessed on 1st October 2013); Working Paper 52 dated 27 February 2007 (An overview of the main issues that Emerged during the discussion on the mechanism for sharing the CCCTB, available on <http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ccctbwp052_sharing_mechanism_en.pdf> accessed on 1st October 2013) , paragraph III of Working Paper 55 dated 28 June 2007 (Summary record of the Meeting of the CCCTB Working group, available on <http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ccctbwp059_summary_en.pdf>, accessed on 1st October 2013) and Working Paper 60 dated 13 November 2007 (CCCTB: Possible elements of the sharing mechanism, available on <http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/ccctbwp060_en.pdf>, accessed on 1st October 2013) reflect the extensive discussions on the complexities and challenges linked to the various apportionment mechanism systems that could have been adopted. In fact, the Commission Services founded its analysis on *The Taxation Paper* (written by Agúndez-García) and analyzing in particular the two main types of apportionment mechanisms: a macro-based apportionment and the micro-based apportionment mechanisms with both the traditional formulary apportionment and the Value Added approach.

¹¹⁴ By default, the general principle based on three elements -sales, labour and assets- shall apply. In the second stage, a certain degree of flexibility regards the application of specific rules to particular sectors of activity. Thirdly, a second degree of flexibility is introduced due to the safeguard clause, allowing the application of another sharing method, in case the apportionment mechanism institutes comes across as insufficient.

represent the extent of a business entity (article 87°).

The idea behind the sharing mechanism (as a natural consequence of the consolidation) is that companies should pay taxes in proportion to their economic presence in a country. In this light, the necessity of employing a sharing formula so to apportion the common tax base amongst the entities of a cross border group appears as a natural consequence of the consolidation, which will entail the elimination of the transfer pricing issues from the European arena. In fact, according to the Directive, intra-group transactions are neutralized for the calculation of the consolidated tax base,¹¹⁵ which can allow the evacuation of the problems connected to the transfer pricing policy. Through this sharing device, the administration is easier and the distribution of the tax base is made in a fair and equitable way and the tax competition within the EU internal market is eliminated. The sharing mechanism will apportion a share of the tax base to each entity not to each Member State. The fact is that this “sharing” is only applied in purely internal situations, namely, to the EU resident entities, PE or subsidiaries and their relationships. Instead, the relations with non- European entities will continue to apply the arm ‘s length.

Under the CCCTB, once the company’s tax base is determined, will then be shared out (apportioned) to all Member States in which the company is active on the basis of a fixed apportionment formula. The option of the Commission has been for a distribution formula based on the economic factors which are the base of the tax base of each individual taxpayer: on the supply side, the labour and capital, and on the demand side, the sales.¹¹⁶ These three factors mean that the formula draws on data which is readily available, will be difficult to manipulate and will be representative of where profit is really created in a business. The CCCTB is not about tax rates but rather the transformation, through apportionment, of the corporate income tax into direct tax under specific factors. It must also be noted that this sharing mechanism is applicable to all the taxable income including passive income, such as interest, royalties and dividends. In brief, it can be said that in the creation of this sharing mechanism, the EC adopted a wide

¹¹⁵ According to article 59°, “*profits and losses arising from transactions directly carried out between members of a group shall be ignored.*” Article 60° states that no withholding taxes or other source taxation shall be charged on transactions between members of a group.

¹¹⁶ Article 86° of the Directive.

perspective, trying to cover a large range of potential situations engendered by the formulary apportionment. Therefore, it put in place a complex formula but subject to flexibility in application in order to meet the objectives of being equitable and difficult to manipulate.

a) The Labour factor

In relation to the labour factor (article 90° and article 91°) three elements must be considered in the calculation of the share of the tax base, namely, the scope, value and location of the workforce.¹¹⁷ The main problem related to this factor is that the corporate tax is modified into a labour tax which may constitute a stimulus for the enterprises to shift part of their labour force to low tax jurisdictions.

b) The Assets element

All the three elements related to the labour factor aforementioned must be applied to the asset factor (article 95° to 96°). The ascertainment of the scope must take only into account tangible property assets. In fact, the intangible assets are excluded for practical reasons, namely, due to its susceptibility of being manipulated, its high risk of factor shifting and also the difficulty of determining its value, with all the high costs associated for the companies. Furthermore, it can also be argued that the income derived from the intangibles is already included in the formula, indirectly, through other factors. ¹¹⁸In what concerns location of this type of assets, it usually corresponds to the location of the economic owner. Notwithstanding, it can be said that the treatment granted to the intangibles is risky and this could become a major problem if the CCCTB is implemented, since many industries have their central activity in the use and production of intangibles and, therefore, their non inclusion allows a wide margin of discretion for manipulation. Insofar, it should be preferable the use of the market value calculation separated from the formula but included in the base asset valued used in the formula.

¹¹⁷ In what regards the scope, the determination of the average number of employees is made by the average of employees at the beginning of the year and at the end, including those outsourcing. In relation to the cost, it may be considered as a deductible expense in the calculation of the tax base. Regarding the location, it must be taken into account the place in which the employees exercise services. The definition of "employee" would be in accordance with domestic legislation and on a mutual recognition approach.

¹¹⁸ For example, it can be argued that income from intangibles is included within the salaries for employees who deals with intangibles; and also in the tangible assets applied in the creation of those intangibles and also the goods or services included the value of intangibles in their own value.

c) *The sales element*

As far as sales are concerned (article 95° and article 96°), they can be measured through two different ways, namely the sales of origin and the sales by destination. ¹¹⁹Under CCCTB, the sales that should be taken into account in order to ensure fair participation of the Member State are the sales by destination.

The implementation of the CCCTB proposed Directive can give rise to several controversial topics regarding litigation between taxpayers and tax authorities, as well as among tax authorities of Member States who adopt the CCCTB. In this sense, the CCCTB proposal, has established some dispositions regarding the disagreements between Member States as well as administrative and judicial appeals lodged by taxpayers.

1.2- Some controversial issues related to the application of the CCCTB ¹²⁰

There is a vast array of practical concerns that can be brought up in consequence of an effective application of the CCCTB. ¹²¹

One main issue that can be pointed out regards the omission of intangibles from the asset factor. The fact is that this, in abstract, can discourage innovation¹²²; these kind of assets are the key drivers of the enterprises so the fact it was overlooked is against the EC policy. Thus, this exclusion seems to work in favour of the Member States that produce material goods under high personnel costs and, therefore creating inequality and lack of satisfaction among the States. For instance, if a disproportional high number of innovative and service companies are established in a State the factor knowledge will play a more important role than the traditional factors of production, such as labour, natural resources and capital. This could erode a

¹¹⁹ The first one is more superfluous since it reflects the payroll and the property distribution, which may result in double taxation. In what regards the second, it would replicate the effect of value added tax and, therefore, also causing double taxation.

¹²⁰ For a deep analysis of the topic, see L. Cerioeni, "The Commission's Proposal for a CCCTB Directive: Analysis and Comment" (2011) Bulletin for International Taxation, September 2011, IBFD, p. 527 ff.

¹²¹ It must be noted that, in the final of 2011 and in the beginning of the 2012 year, the discussion around the CCCTB has intensified and therefore, at the present moment, there are a lot of alteration proposals which, if approved, are able to modify significantly the document base-the Proposal of 2011. One of the main alteration proposals, released in March 2012, is related with the repartition key of the tax base initially, the formula was based on equitable repartition (1/3) of each factor, namely the sales, the labour and the assets. The new proposal grants a lower weight to the factor sales (passing from 33, 33% to 10%) and, therefore, the weight of the other factors is enhanced to 45%. This alteration, if implemented, has a substantial importance.

¹²² This can erode a substantial share of States tax base in the case of a knowledge company is responsible for a significant part of the economic growth. In this sense, if a desproportional high number of innovative and services companies are established in a State, the factor knowledge will play a more important role than the traditional factors of production.

substantial share of States tax base, by provoking a shift of a substantial part of the States tax base to states with more traditional industries.

One main limitation of the proposal is related to the consolidated accounts that need to be filed. Since they only have to include the members of the corporate group resident in participating states, they are able to deprive the CCCTB of a key advantage of the unitary approach, by allowing MNEs to exclude, of their accounts, intermediary agents that they may recur for tax avoidance purposes, including those located in “tax havens”. In order to deal with this problem the rules included in the CCCTB rules, including those regarding transfer pricing, controlled foreign corporations, and general anti-avoidance principles played a crucial role. Maybe a better approach should be to require submission of a worldwide combined report.

Another shortcoming is related to the fairness of the formula. From the analysis of the proposal, it results that different States will benefit from different levels of advantages from the CCCTB depending on how the apportionment is constructed. In this sense, there is a high probability that the proposed apportionment will benefit the states where there is a higher staff density and a large amount of its production. It must be always borne in mind that, in a general way, all the FA, and also in this way the CCCTB as one of its expressions, may not apportioned, in an accurate way, the income among the jurisdictions in which it is earned since the formulas misattribute income by converting the tax into a multiple rate tax on the use of productive factors that enter the formula. Furthermore, the “fairness” of the introduction of the sales factor in the formula is questionable. In fact, this inclusion may bring great advantages for the countries with large markets. In this light, also the allocation of taxing right to the source state can be jeopardized by the idea of the “sales by destination” (article 96^o). In this context, it can be added a structural difficulty related to the revaluation of the assets on a continuous base.

In the same sense, in what concerns the labour factor, it can be said that this might turn the tax burden higher in jurisdiction with superior wage levels.

A further difficulty regards the estimative of loss of revenue. In what regards the compliance costs, it is not clear that the transfer pricing documentation will be reduced. Against this background, it can be argued that, actually, it only shifts the administrative burdens from the enterprises to the tax authorities that will have to adjust their domestic tax systems and establish a new one. The problem is that enterprises are, nowadays, located in more than one member

state, although they are only bind to report their income to the tax authority where their headquarters is located. This means that this authority will have to, in order to comply with the formula, share the tax base with every state which is entitled to tax its portion. In countries where a great number of enterprises are located (eg : The Netherlands) this corresponds to an additional administrative burden to the authorities that will have to divide the tax base throughout the European countries.

Another reservation that can be mentioned is related to the cooperation among tax authorities that FA required. In fact, FA is based on a strong cooperative approach, demanding information obtained from all parts of the unitary business, located in different parts. In this way, under FA tax evasion can only be avoided if the tax authorities of all the jurisdictions involved are able to check the total amount of income reported and the value of the factor situated in each country.

Furthermore, a real problem may arise from the difficulty of quantify the allocated tax base, with the associated risk of tax planning.¹²³ Furthermore, there is not a precise assessment of where the source of origin of the income is which, actually, difficult the prevention of tax avoidance. Notwithstanding this, it can be said that this could be compensated by the fact that CCCTB will mean fewer opportunities for tax planning by companies using transfer pricing or mismatches in Member States tax systems. One of the main advantages advanced by the Proposal supporters is the fiscal transparency, in the way that it will permit a more equitable and effective tax system.

Under the proposal framework, the compensation of losses within the same group is automatically considered and, therefore, some situations of great complexity can be overcome, namely the communicability issues and the transfer of losses among companies of the same group, or between branches and the company multinational accounting. On the other hand the fact is that this can contradict the internal market by creating some situations that can be against its spirit, namely, leading the investments only to big countries by allowing more opportunities of loss deduction, due to a wider tax base.

¹²³ Under FA they may shift the location of their income by altering the valuation of the apportionment factors. Since FA system takes a company on its total combined income, a company cannot shift its income from one location or subsidiary to another but it can reassign the location of its sales or alter the values of its property and payroll factors by hiring independent contractors in a low tax area to shift its factors.

A great merit that can be attributed to the CCCTB proposal is that it will, owing to FA, permit the evacuation of European transfer pricing issues, turning no longer necessary transfer prices for inter concern transaction. In fact, in what concerns transfer pricing, the groups' total profit is determined at the level of the parent, hence transfer pricing is no longer necessary for EU transactions. The non application of the independence principle within the same or between groups of societies and their branches allows, in a certain way, the elimination of tax avoidance, often achieved through the exploitation of this principle. The current complexities of interpretation and application of the OECD guidelines on transfer pricing cease to exist for EU activities. The consolidation of the tax base will allow the determination of the taxable income for the group of companies so the transaction's price will have no influence on corporate income tax paid by companies. Double taxation due to conflicting qualifications would no longer arise for EU transactions as well. Additionally, companies do not have to record transfer prices for the EU tax authorities any longer. Thus, cross-border transactions within the EU would cease to give rise to specific tax costs due to conflicting qualifications. Notwithstanding this advantage, on the other hand, it can be said that this would lead to the "tax base shifting", due to the existence of different corporate tax base rates. One important note: - there is a premise shared either by SA and FA: regardless the company is taxed under one method or another, whenever tax rates and tax bases vary across jurisdictions; enterprises always act in order to reduce their tax burden. If SA is the method applied, normally they alter the location of their income through the modification of the prices that they charge within the multinational group; under the FA taxation system, they transfer the location of their income by changing the valuation of the apportionment factors. According to the FA method, a company is taxed by taking in consideration its total combined income so; therefore, it is not able to shift its income from one location or subsidiary to another. Nonetheless it can relocate the origin of its sales or modify the values of its property and payroll factors in order to shift its factors (for instances, by contracting independent agents in lower tax areas). In the light of this reasoning, a diversion of the production allocation factors might trigger great tax saving for the enterprise: for instance, the shift of the labour factor might trigger loss tax revenues for the countries with high corporate tax base. In brief, whenever the enterprise location and the transfer of business function into Low Countries is decided with the main purpose of tax saving, this will produce a negative influence on the domestic market, which

might be concerned with losing their position as production sites. In this sense, it can be contra argued that transfer pricing problems are replaced by allocation problems. Furthermore, the problems of transfer pricing do not vanish regarding transactions with third countries.

In what concerns the safeguard clause¹²⁴, and since it's still a highly debated issue, this might justify the criticism that is appointed related to the practical rigidity of the apportionment instrument.

According to some authors ¹²⁵ (and in light of what is advocated in the Communication to the Parliament Members of several Member States-2011) the subsidiary and proportionality principle could be harmed with the CCCTB. Against this vision, it can be argued that, in the light of article 5º, nº 3 of the TFUE, the Union may intervene in the creation of a model, but is reserved to the Member States its effective application and functioning.

To sum up: it can be concluded that this method of apportioning the tax base should, first of all, pass the test of practice in order to assess whether it really complies or not with the high purposes addressed by the Commission-namely attaining a both common and consolidated corporate tax base bound to eliminate the issue of transfer pricing within the European Union

1.3 Critical approach

The protection of national tax revenue is a central issue for the financial policy of all Member States, especially for those with high level of taxation. Under these premises, the adoption of a common consolidated corporate tax base in the European Union can be used, on one hand, as an important device in order to limit the migration of tax base among countries by the practice of transfer pricing and, on the other hand, as a tool for increasing the efficiency of the corporate income tax through the simplification of the operations concerning the declaration of the profit by corporations. Its real impact on Member States and MNEs will only become clear

¹²⁴ Some argued that this safeguard clause can entail opportunity to tax planning. Due the practical rigidity of the apportionment mechanism, this can turn the effective use of the safeguard clause highly debated.

¹²⁵ P. R. Pereira, " Proposta de Directiva relativa a uma Matéria colectável comum consolidada do imposto sobre as sociedades (MCCCSIS), II Congresso de Direito Fiscal organizado pela Almedina, IDEFF e OTOC, <http://www.ideff.pt/xms/files/Iniciativas/II_Congresso_de_Direito_Fiscal/Prof._Dr.a_Paula_Rosado_Pereira.pdf> accessed 20th September 2013

when applied but, as we already took notice, in a first approach; it can identify both practical delicate aspects of the sharing mechanism that tend to deviate from the initial purposed address to it by the European Commission. Furthermore, as it deviates from the widely recognized ALP, it is probable that this will cause great anxiety towards this new method.

Despite its limitations, the CCCTB is important, since it provides a fully worked out proposal for a unitary states system as well as it helps the transition from the ALP to unitary taxation. Besides the insistence of the OECD that the ALP is the only accepting principle, it can also benefit from the considerable support of the US for a unitary approach, in conjunction with their experience over nearly a century of combined reporting for state taxation.

Summing up, it must be said that a perfect tax device must achieve one main goal: the balance between equity and efficiency. This is, undoubtedly, a difficult task since taxation, namely international taxation, involves complex cross border transactions, political decisions which, most of the times, have to opt between pure economic efficiency and national interest. Insofar, neither CCCTB nor the arm's length principle achieves this perfect equilibrium since both have their pros and cons. In fact, the arm's length principle does not provide a uniform solution to transfer pricing and, therefore, the CCCTB would probably be more suitable to a region such as the EU. Basically, formula apportionment works like a tax on each factor included in the formula. Since the Commission does not want to question the Member States' right to set the tax rate, there is still room for tax competition via the tax rates.¹²⁶ Due to the common tax base across the EU, it is no longer possible for Member States to compensate high tax rates with a narrow tax base or vice versa. The Member States compete, rather for real investments than for tax bases. In my opinion, I defend that the decision of opting for the application of an apportionment formula, instead of trying to find a fair solution suitable to all countries, should rather centre on the effectiveness of the European economy. Notwithstanding, the fact is that, in order to promote a healthy tax competition among states, the European policy must focus in the competition among the companies real establishments. For example, if the formula is entirely based on the sales factor, a competition with the VAT rates rather than a sound competition with the corporate tax

¹²⁶ It can be said that there is no need to harmonize the tax rates within the EU since tax competition between jurisdictions to attract productive capital is efficiency enhancing. Over time, corporate tax base disparities across countries are likely to diminish but will not disappear since the location of investment responds to many factors of which taxation is only one. On balance corporate taxes will tend to approximate or at least not significantly exceed the net overall benefits of each location national tax policies and administrative autonomy in tax administration can be preserved with resulting benefits,

rates, might occur. This means that, under a formula based entirely on the number of employees it may be preferable, to the Member States, to compete with the individual income tax in order to increase their staff in the country and, therefore, attract more companies. In the light of the aforementioned, it can be concluded that the best way of fostering tax competition is by enlarging the formula base: it shall rely not only on the sales, employees and assets factors but also other proper factors should enter in the apportionment formula so to allocate income according to where it is earned.

Despite its rigidity, its potential to engender unpredicted administrative costs along with the fact that it is not totally immune to strategic tax planning ¹²⁷, it is my personal opinion that the Commission's proposal of a CCCTB could be a solution to the problem of international corporate tax planning within the EU. In particular, the CCCTB eliminates the incentive to shift profits to low tax countries via transfer pricing or financing. However, the existing problems of the arm's length principle continue to exist with respect to third world and there is still room for tax competition between Member States as long as the tax rates are not harmonised within the EU. In fact, as referred above, the apportionment method constitutes the core factor in the political decision of States in supporting the CCCTB Project. To countries such as The Netherlands and Germany, only if the harmonization of the corporate tax rate in the EU takes place, the FA may solve the problems of the apportionment of income. On the other hand, France considers that the adoption of a common single tax base should be mandatory for each Member State, granting substantial advantages since the simplification would be undeniable and the tax competition more transparent.

Despite the establishment of the internal market and of the economic and monetary union, the allocation of resources and the distribution of economic activities as well as investment choices are still affected by the enduring tax barriers, which have become increasingly significant whereas other obstacles of different nature to the operation of the internal market have been removed. Under the arm's length principle, companies cannot generally consolidate profits earned in some Member States with losses incurred in others. Consequently, the result is over taxation problems (when cross border activities create liabilities that would not have occurred in a purely domestic context); double taxation (when the same income is taxed in

¹²⁷ Cristoph Spengel and Carsten Wendt , "A Common Consolidated Corporate Tax Base for Multinational Companies in the European Union: some issues and options" (2008) 07/17 Oxford University Centre for Business Taxation

more than one jurisdiction) and transfer pricing disputes within the EU, coupled with the high costs of compliance with transfer pricing formalities requirements. The fact is that, in the final, this works as disincentives for investments in the EU.

In this way, the general solution achieved by the Commission, which passes to the possibility, granted to the EU businesses, in adopting a unique common consolidated tax base as a way to determine the tax payable of their profits on an EU world-wide basis instead of the 28 national tax systems, seems to me as a suitable long term strategy in order to achieve the priorities set in Europe 2020¹²⁸ namely the smart, sustainable and inclusive growth of the EU. In synthesis the European Union is moving towards tax neutrality between national and cross border activities, which will grant the enterprises with more benefits of the potentialities of the internal mark.

The proposal is currently under consideration by the European Council.¹²⁹ In the context of the euro crisis there is now considerable political support for closer economic policy and fiscal coordination perhaps in the form of a 'euro-plus pact' to support the Euro, although this was not the initial rationale for the CCCTB (Ruding 2012). It seems that not all the EU Member States would be willing to adopt the proposal¹³⁰ but it could still proceed among a smaller growth¹³¹ Although continuing with a smaller group of states would obviously reduce the scope of applicability it might allow amendments which could strengthen the provisions. A similar decision has already been taken in respect to the separate proposal for a financial transaction tax (FTT) which was also given an impetus by the financial crisis. It is important to understand that the CCCTB could, if modified, play a major role in the fight against both major types of international tax avoidance the rise of "tax havens" and transfer pricing. The key to this would be to require all companies to do business in the states operating a CCCTB to submit a worldwide combined

¹²⁸ Communication from the Commission, "EUROPE 2010- a strategy for smart, sustainable and inclusive growth"- COM(2010)2020, 3.3.2010

¹²⁹ In a working group on tax questions: see "report by Finance Ministers in tax Issues in the Framework of the Euro Plus pact, 25th June 2012 ECOFIN 640, available on <http://register.consilium.europa.eu/pfd7en/12/st11803.en12.df>, and Working Party on Tax questions, agenda for meeting of 24th October 2012, available on <http://register.consilium.europa.eu/df/en/12/cm04821.en.12/pdf>, accessed 30th September 2013.

¹³⁰ Objections were expressed during the earlier stages by Bulgaria, Romania, Slovakia, Sweden, The Netherlands and the UK: see Preamble to the European Parliament Resolution on the CCCTB, available on <http://www.europarl.europa.eu/sides/getDocdo!pubRef=-//EP//TEXT+REPORT+A7-2012-0080+0+DOC+XML+V0//EN>, accessed on 30 the September 2013.

¹³¹ Under the enhanced cooperation' procedure, once the Council decides that a proposal could not be adopted by unanimity (which under EU rules is required for taxation measures), a smaller group of states, at least nine, could decide to use that procedure.

report.

CONCLUDING REMARKS

The future of the Europe Union is a current topic both in the international and in national sphere. The increasing global economic crisis has forced Europe to be tested in several fields. A retrospective analysis of corporate tax harmonization, in the past 50 years, does not reveal a successful story. The few achievements have taken many years to be materialized, contrasting, excessively, with the countless studies and recommendations elaborated on the theme.

Notwithstanding some experts' opinion, and following Schön's¹³² position, maybe it is time to face the fact that traditional transfer pricing under the arm's length principle auspices is in crisis in the European Union. Notwithstanding being in application for several decades, the fact is that the system has never worked in a full satisfactory way, since it is plagued by several operational and conceptual shortcomings. Furthermore, integration is increasing these difficulties since intra firm transactions assume a crucial role in the operations carried on by MNEs and financial market integration to amplify the opportunities for tax planning in profit allocating and the debt financing of capital spending.

As afore mentioned, the ECJ normally assumes that intra group transfer prices match to transfer prices among independent parties in the open market but, as we have seen, this can be easily rebutted whenever a corporate group, due to its high level of integration, behaves against third party market pricing within a firm. In fact, the business economic environment of the multinational firms grants the taxpayers good justifications to use transfer prices which divert from those engaged by independent parties. Notwithstanding this, the ECJ only holds to this reasoning in the cases when the tax authorities can prove that the non-arm's length price was applied in order to manipulate the tax base.

The answer to the question raised at the beginning of our discussion: "which is the actual framework of the transfer pricing within the European Union and where does it lead us?" has not a clear answer. On one hand, there is the option of shifting the transfer pricing control to

¹³² Schön, see supra note 53, 109 et ff.

consolidation and formula apportionment. The CCCTB is in the EU agenda, not only to the bodies of the EU institutions but also recognized authors speak, in one common voice, about the advantages of such a system as a great contributor to the construction of the European internal market, namely in the support granted to the European economic integration and to the stability of the Euro zone, revealing major importance, particularly due to the crisis that we currently face. Although, the main problem associated to this is, not only the technical aspects of the arm 's length standard, but rather the political and conceptual implications that influence in this.

Despite all the simplification implicit in the solutions brought by proposal, there are, as Professor João Sérgio Ribeiro ¹³³ pointed out, some other problems which make their adoption very difficult in the short term. Firstly, it must be debated and accepted by the Member States in the Council but, since there are some issues which coped with the tax sovereignty of the States, this agreement will certainly not be easy. Maybe the solution passes, and following the Professor's opinion, by adopting a more radical approach, namely, the method of the Single Compulsory harmonized Tax base, which, notwithstanding the problems related to the threat to tax sovereignty, could avoid tax manipulation.

¹³³ João Sérgio Ribeiro, «Tributação das Sociedades de Acordo com uma Base Comum Consolidada na União Europeia», *Estudos em Homenagem ao Prof. Doutor Alberto Xavier (eds)*, Vol. I, (Almedina 2013), pp.725-742

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