EU AND TRANSFER PRICING. TOWARD PETRIFICATION OR REVOLUTION?

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Abstract: Two EU documents important for transfer pricing were announced in 2021 and 2023. The first one is a framework of the EU's tax strategy disclosed in a document called "Communication on Business Taxation for the 21st century" published in 2021. The next one is Transfer Pricing Directive (TPD) proposal published in 2023. TPD proposes cementing current TP rules proposed by OECD decades ago. The first document contains some very significant proposals, one of which calls for the introduction of a new taxation mechanism imposed on "groups of companies "as the term is used in the document. This new tax would be based on the Formulary Apportionment Mechanism (FA) of income allocation. The article puts forward the thesis that the choice between the directive and the strategy addressed in "Communication on Business Taxation for the 21st century" will have a significant impact on the global development of TP standards and the entire global tax order. The article is to analyse the possible impact of the EU's adoption of FA approach and not petrification of ALP standard through TPD on evolving global taxation principles (which are currently based on the Arm's Length Principle - ALP). We will go on to analyze the impact of its adoption on further development with respect to ALP, potential transformation of the transfer pricing to-date model and e-commerce taxation, and, finally, the emergence of a new global system of taxation.
Keywords: EU Taxation, Transfer Pricing, Arm's Length Principle, Formulary Apportionment, International Taxation

Introduction

Taxation is one area of the law in which EU integration has been and remains inconsistent. On the one hand, the harmonization of indirect taxes is considered to have been moderately successful, but, on the other, the lack of harmonization when it comes to direct taxes is, in the eyes of many eurocrats, an anachronism—that is, a chronological misplacement--that disrupts the evolution of the EU (Wasserfallen, 2014). This correlation between the Union and income taxes results in many negative phenomena and leads to a kind of tax schizophrenia. The EU likes to present itself as a setter of solutions and a source of standards for other less advanced countries or regions. However, in terms of taxation, it is difficult to reconcile, for example, the condemnation of tax havens outside the EU and at the same time the tolerance of several Member States following such practices which, many experts believe, effectively make those countries "tax havens" (The State, 2020). The Covid crisis, however, provided a great excuse to propose fundamental changes to the EU income tax regime—proposals that have been postponed for decades. These proposed changes are set forth in a document entitled "Communication on Business Taxation for the 21st century" (Communication, 2022). This document provides both a long-term and a short-term tax vision to support Europe's recovery from the COVID-19 pandemic and to ensure adequate public revenue over the coming years. The measures set forth in the document would replace the pending proposals for a Common Consolidated Corporate Tax Base - CCCTB (Council, 2022).

The proposals set forth are of a general nature and the Commission is committed to present a full set of rules - a new framework for business taxation in the EU in 2023. There are very significant references to the principle of Formulary Apportionment method and there are also indirect references to transfer pricing, as well. The document, on page 11, states: "the Commission will therefore propose a new framework for the income taxation of businesses in Europe (Business in Europe: Framework for Income Taxation - BEFIT). BEFIT will be a single corporate tax rulebook for the EU, based on the key features of a common tax base and the allocation of profit between the Member States based on a formula (formulary apportionment). It is then suggested that the use of a formula to allocate profit "will remove the need for the application of the complex transfer pricing rules".

As would be expected, the document presents the EU proposal as a necessary step in the right direction. However, it is difficult not to ask whether this change may mean the beginning of a great tax revolution that could lead to the global replacement of the arm's length principle by the formulary apportionment mechanism and sweep away the current transfer pricing order. the European Commission published a proposal of a Directive on transfer pricing rules in the EU (TP Directive 2023). If unanimously agreed by Member States, the TP Directive would apply from 1 January 2026. The proposal seeks to harmonize the most important transfer pricing rules and establish common binding rules on specific transfer pricing matters under the framework of the OECD Transfer Pricing Guidelines. Unfortunately, this will also petrify current set of rules based on arm's length principle (ALP) and separate entity approach, making switch into alternatives impossible within EU as well as globally.

The research approach employed in writing of this document is the doctrinal research methodology, defined as the reliance on text books, articles, journals, newspaper articles as well as legislations and statutes relevant to this area.

Where Does Transfer Pricing Stand Today

As a result of the economic changes associated with globalization, the growth of multinational corporations and new technology, transfer pricing (TP) became one of the fundamental issues in global taxation and economics (De Mooij, Liu, 2020). The number of transactions between the related parties and, consequently, the scope of TP's application, is systematically increasing. Currently, according to various sources, it is estimated that between half and two-thirds of world trade takes place between related parties. TP has an impact on the allocation of revenue between the companies within a corporation and, as a result, on the budgetary revenue of the individual countries (Syromyatnikov, Dolgova, Demin, 2020). TP rules are becoming more and more complicated. I. Grinberg describes transfer pricing environment as a kind of priesthood, where subspecialists "debate arcane pricing matters using a specialized language that they found meaningful and that others left to purview" (Grinberg, 2017). This has been influenced by new forms of activity and, in particular, by the changing structure of corporate assets (from fixed assets to intangible assets), the mobility of companies transferring the location of assets, the attitude of creative corporations looking for solutions that can help minimize their tax burden, as well as the growing needs of countries interested in increasing budgetary revenues (Choi, Furusawa, Ishikawa, 2020).

The complexity of the TP issues leads to accusations that the current system is unfair, especially for the developing countries, that it favors investor's countries and puts the global corporations in a privileged position with their deeper knowledge of TP rules and tricks than the tax authorities in many countries (Brauner, 2009).

Why is transfer pricing where it is today? The current transfer pricing rules date back to the early 20th century, when, due to the international expansion of companies (mainly American but also British) tax authorities began to realize, for the first time, that companies could sell products cheaper or more expensive in countries with different tax rates in order to reduce the real rate of the tax due. This led to the creation of national standards, initially in the US, then in the UK to prevent tax loss from such practices (Farquet, Leimgruber, 2016).

For a while, transfer pricing regulations were matters of domestic law. However, in view of the growing practice of taxpayers operating in more than one country, the prevention of double taxation became an increasingly important concern. The work to address this issue was initiated by the League of Nations in the 1920s and resulted in the famous 1928 report "Methods of allocating taxable income" prepared by Prof. M.B. Carroll.

In the course of their work, researchers considered two basic approaches to the issue: (1) a mechanism to recognize each foreign entity of a corporation as an independent entity and to treat its transactions with affiliated entities as though they were also independent (this came to be known as the "Arm's Length Principle" – ALP); and (2) another mechanism based on the allocation of total revenues between companies based on certain formulas.

Because of the difficulty in developing an objective allocation formula, the researchers decided to choose and recommend the ALP. This principle was included in the proposal for the model double taxation convention drawn up by the League of Nations and then the UN and the OECD--the organization that developed ALP into a global tax mechanism by applying it first in the model tax convention and then in all its transfer pricing documents (Avi-Yonah, 2007). By the end of the 20th century, the OECD became the sole creator of global TP standards (of course based entirely on ALP), its standards are widely used around the world and there is only marginal resistance to those standards (Azam, 2017). This resistance is, moreover, effectively combated by the organization itself (Picciotto, 2018).

ALP - Blessing or Curse?

The arm's length principle requires that transactions between the related parties should be analyzed as if they were concluded by independent entities. Thus, prices (and, similarly, revenues and costs) can be adjusted to the level at which they would have been had there not been a special link or relationship between the parties (Pankiv, 2017). This solution, although logical to a great extent and widely accepted, regularly generates criticism (Sorsa, 2005). It revolves around several groups of issues including:

the general complexity of the mechanism and, in particular, the tendency to continuously increase its intricacy. Such intricacy also tends to increase compliance costs for the taxpayer and increases the risk of challenging the taxpayer's approach;

the inadequacy of the mechanism for new, emerging forms of business;

the increasingly questionable degree of fairness, leading to an asymmetrical distribution of profit between states, to the particular disadvantage of developing countries (Borkowski, 1997);

dominance of entities from the investors' countries at the expense of the countries receiving their investments and

the extreme advantage of multinational corporations relative to state tax authorities that results when the greater part of the transfer pricing process is left to the taxpayer (Sikka, Willmottill, 2010).

The widespread use of the ALP has served to make the introduction of e-commerce taxation much more difficult than it otherwise might have been (Azam, 2012). Taxpayers rightly claim that the current global tax order, based on ALP, allows them to pay taxes in the amount they do. The global tax rules emerge from the OECD model that includes network of 3000 treaties on tax avoidance (Quak, Timmis, 2018).

Despite the obvious dominance of the ALP and the high degree of petrification of TP solutions protected by the position and achievements of the OECD, there is (at least at the level of researchers' discussion) a real alternative to the ALP - the Formulary Apportionment (FA) method. The FA method first emerged at the beginning of the last century. Some federal States consider FA to be an adequate tool for distribute tax revenue amongst member states, provinces or cantons (Weiner, 2005). FA has many advantages. Once a formula has been established (which is, admittedly, difficult), its use is relatively simple. The taxpayer's risk is reduced and administrative and tax-related costs (compared ALP) are lower. FA allows other non-economic factors to be considered, including factors such as the tax-receiving country's needs (such as, for example, social needs, economic level, current budgetary situation, etc.), into the allocation formula (Grinberg, 2020). It also seems that replacing the ALP by the FA mechanism could finally lead to breaking international deadlock and lead to the taxation of the sprawling and undertaxed e-commerce income (Fair tax, 2019).

Unfortunately, as researchers generally agree, FA is not free of weaknesses (Brauner, 2014). Its main shortcoming is the difficulty of creating a universal, objective and fair allocation mechanism (formula). Each formula used would result in a different income allocation to each particular recipient. This is a conflicting factor that can lead to disputes and create a sense of injustice. There is no ideal approach, however and any solution can be perceived by some as unfair.

The EU Proposals and Its Importance for Transfer Pricing

Although there have been some attempts, the EU has not decided to harmonise income taxes. Some timid proposals have met with the resistance from both the so called "old" and "new" members (Podviezko, Parfenova, Pugachev, 2019). The previously referenced document represents an attempt to change the current status quo, within a long-term perspective therein referred to as: "the EU tax mix on the road to 2050" (Business, 2020). It stresses that "EU action on business taxation must be embedded in a comprehensive EU tax agenda" (Business, 2020). There is an expectation expressed within the document that "through a combination of formulary apportionment with a common rulebook for the tax base, BEFIT will mark an important step in building a more robust business tax system in the Single Market" (Business, 2020). There were reasons to believe that one of the EU proposals could be also fundamental to the global future of transfer pricing in general.

The current transfer pricing system is deadlocked on the ALP principle, supported by the OECD, which is very reluctant to allow alternatives (Secretariat, 2018). Currently, no single country is perceived to have the clout that would allow it to push through a change on its own and replace the ALP with another principle (Avi-Yonah, 2007). One exception to this general perception could be the USA which, in the past few decades has shown that it is not only able to stop the adoption of tax solutions globally but can also impose its own, which could be illustrated by quite few examples (Azam, 2017).

The EU could have a very significant impact on global tax governance. This is both because of the strength of the individual countries playing a major role in a global tax discourse (France, Germany and the Netherlands in particular) and also because of the phenomena, such as that described by A. Bradford, as the "Brussels effect" (Bradford, 2012) and its tax equivalent "Luxemburg effect" (Faulhaber, 2017). Thus, the introduction of the FA into a non-federation structure and its adoption by dozens of sovereign states can send a very important signal to the world that a viable alternative to the ALP is being created (Azam, 2017). On the other hand, introduction of TP Directive will petrify ALP based system.

If the FA worked well within the union, it could weaken the OECD's resistance and ignite the debate on the global dominance of the ALP. This can be of a great importance also for the future of transfer pricing. The EU document states: "the use of a formula to allocate profits will remove the need for the application of complex transfer pricing rules". Indeed, adopting the FA to a significant extent can eliminate the need for difficult-to-use TP mechanisms, and that seems to be acknowledged in discussed proposal. The EU countries may be interested in changing the current transfer pricing paradigm for both objective and subjective reasons. Objective reasons include the undoubted growing complexity of the TP, especially the tempo with which it is progressing. Changing the current rules to less complicated would relieve the tax authorities and would benefit some taxpayers (especially smaller and medium-sized companies). A subjective factor is the current set up of roles in the creation of global TP standards. The OECD is the only organization that dominates the process (although some EU countries are very active within this organization) and the EU is a passive observer of this process. This could be confirmed by the scope of work of the EU Joint Transfer Pricing Forum (JTPF) (Compare feedback obtained by JTPF from participants with respect to potential topics it should be focusing at. https://ec.europa.eu/taxation_customs/sites/taxation/files/jtpf-003-2019.pdf, p. 2 (4.05.2022).) which was established within the EU to address TP's problems. JTPF does not even attempt to create an alternative mechanism to the OECD proposals, but limits its' scope to merely analyzing and 'translating' what the OECD imposes into a practical language.

If the FA principle, with the help of the EU, were to effectively replace ALP and its complex rules with a simpler mechanism, it is conceivable that there could be pressure on the OECD to depart from the ALP's global proxies, it could start the end of transfer pricing as we now know it. Such change would be a long process and would need strong support from a globally respected institution to even begin. With its recent action, the EU has done just that. In case TP directive is adopted with ALP standard's leading role, it will make FA future significantly less promising.

Is moving Away from ALP possible?

EU choice on TP approach will be very important for the global TP future. The fact that an international organization and not any single state is behind their creation, gives them the appearance of objectivity from the taxpayer's perspective—as though they were created by a neutral institution (which the OECD is obviously not) (Salzman, 2000).

Moving away from the TP rules developed over decades will not be easy. The rules are deeply rooted in the current reality of business and administration. They offer ready-made, available solutions to current problems. Influential special interest groups would likely be determined to maintain existing practices. Thousands of TP professionals in corporations, tax offices and consulting firms make their living by interpreting and applying the existing TP rules. The advisory business appears particularly lucrative. The introduction of the new rules will not create an alternative area for advice (Heij, 2016). One must not forget about the potential stand of the global Multinational Entities (MNEs), that currently significantly affect the shape of transfer pricing solutions (Saffie, 2006). They benefit from ALP because they have central units developing TP policies. This puts the MNEs at an advantage over the tax authorities, especially in smaller and poorer countries. A taxpayer, especially a large one, can develop its own TP compliance strategies, and if those strategies are in line with OECD guidelines they are usually successful. Tax officials are generally not familiar with any given industry and often do not understand the prevailing business practices. This makes it difficult to question a savvy taxpayer's tax plan. The previously discussed proposal refers to the FA model only for the EU settlements (which is obvious at this stage). However, those companies doing business in the EU almost always operate outside this area. Will there have to be a two-tiered reporting system if the proposal is implemented? Will there be one reporting regime that follows the classic OECD model and another for the EU according to the FA mechanism? This would be costly and inconvenient, although there are cases where MNEs have reported the same information in different formats (e.g. Foreign Account Tax Compliance Act - FATCA) (Gadzo, Clement, 2017).
Previous e-commerce tax attempts have been effectively blocked by industrial companies (mainly from the US) and many governments, including the USA, Sweden and Ireland. These countries protected their interest at others' cost. Any proposed change would allow one party to gain, another to lose. Replacing ALP with FA would potentially generate revenue for countries that currently do not receive tax revenue from e-commerce. However, it could also deprive tax havens of revenue if taxpayers decide that there is no longer any benefit from locating their assets those countries.
Whether it would be possible to introduce a version of FA that actually result in the fair taxation of such taxpayers, despite strong opposition remains to be seen. The OECD is busy working on its' own proposal, but that effort is plagued with delays. Nevertheless, it is expected that the introduction of an FA solution in the EU will strengthen the argument for a global e-commerce tax based on such a formula. Support from the OECD will be critical. That organization launched and bravely defended ALP, but it appears that the OECD has become pragmatic and has recently been giving signals that it is ready to change its approach to achieve a higher goal– the e-commerce tax. The willingness to change is suggested by a number of small signals like the one expressed in a recently released report: "the current context of the COVID-19 pandemic makes the need for a solution even more compelling, than when it was first considered" (Tax Challenges, 2020). Further, OECD is currently examining a model based on a " fixed rate of return on base-line marketing and distribution activities intended to approximate results determined under the arm's length principle" to be adopted globally (Cover Statement, 2020).
Supporters of FA as a global solution to the TP hardship will be augmented by the EU as one common organization as well as by at least some of its members (interested in an effective e-commerce tax solution, for example, the Czech Republic, France, Italy, Austria,

that had already tried to launch their domestic e-commerce tax) (Asen, 2021). It can be also assumed that the developing countries will be content to see the EU development and will provide support for FA for the same reason. These countries are not able to effectively impose an e-commerce tax and are also aware that the costs associated with administering a TP regime are considerable and the effects are not always satisfactory. EU politicians and eurocrats, in particular, will express strong support for the new mechanism because the proposal, as it stands, would go a long way toward fulfilling Brussels' desire for more centralised taxing authority. It would be they who would be charged with creating the formula for dividing the tax among the states—they may also very well appropriate funds from that tax revenue to help cover the expenses of the whole union bureaucracy.

Agreeing the FA formula will not be an easy task and it will certainly require a great deal of diplomacy and determination on the part of the MEPs to impose the final outcome on member states (Chiti, 2011). Once developed, however, the formula could serve as a model for a global standard (possibly after some adjustments). Bottom-up development of a single global formula seems much more challenging than the use of the EU model, which, once adapted, could serve as a global model. This was noted in the aforementioned document: "A consensus on the reform of international corporate tax rules will constitute a historic step forward towards the modernization of global business tax rules"(Business, 2020).

The EU's draft introduction of the FA is more likely to succeed than the solutions proposed in Pilar I by the OECD, as it needs to be administrable between almost 140 jurisdictions (Harris). Nevertheless, any further steps in the global FA promotion would require an organization that could oversee the implementation of the FA globally - not only developing a formula but also reception strategy, monitoring progress, and supervising the collection and distribution of the tax itself. EU notes: "the forthcoming global agreement will mark a decisive step forward in the reform of the international corporate tax system, addressing the important challenges related to the allocation of taxing rights and minimum effective taxation at global level. At EU level, we must build on this progress and take forward a similarly ambitious business taxation agenda" (Business, 2020). Brussels, as the force behind the FA solution, will be well placed to lead such a global effort.

Some scholars suggest that the creation of a completely new tax organization would be a challenge beyond our current capability (Rixen, 2011). However, replacing ALP with FA, changing the entire TP paradigm and implementing a global e-commerce tax could have such a significant impact on global tax governance that the existence of an efficient, reliable organization would be an important key to success.

Even with a procedural organization in place, it is important to secure the appropriate technology to support the function of the FA mechanism. This is critical to the obtaining of data from taxpayers, as well as the verification of that data, tax collection and distribution, and the technical tools for monitoring the entire process in order to determine the tax base and ensure efficient collection. It is currently possible from a technological standpoint to collect and process the needed data (Malinowski, Tomkiewicz, 2015). "Block chain" technology also offers great potential (Heij, 2016). By undertaking its own project, the EU will be the first government entity with the needed technological support in place.

Conclusions and De Lege Ferenda remarks

As we have shown, the EU proposals could be a true break-through in the development of a global tax regime—not only from the perspective of the EU, but also from that of the individual Member States and, on a broader international level, for the further development of international tax cooperation. In the longer term the proposal could very well help the progression toward the formation of the global tax governance. Moreover, it is very likely that this project will be fundamental to further development of the TP regulations. The introduction of FA and the demonstration that this mechanism eliminates the need for complex rules under the ALP principle should start the process of slowly moving away from this century-old mechanism.

Because any agreed formula may be in force for years, its impact on national revenue ought to be fully examined. This process should also address the changes that countries will face as a result of its use. Since it can be assumed that the EU model will be an example for further work at global level, the EU member states are in a privileged position (Hoff, 2013). By participating in the work of the EU they will influence not only the formula used within the EU itself but could also exert great influence on the particulars of any global solution. Replacing ALP with FA will mean a change in the basic principles of TP and, practically speaking, a redesign of the entire tax order. Today there are no answers to questions about who would carry out such a task and under what conditions, although as Professor E. Chiti at Universita Degli Studi Della Tuscia, Viterbo, Italy, notices: "global legal space is characterized by the existence of administrative bodies that are autonomous or fully independent from the member states governments" (Chiti, 2011).

Finally, the EU proposal allowing FA could very well be instrumental in the development of a global allocation formula and oversight of tax collection. Such a turn of events would force countries to actively participate in the development of formulas and mechanisms, lest they put themselves in the position of passive beneficiaries of the new deal (Christensen, Hearson, 2019). For all states, this will be an important challenge that requires answers to the questions of what elements of the formula might be beneficial or disadvantageous for them.

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