

# The EC Transfer Pricing proposal: an initial Legal Assessment

Pasquale Pistone, João Félix Pinto Nogueira, Sergio Messina, Alessandro Turina and Ivan Lazarov<sup>1</sup>

## Summary

This study presents a preliminary legal evaluation of the proposed Council Directive on transfer pricing in the European Union (EU). The authors express their appreciation for the EU Commission's ambitious initiative, which seeks to address disparities and distortions in tax competition across national legislation. However, they identify areas where improvement is still needed to promote legal and tax certainty and simplify compliance, thereby enhancing the effectiveness of the proposed Directive. Consequently, the authors suggest further work in specific domains to achieve the objective of positive integration.

## 1. Introduction

This study aims at providing a first legal assessment of the proposed Council Directive on transfer pricing [the proposed Directive],<sup>2</sup> which endeavours to integrate key transfer pricing principles into EU law. The authors analyse the proposed Directive from a three-fold perspective: the need to comply with the general principles of EU law; the need to coordinate with other secondary tax and non-tax legislation; and the need to align with the international tax framework.

The structure of this paper mirrors the one of the proposed Directive, and thus, after presenting the context against which the directive was adopted (section 2.) it examines in turn: first, the obligation to apply the arm's length principle, its definition, as well as the definitions of the different concepts needed for its operation. As such, section 3. focuses on the harmonisation of the arms' length principle, its essential elements and deals with the adjustments (covering both corresponding and compensating adjustments). Second, section 4. covers the core elements for applying the arm's length principle (analysing the methods and the rules regarding documentation). Third and finally, section 5. addresses the proposed mechanisms to adopt further rules on this subject matter, with particular emphasis on the proposed attribution of delegated powers to the Commission.

## 2. Context – State Aid Decisions

There has been a growing global concern for the use of transfer pricing rulings by tax authorities to grant tax benefits to multinational enterprises. In general terms, transfer pricing

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\* Prof. Dr Pasquale Pistone is Academic Chairman at IBFD, Professor of Tax Law at the University of Salerno (Italy) and at WU Vienna (Austria), Honorary Professor at Ural State Law University (Russia) and the University of Cape Town (South Africa), and Honorary Doctor at the University of Örebro (Sweden). Prof. Dr João Félix Pinto Nogueira is Deputy Academic Chairman at IBFD, Professor of Tax Law at Universidade Católica Portuguesa, Honorary Associate Professor at the University of Cape Town (South Africa) and member of the research centre CEID-CRCFL – Catholic Research Centre for the Future of Law. Dr Ivan Lazarov is a Research Associate at IBFD. Dr Alessandro Turina is a Principal Research Associate at IBFD and visiting lecturer at Bocconi University, Milan (Italy) and at the University of Fribourg (Switzerland). Dr Sergio Messina is a Research Associate at IBFD. The authors can be contacted at [academic@ibfd.org](mailto:academic@ibfd.org). The authors would like to thank Prof. Dr. Craig West for his thoughtful comments and efforts towards improving this contribution.

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<sup>2</sup> European Commission, Proposal for a Council Directive on transfer pricing, COM(2023) 529 final (12 Sept. 2023), available at [COM\\_2023\\_529\\_1\\_EN\\_ACT\\_part1\\_v7.pdf \(europa.eu\)](https://eur-lex.europa.eu/legislation/summaries/com_2023_529_1_en_act_part1_v7.pdf) [hereinafter the proposed Directive].

relates to the conditions agreed for transactions between associated enterprises, also known as intragroup transactions. Transfer pricing is also used for setting the conditions agreed for internal dealings between head offices and permanent establishments.

Currently, the prevailing view across the globe is that the international tax implications of transfer pricing should abide by the arms' length standard. This standard also sometimes referred to as "principle",<sup>3</sup> requires that transactions between related entities of a multinational group be priced on the same basis as transactions between non-related parties under comparable circumstances.<sup>4</sup> To improve legal certainty, businesses often agree the appropriate pricing and/or methodology in advance with tax authorities, and the outcome of this agreement is framed within administrative rulings. Several tax rulings on transfer pricing have been questioned as to their consistency with the arm's length standard or other related matters, most prominently in the investigations undertaken by the European Commission to verify whether such rulings would amount to prohibited state aid.

According to the EU Commission, "the arm's length principle [is] *inherent* in Article 107(1) of the Treaty".<sup>5</sup> Moreover, the "arm's length principle necessarily forms part of the Commission's assessment of tax measures granted to group companies under Article 107(1) of the Treaty independently of whether a Member State has incorporated this principle into its national legal system and in what form".<sup>6</sup> Furthermore, the EU Commission considered that the OECD TP Guidelines could be seen as an appropriate expression of the arm's length principle. In the words of the Commission, "[w]hen examining whether a transfer pricing ruling complies with the arm's length principle [...] the Commission may have regard to [...] the 'OECD Transfer Pricing Guidelines'".<sup>7</sup>

The absence of tax harmonisation on transfer pricing has brought the EU Commission to conduct its investigations on State Aid with a notable insight of domestic law. In particular, the EU Commission had to bring evidence of the relevance of arm's length in each country involved as well as the existence of a different interpretation of such standard by the scrutinised ruling, as compared to that which would have otherwise applied.

This line of reasoning has been rejected by recent case law of the CJEU. The most recent decision was adopted on the 14 December 2023, in the *Amazon* case.<sup>8</sup> In particular, the CJEU rejected the Commission's appeal against the General Court's judgment, which had annulled the Commission decision that had declared the administrative ruling issued by the Luxembourg tax authorities to Amazon as prohibited State Aid. The CJEU's judgment was in line with its prior case law, ever since the *Fiat* case.<sup>9</sup> According to the Court, "the arm's length principle can only be applied if it is recognized by the national law concerned and in accordance with the detailed rules defined by it".<sup>10</sup> In fact, "as EU law currently stands, there is no autonomous arm's length principle

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<sup>3</sup> Although the configuration of the arm's length standard as a "principle" can be questioned from a conceptual perspective, this study will use the two expressions, considering the EU Commission (followed by the Court of Justice) has expressly used this terminology in its international tax practice and documents.

<sup>4</sup> See further section 3.2.3.

<sup>5</sup> European Commission, *Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union* (2016/C 262/01), para. 173, Primary Sources IBFD.

<sup>6</sup> *Id.* Para. 172.

<sup>7</sup> *Id.* Para. 173.

<sup>8</sup> LU: ECJ, 14 Dec. 2023, Case C-457/21 P, *European Commission v. Grand Duchy of Luxembourg, Amazon.com Inc, Amazon EU Sàrl*, Case Law IBFD.

<sup>9</sup> LU: ECJ, 8 Nov. 2022, Case C-885/19 P, *Fiat Chrysler Finance Europe, Ireland, Grand Duchy of Luxembourg v. European Commission*, Case Law IBFD.

<sup>10</sup> *European Commission v. Grand Duchy of Luxembourg, Amazon.com Inc, Amazon EU Sàrl* (C-457/21), para. 42.

that applies independently of the incorporation of that principle into national law to examine tax measures in the context of the application of Article 107(1) TFEU”.<sup>11</sup>

These cases gave the Court an opportunity to clarify its position on the role and relevance of the OECD TP Guidelines for EU law. In fact, “even assuming that there is a certain consensus in the field of international taxation”<sup>12</sup> on the arm's length standard, and although “many national tax authorities are guided by the OECD Guidelines in the preparation and control of transfer prices”,<sup>13</sup> “it is only the national provisions that are relevant for analysing whether particular transactions must be examined in the light of the arm's length principle and, if so, whether or not transfer prices, which form the basis of a taxpayer's taxable income and its allocation among the States concerned, deviate from an arm's length outcome”.<sup>14</sup> Accordingly, “[p]arameters and rules external to the national tax system [...] cannot [...] be taken into account in the examination of the existence of a selective tax advantage within the meaning of Article 107(1) TFEU and to establish the tax burden that an undertaking should normally bear, unless that national tax system makes explicit reference to them”.<sup>15</sup> Hence, the Court has consistently ruled against the Commission’s assertion that the arm’s length principle is inherent in Article 107 TFEU and has instead always used the domestic legal framework and its incorporation of the arm’s length principle as a frame of reference. However, a theoretical possibility exists for the European Commission to apply the *Gibraltar*<sup>16</sup> line of reasoning if, in exceptional cases, the totality of the domestic TP framework creates a systematic advantage for MNEs.<sup>17</sup>

The interpretation provided by the CJEU, in both *Fiat* and *Amazon*, reinstates the relevance of the principle of legality for matters of taxation. In confirming this approach, the CJEU sets a limit to the open-ended growth and relevance of international soft law developed under the auspices of international organisations, besides instances where such soft law is formally translated into hard law, either on the international or domestic settings (e.g. by the adoption of domestic rules inspired by model rules agreed upon in an international framework).

Positive integration and explicit inclusion of the arm's length standard as an EU law norm overcomes such limitations, and any future deviations may be assessed merely against the standard adopted in the proposed Directive.

These developments constitute a background that, although essential for a proper understanding of the context of the proposed Directive is not mentioned by the Explanatory Memorandum, which emphasizes how the Directive “aims at simplifying tax rules through increasing tax certainty for businesses in the EU, thereby reducing the risk of litigation and double taxation and the corresponding compliance costs and thus improve competitiveness and efficiency of the Single Market”.<sup>18</sup>

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<sup>11</sup> Ibid. See to that effect, LU: ECJ, 8 Nov. 2022, Case C-885/19 P, *Fiat Chrysler Finance Europe, Ireland, Grand Duchy of Luxembourg v. European Commission*, Case Law IBFD, para. 104.

<sup>12</sup> Id. para. 96.

<sup>13</sup> *Ibidem*.

<sup>14</sup> *Ibidem*.

<sup>15</sup> *Ibidem*.

<sup>16</sup> UK: CJEU, 15 November 2011, Case C-106/09 P, *Commission and Spain v Government of Gibraltar and United Kingdom*, Case Law IBFD.

<sup>17</sup> The Court has already hinted to that in *Fiat*: see LU: ECJ, 8 Nov. 2022, Case C-885/19 P, *Fiat Chrysler Finance Europe, Ireland, Grand Duchy of Luxembourg v. European Commission*, Case Law IBFD, paras. 70 and 122. See also S. Buriak et al., *Between State aid and the fundamental freedoms: The arm's length principle and EU law*, 56 *Comm. Market Law Rev.*, 4, p. 914 (2019).

<sup>18</sup> See Explanatory Memorandum of the proposed Directive, p. 3.

### 3. The arm's length principle

#### 3.1 Article 1 - Subject matter

Article 1 sets out the *Subject matter* of the proposed Directive. It stipulates that the proposed Directive “lays down rules to harmonize transfer pricing rules of Member States and to ensure a common application of the arm's length principle within the Union”.<sup>19</sup>

The arm's length principle is an international recognized standard which, however, is not implemented uniformly in different jurisdictions around the globe, and namely within the EU Member States.

The wording used by the proposed Directive appears to focus solely on its operation within the EU or, following the wording of the proposal, to “ensure a common application of the arm's length principle *within* the Union” [emphasis added]. If, on the one hand, this appears coherent with the nature of a Directive as EU secondary law which applies to Member States, on the other hand, it might not prevent the adoption of different rules for transactions with third countries. Moreover, if the third-countries transactions treatment is to the detriment of the latter, such discrimination will scarcely be addressed by the Court in framework of the free movement of capital and payments (which also applies to the relations with third countries), since TP rules apply mostly to cases that would also constitute definite influence for the purposes of delimiting the scope of the free movement of capital.<sup>20</sup>

Therefore, we suggest that the provision is amended to cover not only intra-EU situations but all instances of application of the arm's length principle by the Member States, of course, subject to limitations that might stem from existing Double Tax Treaties with third countries. To achieve this result, Article 1 might be amended to read: “This Directive lays down rules to harmonise transfer pricing rules of Member States and to ensure a common application of the arm's length principle *by the Member States, taking also into account the existing international obligations of the Member States with third countries.*” [emphasis added]

Absent such changes and insofar as there is the slightest deviation from the international standard, the proposed Directive poses the risk of leading to an overall asymmetry in the worldwide application of the standard. For instance, the authors note that the proposed Directive has explicitly discarded the option to “follow the UN developed definition of the arm's length principle and Guidance”, which some third countries may prefer over the OECD version.<sup>21</sup>

Furthermore, although the Commission has discarded the option of developing “an EU arm's length principle with subsequent EU-origin guidance”,<sup>22</sup> and has expressed an explicit intention to implement the OECD arm's length principle and its guidelines in EU law,<sup>23</sup> the proposed Directive sets out its own definition of ‘arm's length principle’,<sup>24</sup> which seems to not align (at least in its entirety) with the OECD one, as the authors will address infra. This begs the question of whether such option does not risk paving the way for an interpretation that is not completely in line with the OECD TP Guidelines.

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<sup>19</sup> The same goal is formulated similarly in recital 5 of the Preamble to the proposed Directive.

<sup>20</sup> Whether or not domestic law of EU Member States might allow for such different treatment, it will become a matter to address from the perspective of the principle of equality.

<sup>21</sup> See the Impact Assessment, p. 36, letter iii).

<sup>22</sup> See the Impact Assessment, p. 36, letter i).

<sup>23</sup> Id. p. 60.

<sup>24</sup> See Art. 3(1) of the proposed Directive.

As discussed further in section 3.3.2., within the Union, a directive would override applicable tax treaties. Hence, on the one hand, any deviation would require Member States to adjust their treaties, following the principle of sincere cooperation. On the other hand, however, it must be noted that the proposed Directive also sets out rules that are applicable in third country scenarios.<sup>25</sup> Therefore, the proposed directive would allow two different approaches; one for intra-EU transactions and one for transactions involving third-countries. Asymmetry between the two may yield damage to the internal market along with EU based MNEs and increase complexity.

In the authors' view, to avoid this risk, instead of an autonomous definition, the proposal could either copy the wording of the TP Guidelines, or simply make a *renvoi* to the relevant paragraphs. The former option might better operate in a context that would characterise them as sources of technical inspiration for the content of the proposed Directive; the latter might be more complex to reconcile with the position held by the CJEU on soft international tax law.

Moreover, it would be good to clarify that the goal is not to merely harmonize TP rules within the Union, but also to align such rules to the international recommendations in this area as conveyed by the internationally agreed international standard OECD TP Guidelines. Still, however, more consideration should be given to whether a global topic such as TP should be addressed at the EU level or whether global solutions would be preferable, especially in the light of issues which may arise with respect to third countries when the EU approach fails to align with the international one,<sup>26</sup> and when developing countries do not follow the OECD approach.

### 3.2 Article 2 - Scope

Article 2 stipulates that the proposed “Directive applies to taxpayers registered in, or subject to, tax in one or more Member States, including permanent establishments in one or more Member States”.

Since it reads “in one or more Member States” rather than in two or more Member States, at first glance it would cover both the domestic and the cross-border framework (i.e. covering purely domestic and cross-border situations). However, when one looks at the specific obligation imposed under Article 4, it becomes clear that the obligation to transact at arm's length applies to cross-border situations only. This is further confirmed by the very first sentence of Recital 1 that reads: Transfer pricing refers to the setting of prices for *cross-border transactions* between associated enterprises within an MNE group [emphasis added]. Although it must be noted that this statement is not technically correct as a number of Member States apply transfer pricing also to purely domestic transactions,<sup>27</sup> nevertheless it serves to outline the cross-border focus of the proposed Directive.

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<sup>25</sup> See Art. 6(1)(c) of the proposed Directive.

<sup>26</sup> See *Regeringskansliet Faktapromemoria 2023/24: FPM9*, p. 1, available at <https://www.regeringen.se/faktapromemoria/2023/10/202324fpm9/>. With regard to the legal nature of the OECD TP Guidelines, case law from OECD Member States seems to convey that said Guidelines are regarded as international recommendations providing guidelines on the application of the arm's length standard rather than having a binding nature, see in this respect, inter alia, *SNF (Australia) Pty Ltd v Commissioner of Taxation* [2010] FCA 63 as well as the considerations further developed in section 5.1.1. *infra*. With regard to the related but distinct issue of the relationship between the OECD TP Guidelines and tax treaty interpretation, see M. Kobetsky, *The Status of the OECD Transfer Pricing Guidelines in the Post-BEPS Dynamics*, 3 Int. Tax Stud. 2 (2020), Journal Articles & Opinion Pieces IBFD.

<sup>27</sup> S. Buriak et al., *Transfer Pricing Rules under the ECJ's Scrutiny: Green Light for Non-Arm's Length Transactions?*, 25 Intl. Transfer Pricing J., 5 Table 1 (2018), Journal Articles & Opinion Pieces IBFD.

Such an interpretation of the objective scope is also in line with the subjective scope as defined in Article 3(17), which clarifies that MNE group means multinational enterprise group of associated enterprise “in two or more jurisdictions”. What remains unclear is how the proposed Directive relates to taxpayers that are non-MNE groups because they are established in only one Member State or to the MNE transaction between entities located in the same Member State. It may be the case that, as with the Pillar II directive,<sup>28</sup> the rules have to be extended to internal situations, to avoid infringement of the EU fundamental freedoms. We will further expand infra, when addressing Article 4 of the proposed Directive.

### 3.3 Article 3 - Definitions

#### 3.3.1 Arm's length principle

Article 3(1) contains the most important of the 19 sets of definitions of the proposed Directive: the definition of ‘arm’s length principle’. Remarkably however, it significantly diverges from Article 9 OECD MC.

In particular, the definition contained in the proposed Directive uses the term “transact” differently from the OECD MC, which refers more broadly to “commercial or financial relations”.<sup>29</sup> Furthermore, the reference to “(open) market forces” brings little added value to the conditions that would be agreed between independent parties. Such expression is included in neither Article 9 OECD MC nor in the OECD TP Guidelines. Moreover, it is currently not used in any provision contained in the proposed Directive and therefore it makes little sense. And this is not due to absence of opportunities: Article 11(2)(d) of the proposed Directive, on the comparability analysis refers only to “the market in which the parties operate”.

From a technical perspective, it might make sense to improve and clarify the wording. However, one could argue that the outcome should not necessarily bring the EU notion of arm's length principle to completely align with the OECD’s international standard. The consistent CJEU case law clarifies that a concept that appears in a provision of a directive that does not contain any reference to domestic law must be regarded as an autonomous concept of EU law and interpreted uniformly throughout the European Union.<sup>30</sup>

In this sense, it should be recalled that, in the *Starbucks* decision, the Commission took the position that “the arm’s-length principle that the Commission applies in its State Aid assessment is not that derived from Article 9 of the OECD Model Tax Convention, which is a non-binding instrument, but is a general principle of equal treatment in taxation falling within the application of Article 107(1) of the Treaty, which binds the Member States and from whose scope the national tax rules are not excluded”.<sup>31</sup> As such, the EU Commission’s understanding of the arm’s-length principle would reveal a more market-oriented nuance than a TP-specific one.

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<sup>28</sup> Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union, ST/8778/2022/INIT, 1–58, OJ L 328 (2022).

<sup>29</sup> See Art. 9, OECD Model (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, OECD Publishing, Paris. OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, Glossary: ‘arm’s length principle’ p. 19 and para 1.6. OECD Publishing, Paris, <https://doi.org/10.1787/0e655865-en>. See also R. Petrucci et al., *The EC’s Proposal for a Directive on Transfer Pricing: Paving the Road for a Common Application of the Arm’s Length Principle*, 31 Int. Transfer Pricing Journal 1, sec. 4.1.1. (2023).

<sup>30</sup> CJEU, Case C-467/08, *Padawan*, EU:C:2010:620, para. 33.

<sup>31</sup> Commission Decision (EU) 2017/502 of 21 October 2015 on State aid SA.38374 (2014/C ex 2014/NN) implemented by the Netherlands to Starbucks, para. 264, OJ L83 (2017).

Since this shows that the EU Commission has already attempted to frame a notion of the ‘arm’s length principle’ different from the one upheld by the OECD, the mentioned doubts appear well grounded and may require further clarification in the final text of the proposed Directive.

This would confirm the concern expressed above, since the EU might end up having its own notion of ‘arm’s length principle’, which would differ from the OECD standard. The authors stress that the Preamble indicates that the option has been, indeed, to align the standards, but, in the presence of divergences, the legal binding text will prevail, from the perspective of legal interpretation.

Vice versa, if the intent, as outlined by the explanatory memorandum and by Article 14, is to align arm’s length with the OECD approach, it would be advisable for this proposed Directive to be as close as possible to that source and avoid, as much as possible, any discrepancy which might give rise to doubts.

### 3.3.2 Permanent establishment

Article 3(4) defines ‘permanent establishment’ as “a fixed place of business, as defined under the relevant bilateral convention on the avoidance of double taxation or, in the absence thereof, in national law”.

Accordingly, the proposed definition hinges on the ‘fixed place’ criterion, reflecting the core concept enshrined in Article 5(1) of the Model Conventions. This might raise the issue as to whether it also includes agency PEs,<sup>32</sup> and service PEs as depicted by the UN MC,<sup>33</sup> as well as any other type of PEs, included in bilateral treaties, for which the requirement of a fixed base is not clearly evident. And would lead to a potential different treatment between PE’s, depending on whether they had a fixed base or not.

In the authors’ view, the “fixed base” criterion should not play a decisive role in the applicability of the proposed rules. One possibility is to instead include either a general reference to the treaty definition of permanent establishment (i.e. not accompanied by the expression “fixed”), or to a place of business under domestic law and tax treaties. The downside of this approach is that the reference to double tax treaties and domestic law would remain and thereby undermines the uniform application of EU law (i.e. a place of business would be or not caught depending on whether it would fall within the definitions provided by domestic and tax treaty law).

Therefore, and in light of the fact that PE profit attribution is a key component of any TP regime, providing a single autonomous definition of a permanent establishment might be a preferable option. In that respect, the authors consider a broad definition encompassing as wide range of arrangements (similar to the definitions already found under some domestic systems)<sup>34</sup> as

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<sup>32</sup> See also Q. Mulder et al., *A Closer Look at the European Commission Proposal for Harmonized Rules for Transfer Pricing*, 31 Intl. Transfer Pricing J. 1, sec. 3.5. (2023), Journal Articles & Opinion Pieces IBFD: “The authors note that this definition seems to exclude an agent PE, which is generally included in the PE definition in tax treaties. In other words, based on the current wording of the TP Directive, transactions between a head office and agent PE would not have to comply with the OECD Guidelines.”

<sup>33</sup> See Art. 5(5) OECD Model (2017). See also Art. 5 commentary para 82. Art. 5(3)(b) of the United Nations Model Double Taxation Convention between Developed and Developing Countries (2021). See also commentary p. 178. *Petruzzi et al.*, sec. 2.2.2.4.1.

<sup>34</sup> For example the ‘permanent establishment’ definition under German domestic law includes also activities that might be considered auxiliary under the OECD Model, covers independent agents, and applies shorter thresholds for construction site permanent establishment (A. Perdelwitz, Germany - Corporate Taxation sec. 7., Country Tax Guides IBFD (accessed 3 Jan.

being the most appropriate. This definition is to be provided without prejudice to possible restrictions by *relevant* double taxation agreements (those that EU law cannot override). At the same time, since the proposed Directive endorses the treatment of PEs as separate enterprises, the definition should capture only instances where proper functions, assets and risks attribution can be made.

### 3.3.3 Multinational enterprise group

The definition of ‘multinational enterprise group’ (‘MNE group’) under Article 3(17) includes a mention to the expressions “associated enterprises”, which is to be determined in line with the definition contained in Article 5, and to that of “business establishment”. However, the latter is nowhere to be found and differs, as to its wording, from that of permanent establishment, contained in Article 3(4), and of independent enterprise, contained in Article 3(5).

Even though the very presence of the definition constitutes an innovation as compared to the corresponding international tax legal framework, such definition might have no strict added value in the overall context of the proposed Directive, as no clause concretely uses it.

As the definition currently stands, one of the important issues is what the definition does not say. The Explanatory Memorandum to the proposed Directive states that “SMEs will also benefit from a more harmonized approach which could lead to a reduction of compliance cost as well as increased certainty vis-à-vis tax authorities in the different Member States”. That being the case, one could further question whether MNE is the best term or whether it should be substituted by the term “associated enterprises”.

The lack of a clear specific reference to SMEs appears odd since Annex 7 of the impact assessment acknowledges that “[t]here are also differences in domestic legislation regarding the exclusions from the rule’s scope”.<sup>35</sup> For instance, “the newly adopted transfer pricing legislation in Malta excludes in any case from the scope of the rule the SMEs as defined by the EU State Aid Regulations while such exclusion is not provided in the Italian legislation and many others”.<sup>36</sup>

Finally, the OECD TP Guidelines clearly state that “[i]n order not to impose on taxpayers costs and burdens disproportionate to the circumstances, it is recommended not to require SMEs to produce the amount of documentation that might be expected from larger enterprises”.<sup>37</sup>

Therefore, not only would a clear definition of SMEs be necessary to clarify the scope of application of the proposed Directive, but it would also be instrumental in distinguishing TP documentation obligations between SMEs and MNEs. This would be essential to reduce tax compliance costs and foster the objective of simplification while removing obstacles to access to the internal market.

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2024)); Taxability under French law departs from the traditional permanent establishment concept and covers also instances such as the completion of a full business cycle containing transactions that contain habitual and distinct business (P. Burg, France - Corporate Taxation sec. 7., Country Tax Guides IBFD (accessed 3 Jan. 2024)); Bulgarian law recognizes a PE status also when the non-resident habitually executes transactions with their place of fulfilment on the territory of the country (D. Shishkova & G. Ahtchieva, Bulgaria - Corporate Taxation sec. 7., Country Tax Guides IBFD (accessed 3 Jan. 2024)). This short comparative exercise is sufficient to demonstrate the different legal traditions, how broad many domestic definitions are, and how important it is to introduce an autonomous concept that takes into account these traditions.

<sup>35</sup> See the Impact assessment, Annex 7, p. 126.

<sup>36</sup> *Ibidem*.

<sup>37</sup> *OECD TP Guidelines*, para 5.33.

### 3.3.4 OECD Transfer Pricing Guidelines

Article 3(18) defines what is to be understood by “OECD Transfer Pricing Guidelines” for the purposes of the proposed Directive. This “definition” raises several concerns.

First, whether it should be interpreted as covering three “different” guidelines, given the use of the ‘and’.<sup>38</sup> If so, these would be three different documents harming tax certainty and giving room for mismatches.

Some authors understand this definition as referring to “the 2022 OECD Guidelines, as well as ‘any further amendments to these OECD TP Guidelines that the EU approves in the context of the OECD Committee on Fiscal Affairs’”.<sup>39</sup> Others, instead, consider that “[b]ased on the wording of the above provision, it is clear that the application of EU Member States’ transfer pricing rules following the implementation of the Proposal should be “consistent” with the OECD Guidelines in their 2022 version”.<sup>40</sup> Recent scholarship commenting on the concerned provision of the proposed Directive appears inclined to interpret it as meaning that “the term ‘OECD Transfer Pricing Guidelines’ by definition only includes the 2022 guidelines”.<sup>41</sup> Accordingly, it is debatable whether, even after the approval of the newest OECD TP Guidelines, the 2022 version would remain relevant or not. This would clearly create a conflict where the newest version provided a discrepancy with that of the 2022 version.

Second, and most importantly, the definition does not clarify whether it entails an obligation to comply with the most updated version of the OECD TP Guidelines and how this would be achieved. The definition includes a reference to the adoption of a position under the procedure foreseen in Article 218(9) TFEU. As such, in the absence of such position, “any further amendments” should be disregarded. The authors will refer back to this topic in the section addressing Article 14 of the proposed Directive.

## 3.4 Article 4 - The general rule

The overall goal of Article 4(1) is to introduce the obligation under EU law to comply with and to implement, under domestic law, the arm’s length standard. By doing so, it fills the gap that may have existed under the domestic legislation of some Member States, which had brought the CJEU to state that “it is clear from paragraph 104 of the judgment of 8 November 2022, *Fiat Chrysler Finance Europe v Commission* (C-885/19 P and C-898/19 P, EU:C:2022:859), that, as EU law currently stands, there is no autonomous arm’s length principle that applies independently of the incorporation of that principle into national law”.<sup>42</sup>

Article 4(2) introduces the obligation to conduct the corresponding adjustment as defined in Article 3(7) of the proposed Directive. Its strong resemblance to Article 9(2) of the Model

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<sup>38</sup> 1) the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, endorsed by the OECD Council according to the OECD Council Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises [C(95)126/Final]; 2) the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 as amended on 20 January 2022 and included in Annex I; and 3) any further amendments to these OECD Transfer Pricing Guidelines that the Union approved in the context of the OECD Committee on Fiscal Affairs via the adoption of a Union position under 218(9) TFEU.

<sup>39</sup> See *Mulder et al.* sec. 3.3.

<sup>40</sup> See *Petruzzi et al.* sec. 3.2.

<sup>41</sup> J.J.A.M. Korving, *BEFIT and HOT: FASTER and SAFE! EU Law or Slogan for Slimming Pills?*, 63 *Eur. Taxn.* 12, sec. 2.3. (2023), *Journal Articles & Opinion Pieces IBFD*.

<sup>42</sup> *European Commission v. Grand Duchy of Luxembourg, Amazon.com Inc, Amazon EU Sàrl* (C-457/21), para. 53.

Convention should raise no major technical issue of interpretation and application, except for the ones that relate to the broader notion of “associated enterprise”, which will be addressed below.

One of the main possible issues related to the application of Article 4 is its compatibility with the fundamental freedoms. As mentioned in section 3.2.3 above, the proposed Directive is aimed at applying the arm’s length principle to cross-border transactions only. Hence, the measure introduces a difference in treatment between purely domestic and cross-border situations. The difference is undoubtedly to the detriment of cross-border situations since only they must comply with the arm’s length standard. At the same time, unless a Member State applies mandatory group consolidation and always treats constellations of domestic associated enterprises as a single taxpayer, the general reasons for applying transfer pricing remain also in purely domestic situations: e.g. to prevent the shifting of profits from profit making to loss making companies, or between taxpayers with a different tax burden due to disparities in the treatment in the domestic legislation (e.g. between companies subject to different tax regimes or between a company and an associated individual). In this respect, the rule introduced by Article 4 of the proposed Directive closely resembles the rationale of the German domestic provision that was challenged in the case *Hornbach-Baumarkt*. The latter case also confirmed that domestic and cross-border associated enterprises are comparable for the purposes of testing a TP rule in light of the fundamental freedoms.<sup>43</sup>

Importantly, although the CJEU recognized that a provision which introduces a TP rule only for cross-border situations might in principle be justified by the balanced allocation of taxing rights (implicitly taken together with anti-avoidance),<sup>44</sup> it has introduced an elaborate proportionality test. In particular, and especially relevant in the context of the proposed Directive, according to the Court, the taxpayer must be provided with an opportunity to demonstrate that there were commercial justifications, which would justify the conclusion of a transaction “under terms that *deviated* from arm’s length terms” [emphasis added].<sup>45</sup> According to the CJEU such justifications might stem from the very fact that a shareholder is interested in the financial success of its subsidiaries. One might agree or not with the conclusion of the Court that the very relationship between associated enterprises might justify a non-arm’s length price, but the fact remains that under the case law there are specific circumstances where a price that deviates from the arm’s length price must be allowed for a discriminatory TP provision to withstand the proportionality test.<sup>46</sup> A later case related to the attribution of profits to a permanent establishment and the accurate pricing of its dealings with the head office, where the CJEU made no mentioning of a non-arm’s length price,<sup>47</sup> demonstrates that the conclusions in *Hornbach-Baumarkt* are to be somewhat restricted, perhaps to associated enterprises in financial distress.

Therefore, and in order to make sure that the proposed Directive, and especially its Article 4, is in line with the fundamental freedoms, the European legislator must take account of the above mentioned case law. In our view, this might be achieved in two distinct ways. The first approach

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<sup>43</sup> DE: CJEU, 31 May 2018, Case C-382/16, *Hornbach-Baumarkt*, EU:C:2018:366, para. 40.

<sup>44</sup> Id. paras. 44-45.

<sup>45</sup> Id. para. 56.

<sup>46</sup> This is also reflected in a letter by the German Tax Authorities (albeit giving more restrictive interpretation to the case): see *Wirtschaftliche Gründe, die den Abschluss eines Geschäfts unter nicht „fremdüblichen Bedingungen“ rechtfertigen* - EuGH-Urteil vom 31. Mai 2018 in der Rechtssache C-382/16, available at [https://www.bundesfinanzministerium.de/Content/DE/Downloads/BMF\\_Schreiben/Internationales\\_Steuerrecht/Allgemeine\\_Informationen/2018-12-06-fremduebliche-Bedingungen.pdf?\\_\\_blob=publicationFile&v=3](https://www.bundesfinanzministerium.de/Content/DE/Downloads/BMF_Schreiben/Internationales_Steuerrecht/Allgemeine_Informationen/2018-12-06-fremduebliche-Bedingungen.pdf?__blob=publicationFile&v=3).

<sup>47</sup> RO: CJEU, 8 October 2020, Case C-558/19, *Impresa Pizzarotti (Avantage anormal consenti à une société non-résidente)*, EU:C:2020:806, paras. 36-38.

would be to introduce specific wording in the Recitals that the obligation to transact at arm's length is without prejudice to the case law of the CJEU regarding potential permissible deviations from arm's length terms in specific circumstances. While the Recitals are not part of the legally binding text of the legislation, such wording would give enough room for the Court to perform conforming interpretation and read Article 4 somewhat restrictively in light of its earlier case law. The second approach might envisage a new paragraph to Article 4 that entrusts the Council with the power to adopt implementing acts on a proposal by the Commission, which spell out in more detail the circumstances under which a deviation from the arm's length principle is permissible. In our view the explicit codification of the *Hornbach-Baumarkt* case law at the level of the proposed Directive itself is hardly practical for it is difficult to extract a single abstract rule from the wording that the Court has used in its case law.

### 3.5 Article 5 - Associated enterprises

The definition of “associated enterprise” under Article 5(1) is broader than the one that can be found in most tax treaties worldwide, due to its content on the involvement in management, control, profits and the precise indication of the shareholding.

First, the concrete meaning of associated enterprises in this context seems to leave too much leeway to legal interpretation without a precise definition of what may be required in the context of the proposed Directive and to possible forms of over implementation of the proposed Directive that affect the scope of the proposed Directive in some EU Member States.

Second, the proposed definition also raises the issue of whether the proposed Directive aims to cover cases where an individual transacts with an associated enterprise (e.g. a wholly owned enterprise).<sup>48</sup> Despite falling within the rationale of the normative intervention, at first glance it might appear unclear whether this situation falls within the scope of application of the proposed Directive. This doubt seems resolved by Article 5(4) which explicitly refers to both legal and natural persons.

To the contrary, confusion arises as a result of the lack of a definition of the term “enterprise”. It is worth reiterating that the proposed Directive is aimed at applying to instances where “[...] an *enterprise* engages in one or more commercial or financial cross-border transactions with an associated enterprise [...]”,<sup>49</sup> but this is stated without further qualifications. Thus, in the absence of a clear explanation as to the meaning of an “enterprise” – for example, whether an individual can form an enterprise would be a relevant question as demonstrated in the previous paragraph – the scope of the proposed Directive lacks clarity. One possible solution would be to refer to the OECD Model definition which clarifies that an enterprise refers to the carrying on of any business (with a further definition of what constitutes “business”).<sup>50</sup> However, reading Article 5 of the proposed Directive (that defines “associated enterprises”) casts some doubts on this interpretation since according to this provision an associated enterprise means “a person who is related to another person” in a number of ways. Thus, it seems that any person related to another person is an associated enterprise without any need for them to perform business. This is a substantive deviation from Article 9 of the OECD Model which defines associated enterprises by reference to enterprises and not to persons (except for common management or control). Therefore,

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<sup>48</sup> Case in which some Member States decide to apply transfer pricing rules.

<sup>49</sup> Art. 4(1) of the proposed Directive.

<sup>50</sup> Art. 3(1)e) OECD Model Tax Convention 2017.

especially since the main provision of Article 4 refers to “enterprise”, it is imperative to define the term and bring it in line with the definition of Article 5.

Third, the phrase “significant influence” is not defined in Article 3 of the proposed Directive nor anywhere else in the proposed Directive. The lack of definition for such a key term might undermine legal certainty rather than improving it.<sup>51</sup>

Fourth, and insofar as the conditions do not match with those currently set out under Member States’ domestic law, the Member States would need to adjust their definitions and, eventually, include under the purview of their TP frameworks some cases which, according to their own risk assessment, should be left out of the scope of the TP regulations. This may increase administrative costs beyond that which the Member State had considered appropriate.<sup>52</sup>

Significant issues arise also when the domestic scope sets out stricter requirements than those set out by the proposed Directive. In particular, the proposed Directive sets control at 25%. What if a Member State defines “associated enterprises” more broadly, covering, for instance, cases in which a person participates in the control of another person through a 20% holding. This is the case in Portugal, where Article 63(4)(a) and (b) of its Corporate Income Tax Code sets out a 20% control threshold.<sup>53</sup> Would the proposal require that Member States increase their thresholds, removing from the scope of the TP rules cases which a State considers worthy for regulation? The ATAD Directive, which was not aimed at harmonisation, included Article 3 which clarified that the rules thereby approved only set a “minimum level of protection” which could be exceeded by Member States. That is not the case of the proposed Directive which is driven towards harmonisation and uniformization of TP rules. Accordingly, a Member State going beyond the conditions set out in the proposed Directive may risk an infringement procedure.

Finally, one may wonder about the reasons for which the 25% threshold “differs from the ones included in the BEFIT proposal and Pillar Two. This situation may potentially cause difficulties in coordinating the different initiatives”.<sup>54</sup> The same might apply to other forms of secondary law on direct taxation that applies to the relations between companies of the same group.

### 3.6 Article 6 - Corresponding Adjustments

Double taxation and litigation on matters of transfer pricing also results from the fact that this area is “more subjective than other areas of direct and indirect taxation”.<sup>55</sup> Since transfer pricing is highly subjective, tax administrations do not always share the same view on how a transaction is priced. Additionally, they often do not share the same interests. For that reason, an adjustment made in one State (increasing the tax base in that State) may not be easily followed in the other State involved in the transaction, since it would decrease the taxable base in that jurisdiction.

Article 6 requires Member States to make unilateral corresponding adjustments whenever a primary adjustment has been made. The Explanatory Memorandum clearly outlines the novelty

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<sup>51</sup> See *Petruzzi et al.*, sec. 4.3. Art. 4(1)(36) of the Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Text with EEA relevance OJL 176/1, uses this expression (“to exercise a significant influence over the”) to define ‘qualifying holding’.

<sup>52</sup> See *Mulder et al.* sec. 3.4.

<sup>53</sup> C. Breia, Portugal - Transfer Pricing, sec. 2.5. Country Tax Guides IBFD, available at [https://research.ibfd.org/#!/doc?url=/document/tp\\_pt\\_s\\_2](https://research.ibfd.org/#!/doc?url=/document/tp_pt_s_2).

<sup>54</sup> See *Mulder et al.* sec. 3.4.

<sup>55</sup> See the Impact Assessment, p. 125.

of this provision, stating that “[w]hilst most bilateral double tax treaties include a provision for a corresponding downward adjustment of profits of the associated enterprise concerned, they do not generally impose a binding obligation on the Contracting States to eliminate the double taxation”.<sup>56</sup>

Against this premise, Article 6 enshrines an obligation on Member States to make a corresponding adjustment that removes double taxation. However, this obligation is substantially restricted by the fact that the Member State concerned must be in agreement that the primary adjustment is consistent with the arm’s length principle, while it is usually the lack of such an agreement that frustrates corresponding adjustments in the first place.<sup>57</sup> Still, while the current wording may provide an easy escape from the obligation enshrined in the proposed Directive, thereby easily frustrating the pursued objective to bind Member States, and depriving this provision of any actual binding force,<sup>58</sup> nevertheless, Recital 6 of the Preamble clarifies that to comply with this obligation and ensure the mitigation of double taxation, “Member States should have adequate mechanisms in place to enable them, when a primary adjustment is made in another Member State or third country jurisdiction, to make a corresponding adjustment”. Hence, this provision would still yield improvements where Member States that currently domestically do not foresee corresponding adjustments mechanisms would now be obliged to do so.

In principle, it might be argued that the unilateral corresponding adjustment conceived in article 6(1) of the proposed Directive embeds more restrictive conditions than those under article 9(2) of the OECD Model, and this could in principle undermine its application.<sup>59</sup> However, in this respect it must be noticed that in intra-EU situations, the underlying harmonisation goal might lead to intra-EU tax treaties being disregarded. With reference to treaties with third countries, two distinct scenarios can be envisaged: i) those prior to 1 January 1958 or prior accession would not be affected; ii) all others should be amended, as required by the common interpretation of Art. 351 of the TFEU.

The obligation appears particularly interesting in third country situations, as envisaged in Article 6(1)(c). In that case, a Member State would be subject to the fast-track (Article 6(3)) corresponding adjustments procedure, the same will not occur for third-country jurisdictions. Consequently, the proposed Directive would lead to asymmetrical positions between the two Contracting States and decrease the bargaining power of the EU Member States, which are required to adhere to a corresponding adjustment procedure even in the absence of a treaty provision requiring it to grant such adjustment.<sup>60</sup>

With specific reference to the MAP, once more, the same doubt often outlined arises. Since this proposed Directive would set out substantive law provisions, Member States and taxpayers willing to apply the arm’s length principle would find the legal source in this proposed Directive. However, Article 6(2) also refers to the possibility of using the MAP under DTCs and the Arbitration Convention. Both the DTCs and Article 4(1) of the Arbitration Convention would set out their own notions of “arm’s length principle”. This begs the question whether the concept would be treated as the same and, if not, which meaning would apply. This once again raises a problem of coordination among international sources.

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<sup>56</sup> See the Explanatory Memorandum to the proposed Directive, p. 5.

<sup>57</sup> Art. 6(a)(c) of the proposed Directive.

<sup>58</sup> Unless the CJEU adopts a strict stance in what concerns the burden of proof required to avoid the corresponding adjustment.

<sup>59</sup> See *Petruzzi et al.*, sec. 4.4.

<sup>60</sup> In fact, Art. 6(1)(c) does not require a treaty provision granting the corresponding adjustment but merely that “is in force to prevent economic double taxation”, which is a rather vague requirement.

Article 6(3) frames what the proposed Directive calls the “fast-track” procedure, since it mandates that the procedure be concluded within 180 days of receiving the taxpayer’s request. Remarkably, letter e) stipulates that “when the corresponding adjustment is not granted, the taxpayer is still able to pursue mutual agreement procedures under a double tax convention, the Arbitration Convention or Directive (EU) 2017/1852”. The wording of this clause establishes a clear obligation to conduct the corresponding adjustment, which to some extent end up subordinating the exercise of taxing powers to the State that operates the primary adjustment. Even though this might be a common element also of the main clause of Article 6(1), the fast-track procedure might in fact prevent a proper assessment of whether the primary adjustment was properly conducted.

Article 6(4) allows resorting to a joint tax audit mechanism or “other forms of international administrative cooperation”. Although Recital 6 of the Preamble refers to “multilateral risk assessment programs like the European Trust and Cooperation Approach (ETACA) and the International Compliance Assurance Programme (ICAP)”, the wording of the provision might give opportunity to broader interpretations. In particular, the circumstance that DAC establishes a general mechanism of joint audits in the field of direct taxes should allow for the application of those rules.

Moreover, it is unclear whether Article 6 includes a hierarchy of norms, or whether its clauses are mutually exclusive. The wording appears to allow all these mechanisms to apply simultaneously, thereby generating increased administrative burden, without ensuring better outcomes. For instance, in the case of the “fast-track”, a rejection within 180 days would still allow the taxpayer to resort to the MAP.

Lastly, while in the case of a primary adjustment, there is an obligation to make a corresponding adjustment, instead, when there is no primary adjustment, paragraph 5 states that “Member States may perform a downward adjustment”. This provision is particularly relevant because it would be unique. In fact, this mechanism is not foreseen in the OECD Guidelines nor by the national laws of EU Member States.<sup>61</sup> The content of this provision is remarkable because one of the conditions for the exercise of the option is that the amount of the downward adjustment is “subject to double taxation”.<sup>62</sup> The rationale of this provision appears to be the single taxation principle since, if there was no double taxation, allowing for a unilateral downward adjustment this would result in non-taxation. This rationale could also be retrieved from the Impact Assessment, which encouraged the adoption of a specific anti-tax avoidance framework which would “ensure that unilateral downward adjustments do not result in double non-taxation”.<sup>63</sup>

## 4. Core elements for applying the arm’s length principle

### 4.1 Article 9 - Transfer Pricing Methods

Article 9 of the proposed Directive sets out the admissible transfer pricing methods, which are defined in Article 3(9) to (13). Article 10 establishes the obligation to adopt the method which is most appropriate to the circumstances of the case, thus creating some leeway for the taxpayers. From a methodological approach, the endorsement of one-sided application of the methods might

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<sup>61</sup> See *Petruzzi et al.*, sec. 4.4.

<sup>62</sup> Art. 6(5), letter b) of the proposed Directive.

<sup>63</sup> See the Impact Assessment, pp. 35-36. See the Explanatory Memorandum to the proposed Directive, p. 9.

frustrate the overall ratio of the proposed Directive which is to ensure a common application of the arm's length principle within the EU. If, in the same transaction, different methods are applied by the different Member States involved in the transactions, mismatches will appear, potentially leading both to double taxation as to double non-taxation. Such mismatches can easily be exploited for tax planning purposes, and anti-abuse clauses may be ineffective. Nevertheless, it is acknowledged that the rules contained in Article 12 sets some benchmarks for how the selection of methods relates to the arm's length range and the ones contained in Article 11 determine how the comparability analysis should concretely be conducted.

The five methods listed in Article 9(1) seem to indicate that the arm's length price might be "determined using one of" these methods, without any pre-defined order or priority.<sup>64</sup> The proposed Directive appears to merely allow the use of "one" method. However, the OECD TP Guidelines approach acknowledges that "for difficult cases, where no one approach is conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction".<sup>65</sup> Additionally, although resembling the OECD TP guidelines methods, the wording used by the proposed Directive deviates.

Article 9(2) mandates the Member States to allow "for the application of any other valuation methods and techniques to estimate the arm's length price". However, this option is admissible "only if it can be demonstrated in a "satisfactory manner" that two conditions are met, namely that none of the five methods listed in Article 9(2) is suitable, and that the selected method is consistent with arm's length and achieves a more reliable result.

This rule, which derogates to the main one contained in Article 9(1), gives rise to two main doubts. First, whether that of "satisfactory manner" would be an objective criterion or not and how it should be judicially reviewed. Second, it does seem that letters a) and b) of paragraph 2 would impose a double burden. On the one hand, the taxpayer must demonstrate that the valuation methods under paragraph 1 are not "appropriate" or "workable" for the case at stake. On the other hand, the taxpayer must also prove that the chosen valuation method, although different from those under paragraph 1, is "consistent with the arm's length principle and provides a more reliable estimate" than the methods listed. Apparently, these two conditions are not mutually exclusive but cumulative. However, and currently it would be sufficient "for taxpayers in most EU Member States to prove that the "other TP method" provides an arm's length result"<sup>66</sup> without providing evidence that the others do not. In fact, the OECD TP Guidelines clearly state that "[n]o one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances".<sup>67</sup> This would seem reasonable since if a valuation method complies with the arm's length standard, this should suffice.

## 4.2 Article 13 - Transfer Pricing Documentation

The impact assessment acknowledges that "[t]ransfer pricing regulations, in particular, appear to drive much of the complexity related to documentation requirements".<sup>68</sup> Article 13 of the proposed Directive deals with transfer pricing documentation. Although this provision provides

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<sup>64</sup> See recital 10 of the Preamble.

<sup>65</sup> *OECD TP Guidelines*, paras. 2.12. See also 3.58-3.59.

<sup>66</sup> *Mulder et al.*, sec. 3.7.

<sup>67</sup> *OECD TP Guidelines*, para. 2.2.

<sup>68</sup> See the Impact Assessment, p. 11.

some guidelines on the transfer pricing documentation needed, it might fail to achieve a significant degree of harmonization. From the perspective of reducing the cost of tax compliance, this might be regarded as a missed opportunity.

This shortcoming will not be remedied by the adoption of delegated acts. Article 13(2) determines that “the Commission shall be empowered to adopt delegated acts, in accordance with Article 18, to supplement further the rule referred to in paragraph 1 with regard to the documentation”. When clarifying the scope of these delegated acts, paragraph 2 only refers to “laying down common templates, setting linguistic requirements, defining the type of taxpayer to abide by these templates and the timeframes to be covered”. As such, delegated acts could impact on the form of the transfer pricing documentation but not its substance.

A different view is expressed in the wording of the Explanatory Memorandum, which refers to the delegated acts as “standard templates setting the type and content of transfer pricing information”.<sup>69</sup> The failure to comply with the ratio of this provision is further witnessed by comparison with Recital 14 of the Preamble, which states: “[i]n order to lower the compliance burden for taxpayers that operate cross-border within the Union a common approach towards the documentation on transfer pricing should further be introduced”.<sup>70</sup> In particular, “[o]ne standard template, rules on content and linguistic arrangements [...] would bring simplicity and potential cost savings”.<sup>71</sup> The lack of any clear rule on which documents are required affects the implementation of the proposed “common template”. The discrepancy between TP documentation required among countries and the requirement imposed on all Member States to comply with the same template would create room for further complexity and increase mismatches.

From a different perspective, authors notice that Article 13 embeds an important protection of the taxpayer's right to obtain sufficient information to verify the consistency with the general rule of Article 4(1), also including an express reference to Articles 8 to 12 of the proposed Directive. Considering the wording of this clause, this is a clear and unconditional obligation that secures legal certainty in line with the standards of protection of fundamental rights of taxpayers under EU law. In such sense, authors acknowledge that this is a step forward in the right direction.

## 5. Mechanism for establishing further common rules

### 5.1 Article 14 - Application of the arm's length principle

#### 5.1.1 Article 14(1) – Obligation of consistency with the OECD Transfer Pricing Guidelines

The rationale for Article 14(1) is that “in the absence of EU coordination on future revisions of these Guidelines, [the proposed Directive's] effectiveness would be limited”.<sup>72</sup> Also, in terms of efficiency, “[l]egislating to integrate the OECD arm's length principle in EU law, without including any *dynamic reference* to the OECD Transfer Pricing Guidelines, would be [...] inefficient”<sup>73</sup> [emphasis added].

Article 14 should be read in conjunction with Article 3(18), which, as seen above, sets out the definition of “OECD Transfer Pricing Guidelines” for the purposes of the proposed Directive.

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<sup>69</sup> See the Explanatory Memorandum to the proposed Directive, p. 17.

<sup>70</sup> See recital 14 of the Preamble to the proposed Directive.

<sup>71</sup> *Ibidem*.

<sup>72</sup> See the Impact Assessment, p. 53.

<sup>73</sup> *Id.* p. 54.

Article 14(1) establishes that “Member States shall include in the national rules transposing the transfer pricing rules laid down in Chapter II of this Directive provisions that ensure that those transfer pricing rules are applied in a manner consistent with the OECD Transfer Pricing Guidelines”.

First, Article 14(1) does not mandate to include in the national rules, the OECD Transfer Pricing Guidelines but rather to include “provisions that ensure” consistency with the OECD Transfer Pricing Guidelines. This entails an obligation of result rather than of means since even incorporating the OECD TP Guidelines into domestic law would not suffice to comply with the obligation enshrined by Article 14. However, critical issues may arise insofar as one interprets such obligation in strict terms, especially considering that the proposed Directive may not invoke that consistency for violating other applicable rules of primary or secondary law of the European Union. Therefore, it should rather be interpreted as an obligation to preserve technical consistency with the OECD Transfer Pricing Guidelines to the extent that the proposed Directive allows for it and does not otherwise indicate, and that no other rule of EU law may prevent it.

Second, Article 14(1) does not cover also those rules set out in Chapters I, III, and IV. The reference only to Chapter II means that the definitions under Article 3, Chapter I, would not fall under this obligation. This could be interpreted as leading to the odd case scenario in which there would be no obligation to apply the “arm’s length principle” in a manner consistent with the OECD Transfer Pricing Guidelines. At the same time, there would be the obligation to apply Article 14 to the TP methods (Article 9(1)) or to assess whether the primary adjustment is consistent with the arm’s length principle (Article 6(1)(a)).

Furthermore, this provision prescribes an obligation to ensure consistency with the OECD TP Guidelines, which Article 3(18) defines as i) the 2022 OECD TP Guidelines ii) “and any further amendments to these OECD Transfer Pricing Guidelines that the Union approved in the context of the OECD Committee on Fiscal Affairs via the adoption of a Union position under 218(9) TFEU”. As such, Member States would be required to comply with both the 2022 OECD TP Guidelines and with that version of the OECD TP Guidelines approved by the Union. This would mean that without approval, there would be no obligation to comply with the newest version.

However, it is not clear whether this would be a minimum standard or not; namely, whether States would be free to comply also with those OECD TP Guidelines successive to the 2022 even if not approved by the EU.

The General Court has clarified that “[u]nder Article 218(9) TFEU, it is only on a proposal from the Commission or the High Representative of the Union for Foreign Affairs and Security Policy that the Council may act, with the result that, if the Commission or High Commission do not do so, the adoption of an appropriate measure is impossible”.<sup>74</sup> This obligation to wait for the approval by the EU, through the mechanism set out under Article 218(9) TFEU, might conflict with the approach of Member States that already apply a dynamic approach since if the EU fails to endorse the newest OECD TP guidelines, they would be restricted in their options. It would also conflict with the obligations that the EU member States that are also OECD members have to follow the OECD recommendations.

This restriction appears to go beyond the objective pursued with this provision, as affirmed in the Explanatory Memorandum which states that “the latest version of the OECD Transfer Pricing

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<sup>74</sup> G CJ, 8 March 2023, Case T-100/21, para 48.

Guidelines will be binding when applying the arm's length principle in the Member States".<sup>75</sup> Hence, the intent of this provision would be to ensure the update rather than to hold back or restrict Member States' ability to align with the newest OECD TP Guidelines individually.

Nevertheless, while the provision might undermine to a degree the domestic leeway of Member States, it would greatly improve the consistency of the approach in the internal market and will thus lead to greater coordination which is a positive development. Moreover, it would indirectly force the Member States to align in a common EU position at the OECD for they would be prevented to unilaterally adopt divergent approaches under their domestic laws. This might lead, as an indirect effect, to the increased significance of the EU group in the OECD decision making process, since Member States are likely to agree only upon changes that would be endorsed by the EU as a whole (as otherwise, such changes cannot become part of their own domestic approaches to transfer pricing due to the restriction imposed on the dynamic approach by the proposed Directive).

However, this provision raises at least two further questions. First, whether it would have any repercussions on the legal status of the OECD TP Guidelines for Member States. Second, the frequency of the update.

Regarding the legal status, the question would be whether the proposed Directive would entail hardening of soft law, namely whether it would make the OECD TP Guidelines legally binding for Member States. The term "binding" is used in the Explanatory Memorandum. However, it is not used in the wording of the proposed Directive. Yet, it would nevertheless seem that the obligation to apply the rules consistently with the OECD TP Guidelines would indirectly reach the same effect.

The transposition into EU secondary law of the OECD non-binding guidelines, which are non-binding for the OECD Member countries in the first place, let alone for EU Member States that are not OECD Members,<sup>76</sup> might raise a fundamental issue of democratic legitimacy (even if the Directives are approved by unanimity of the Member States). Nevertheless, interpreting a concept within the meaning of a Directive in the light of the OECD documents would not always lack democratic legitimacy. In fact, this would not be the case "where such an interpretation, even if it draws on the OECD's documents, has its basis in the Directive itself and in its legislative history reflecting the democratic process of the European Union".<sup>77</sup>

This leads to the second question raised above regarding the update frequency. In particular, whether the procedure under Article 218(9) would ensure said democratic legitimacy. With regard to the mechanism under Article 218(9) TFEU, it is not clear whether this is the first time a reference is made to the TFEU chapter regulating international agreements by the European Union in a proposed Directive concerning direct taxation.<sup>78</sup>

Article 218(9) would apply where there is a body "called upon to adopt acts having legal effects"<sup>79</sup>. However, it would not seem that the OECD would be such a body nor would the OECD

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<sup>75</sup> See the Explanatory Memorandum to the proposed Directive, p. 17.

<sup>76</sup> Bulgaria, Cyprus, Malta, and Romania are not members of the OECD.

<sup>77</sup> AG Opinion, C-115/16, para 91.

<sup>78</sup> *Korving*, sec. 2.3.

<sup>79</sup> See Art. 218(9) TFEU.

TP Guidelines constitute acts having legal effects.<sup>80</sup> Therefore, it is unclear what the functioning and the real consequences of the reference to Article 218(9) TFEU would be.

### 5.1.2 Article 14(2) – the additional rules laid down by the EU Council

Article 14(2) delineates the scope within which, by means of Council implementing acts,<sup>81</sup> the Council may lay down further rules “on how the arm’s length principle and the other provisions laid down in Chapter II of this Directive are to be applied in specific transactions”. For this purpose, the provision sets out a list of six types of transactions.

This list does not cover several other transactions, and it is not clear which were the selection criteria followed to identify the included transactions. Since this appears to be a closed list, doubts might arise as to whether and how the Council may concretely lay down further rules by implementing Article 14(3).

In light of Recital 16 of the Preamble, it may be foreseen that, although not limited thereto, such implementing acts would lay down the terms of applicable safe harbours to the identified transactions. This resonates in particular with the increasing prevalence of safe harbours with regard to intragroup financial transactions and the provision of services between associated enterprises, including the provision of marketing and distribution services. In this respect, the EU Joint Transfer Pricing Forum had already developed safe harbours based on pre-determinations with regard to low value-adding safe harbours, which eventually also made their way into the OECD TP Guidelines. On the other hand, the reference to marketing and distribution services may perhaps be seen as an opening in connection with potential developments surrounding the possible prospective adoption of “Amount B” approaches within international TP recommendations.

Safe harbours are advantageous as they provide legal certainty. However, at the same time, they may be seen as obstacles to the full application of the arms’ length standard. From a substantive perspective, safe harbours amount to a “pre-determination” which runs contrary to one of the fundamental axioms of the arms’ length, which is comparability analysis. Moreover, it is not clear whether the taxpayer would be able to override the safe harbour, in so far as it was possible to demonstrate that the arms’ length analysis would lead to a different (and more favourable) result.

It thus seems desirable for the proposed Directive to lay down at least the fundamental architecture (e.g., with regard to the content and legal nature) of said safe harbours in a less vague way than what is foreseen in the currently proposed text, ideally beyond a mere statement of purpose in the Preamble.

### 5.1.3 Article 14(3) – the Council implementing acts based on a proposal from the Commission

Article 14(3) empowers the Council to adopt implementing acts based on a proposal from the Commission as regards the rules governing the list of transactions mentioned above. Therefore, it is important to delimit the powers of the Council in this respect.

The implementing powers “conferred on the Commission and the Council under Article 291(2) TFEU entail, in essence, the power to adopt measures which are necessary or appropriate for the uniform implementation of the provisions of the legislative act on the basis of which they are adopted and which merely specify the content of that act, in compliance with the

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<sup>80</sup> See position of Netherlands available at <https://open.overheid.nl/documenten/f89a2b32-39d4-4c79-b816-8e9f0663d25b/file>, p. 8.

<sup>81</sup> See Art. 14(3) of the proposed Directive.

essential general aims pursued by that act, without amending or supplementing it, in its essential or non-essential elements”.<sup>82</sup>

This means that implementing acts cannot amend nor supplement Article 14 in any way. In particular, to determine whether the Council would comply with the limits of the implementing powers conferred on it, pursuant to Article 291(2) TFEU, it would be necessary to ascertain whether the implementing acts merely clarify the content of Article 14 of the proposed Directive. This would entail examining whether the implementing acts: i) respect the essential general objectives of the proposed Directive; ii) are necessary or appropriate for the uniform implementation of Article 14; and iii) neither supplement nor amend Article 14 in any way.<sup>83</sup> Therefore, it would appear that no additional transaction can be added, at least under Article 14(2).

Finally, Article 14(3) allows for a dynamic shift of sovereignty on the determination of the arm’s length principle, which uses the EU Council implementing acts to move away from the level of Member States towards that of the European Union.

## 5.2 Article 18 - Exercise of delegation

Differently from Article 14, which introduces the possibility of adopting *implementing* acts, Article 18 instead delegates the EU Commission to adopt *delegated* acts pursuant to Article 290 TFEU, as confirmed by Recital 21 of the Preamble.<sup>84</sup> This empowerment is not accompanied by any further guidance, which may lead to several issues.

First, the proposal merely “empowers” the Commission. An omission of action by the Commission will likely never amount to unlawful behaviour by the Commission and may never be scrutinized by the Court. One could wonder if the Court would take a different view if it were asked to ascertain the omissive behaviour of the Commission in light of the good management duty, as regulated by Article 41 of the EU Charter, which also contains an obligation to provide motivation in respect of all acts of EU institutions.

Second, the Court may be requested to scrutinize the validity and legitimacy of such delegation in view of its “essential elements” doctrine. The Court may check whether: i) the definition of the scope may amount to an “essential element” of the act;<sup>85</sup> ii) there is a lack of determinacy regarding “not only the objectives but also the content, scope and duration of the delegation of power”;<sup>86</sup> iii) the delegation enables “the Commission’s use of the power to be reviewed [by the Court] by reference to objective criteria fixed by the EU legislature”.<sup>87</sup> These components of the “essential elements doctrine” aim “to guard against the danger of the Union legislator abandoning its legislative function in favour of administrative rule making” and “protects the principle of democracy and the rule of law, in particular, the horizontal and vertical allocation of powers within the Union legal system”.<sup>88</sup>

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<sup>82</sup> UK: ECJ, 28 Feb. 2023, Case C-695/20, *Fenix International Limited v. Commissioners for Her Majesty’s Revenue and Customs*, Case Law IBFD, para. 49.

<sup>83</sup> Id. para 51.

<sup>84</sup> See recital 21 of the Preamble to the proposed Directive.

<sup>85</sup> Condition required in Art. 290(1) TFEU for all delegated acts.

<sup>86</sup> See Judgment of 26 July 2017, *République Tchèque / Commission* (C-696/15 P) ECLI:EU:C:2017:595, para 48.

<sup>87</sup> Id. para. 49.

<sup>88</sup> See A. H., Turk, *Legislative, Delegated Acts, Comitology and Interinstitutional Conundrum in EU Law - Configuring EU Normative Spaces*. 26 Eur. Law Journal (5–6), p. 419 (2020).

## 6. Final remarks

The authors welcome the EU Commission's ambitious initiative and commend its efforts in tabling the proposal for an EU Directive on transfer pricing. This is surely a step in the right direction, which completes a long process of removing the disparities across national legislation and its distortions to tax competition.

After various attempts to intervene at the level of settling disputes, through the soft law approach to fade out harmful tax competition, through the hard law approach based on the prohibition of State aids, the introduction of a comprehensive form of positive tax integration in the form of a transfer pricing Directive might yield an effective solution to such issues.

The study has identified several pressing and critical issues and dwells on their ramifications with special emphasis on those that arise from the legal interpretation of the provisions contained in the proposed Directive. Within this framework authors outline specific areas which might benefit from further work and set out several proposals.

In particular, given the EU Commission's aim to align with the OECD Transfer Pricing Guidelines, the analysis of the proposed Directive has revealed some discrepancies, which might result in frustrating (at least partly) the overall goal of positive integration, and may cast doubts as to whether the proposed Directive is really able to yield the envisaged harmonization, promote legal and tax certainty and simplify compliance.