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# TRANSFER PRICING REGULATIONS IN SELECTED EUROPEAN COUNTRIES

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***Abstract:*** *Transfer pricing is turning into a focal point of tax authorities of every country, as a result of expansion of multinational corporations and modern business conditions. The objective of this article is to contribute further insights into similarities and differences between transfer pricing practices. Therefore, we shall attempt to examine transfer pricing policies in selected European countries and determine future trends of this complex issue. We limit our research just on European countries that are also OECD members.*
***Key words:*** *transfer pricing, methods and rules, European practices, comparison*

## 1. INTRODUCTION

After the period of the Second World War, a great growth of big and modern companies and conglomerates, as well as their diversification, was noted. These complex business systems are vertically integrated, consisting of smaller or bigger independent profit centres. Greater level of centres' autonomy implies a monopolistic or monopsonistic policy to be adopted and used by some profit centres. Thus they try to increase their own profit at the expense of other profit centres, but such actions can cause the decrease of profitability and efficiency of the whole company.

The problem becomes more complex in the terms of geographically dispersed companies – multinational corporations with dislocated parts that operate according to different tax rules and regulations. Under these circumstances, it becomes obvious that managers of multinational corporations strive to shift profit from high-tax countries to the branches that operate in the low-tax countries.

The most common practice of mentioned tax leakage is through manipulation with transfer prices. "A transfer price is the internal value assigned to a product or service that one division provides to another. The transfer price is recognized as revenue by the division providing goods and services and as expense (or cost) by the division receiving them." (Morse et al, 2002). Tax authorities of every country try to protect its tax interests by designing transfer pricing regulations and methods that would in the long run prevent unacceptable allocation of profit, i.e. imply optimum value for tax assessment.

## 2. THEORETICAL FRAMEWORK OF TRANSFER PRICING

Acceptable transfer price would be the price assigned according to the existing price on a free, open market in comparable transaction between independent subjects. But, the problem sometimes occurs when there is no external market with similar transactions, or when the market is imperfectly competitive. Under such circumstances the arm's length principle is preferred (Sekulic Grgic, 2005), according to which efforts are being made to determine a price agreed between independent subjects within a same or comparable transaction. Besides, managers should always have in mind a general formula to set a lower limit for a transfer price and its definition is "the price should be equal to the unit variable costs of the good being transferred, plus the contribution margin per unit that is lost to the selling division as a result of giving up outside sales" (Garrison, 1991).

Two main groups of methods are established in theory, and used in practice:

- transaction-based methods and
- profit-based methods.

The first group of methods is more "traditional" as it determines the transfer price for each transaction, while the second group is more "controversial", because it requires a detailed functional analysis.

### 2.1 Transaction-based methods

This group of methods is mainly applied to tangible property. It comprises:

- the comparable uncontrolled price (CUP) method,
- the resale price method (RPM) and
- the cost plus (CP) method.

CUP method compares the prices of transactions effected between related parties, i.e. within the group (subsidiaries or associates) with the prices of same or similar transactions between independent enterprises in comparable circumstances.

RPM determines the price of transaction between related parties by taking the price at which the same transaction is resold to an independent enterprise. That resale price is reduced for gross margin and eventually corrected for the costs associated with the purchase of the product, thus the balance incurred is the arm's length price.

CP method calculation is based on the costs sustained by the supplier in a controlled transaction. The mentioned costs are increased for gross profit that may be incurred within existing market conditions and thus an acceptable transfer price is obtained.

It is obvious that the first method is product comparable, while the rest two are functional comparable. However, all three of them have a common disadvantage which occurs when there's the lack of arm's length comparables. Underneath this problem is mostly absence of external market price, but also lack of required information.

### 2.2 Profit-based methods

This group of methods was established as a supplement to transaction-based methods, i.e. an attempt to eliminate their disadvantages. It comprises:

- the profit split method (PSM),
- the transactional net margin method (TNMM) and
- the comparable profits method (CPM).

PSM splits gross profit, i.e. operating profit under certain circumstances, between related parties in a controlled transaction on an economically valid basis. The associated part of the profit is added to supplier's cost and acceptable arm's length price is obtained.

TNMM compares net profit margin with selected base (most commonly the costs, sales, revenues, assets, capital etc.), and the obtained ratio is compared with the same ratio in independent enterprises.

Application of CPM is not recommended in OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration (Zgombic, H., Ed., 2005), since this method is focused on profit level indicator / net profit margin of just one of the two related parties – tested party. The selection is often made on the basis of data available. In the long run net profit margin is compared with interquartile range of the unrelated firms and consequently the arm's length price is ascertained.

## 3. ADOPTED APPROACHES IN THE PRACTICES OF THE SELECTED EUROPEAN COUNTRIES

Regardless the attempts at obtaining common regulation by OECD most governmental taxing authorities have specific transfer pricing regulations that dictate acceptable methods. Further in this paper we have attempted to explore and compare acceptable transfer pricing methods in 19 chosen European countries (Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Poland, Portugal, Slovak Republic, Spain, Sweden, and United Kingdom) that are also OECD members.

The starting point for comparison was OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which outlines the current methods for pricing intrafirm transactions in goods, services and intangibles. Namely, there is no general view on whether there is a hierarchy of methods, but a CUP is generally seen as preferable if available. Transaction-based methods are generally preferred; profits-based methods are now more widely acceptable and are increasingly seen as on a par with traditional methods.

Research results indicate that 13 out of 19 countries, i.e. some 68% evidently prefer transactional methods which, as such, have been implemented in the regulations. They quote simple application of transactional methods and their compliance with OECD's Transfer Pricing Guidelines as the prevailing element when giving clear preference to the mentioned methods.

In countries such as Austria and Ireland OECD's transfer pricing methods are recommended, but they are not implemented in the regulations. Nevertheless, despite the differences observed in transfer pricing regulations in 19 selected countries the arm's length principle, as set out in the OECD's Guidelines, is practically always the starting point (Fris & Gonnet, 2006). The exceptions are countries such as Finland, Hungary, Luxembourg and Netherlands, because their tax authorities do not prescribe a specific pricing method.

All the countries, giving clear preference to transactional methods and following OECD's Transfer Pricing Guidelines in their legal regulations, have also implemented profit based methods, i.e. TNMM and PSM. Application of profit based methods, however, is to a certain extent limited. Use of profit based methods in Czech Republic and Greece must be substantiated.

Under the new law in Germany (effective from 1 January 2008); the application of the transfer pricing method is dependent on the availability and quality of third-party comparable data. Three different situations are distinguished:

- full comparability of the data,
- limited comparability of the data and
- non-availability of third-party comparable data.

When full comparability of third-party data exists, the new stipulates the priority of the traditional transaction methods. If limited comparability of data is available, the taxpayer has to select an appropriate transfer pricing method to determine the transfer price. If no comparable data is available, a „hypothetical arm's length price" determination applies.

In Hungary and Spain any other method may be applied if the traditional transaction methods (CUP method, RPM and CP method) are not applicable. Finally, we emphasize the case with Italy, which within profit based methods accepts PSM and CPM that is not accepted by the OECD, as well as two completely new methods: Economic Sector Gross Margin and Invested Capital Profitability. However, according to the Italian transfer pricing rules (particularly the 1980 Circular Letter) the profit-based methods could be used:

- when it is impossible to use three basic methods,
- when uncertainties arise in verifying the correct use of the three basic methods and
- when it is necessary to separate the differential element between two transactions which are susceptible to comparison in order to use one of the tree basic methods.

## 4. CONCLUSION

The research carried out in 19 European countries has shown that even though transfer pricing legislation may differ from one country to another, the starting point of chosen transfer pricing policies at all times is the arm's length principle. Although easily understandable in theory, the arm's length concept triggers considerable application difficulties. Practice shows that commonly used transfer pricing methods may not be the best practice and that the inherent difficulties of applying the arm's length principle can result with sub-optimal transfer pricing systems.

In response to difficulties produced by application of traditional transfer pricing alternative approaches have been emerging in Europe. Among them the most interesting is Relational Arm's Length (ReAL) transfer pricing. It is a toolset that enables the definition of transfer prices that are consistent with both tax and business objectives. This approach can notably be used in European context, aiming on designing a better application of the described transfer pricing methods and implementing more rational transfer pricing policies. In this paper we try to make a contribution to the understanding of existing European transfer pricing practices and provide guidance for the future research in the case of Croatia.

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