Contributions to Management Science

Veronika Solilova
Danuse Nerudova

Transfer Pricing in SMEs

Critical Analysis and Practical Solutions

Contributions to Management Science

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Contents

1 Introduction 1
References 7

2 Transfer Pricing Rules for SMEs in the EU 9
2.1 The Arm's Length Principle: Its History, Purpose and Role in the Twenty-First Century 9
2.2 Comparability Analysis: Key Part of the Application of Arm's Length Standard 16
2.3 Transfer Pricing Methods and Their Practical Application in the Twenty-First Century 23
2.3.1 Strengths and Weaknesses of Transfer Pricing Methods . . . 25
2.3.2 Practical Application of Transfer Pricing Methods: Critique Aspects 25
2.4 Transfer Pricing Documentation: Proof of the Arm's Length Standard 36
2.5 Simplified Transfer Pricing Rules for SMEs 44
2.5.1 Simplified Transfer Pricing Measurements: Documentation 48
2.5.2 Other Simplified Transfer Pricing Measurements 53
2.6 Conclusion and Recommendations 54
References 55

3 Evaluating a Questionnaire on Transfer Pricing Issues of SMEs That Operate in the EU 59
3.1 General Evidence from EU Member States 63
3.2 Compliance Costs and Duration 64
3.3 Suggestions 68
3.4 Conclusion 71
Annex 76
References 81

4 Compliance Costs of Transfer Pricing for SMEs 83
4.1 Introduction 83
4.2 Theoretical Background 85
4.2.1 Transfer Pricing Issue 85
4.2.2 Compliance Costs of Taxation 87
4.3 Determination of Compliance Costs of Transfer Pricing: The Czech, Polish and Slovak Cases 88
4.3.1 Data Description and Processing 88
4.3.2 Determination of Compliance Costs 90
4.4 Determination of Compliance Costs of Transfer Pricing for EU Member States 97
4.4.1 Data Description and Processing 97
4.4.2 Determination of Compliance Costs 98
4.5 Conclusions 101
References 103

5 Safe Harbour as an Alternative Approach to Transfer Pricing of SMEs 105
5.1 Relaunching of Safe Harbours 105
5.2 Advantages and Disadvantages of Safe Harbours 108
5.3 Recommendations of the Form and Scope of Safe Harbours 111
5.4 Current Situation of Safe Harbours as Simplified Measurements in European Union 112
5.5 Proposal for Safe Harbours for SMEs 116
5.6 Conclusion 126
References 127

6 CCCTB as a Suitable Solution? 129
6.1 History of the Efforts to Harmonize Corporate Taxation in the EU 129
6.2 Current Situation of Corporate Taxation in the EU 138
6.2.1 Separate Entity Approach Versus Single Entity Approach 138
6.2.2 Corporate Taxation Systems Within the EU 142
6.2.3 Cross-Border Loss Offsetting 143
6.3 Proposal of the CCTB Directive 146
6.4 Proposal of the CCCTB Directive 152
6.5 Is the C(C)CTB Suitable? 155
6.5.1 Methodology 155
6.5.2 Results of the CCTB in the Context of SMEs 160
6.5.3 Results of the CCCTB in the Context of SMEs 167
6.6 Conclusion 180
References 182

7 Conclusion 187
References 192

List of Figures

Fig. 2.1 Selecting of external comparables—current practice (EU JTPF 2016, adjusted) 21
Fig. 2.2 Current application of size indicators in the EU for transfer pricing purposes (own compilation through Google Charts) 46
Fig. 2.3 Documentation requirements in relation to size in the EU (own compilation through Google Charts) 48

Fig. 3.1 Number and proportion of SMEs (respondents) across NACE sectors (*A* Agriculture, forestry and fishing, *B* Mining and quarrying, *C* Manufacturing, *D* Electricity, gas, steam and air conditioning supply, *E* Water supply; sewerage; waste management and remediation activities, *F* Construction, *G* Wholesale and retail trade; repair of motor vehicles and motorcycles, *H* Transporting and storage, *I* Accommodation and food service activities, *J* Information and communication, *K* Financial and insurance activities, *L* Real estate activities, *M* Professional, scientific and technical activities, *N* Administrative and support service activities, *O* Public administration and defence; compulsory social security, *P* Education, *Q* Human health and social work activities, *R* Arts, entertainment and recreation, *S* Other services activities) (compiled by author) 62
Fig. 3.2 Tax consultant services used by SMEs for transfer pricing issues (%) (compiled by author) 63
Fig. 3.3 Simplified measurements used by SMEs (compiled by author) 64
Fig. 3.4 Average costs and time per year spent managing the transfer pricing issue (%) (compiled by author) 65
Fig. 3.5 Average time and costs per year necessary for the selection of the most suitable transfer pricing method (%) (compiled by author) 66

Fig. 3.6 Average time and costs per year necessary for preparation of transfer pricing documentation (%) (compiled by author) 67
Fig. 3.7 Average time and costs per year necessary for preparation of country-by-country report (%) (compiled by author) 68
Fig. 3.8 Average time and costs per year necessary for preparation of APA (%) (compiled by author) 69
Fig. 3.9 Suggestions related to safe harbours (%) (compiled by author) 71
Fig. 3.10 The introduction of simplified transfer pricing documentation for SMEs (%) (compiled by author) 72
Fig. 3.11 The introduction of lower penalties for SMEs (%) (compiled by author) 72
Fig. 3.12 The exclusion of micro and small enterprises from the obligation to prepare transfer pricing documentation (%) (compiled by author) 72
Fig. 3.13 The exclusion of micro and small enterprises from the obligation of transfer pricing issue (%) (compiled by author) 73
Fig. 3.14 Availability of complex information for SMEs (%) (compiled by author) 73
Fig. 3.15 The implementation of the C(C)CTB system in EU (%) (compiled by author) 74
Fig. 3.16 The introduction of EU comparables (benchmarks) for selected industries (%) (compiled by author) 74
Fig. 3.17 The introduction of the transfer pricing guidelines for SMEs like as OECD TP Guidelines (%) (compiled by author) 75
Fig. 3.18 The possibility of communication with tax authorities in other language (%) (compiled by author) 75
Fig. 3.19 The possibility of submitting a tax return in other language (%) (compiled by author) 75
Fig. 4.1 Use of tax consultant services for transfer pricing issues (own processing, questionnaire) 91
Fig. 4.2 SMEs based on residency (own processing, questionnaire) 97
Fig. 4.3 Using of tax consultancy in the respect of transfer pricing issues (own processing, questionnaire) 99
Fig. 6.1 Re-allocation of cross-border losses of SMEs across the EU based on the CCTB proposal (own processing, Amadeus database) 165
Fig. 6.2 Re-allocation of cross-border losses of SMEs across the EU—current situation (Fig. 6.2 represents the assignment of cross-border losses based on the tax residency of the subsidiary.) (in EUR) (own compilation through Google Charts, Amadeus database) 166

Fig. 6.3 Re-allocation of cross-border losses of SMEs across the EU—based on the CCTB (Fig. 6.3 represents the assignment of cross-border losses based on the tax residency of the parent company, where loss relief will be applied in accordance with the CCTB proposal.) (in EUR) (own compilation through Google Charts, Amadeus database) 167
Fig. 6.4 Change in corporate tax liability after the adoption of the CCCTB system across the EU (in %) (own processing) 176
Fig. 6.5 Re-allocation of corporate tax liability of SMEs across the EU—current situation (This figure represents the assignment of corporate tax liability based on the tax residency of the subsidiary.) (in million EUR) (own compilation through Google Charts, Amadeus database) 180
Fig. 6.6 Re-allocation of corporate tax liability of SMEs across the EU—based on the CCCTB proposal (This figure represents the assignment of corporate tax liability based on the tax residency of the subsidiary. The limitations of the study—the same tax base and the same nominal tax rate with the application of an apportionment formula—are considered.) (in million EUR) (own compilation through Google Charts, Amadeus database) 181

List of Tables

Table 1.1 Enterprises, employment and gross value added of SMEs in the EU28, 2015 (Eurostat, National Statistical Offices and DIW Econ; mentioned in the European Commission 2016) 2

Table 2.1 Strengths and weaknesses of traditional transaction methods (own compilation, TP Guidelines, OECD 2017) 26

Table 2.2 Strengths and weaknesses of transactional profit methods—Profit Split (own compilations, TP Guidelines, OECD 2017) 29

Table 2.3 Strengths and weaknesses of transactional profit methods—TNMM (own compilations, TP Guidelines, OECD 2017) 30

Table 2.4 Denominators of net profit level indicators (OECD TP Guidelines 2017, own processing) 32

Table 2.5 Selection of the most appropriate method according to the circumstances of the case (Cottani 2016) 36

Table 2.6 Transfer pricing documentation requirements—OECD and EU perspective—Master file (TP Guidelines, OECD 2017; EU Council 2006/C176/01—EU TPD) 38

Table 2.7 Transfer pricing documentation requirements—OECD and EU perspective—Local file (TP Guidelines, OECD 2017, EU Council, 2006/C176/01—EU TPD) 40

Table 2.8 CbCR—OECD and EU perspective (TP Guidelines, OECD 2017; EU Council 2006/C176/01—EU TPD, Directive 2016/881 and Proposal Directive COM(2016)198) 43

Table 2.9 Transfer pricing documentation requirements and exemption from the transfer pricing rules—SMEs and small transaction perspective (Deloitte 2016; PwC 2015; IBFD 2017) 47

Table 2.10 Other transfer pricing simplified measurements—SMEs and small transaction perspective (Deloitte 2016; PwC 2015; IBFD 2017) 53

Table 3.1 Classification of respondents across the EU (compiled by author) 61

Table 3.2 Simplified measurements used by SMEs (For more details regarding transfer pricing rules and the simplified measurements that SMEs use, see Chaps. 2 and 5) (compiled by author) 64
Table 3.3 Suggested simplified measurements for SMEs (compiled by author) 70

Table 4.1 Data for calculating compliance costs (own processing, Amadeus, Hays Salary Guide) 90
Table 4.2 Transfer pricing documentation—costs and time (own calculation, questionnaire) 92
Table 4.3 Country-by-country report—costs and time (own calculation, questionnaire) 93
Table 4.4 Determination of compliance costs of transfer pricing for Medium-sized—based on the costs indicator (own calculation, questionnaire, MF Czech Republic, MF Slovak Republic, MF of Poland) 94
Table 4.5 Determination of compliance costs of transfer pricing for medium-sized—based on the time indicator (own calculation, questionnaire, MF Czech Republic, MF Slovak Republic, MF of Poland) 95
Table 4.6 Determination of compliance costs of transfer pricing for SMEs (own calculation) 96
Table 4.7 Transfer pricing documentation—costs and time—European Union (own calculation, questionnaire) 100
Table 4.8 Determination of compliance costs of transfer pricing for SMEs—European Union—cost indicator (own calculation) 100
Table 4.9 Comparison of compliance costs (own processing, World Bank Paying Taxes 2017) 102

Table 5.1 Advantages and disadvantages of safe harbours (OECD, Multi-country analysis of existing transfer pricing simplification measures, 2012. OECD, The comments received with respect to the discussion draft on the revision of the safe harbours section of the transfer pricing guidelines, 2012. OECD, TP Guidelines, 2013 and 2017. Own analysis and processing) 110
Table 5.2 Transfer pricing rules in EU Member States (Deloitte (2016), PwC (2015), IBFD (2017)) 113
Table 5.3 Profitability of independent SMEs between 2005 and 2014 for all industry sectors (Amadeus (2015), own processing) 117
Table 5.4 Profitability of independent SMEs across industry and time—median values (Amadeus (2015), own processing) 120
Table 5.5 Profitability of independent SMEs across industry sectors between 2005 and 2014 (Amadeus (2015), own processing) . . . 123
Table 5.6 Proposal of safe harbours for selected sectors—small entities (Amadeus (2015), own processing) 125

Table 5.7 Proposal of safe harbours for selected sectors—medium sized entities (Amadeus (2015), own processing) 126

Table 6.1 Consolidation regimes in the European Union (IBFD research platform 2016) 142
Table 6.2 The application of domestic and cross-border loss relief (IBFD tax research platform 2016) 144
Table 6.3 Methods of cross-border loss relief used by member states that allow cross-border loss relief (IBFD tax research platform 2016) 145
Table 6.4 Nominal corporate tax rate and effective average tax rate in EU Member States, 2014 (Spengel et al. 2014) 158
Table 6.5 Distribution of SMEs qualified for the CCTB system across the EU (own processing, Amadeus database) 161
Table 6.6 Classification of losses and profits based on the type of parent company—assignment to the state of the tax residency of subsidiary (own processing, Amadeus database) 163
Table 6.7 Loss relief and its impact on corporate tax revenue (own processing, Amadeus database) 168
Table 6.8 Employees and expenditures in R&D in business sector in the EU by size class in 2013 (own processing, Eurostat 2017) 170
Table 6.9 Division of SMEs according to their motivation to opt for the CCCTB or not (own processing, Amadeus database) 172
Table 6.10 CCCTB and its impact on corporate tax revenue (Corporate tax revenue based on the CCCTB system allocated at the level of the subsidiary based on its tax residency.)—part A (own processing, Amadeus database) 174
Table 6.11 CCCTB and its impact on corporate tax revenues (The corporate tax revenues based on the CCCTB system allocated at the level of subsidiary based on its tax residency.)—part B (own processing, Amadeus database) 175
Table 6.12 CCCTB and its impact on corporate tax revenue (The corporate tax revenue based on the CCCTB system allocated at the level of subsidiary based on its tax residency.)—part C (own processing, Amadeus database) 177

List of Abbreviations

APA	Advance Pricing Agreements
AT	Austria
ATAD	Directive Against Tax Avoidance
BE	Belgium
BEPS	Base Erosion and Profit Shifting
BG	Bulgaria
CbCR	Country-by-Country Reports
CCCTB	Common Consolidated Corporate Tax Base
CCTB	Common Corporate Tax Base
CFC	Controlled Foreign Company Legislation
COST+	Cost Plus Method
CUP	Comparable Uncontrolled Price Method
CY	Cyprus
CZ	Czech Republic
DE	Germany
DK	Denmark
EBIT	Earnings Before Interest and Tax
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortization
EC	European Commission
EE	Estonia
EL	Greece
ES	Spain
EU	European Union
EU JTPF	EU Joint Transfer Pricing Forum
EU TPD	Transfer Pricing Documentation for Associated Enterprises in the EU
EUCIT	European Union Company Tax
FI	Finland
FR	France

G20	Group of Twenty
GAAR	General Anti-Abuse Rule
HR	Croatia
HTS	Home State Taxation
HU	Hungary
IE	Ireland
IT	Italy
LEs	Large Enterprises
LT	Lithuania
LU	Luxembourg
LV	Latvia
MAP	Mutual Agreement Procedure
MF	Ministry of Finance
MNEs	Multinational Enterprises
MT	Malta
NL	Netherlands
OECD	Organisation for Economic Co-operation and Development
OECD Model Convention	OECD Model Tax Convention on Income and Capital
PL	Poland
PT	Portugal
R&D	Research and Development
RO	Romania
RPM	Resale Price Method
SE	Sweden
SI	Slovenia
SK	Slovak Republic
SMEs	Small and Medium-Sized Enterprises
TNMM	Transactional Net Margin Method
TP Guidelines	Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
UK	United Kingdom
UN	United Nations
UN TP Manual	Manual on Transfer Pricing for Developing Countries

Chapter 1
Introduction

This chapter presents a brief overview of the importance of small and medium-sized enterprises (SMEs) and highlights their key role for the EU economy and the major economic issues and obstacles they are facing. SMEs occupy a very important position in the EU economy, mainly in the area of growth and employment. However, the group of SMEs in the EU is very heterogeneous and differs significantly from large enterprises (LEs). Not only do they differ in size, but they also perform different activities, have different needs and require different resources. Currently, SMEs already face special rules in the area of accounting and financial reporting in comparison with LEs; however, SMEs also face specific problems and have specific needs in the area of practical international taxation issues. As studies show, SMEs face higher compliance costs of taxation in the internal market, compliance costs connected with transfer pricing and the problem of accessibility of cross-border loss compensation. Taking into account the existing environment in which SMEs are operating, this book provides a deep analysis of SMEs' compliance costs with respect to transfer pricing. Based on the results of empirical research, this work presents the critical concerns; however, the book also presents suggestions on simplifying transfer pricing rules for SMEs. This book is the result of a 3-year project (No. 15-24867S "Small and medium-sized enterprises in global competition: Development of specific transfer pricing methodology reflecting their specificities" granted by the Czech Grant Agency.

The European Commission (2003) defines small and medium-sized enterprises (hereinafter, SMEs) based on the number of employees, the volume of turnover, or balance sheet total. Accordingly, SMEs are categorized as micro, small and medium-sized enterprises. Medium-sized enterprises are defined as those "enterprises employing fewer than 250 persons and having an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million". Small enterprises are defined as "enterprises having fewer than 50 employees and turnover or balance sheet total less than EUR 10 million. Microenterprises are defined as entities with fewer than 10 employees and a balance sheet total or turnover below EUR 2 million.

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Table 1.1 Enterprises, employment and gross value added of SMEs in the EU28, 2015 (Eurostat, National Statistical Offices and DIW Econ; mentioned in the European Commission 2016)

	Micro	Small	Medium	SME	Large	Total
Enterprises						
Number	21,356,252	1,378,702	224,647	22,959,600	44,458	23,004,059
%	92.80	6.00	1.00	99.80	0.20	100
Persons employed						
Number	40,057,408	27,503,428	23,170,352	90,731,192	45,168,732	135,899,904
%	29.50	20.20	17.00	66.80	33.20	100
Value added						
EUR billion	1,453,926	1,233,270	1,250,907	3,938,103	2,923,873	6,861,976
%	21.20	18.00	18.20	57.40	42.60	100

Based on the definition of SMEs used by the European Commission, SMEs account for over 99% of all companies in each European country and operate in a wide range of sectors. In the non-financial sector, they operate mainly in NACE sector I "accommodation and food", NACE sector M "business services", NACE sector F "construction", NACE sector C "manufacturing" and NACE sector G "wholesale/retail trade". According to the European Commission (2016), those sectors accounted for 78% of SME employment and 71% of SME value added in 2015. Moreover, with respect to the density of SMEs, the number of SMEs per 100 inhabitants ranged from 2.2 in Romania to 9.4 in the Czech Republic, with 4.5 for EU28 (as a whole) as states the European Commission (2016). Furthermore, with respect to SME performance and business environment, SMEs contribute significantly to total employment. According to the European Commission (2016), they provide more than 90 million jobs, mainly in the service sector. Moreover, almost 30% of people employed contribute to micro enterprises, which accounted for 37% of the growth in the total employment in 2015. In addition, SMEs contribute to a considerable proportion of value-added (57%), posting growth of 5.7% in 2015 (for more details see Table 1.1).

According to the surveys conducted,[1] there is no doubt that the SMEs play a key role in the EU economy. However, the economic performance of SMEs is strongly related to the EU economy. The European Commission (2016) states that the SME sector is affected by the macroeconomic environment of the EU, i.e., by overall economic activity, household consumption, investment expenditures and export of

[1]European Commission, *Company Taxation in the Internal Market* (COM(2001)582 final), and also in *Internationalisation of European SMEs* (2010) or *Modern SME policy for growth and employment* (COM(2005)551 final), European Commission. Furthermore, in *Report on Small and Medium Enterprises and Transfer Pricing*, EU Joint transfer pricing forum, European Commission (2011), and in Annual reports on European SMEs 2013, 2014, 2015 and 2016.

goods and services. More precisely, the overall economic activity has an impact on the level of SME activity and employment. Household demand has an impact on NACE sector I "accommodation/food", NACE sector G "retail and wholesale trade" and "other sectors". Investment expenditures and gross fixed capital formation have an impact on NACE sector F "construction" and NACE sector M "business services". Exports of goods and services stimulate SME value added in NACE sector C "manufacturing".

With respect to profitability, the European Commission (2016) states that LEs are generally more profitable than SMEs. This can be caused by the fact that the most pressing problem faced by SMEs is the lack of market demand and consequently finding customers (25%), as well as the availability of skilled staff or experienced managers (18%), competition (14%), costs of production or labour (13%) and regulation (13%), according to the SAFE report (European Commission 2015b). Moreover, it is important to note that most SMEs focus on their domestic market. When domestic demand for goods and services showed no growth from 2009 to 2013 and only moderate growth in 2014 and 2015 (between 1.5% and 2%), contrary to the growth of external demand for goods and services, SMEs also showed no growth. Furthermore, SMEs usually operate in economic sectors having low export intensity. However, when they are involved in cross-border activities, it is mostly on the internal market within EU28 member states. The European Commission (2016) adds that only 1.2 million SMEs are exporting, while 1 million of them export within the EU.

The lower degree of internationalization of SMEs in comparison with LEs can be considered another aspect causing lower profitability of SMEs. Based on the survey done by Directorate General of Enterprise and Industry,[2] only 44% of SMEs (in EU average) are active in any form of international activities (exporting, importing, investing abroad, cooperating internationally, or having international subcontractor relationships) within the EU. The most internationalized economic sectors are considered NACE sector G "retail and wholesale trade", NACE sector B "mining", NACE sector C "manufacturing" and NACE sector G "sale of motor vehicles". However, only 2% (for micro), 6% (for small) and 16% (for medium) of SMEs invest abroad. This is connected mainly with the fact that only 5%[3] of SMEs are associated (having subsidiaries abroad) and that SMEs are less involved in cross-border activities. The survey further highlights that the lack of capital, lack of information, lack of public support, as well as law and regulations are crucial barriers for doing international business from the perspective of SMEs.

Regarding law and regulations, there are 28 different tax systems in the European Union which may inherently disadvantage SMEs and may have distortive impacts on commercial decisions concerning the different business forms and

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[2]European Commission, *Internationalization of European SMEs*, 2010. Directorate-General for Enterprise and Industry.

[3]European Commission, *Observatory of European SMEs, analytical report, 2007*. Directorate-General for Enterprise and Industry.

different business activities. Already in 2007,[4] the European Commission highlighted the need for a regulatory environment that would be simple and transparent with respect to SME issues. Its statement is mainly supported by the fact that on average, where a big company spends one euro per employee to comply with a regulatory duty a medium-sized enterprise might have to spend around four euros and a small business up to 10 euros (European Commission 2007a, b). Moreover, there are different SME definitions for various purposes in the EU, which create the distortions itself within the EU internal market. The disproportionately high impact of regulatory requirements also creates disproportionally high compliance costs in comparison with LEs. Understanding the tax system and proposal of an SME-specific tax are therefore critical in the growth of SMEs. In this context, OECD (2015) states that the provision of SME-specific tax rules can, if carefully designed, play a useful role in addressing the challenges and the disproportionally high tax compliance burdens faced by SMEs.

Considering all of the abovementioned aspects, we assume that the very small percentage of SMEs involved in international business activities can also be caused by the complexity and specialized knowledge required to address international taxation and transfer pricing issues. The European Commission (2013a) proved that the Value Added Tax and corporate taxation are the most burdensome legislative acts for SMEs in the European Union.[5] In those aspects, SMEs face difficulties mainly due to the lack of human and financial capital, and due to the lack of knowledge, experience and resource availability in comparison with LEs. Generally, SMEs differ in size, activities, needs and resources in comparison with LEs. It resulted in lower labour productivity, lower profitability, differences in the qualification and skill levels of the employees and capital intensity. Therefore, it is obvious that SMEs cannot reach the same scale of economy as LEs. Moreover, they do not have the same resources available to bear the high administrative burden to comply with the taxation rules, particularly with transfer pricing rules.

In the EU, transfer pricing compliance means adherence to the arm's length principle stipulated in Art 9 of the OECD Model Convention,[6] Furthermore, to apply the arm's length principle in practice, the OECD has issued the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter, TP Guidelines)[7] that provide guidance for the application of the arm's length

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[4]European Commission, *Models to reduce the disproportionate regulatory burden on SMEs. Report of the Expert Group*. Further, European Commission, 2007: *Simplified tax compliance procedures for SMEs*. DG Enterprise Publications.

[5]European Commission, *Results of the public consultation on the TOP10 most burdensome legislative acts for SMEs*. http://ec.europa.eu/DocsRoom/documents/10036/attachments/1/translations

[6]OECD (2014). *Model Tax Convention*. http://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-2015-full-version-9789264239081-en.htm

[7]OECD (2017). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. http://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm

principle to pricing for tax purposes and to the cross-border transactions between associated enterprises. However, it is clear from the name itself that these TP Guidelines set treatments of transfer pricing issues with respect to multinational enterprises (hereinafter, MNEs), which are generally LEs. In addition, the TP Guidelines make no direct distinction between the types or sizes of MNEs. In theory, all enterprises, regardless of their size, are subject to the same principles and recommendations. We consider that the application of transfer pricing rules in accordance with Art 9 of the OECD Model Convention and with recommendations included in the TP Guidelines to be very complex and its application for SMEs is connected with certain difficulties. They are compounded by the fact there is neither a common definition of SMEs for tax purpose in the EU nor symmetry of treatment of this issue. Furthermore, the costs associated with transfer pricing matters can be disproportionally large for SMEs in comparison to LEs for both the taxpayer and the tax administration. Therefore, we believe that a "one-size fits all" approach is not possible in the case of SMEs facing transfer pricing issues.

Furthermore, there are several studies[8] by the European Commission addressing the position of SMEs on the internal market and highlighting the importance of SMEs for the economy. Therefore, the European Commission initiated several activities to help SMEs. The first was in the form of the Small Business Act[9] (2008), which aimed to promote competitiveness of SMEs, improve the approach to entrepreneurship in Europe, simplify the regulatory and policy environment for SMEs, and remove the remaining barriers to their development. The aims of the Small Business Act are being integrated with the Europe 2020 strategy through the Small Business Act Review,[10] where SMEs represent the heart of the strategy and its key position is again highlighted. It must be emphasized that six of the seven Europe 2020 Flagship Initiatives[11] should help SMEs achieve sustainable growth.

The second was when the European Commission established the EU Joint Transfer Pricing Forum (hereinafter, JTPF) as an expert group on transfer pricing

[8]Examples are European Commission, *Modern SME Policy for Growth and Employment*. COM (2005)551 final. European Commission, *Company Taxation in the Internal Market*. COM(2001) 582 final. European Commission, *Implementation of the community Lisbon programme – Communication from the Commission to the Council and the European Parliament – The Contribution of Taxation and Customs Policies to the Lisbon Strategy*. COM(2005)532 final. European Commission, *Tackling the corporation tax obstacles of small and medium-sized enterprises in the Internal Market – outline of a possible Home State Taxation pilot scheme*. COM(2005)702, and also in *Internationalisation of European SMEs* or *Modern SME policy for growth and employment* (COM(2005)551 final), European Commission.

[9]European Commission, *A "Small Business Act" for Europe*. COM(2008) 394 final. http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008DC0394&from=EN

[10]A major landmark in tracking the implementation of the Small Business Act.

[11]Smart growth (Digital agenda for Europe, Innovation Union, Youth on the move), Sustainable growth (Resource efficient Europe, An industrial policy for the globalisation era) and Inclusive growth (An agenda for new skills and jobs, European platform against poverty). For more details see: http://ec.europa.eu/europe2020/europe-2020-in-a-nutshell/flagship-initiatives/index_en.htm

on December 2006.[12] In 2010, the EU JTPF included the SME transfer pricing issues into the work programme of JTPF and 1 year later issued a report[13] with several recommendations primarily in the area of compliance costs, definition of SMEs across EU Member States, dispute resolution and other areas.

With respect to SMEs, the task of the European Commission is to increase their cross-border activities, preserve their competitiveness within the internal market and to increase their performance, which would remarkably influence the EU economy and ensure smart, sustainable and inclusive growth. Therefore, we believe it is necessary to analyse transfer pricing issues in relation to SMEs across the EU Member States and to suggest alternative approaches as a suitable solution for transfer pricing issues of SMEs. This necessary step will contribute to further internationalization of SMEs, which the European Commission considers crucial for EU economy based on the EU2020 strategy.

This book is organized into seven chapters that provide a solid critique of the current approaches in the area of transfer pricing in the context of SMEs based on the research results of a 3-year project. The book focuses on the presentation of three specific topics that have not previously been presented in the literature:

- The first topic aims to analyse and document specific transfer pricing rules for SMEs across the EU. Chapter 2 contains an overview of transfer pricing rules applied for SMEs across the EU, focusing on simplified measurements, methods, transfer pricing documentation, penalties and tools for ensuring higher certainty, such as advance pricing agreements (APA). Based on the results of the research, it was possible to determine and categorize the main approaches in transfer pricing rules in the context of SMEs and to define the current trend in the rules. Moreover, mapping the transfer pricing rules for SMEs helped to develop a questionnaire targeting both aims—current approaches in transfer pricing rules for SMEs and suggestions for new rules that could be used as a tool for decreasing compliance costs of transfer pricing. Moreover, the questionnaire also served as the main methodological tool for the determination of compliance costs of transfer pricing, which enabled the research of the second headline topic of the book. In addition, the questionnaire enabled detection of whether SMEs would like to introduce simplified measurements in the area of transfer pricing rules and in which form. The evaluation of the questionnaire is presented in Chap. 3, which focuses on general transfer pricing issues (first aim of the book), compliance costs of transfer pricing (second aim of the book) and tools for decreasing those compliance costs (third aim of the book).

[12]European Commission. Commission Decision of 22 December 2006 setting up an expert group on transfer pricing (2007/75/EC) http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:032:0189:0191:EN:PDF

[13]EU JTPF, European Commission, *Report on Small and Medium Enterprises and Transfer Pricing*. http://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/company_tax/transfer_pricing/forum/jtpf/2011/jtpf_001_final_2011_en.pdf

- The second topic aims to determine the compliance costs of transfer pricing according to the results of the questionnaire collected for European SMEs across the EU Member States. The results can be found in Chap. 4. It should be mentioned that the current literature completely lacks the topic of the determination of compliance costs of transfer pricing. Studies determining compliance costs of taxation in relation to Value Added Tax, Corporate Income Tax or other types of taxes can be found. Based on the results of the research, Chaps. 5 and 6 suggest tools for possible reduction of compliance costs of transfer pricing for SMEs since they can significantly affect the economic performance and internationalization of SMEs in the EU and therefore ensure smart and inclusive growth.
- The third topic aims to suggest alternative approaches to the transfer pricing rules in relation to SMEs as a suitable solution for transfer pricing issues of SMEs, namely, the introduction of safe harbours and a common consolidated corporate tax base (CCCTB). Chapter 5 presents the suggested simplified measurement in the form of a safe harbour arm's length range that can eliminate the considerable burden of compliance costs of taxation and make transfer pricing issues easier. As a result, SMEs would not be required to perform comparable and functional analysis needed to determine the arm's length prices or margins. The second alternative approach, CCCTB, can offer different solutions of transfer pricing issues, as upon entering the CCCTB system, all inter-transactions between associated enterprises would be eliminated and the tax base of the entire group would be determined based on the new set rules. This system not only focuses on transfer pricing issues, but on the taxation of corporate enterprises as a whole. Moreover, the new proposal of the CCCTB Directive includes some advantages and motivational incentives for SMEs to enter into the systems. Therefore, Chap. 6 includes analysis of this new system of corporate taxation and its benefits for SMEs.

Finally, Chap. 7 offers conclusions covering general transfer pricing issues, compliance costs of transfer pricing and suggestion of tools to decrease those compliance costs in the context of SMEs. These results highlight the fact that reducing compliance costs and simplifying measurement in transfer pricing rules, or a different approach such as CCCTB, can significantly affect the economic performance of SMEs and their internationalization and can help to achieve the long-term goals of the EU2020 agenda, such as smart and inclusive growth in the EU. The chapter also presents policy recommendations with respect to the EU2020 strategy.

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Chapter 2
Transfer Pricing Rules for SMEs in the EU

The aim of this chapter is to provide the background of transfer pricing rules from both the theoretical and practical points of view. The arm's length principle is considered a key pillar of the rules; therefore, great emphasis is placed on explaining these rules as well as their history and practical application. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter TP Guidelines) provide guidance for applying the arm's length principle to pricing for tax purposes and to cross-border transactions between associated enterprises; therefore, the chapter provides a detailed explanation of the TP Guidelines, particularly a comparability analysis, which is considered the core issue in the application of the arm's length principle, transfer pricing methods, and documentation requirements and administrative approaches to transfer prices. However, TP Guidelines make no direct distinction between types or sizes of multinational enterprises; i.e., all enterprises, regardless of their size, are subject to the same principles and recommendations. Therefore, the chapter also focuses on transfer pricing rules in relation to SMEs, critical concerns in transfer pricing and compliance costs issues. The last part focuses on recommendations, namely, an introduction of safe harbour and common (consolidated) corporate tax base.

2.1 The Arm's Length Principle: Its History, Purpose and Role in the Twenty-First Century

The arm's length principle, which was established as a rule against manipulating transfer prices (and ultimately, therefore, manipulating the volume of the tax base), represents the key pillar of the transfer pricing rules and a standard that has been used in the international tax field since 1933. Under this principle, associated enterprises must set transfer prices for any intra-group transaction in the same amount as they would be set between the unrelated entities, and all other aspects

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of the relationship are unchanged. The international consensus is that the taxable profits realized by an enterprise from controlled transactions should not be distorted by the relationship that exists between the parties but should be comparable to the profits that the enterprise would have realized if it had been dealing in comparable conditions with an independent party. It also means that the conditions of controlled transactions do not differ from the conditions that would be obtained in comparable uncontrolled transactions and thereby transfer prices reflect market forces. Once transfer prices do not reflect market forces and, therefore the, arm's length principle, the tax liabilities of the associated enterprises and the tax revenues of the second tax jurisdiction could be distorted. Any such distortions shall be corrected by a primary adjustment and thereby ensure that the arm's length principle is met. From the practical point of view, it can be conducted by the imputing or reducing of profits/expenses of associated enterprises and establishing the conditions of the commercial and financial relations that they would expect to find between independent enterprises in similar transactions under similar circumstances.

The authoritative statement of the arm's length principle can be found in Article 9(1) of the OECD Model Convention on Income and Capital (hereinafter as OECD Model Convention[1]) known as primary adjustment:

> When conditions are made or imposed between two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

As state Wittendorf (2010) and OECD (1977, 1992, 2010a, 2014), the primary purpose of Article 9 of the OECD Model Convention is to prevent economic double taxation[2] caused by a transfer pricing adjustments. Article 9 comprises two parts:

- Article 9(1) considers the primary adjustments mentioned above, whose legal basis and the method of its application shall be stated in national tax law and whose application is not conditional on the other contracting state agreeing with the adjustment.
- Article 9(2) addresses corresponding adjustments.

The provision about corresponding adjustment in cases of associated enterprises was added to Article 9 during the first revision of the OECD Model Convention in 1977, with the purpose of avoiding economic double taxation in cases, where one tax administration adjusts associated enterprise's taxable profits due to a primary adjustment—i.e., applying the arm's length principle to controlled transactions involving an associated enterprise in a second tax jurisdiction. As mentioned in the TP Guidelines (para 4.32), the corresponding adjustment is a downward

[1] OECD: Model Tax Convention on Income and Capital.

[2] The treaty protection under Article 9(1) is applied to both actual and virtual double taxation. In contrast, a corresponding adjustment under Article 9(2) is only available with respect to actual double taxation. For further details, see Solilova and Steindl (2013).

adjustment to the tax liability of that associated enterprises (made by the tax authority of the second jurisdiction), so the allocation of profits between the jurisdictions is consistent with the primary adjustment, and no double taxation occurs.[3] However, with respect to OECD (2010a, b, 2014 and 2017),[4] a corresponding adjustment is not made automatically, but once the contracting state agrees that the primary adjustment is justified both in principle and in the amount, then a corresponding adjustment shall be made; i.e., the other contracting state is not liable to make a corresponding adjustment if it considers the transaction to have been conducted at arm's length, resulting in the situation of economic double taxation.[5]

In cases of transfer pricing dispute resulting in economic double taxation, Article 9(2) suggests considering corresponding adjustment requests under mutual agreement procedure of Article 25 OECD Model Convention. Moreover, as the OECD (2010b, 2017) states, it is also recommended in cases when double tax treaties do not include the corresponding adjustment statement in Article 9(2). This situation occurred frequently at the beginning of the period when the corresponding adjustment was introduced by the OECD in Article 9(2) due to uncertainty about its mandatory or non-mandatory application.[6] Therefore, some of the OECD member states raised the reservation to Article 9(2) OECD Model Convention in the following forms: (i) to obtain the right not to insert paragraph 2 in the double tax treaties but to be prepared to accept this paragraph with an addition of a third paragraph which limits the potential corresponding adjustment to bona fide cases; (ii) or to make adjustments in accordance with the procedure provided for by the mutual agreement only; (iii) or only if they consider that the primary adjustment is justified.[7]

The introduction of the arm's length principle and its implementation into domestic tax framework is a matter not only for the OECD member countries but also for the United Nations member countries. The arm's length principle is also expressed in Article 9 of the United Model Double Taxation Convention between Developed and Developing Countries (hereinafter as UN Model Convention[8]) in an identical form as in the OECD Model Convention. However, the article includes

[3]For more details see paras 4.32–4.39 of the TP Guidelines (OECD 2017) and para 11 of the Commentary on Article 9 of the OECD Model Convention.

[4]For more details see OECD Commentary on Article 9(2), para 6, 2010a and TP Guidelines, para 4.35, 2017.

[5]For more details see Wittendorf (2010), part 2 and 3.

[6]Currently, the corresponding adjustment is not mandatory.

[7]Currently, on the basis of the last revision in 2014, only four member states, namely, the Czech Republic, Hungary, Italy and Slovenia, have a reservation with respect to Article 9(2) OECD Model Convention. Furthermore, Australia has a general reservation on Article 9 OECD Model Convention. Moreover, there is one observation on Article 9 OECD Model Convention with regard to the thin capitalization made by the United States.

[8]United Nations, "Model Double Taxation Convention between Developed and Developing Countries", updated 2011. Available from: http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

fraud exclusion in paragraph 3, which is not included in Article 9 of OECD Model Convention:

> The provision of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or willful default.

The purpose of the third paragraph is to cover the situation when a contracting state does not need to make a corresponding adjustment via Article 9(2).

As is obvious from the statement of Article 9 in the OECD Model Convention and UN Model Convention, administrative guidance is needed on the application of legal basis relating to the arm's length principle or methods how the primary adjustment or corresponding adjustment shall be made. However, no administrative guidance[9] was available until 1979, when the OECD published its first transfer pricing report—The OECD Report on Transfer Pricing and Multinational Enterprises (hereafter OECD Report), which was supplemented and followed by other reports on the complexity of transfer pricing issues. During the period 1992–1997, the OECD Report was significantly revised to reflect the developments in international trade. A first important result of revision was a reference to this report being included in the Commentary on Article 9 of the OECD Model Convention (1992),[10] which resulted in both the OECD Report, as a predecessor to the TP Guidelines, and the TP Guidelines themselves are considered a way of interpreting Article 9 of the OECD Model Convention. The second important result of revision is the TP Guidelines[11] being published and thus providing more detailed guidelines on the application of the arm's length principle, as neither Article 9 nor the Commentaries on Article 9 contain detailed guidance on the principle. However, similar to the OECD Commentary, the TP Guidelines are not legally binding under international tax law, but they are considered a means of interpretation as far as they were available when the respective tax treaty was signed, as stated (UN, Vienna Convention, Article 31, 1969).[12] The aim of the TP Guidelines is to create an

[9]Only in the US; the US Treasury issued regulations for specific types of intercompany transactions in 1968, which was the motivation for the OECD to publish a guidance of transfer pricing issue.

[10]For more details see OECD Commentary 1992, Article 9 para 3.

[11]The groundwork for the 1995 and other revisions of the TP Guidelines was laid by the OECD Report 1979 and OECD Mutual Agreement Report from 1984. In 2009, a limited update of TP Guidelines was made to reflect the adoption of update of the *Model Tax Convention* in the 2008. In the 2010 edition, significant revisions were made; namely, Chapters I–III and a new Chapter IX, on the transfer pricing aspects of business restructurings, was added. Since 2013, the TP Guidelines has been a subject of a huge revision due to the results of individual actions of Base Erosion Profit Shifting project (hereinafter BEPS). Currently, the 2017 edition of the TP Guidelines reflecting a consolidation of the changes resulting from the BEPS project and other changes was released on 10 July 2017.

[12]In this fact is relating the static and dynamic approach of interpretation of Tax Conventions. For more details see https://www.wu.ac.at/fileadmin/wu/d/i/taxlaw/institute/staff/publications/langbrugger_australiantaxforum_95ff.pdf, or see Wittendorf (2010), Chap. 3.

international consensus on a common interpretation of the arm's length principle and its application, according to the OECD (1997, 2010b). Thus, as Owens (2005) states, the separate entity approach is considered the underlying concept supporting the arm's length principle. Further, as the OECD (1997) notes in the TP Guidelines, the fundamental basis to the arm's length principle is the equal treatment of associated and independent enterprises. However, currently, this equal treatment is often criticized by opponents of the arm's length principle.[13] Moreover, because the TP Guidelines set treatments of transfer pricing issues with respect to multinational enterprises and regardless of the size or type of enterprise, the application of the arm's length principle can be a resource-intensive process that results in heavy compliance costs, particularly for SMEs.

The UN along the lines of the OECD published a practical Manual on TP for Developing Countries (known as the UN TP Manual) in 2013. Currently, the second edition (2017) is available, which reflects the experience and developments in the area of transfer pricing analysis and administration since 2013 and endorses the arm's length standard for the pricing of transactions within associated enterprises.

There are several reasons why OECD and UN member countries and other countries have adopted the arm's length principle. The TP Guidelines highlight that the main reason for adopting this principle is that it provides a broad parity of tax treatments for associated and independent enterprises, resulting in the avoidance of tax advantages or disadvantages among entities. Therefore, as Cottani (2016) states, almost all countries introduced domestic tax provisions endorsing this standard allowing adjusting transfer prices that deviate from the arm's length principle. In this context, as Solilova and Steindl (2013) mention, the primary purpose of this standard is to ensure the compliance of domestic rules with the arm's length principle with respect to transactions on business income between associated enterprises with the objective of mitigating economic double taxation.

However, they are many experts who view on this standard as inherently flawed, which is incompatible with today's global economy, i.e., the global nature of international business, as Avi-Yonah and Clausing (2007) state; Durst (2010, 2011) highlights that this standard is based on a fundamental misunderstanding of both practical economics and the way in which multinational business is conducted. The author further notes that the current corporate tax system is based on faulty assumptions and, therefore, on the unenforceability of the arm's length principle resulting from its central premises: the comparison of profit from transactions among associated enterprises with the results of comparable transactions among unrelated parties. According to the author, the activities of unrelated parties are systematically different from those of associated enterprises; therefore, they cannot be comparable. Moreover, it is absolutely incorrect to evaluate the results of associated enterprises based on the assumption that they are a group of unrelated enterprises transacting with one another at arm's length while holding associated enterprises to the arm's length principle for pricing intra-group transactions, as state Avi-Yonah and Clausing (2007) and Durst (2010,

[13] For more details see last part of this Section.

2011). The authors add that this approach does not make sense anymore. Such an approach might well have made sense 80 years ago, when the arm's length standard for tax purposes was first developed.

In 1930s, the arm's length principle was considered a suitable allocation norm (Carrol 1933)[14] because cross-border transactions were limited and business structures were not as complex and complicated. The principle was incorporated into international taxation law through the League of Nations Draft Convention on the Allocation of Profits and Property of International Enterprises in 1933 and by the first OECD Model Convention draft Tax Treaty (1963) with the same wording as the London Model (1946). It is obvious that at that time, the nature of business and technology did not permit the close centralized management of associated enterprises operating in different countries. Therefore, comparing their activities/transactions with those of uncontrolled comparable entities probably made sense. However, with the technological changes, globalization and digital nature of business, it is economically infeasible to do business without controlled structure, resulting in markets with a lack of comparables, i.e., where it is unlikely to find uncontrolled comparable entities, as state Avi-Yonah and Benshalom (2010).

Furthermore, there is some evidence that the arm's length standard does not reflect either economic reality or whether the third party would enter the transaction, but instead, it proves the income shifting between enterprises, as state Keuschnigg and Devereux (2013), Taylor et al. (2015), Bartelsman and Beetsma (2000), Wells and Lowell (2014), Hines and Rice (1994), and Huizinga and Laeven (2006). It fully corresponds with the fact that the transfer pricing represents an instrument that is used as tax planning tool; i.e., properly chosen transfer pricing strategies can enable the distribution of the tax risks and profits, resulting in a reduction of the overall corporate tax liability, as state Buus (2009), Solilová and Nerudová (2012, 2013), Swenson (2001), Rojíček (2012) and others. Moreover, the corporate income is taxed at the national level, whereas economic environment and business models have become more complex and complicated with the increasingly globalized, mobile and digital nature of business. Therefore, profit shifting is done more easily, and the divergence of national corporate tax systems has created a space for aggressive tax planning.[15] The international tax rules, including the arm's length standard and tax systems, seem to be inefficient and non-transparent and are not able to react on increasingly sophisticated tax planning structures.

In this respect, the OECD (2013a) estimates annual losses from 4 to 10% of global corporate income tax revenues, i.e., USD100–240 billion annually.[16] In the

[14]One year previously, the first tax treaty was signed with an allocation norm for business income between associated enterprises in the form of the arm's length principle.

[15]Aggressive tax planning involves taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems to reduce tax liability. For more details, see Commission Recommendation of 6 December 2012 on aggressive tax planning, C(2012) 8806 final.

[16]For more details see: http://www.oecd.org/tax/addressing-base-erosion-and-profit-shifting-9789264192744-en.htm and https://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf

EU, the estimation of annual losses of tax revenue is approximately EUR 1 trillion, and in the case of corporate taxation, approximately EUR 50–70 billion is lost.[17] To avoid this practice and ensure the correct application of the separate entity approach, in February 2013, the OECD and G20 countries[18] launched a project on Base Erosion and Profit Shifting (hereafter BEPS) that included 15 Action plans[19] referring to tax planning strategies and shifting profits to low or no-tax jurisdictions, resulting in little or no overall corporate tax being paid. The final reports of the project were published on 5 October 2015. Consequently, the TP Guidelines were updated and released on 10 July 2017, reflecting the recommendations from the BEPS project.[20]

To avoid the divergent implementation of BEPS by each EU Member States and a disruption of the functioning of the internal market, the European Commission published the draft of the Directive "*laying down rules against tax avoidance practices that directly affect the functioning of the internal market*", known as the Anti Avoidance Directive, on 28 January 2016, which was adopted after 5 months by Council as a Directive 2016/1164.[21] Furthermore, on 28 January 2016, the Commission proposed a framework for a new EU external strategy for effective

[17]For more details see: European Parliamentary Research Service *Aggressive corporate tax planning under scrutiny* http://www.europarl.europa.eu/RegData/etudes/ATAG/2015/571345/EPRS_ATA(2015)571345_EN.pdf

[18]The EU confirmed support for work within the BEPS project in May 2013, see Council document 9405/13

[19]For the transfer pricing issue, only two deliverables of BEPS project focus on it: Action plan 8–10 "Aligning Transfer Pricing Outcomes with Value Creation" and Action plan 13 "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting". Based on the Action Plan 13, all enterprises are required to report information relating to their economic activity such as revenues, profits, taxes paid and certain measures of economic activity, and to articulate their consistent transfer pricing positions through this standardized approach of reporting. Thus, a new reporting obligation is required for the current transfer pricing documentation. Based on the Action plan 8–10, in the area of transfer pricing analysis and determination of transfer prices, a correct application of the arm's length standard demands an understanding of the value drivers and relevant risks involved and how responsibility for those risks is attributed among the associated enterprises in the context of their commitment to creating value jointly. For the level and assumption of risk are economically relevant characteristics that can be significant in determining the outcome of a transfer pricing analysis.

[20]Only one part is waiting on the revision, particularly the section related to the profit split method, due to on-going work.

[21]Anti-Tax Avoidance Directive contains five legally-binding anti-abuse measures (Controlled foreign company (CFC) rule, switchover rule, exit taxation, interest limitation, and general anti-abuse rule) which all Member States should apply against common forms of aggressive tax planning. It creates a minimum protection for all Member States' corporate tax systems by transposition of the OECD BEPS measures into their national systems in a coherent and coordinated fashion and ensures a fairer and more stable environment for business. Member States should apply these measures as from 1 January 2019.

taxation[22] with the aim of promoting good tax governance globally, tackling external base erosion threats and ensuring a level playing field for all businesses.

However, it is not clear whether steps performed through BEPS will lead to the proper application of the arm's length standard and proper corporate income taxation and whether those steps are just another patch on the already inadequate and inefficient corporate income tax system, which can generate annual losses between EUR 50 and 190 billion[23] due to profit shifting and system inefficiencies. Therefore, the issue of possible alternatives to the arm's length principle (as an allocation norm) should be discussed because, as discussed above, the arm's length principle can no longer be considered the fairest and most reliable basis for determining where taxable profits fall.

The following part of the chapter is aimed at discussing the comparability analysis as the key part of the application of the arm's length principle, practical application of transfer pricing methods, documentation of transfer prices and transfer pricing rules in the context of SMEs, in light of 2017 update of the TP Guidelines covering the recommendations that resulted from the BEPS project.

2.2 Comparability Analysis: Key Part of the Application of Arm's Length Standard

As mentioned above, the central premise of the arm's length standard is the comparison of conditions of controlled transactions with those of comparable uncontrolled transactions. The comparability analysis plays a crucial role because based on its results, the most appropriate transfer pricing method is selected, and the arm's length price or margin is determined. There is no doubt that it represents a core part of the application of the arm's length standard.

Selecting the appropriate transfer pricing method depends on the consideration of the all connected circumstances of the case. For this purpose, the selection process should consider the strengths and weaknesses of each method recognized by the TP Guidelines. The suitability of the method should be considered in the view of the nature of the controlled transaction and should be determined through a functional analysis, which is an important part of the comparability analysis. Therefore, the TP Guidelines have set *five comparability factors* that may be important in a comparability determination: *"The characteristics of the property and services transferred, the functions performed by the parties with taking into account assets used and risks assumed (known as functional analysis), the*

[22]See COM(2016)24final, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52016DC0024

[23]For more details see: European Parliamentary Research Service Aggressive corporate tax planning under scrutiny http://www.europarl.europa.eu/RegData/etudes/ATAG/2015/571345/EPRS_ATA(2015)571345_EN.pdf

contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties." The selection process should also consider the availability of reliable information needed to apply the selected method(s) and the degree of their comparability.[24] In addition, for a functional analysis, the TP Guidelines state (para 1.51, OECD 2017), that the following may be helpful:

- to understand the structure and organization of the group and how they influence the context in which the taxpayer operates,
- how value is generated by the group as a whole, the interdependencies of the functions performed by the associated enterprises with the rest of the group and its contribution to that value creation,
- and to determine the legal rights and obligations of the taxpayer in performing its functions with respect of the basic principle that the functions carried out will usually determine the allocation of risks between parties.

It means that functional analysis seeks to *identify the commercial and financial relations between the associated enterprises, the conditions and economically relevant circumstances attaching to these relations in order that the controlled transaction is accurately delineated.*[25]

To accurately delineate the actual transaction with respect to the functions performed, assets used and risks assumed, the TP Guidelines state (Section D.1.2., Chapter 1, OECD 2017) that a functional analysis compares the economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties to the transactions. The functions that taxpayers and tax administrations might need to identify and compare, include the capabilities of the parties, type of assets used (e.g., plant and equipment, the use of valuable intangibles, financial assets), logistics, warehousing, marketing, sales, design of products, manufacturing, assembling, research and development, servicing, purchasing, distribution, advertising, transportation, financing, and management. The economically significant risks[26] assumed by each party can be categorized in various ways, but a relevant framework in a transfer pricing analysis is to consider the sources of uncertainty that give rise to risk. Based on these sources of uncertainty, the TP Guidelines (para 1.72, OECD 2017) now classify risks (as a non-exclusive list of risks) as strategic or marketplace risks, infrastructure or operational risks, financial risks, transactional risks and hazard risks. Further, human and intellectual capital risks can be identified during the functional analysis. Reference is also made to risks that are externally driven and those that are internally driven to help clarify the sources of uncertainty.

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[24]The term "degree of comparability" is defined as the comparability between controlled and uncontrolled transactions.

[25]For more details see para 1.33, and section D.1.2., Chapter 1 TP Guidelines, OECD 2017.

[26]The significance of a risk depends on the likelihood and size of the potential profits or losses arising from the risk.

Identifying risks, functions and assets is an integral part of both identifying the commercial and financial relations between associated enterprises and accurately delineating the transactions. In this respect, it is important to note that the definition of risks in business should neither be performed on the primitive level (i.e., just listing the risks from the general point of view) nor interpreted as risks being more important than functions or assets. The practice, however, showed that it can be more difficult to identify the risks in a transaction than functions and assets. The TP Guidelines therefore introduce a *six-step process to analyse the risks* (in para 1.60, OECD 2017), which can be summarized as follows:

1. Identification of economically significant risks in the relevant relational context[27]
2. Determination of how risks are contractually assumed under the terms of the transaction
3. Determination through a functional analysis which enterprise(s)
   - perform(s) control functions and risk mitigation functions,
   - encounter(s) upside or downside consequences of risk outcomes, and
   - have(s) the financial capacity[28] to assume the risks
4. Determination of whether the contractual assumption of risks is consistent with the conduct of the associated enterprises by analysing whether
   - the associated enterprises follow the contractual terms; and
   - the party assuming risk exercises control[29] over the risk and has the financial capacity to assume the risk
5. Where the party assuming risk does not control the risk or have the financial capacity to assume the risk, then the risk should be allocated to the entity exercising control and having the financial capacity to assume the risk

[27]The identification of an associated enterprise(s) assuming risks is usually set out in written contracts between the parties to a transaction involving these risks. A contractual assumption of risk constitutes an ex ante agreement to bear some or all of the potential costs associated with the ex post materialization of downside outcomes of risk in return for some or all of the potential benefit associated with the ex post materialization of positive outcomes. It must be highlighted that an ex ante contractual assumption of risk should provide clear evidence of a commitment to assume risk prior to the materialization of risk outcomes. Such evidence is a very important part of the tax administration’s transfer pricing analysis of risks in commercial or financial relations.

[28]Financial capacity in this area means the access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes. If the financial capacity to assume a risk is lacking, then the allocation of risk requires consideration under step 5 above.

[29]Control over risk, as the last essential part of analyzing risks, involves the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, and the capability to make decisions on whether and how to respond to the risks associated with the opportunity. Day-to-day mitigation is not necessary to be performed in order to have control of the risks; i.e., these activities can be outsourced.

  – In case of multiple associated enterprises that both exercise control and have the financial capacity, then the risk should be allocated to the entity(ies) that have the most control.

6. The actual transaction as accurately delineated by considering the evidence of the economically relevant characteristics of the transaction and should be price, taking into account the financial and other consequences of risk assumption.[30]

It is obvious that a more comprehensive and realistic approach to the risk is inevitable, as well as an understanding of the drivers of the value in the enterprise. Further, how the associated enterprises can be rewarded depends on the *ex ante* and *ex post* analyses of company price policy. Moreover, the responsibilities of entities with respect to different risks affect the final remunerations for those entities; i.e., *ex post* outcomes can only be understood and explained in view of those responsibilities.

To summarize, an accurately delineated transaction should also be priced in accordance with the financial and other consequences of risk assumption and the remuneration for risk management. Thus, a taxpayer that both assumes and mitigates a risk should be entitled to greater anticipated remuneration than should a taxpayer that only assumes or mitigates a risk but does not do both. With respect to the recognition of the accurately delineated transaction, the key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances rather than whether the same transaction can be observed between independent parties.

For the other parts of the comparability analysis, *a nine-step process for performing a comparability analysis* was added to the TP Guidelines in 2010, representing an accepted good practice:

- Step 1: Determination of years to be covered.
- Step 2: Broad-based analysis of the taxpayer's circumstances.
- Step 3: Understanding the controlled transaction(s) under examination, based in particular on a functional analysis.
- Step 4: Review of existing internal comparables, if any.
- Step 5: Determination of available sources of information on external comparables.
- Step 6: Selection of the most appropriate transfer pricing method.
- Step 7: Identification of potential comparables.

[30]The TP Guidelines now use the term "risk management", which refers to the function of assessing and responding to risk associated with commercial activity. Risk management means taking on both the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materializes. Risk management is addressing the impact of volatility on profits and value; therefore, associated enterprises must identify the source and impact of volatility on their business to manage risks better.

- Step 8: Determination of and making comparability adjustments where appropriate.
- Step 9: Interpretation and use of data collected, determination of the arm's length remuneration.

The "broad-based analysis" is an essential step in the comparability analysis since it helps in understanding the conditions in the taxpayer's controlled transaction and those in the uncontrolled transactions to be compared, particularly the economic circumstances of the transaction. As a common source of information for the comparability analysis serves commercial databases, which can be a practical and occasionally cost-effective way of identifying external comparables and may provide the most reliable source of information, depending on the facts and circumstances of the case. However, the use of commercial databases should not encourage quantity over quality.

The process of identifying potential comparables is one of the most important aspects of the comparability analysis with the objective of finding the most reliable data. The TP Guidelines, in para 1.33 (OECD 2017) describe this process "*as comparing the conditions and the economically relevant circumstances of the controlled transaction as accurately delineated with the conditions and the economically relevant circumstances of comparable transactions between independent enterprises*". However, the TP Guidelines bear in mind the burden of an exhaustive search of all possible sources of comparables or the considering of all methods as well as limitations in information availability, namely, in case of SMEs. Therefore, the aim is to find the most reliable data under the circumstances of the case, recognizing that they will not always be perfect.[31] To combat this issue is recommended to use some statistical methods. In this respect, Cottani (2016) adds that taxpayers are at risk if the comparables search process is not sufficiently thorough. The EU JTPF is aware of the risks and difficulties involved in the comparability analysis and thus, in 2016, released the *Report on the Use of Comparables in the EU* containing recommendations and good practice in respect of search strategy and specific aspects of comparability adjustments in line with the arm's length principle.[32] The current practices observed by both taxpayers and tax administration are explained and presented in Fig. 2.1. As is obvious, the first step is setting the analysis with the aim of ensuring the objectivity of the process. The second step is the quantitative analysis covering the process of Boolean search of external potential comparables through industry sectors codes, keywords, turnover thresholds, independence tests,[33] "diagnostic ratios"[34] and others, for which

[31]For more details see TP Guidelines para 3.2, 3.80–3.83, and 3.57 OECD 2017.

[32]For more details, EU JTPF report available at: https://ec.europa.eu/taxation_customs/sites/taxation/files/jtpf0072017encomps.pdf

[33]It is worth noting that percent-based indicators reflecting a maximum share of interest owned in subsidiaries differ significantly among the EU member states, particularly between 20% and 50%.

[34]Diagnostic ratios represent certain ratios of balance sheet / profit and losses account items of the tested party, which are compared with those of potential comparables and can help increase

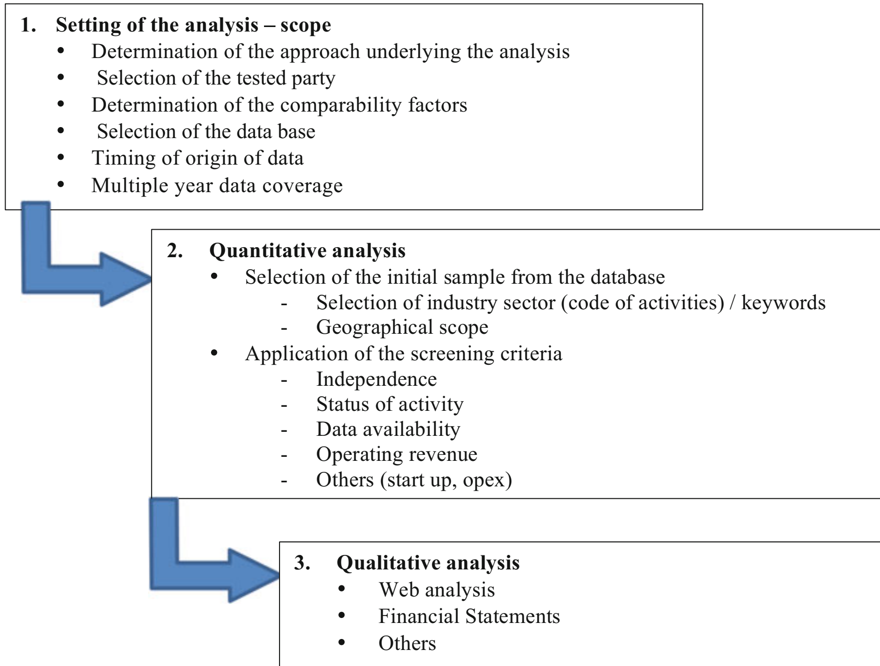

Fig. 2.1 Selecting of external comparables—current practice (EU JTPF 2016, adjusted)

multiple year data covering a time period of 3–5 years are recommended. The last step is a qualitative analysis that covers the manual analysis of potential comparables received through the previous step, namely, website, company reports, financial statements, detailed independence test, and losses.

Further, it is important to note that two transactions are seldom completely comparable in currently existent "imperfect" environment. As highlights Cottani (2016) an apple-to-apple comparison is not possible as. In accordance with TP Guidelines (para 3.47, OECD 2017), "*to be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology, or that reasonably accurate adjustments can be made to eliminate the effect of any such difference*". Therefore, if there are material differences on prices or profits between controlled and uncontrolled transactions, the reliability of comparability adjustments that may eliminate these differences between them should be considered with aim to improve the reliability of the comparability analysis's results. Furthermore, it has to be mentioned that even in cases where comparable data are scarce and imperfect,

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valuable input of the comparability analysis, namely, whether the potential comparables match these ratios of the tested party.

the selection of the most appropriate transfer pricing method should be consistent with the functional analysis of the parties.

However, in para 1.11 (TP Guidelines, OECD 2017), it is mentioned that not having comparables does not itself mean that the transactions between associated enterprises are not at arm's length. This statement can be considered crucial because there are some significant cases in which the arm's length principle is difficult and complicated to apply. An example may be the case of integrated production of highly specialized goods, in unique intangibles, and/or in the provision of specialized services. A practical difficulty in applying the arm's length principle is that associated enterprises may be engaged in transactions that independent enterprises would not undertake. Such transactions may not necessarily be motivated by tax avoidance. In some cases, it will be possible to apply the arm's length principle to arrive at a single figure (e.g., price or margin) that is the most reliable to establish whether the conditions of a transaction are at arm's length. However, because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures that are all relatively equally reliable. In these cases, differences in the figures that comprise the range may be caused by the fact that in general, the application of the arm's length principle only produces an approximation of the conditions that would have been established between dependent enterprises. It is also possible that the different points in a range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction. To enhance the reliability of comparable analysis, the TP Guidelines (para 3.57, OECD 2017) and EU JTPF (2016) recommend narrowing the range by using statistical methods (i.e., the interquartile range, other percentile).

In general, the search for information on potentially comparable uncontrolled transactions and the process of identifying potential comparables is dependent on prior analyses of the taxpayer's controlled transaction and the relevant comparability factors. The entire analytical process should be consistent, transparent, systematic and verifiable, from the preliminary analysis of the conditions of the controlled transaction, to the identification of potential comparables, to the selection of the transfer pricing method, and ultimately to the conclusion about whether the controlled transactions are consistent with the arm's length standard. There is no specific procedure for SMEs; therefore, they have to follow the same principles, rules and recommendations through the TP Guidelines. In addition, it is a good practice for taxpayers to set up a process to establish, monitor and review their transfer pricing policy, and they should expect to provide documentation demonstrating the conduct of a detailed comparability analysis.

2.3 Transfer Pricing Methods and Their Practical Application in the Twenty-First Century

To establish whether the conditions imposed in the commercial or financial relations between the associated enterprises are consistent with the arm's length principle, the TP Guidelines distinguish among five transfer pricing methods, which are known as traditional transaction methods (these methods are comparable uncontrolled price method or CUP method, the resale price method or RPM, and cost plus method or COST+) and transactional profit methods (these methods are transactional profit split method and the transactional net margin method or TNMM). Further, associated enterprises are free to apply methods not described in the TP Guidelines, provided that the arm's length principle is followed (para 2.9 TP Guidelines, OECD 2017).

The first method, *the comparable uncontrolled price method* (hereafter CUP), compares the price charged for property or services in a controlled transaction to the price charged in a comparable uncontrolled transaction between independent enterprises in comparable circumstances. If there is any difference between the prices, it may indicate that the arm's length principle is not followed and that the primary adjustment (through Article 9(1) of OECD Model Convention) should be considered and subsequently performed based on the result of the consideration. The CUP method is the most direct and reliable way to apply the arm's length principle because any difference in the prices (between controlled and comparable uncontrolled transactions) can be traced directly to the commercial and financial relations made or imposed between the enterprises because and the arm's length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction. Thus, for the case of CUP, the price of controlled transaction is equal to the price of comparable uncontrolled transaction, provided that the commercial and financial relations are comparable.

The major breakthrough of the 2010 update of the TP Guidelines represents the introduction of a new concept in the form of the "most appropriate method", which resulted in the removal of the distinction between traditional and profit methods. Currently, the selection of the most appropriate method is based on the circumstances of the case. However, as the TP Guidelines state (para 2.3, OECD 2017), *where the CUP method and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.*

Under the second method, the *resale price method*, the reseller's gross margin on a product that is purchased from an associated enterprise and resold to an independent enterprise, is compared to the gross margin on product purchased from an independent enterprise in light of its comparable functions, assets and risks. An appropriate gross margin known as resale price margin represents the costs of goods sold and an appropriate profit in the light of the functions performed, assets used and risks assumed. After subtracting the gross margin from the sales price (i.e., price at which a product is resold to an independent enterprise), an arm's length

price remains for the original transfer of the property between associated enterprises.

The third method, *the cost plus method*, tests whether the profit mark-ups charged in a controlled transaction conducted at arm's length compared with the profit mark-ups charged in comparable uncontrolled transactions. In applying the COST+ method, the cost base should sufficiently and reasonably reflect the costs borne under the results of functional analysis reflecting appropriate allocation key. Appropriate profit mark-ups is then added to this cost base, resulting in an arm's length price for the original controlled transaction.

Transactional profit methods (TNMM and profit split) can be considered the most appropriate methods in cases where the parties make unique and valuable contributions to the transaction, they engage in highly integrated activities or there is no or limited publicly available data on independent third parties. The fourth method, the *transactional net margin method*, operates in a similar way as the COST+ and RPM methods. However, the TNMM method examines the net profits, relative to an appropriate base, that an associated enterprise earned in controlled transactions and compares them to the net profits realized from comparable uncontrolled transactions. The method operates on the basis of profit-level indicators. The choice of a profit-level indicator and the suitability of its application depend on the results of functional analysis. The selection of the denominator should be consistent with the comparability analysis of the controlled transaction, and in particular, it should reflect the allocation of risks between associated enterprises.

The last method, the *profit split method*, is the only method that is based on a comprehensive two-sized approach with the aim of determining appropriate profits for all associated enterprises engaged in the controlled transaction by reference to the conditions that would have been obtained between independent enterprises in comparable transactions and comparable circumstances. There are a number of approaches for estimating the division of profits; however, the TP Guidelines recommend two approaches: contribution analysis and residual analysis.[35]

Considering the recommended transfer pricing methods, it is obvious that the application of the arm's length principle is based on a comparison of the price, margin or profits from particular controlled transactions with the price, margin or profits from comparable transactions, contrary to the profit split method, which is based on an approximation of the division of profits that independent enterprises would have expected to generate from engaging in the transaction.[36] It can be said that CUP compares prices, RPM compares gross margin, COST+ compares profit mark-ups on costs and TNMM analyses net profits in relations to an appropriate

[35]Currently, the Chapter III, part III, section C—Transactional profit split method, in the TP Guidelines (OECD 2017) is without update due to the on-going work based on the BEPS project. Therefore, the profit split method is not described in detail.

[36]For more details see Chapter II TP Guidelines, 2017.

base, such as sales or operating revenue, costs (usually total operating costs) or assets.

It is worth highlighting that the selection of the most appropriate method does not mean the deep analysis and testing of all transfer pricing methods because the TP Guidelines do not require using more than one method for analysis.[37]

2.3.1 Strengths and Weaknesses of Transfer Pricing Methods

The TP Guidelines state that the essential part of selecting the most appropriate method is to identify the strengths and weaknesses of the considered transfer pricing methods. Therefore, the following section is aimed to identify these characteristics for the mentioned methods.

As is obvious from Tables 2.1, 2.2 and 2.3, each of the recommended transfer pricing methods has at least one weakness. The preferred CUP method, which is considered the most direct and reliable way to apply the arm's length principle, is presented with several weaknesses as well as, in practice, the most frequently used TNMM method. Therefore, it is desirable to select the appropriate transfer pricing method with respect to circumstances of the case, considering the strengths and weaknesses of the methods and the results of comparability and functional analyses, and the nature of the controlled transaction.

2.3.2 Practical Application of Transfer Pricing Methods: Critique Aspects

The application of the CUP method is based on internal or external comparable uncontrolled transactions, when internal comparable uncontrolled transactions are considered for the most reliable arm's length results. Furthermore, the CUP method allows the prices to be compared in either the direct or indirect form. The direct price comparison is possible when none of the differences materially influence the prices, in contrast to indirect price comparison, when the effects of differences are eliminated through accurate adjustments. In practice, due to very high comparability standards,[38] it is often difficult to identify comparable uncontrolled transactions where no adjustments should be performed. Therefore, if the CUP method is applied, the indirect price comparison prevails, and the relative reliability of the CUP method after adjustments must be considered. Furthermore, as King (2010)

[37]For more details see para 2.8., 2.12. TP Guidelines, OECD 2017.

[38]Transactions must be similar or the same in terms of product type, contractual terms, design, functionality and quality, geographic market, level of market, functions performed, assets used and risks assumed, etc.

Table 2.1 Strengths and weaknesses of traditional transaction methods (own compilation, TP Guidelines, OECD 2017)

	Traditional transaction methods	
	Strengths	Weaknesses
CUP	• Simple application if all conditions are fully met • The most direct and reliable way to apply the arm's length principle • Relatively independent on the internal information system as the price can be verified on the market. Moreover, the method requires neither the identification of a tested party nor the use of commercial databases • Preferable method over all other method under specific condition • The method is probably most useful where an associated enterprise sells the same product as is sold to an independent enterprise to an associated enterprise	• The method requires very high comparability; therefore, all material differences need to be eliminated through reasonably accurate adjustments. Reliability of the method depends on the accuracy of the necessary adjustments • Based on the practical experience, it is difficult to find comparable uncontrolled transactions among independent entities without material differences having effect on price. Therefore, the CUP method is not often used
RPM	• The method is based partly on information found on the market (independent price), which is then supplemented with internal company information (margin) • The method is less sensitive to difference in product comparability; therefore, fewer adjustments are normally needed to account for product differences than under the CUP method, because minor product differences are less likely to have as material an effect on profit margins as they do on price • The method is more accurate where it is realized within a short time of reseller's purchase of the goods • The method is easiest to determine where the reseller does not add substantially to the value of the product • The method is probably most useful where it is applied to marketing operations, sales organizations such as reseller, or vertical integration (where the process is technologically linked, the product is gradually being valued with the result of increase of its price). Further, the method can be used in the case of sales agents performing routine brokering activities when the brokerage fee rate replaces the gross margin and it is determined as a percentage of the sales of the product provided that the functional analysis is performed, i.e., the brokerage fee rate	• Time factor—the more time elapses between the original purpose and resale, the more likely it is that other factors, such as changes in the market, in rates of exchange, in costs, etc. will need to be taken into account in any comparison of gross margin • The reliability of the RPM may be affected if there are material differences in the ways the associated enterprises and independent enterprises carry out their businesses, such as those that affect the level of costs, which may well have an impact on the profitability but which may not necessarily affect the price • The method is more sensitive to differences in functions performed, risks assumed, and assets used between controlled and uncontrolled transactions. Where there are material differences that effect the gross margins earned, accurate adjustments should be made • The method is difficult to use where before resale the goods are further processed or incorporated into a more complicated product so that their identity is lost or transformed, or the reseller contributes substantially to the creation or maintenance of intangible property associated with the product that is owned by an associated enterprise. In such a case, the contribution of the goods originally

(continued)

Table 2.1 (continued)

	Traditional transaction methods	
	Strengths	Weaknesses
	takes into account whether an associated enterprise is in the position of commissionaire, commission agent or classic buy-sell distributor	transferred to the value of the final product cannot be easily evaluated • The method is facing differences in accounting practices, mainly with respect to costs of goods sold and the resale price margin. Accurate adjustments should be made to ensure that the same types of costs are used to determine the gross margin. The final transfer price is primarily affected by the way that the gross margin is determined
COST +	• The method requires fewer adjustments for differences in product comparability than the CUP method • The method is less sensitive to differences in functions performed, risks assumed, and assets used between controlled and uncontrolled transactions than the RPM method provided that any such differences are properly reflected in the cost base • The method is probably most useful in case of long-term buy-and-supply agreements, pricing of semi-finished goods, toll or contract manufacturing, services of purchasing agents, contract research and developments, where associated parties have concluded joint facility agreements, or where the controlled transaction is the provision of services (i.e., consultancy, IT support, management services, accounting, etc.). Further, the method is probably most useful in case of low or no-adding-value service activities	• During the determination of costs arises the issue that there is no discernible link between the level of costs incurred and a market price • The issue of cost allocation—it may be difficult to allocate some costs between suppliers and purchasers. The cost base should sufficiently and reasonably reflect costs borne under the results of functional analysis reflecting appropriate allocation key • The method requires extensive information about the cost base used in comparing the mark-up of the controlled and uncontrolled transactions • Where there are material differences that affect the cost plus mark-ups earned in the controlled and uncontrolled transactions, reasonably accurate adjustments should be made. The extent and reliability of those adjustments will affect the relative reliability of the analysis under the cost plus method. The reasonable accurate adjustments may not be possible when looking at external comparables due to lack of data • The method is based only on the data from the internal information system. Therefore, its inappropriate application may lead to a failure to comply with the arm's length principle • In applying the method, it requires greater emphasis on other comparability factors, namely, on the comparability of the cost base • To ensure comparability of uncontrolled and controlled transactions, reasonably accurate adjustments should be made if

(continued)

Table 2.1 (continued)

	Traditional transaction methods	
	Strengths	Weaknesses
		there are differences in the amount and type of costs used in respect of functions performed, risks assumed and assets used • The method is facing differences in accounting consistency. Where the accounting practices differ, accurate adjustments should be made to ensure that the same type of costs are used in each case for the determination of gross profit mark-ups

states, the CUP method has economic validity if associated enterprises operate in "a truly competitive market", contrary to the situation when they operate in imperfectly competitive markets or in markets with differentiated products/services, in which case the CUP method cannot be based on economic principles.

For the RPM method, an internal or external comparison of gross margin is also possible, of which an internal comparison gives more reliable arm's length results. In an external comparison, commercial or publicly available databases, as well as Internet resources, are generally used to identify potential comparable resellers. Further, no accurate adjustments are needed for direct resale price margin comparisons, contrary to the indirect resale price margin comparisons. The extent and reliability of those adjustments will affect the relative reliability of the RPM method. Analogically, the last traditional transaction method, the COST+ method, also allows both internal and external comparisons and indirect and direct comparisons. However, it is worth highlighting that reasonable accurate adjustments (in the case of indirect comparison) may not be possible when looking at the external comparables received from databases due to a lack of data. Generally, after adjustments are made, the reliability of the method must be considered.

With respect to the economic rationale, King (2010) states that both methods (RPM and COST+) are not valid on economic principles for external comparisons; i.e., there is no sense to compare associated enterprise's resale margin (or gross mark-ups) with "comparable" margins (or gross mark-ups) of independent enterprises. The author emphasizes that there is no reason to expect close correlations in profitability rates based on the assets, gross margins and gross mark-ups across enterprises and that there is no reason to believe that two independent enterprises with the similar profitability rates will have similar gross margins or gross mark-ups. Further, in the case of internal comparison, such comparisons can be valid in certain hypothetical circumstances but are rarely feasible in practice, as adds King (2010). In the case of routine support services, where COST+ is often used as an appropriate method, the method does not have economic validity, as mentioned by King (2010). From the practical point of view, many tax authorities are focused on the services cost base than consider the mark-ups, such as the EU JTPF-issued

Table 2.2 Strengths and weaknesses of transactional profit methods—Profit Split (own compilations, TP Guidelines, OECD 2017)

	Transactional profit methods	
	Strengths	Weaknesses
Profit split[a]	• The application of method when other transfer pricing methods fail, namely, when no uncontrolled comparable transactions among independent enterprises can be identified • The method is based on the internal company information and the allocation of profits is determined through the division of functions performed, risks assumed and assets used among associated enterprises by the way how independent enterprises would have expected to realize it • Comprehensive two-sized approach—it is less likely that the party to the controlled transaction will be left with an extreme and improbable profit, since both parties to the transactions are evaluated • Flexibility of the method, as it enables the specificities of the industry and of the group, possibly unique, facts and circumstances to take into account • The method enables to take into account the returns associated with valuable intangible • The method is probably most useful for highly integrated operations (i.e., where unique and valuable contributions are performed or transferred), for complex and closely interrelated business transactions, for which one-sided method would not be appropriate; further, in the case when the intangible property is employed in the controlled transactions, or in case of economies of scale, etc	• The method is based on the internal company information, and it relies less on information about independent enterprises. Therefore, the reliability of the method should be considered due to the possibility of more subjective of the results • Difficult access to information from foreign associated enterprises. The necessity of financial data and other information may be critical issue in the context of tax audits • The method is not used for independent enterprises, except joint ventures • Complexity and data requirements in respect to practical application—determination of combined revenue and costs for all associated enterprises involved in the controlled transactions requires the keeping books and records on a common basis and making adjustments in accounting practices and currencies • When the method is used for operating profit, it is difficult to identify the operating costs associated with the controlled transactions and to divide those costs between the transactions and other activities of the associated enterprises • Reliability of the method should be considered, particularly when the accurate adjustments are performed and the appropriate allocation key for the division of combined profit is determined

[a]Section to Profit Split method is not revised under 2017 update, due to the on-going work on it

report “Guidelines on Low Value Adding Intra-Group Services”, which uses a safe harbour approach to valuate low-value adding services by mark-up in the range of 3–10%, often approximately 5%.[39]

With regard to transactional profit methods, the profit split method is considered the most comprehensive transfer pricing method and enables the specificities of both the industry and the group, economies of integration, and possibly unique, facts and circumstances to be considered, leading to all parties involved in the controlled

[39]EU JTPF: Guidelines on Low Value Adding Intra-Group Services, 2011.

Table 2.3 Strengths and weaknesses of transactional profit methods—TNMM (own compilations, TP Guidelines, OECD 2017)

	Transactional profit methods	
	Strengths	Weaknesses
TNMM	• The relevant profit level indicators are less sensitive to transactional differences than is the case with price as used in the CUP method • The profit level indicators are less sensitive to differences in the extent and complexity of functions and to differences in the level of risks between the controlled and uncontrolled transactions than in case of gross profits margins • When no internal comparable data are available, the method TNMM may be the only possible transfer pricing method • It is necessary to examine functions performed, risks assumed and assets used as well as a financial indicator for only one of the associated enterprises, i.e., tested party • It is not often necessary to state the books and records of all participants in the business activity on a common basis or to allocate costs for all participants as in the case of profit split method • The method is not used the comparison of absolute amounts but it is based on the comparison of profit level indicators selected on the facts and circumstances of the transactions. This approach enables one to compare transactions that cannot be compared at the level of absolute amounts • To achieve more reliable results, net profit margins may be narrowed by using the interquartile range or other statistical methods • The application of method is relatively feasible (due to the access to databases) and reasonable from a cost-benefit perspective • The method is frequently used in practice due to the data from external database • The method is probably most useful for the case when the costs of services or performances cannot be accurately determined, or it is not possible to identify the respective costs of controlled transactions for which accurate adjustments are required, or the costs of transactions	• The method is unlikely to be reliable if each party to transactions makes unique and valuable contributions • The methods is not appropriate in the case where differences in the characteristics of the enterprises being compared have a material effect on the net profit indicators being used, unless accurate adjustments are made. The extent and reliability of those adjustments will affect the relative reliability of the TNMM • The net profit margins may have been influenced by factors that do not have a direct impact on prices or gross margins, because of the potential for variation of operating expenses across enterprises • The method may be more sensitive than the COST+ or RPM to differences in capacity utilization, because differences in the levels of absorption of indirect fixed costs would affect the net profit indicator • The application of method requires information about independent transactions that may not be available when the controlled transaction is executed • Identifying comparable transactions and obtaining the required level of information, mainly on factors affecting external comparable transactions, is often limited in practice • The impossibility of taxpayer access to specific information about profits of controlled transactions may make the application the TNMM less reliability • It may be difficult to identify the revenue and operating costs of controlled transactions • One-sided approach issue—the application on one associated party may result in an inconsistent profit allocation among associated enterprises. Further, in respect of other factors that affect the net profit level indicators, it may result in less reliability of the TNMM than the COST+ or RPM

(continued)

Table 2.3 (continued)

	Transactional profit methods	
	Strengths	Weaknesses
	cannot be separately identified. Further, the method in the form of Berry ratio (measuring the gross profit to operating expenses) is probably most useful in case of intermediary activities where COST+ or RPM cannot be applied	

transaction being remunerated in light of the functions performed, assets used and risks assumed; further, the risk of extreme results (remuneration) is eliminated. To split the profits, the TP Guidelines describe two approaches—contribution analysis and residual analysis.[40] With respect to economic rationale, King (2010) emphasizes that the best starting point of this method would be to consider the combined after-tax free cash flows for splitting among the associated enterprises engaged in the controlled transactions rather than the combined before-tax operating profits. This approach will be more reasonable, mainly in the context of main weaknesses of the method that requires book- and recordkeeping on a common basis for all associated enterprises engaged in controlled transactions.

The last transactional profit method, the TNMM method, operates similarly as the COST+ RPM methods; however, it examines net profits relative to an appropriate base. In contrast to the COST+ method, which generally computes the arm's length price by adding the mark-ups to the direct and indirect costs of production (i.e., costs of goods sold), the TNMM method applies the net margins computed after operating expenses. Therefore, the method is presented as "net margin", as all operating costs are included in the costs base or subtracted from the operating revenues. The method enables internal or external comparison. The main assumption for the application of the TNMM method is that a tested party should perform only routine functions without its own valuable intangibles or unique assets, as a tested party is less complex and is thus more likely to find comparable enterprises. Moreover, the TNMM method is not appropriate when the differences in the characteristics of the enterprises being compared have a material effect on the net profit indicators being used, unless accurate adjustments are made. The extent and reliability of those adjustments will affect the relative reliability of the TNMM.

The profit-level indicators that are applicable in the case of the TNMM method can be affected by many factors.[41] The choice of a profit-level indicator and the

[40]For more details see section C, Chapter II, TP Guidelines, OECD 2017. Unfortunately, this section does not cover 2017 update due to ongoing work on this part, its update is expecting based on the results of BEPS project, as well as it was performed in case 2017 update TP Guidelines.

[41]For more details see section B.3, part III—Chapter II—Transfer pricing methods, TP Guidelines, OECD 2017. For example by new entrants, competitive position, market shares, management efficiency, business strategies, substitute products, costs structures, differences in the cost of capital, nature of business, whether the business is in a start-up phase, the degree of business experience, etc.

suitability of its application depend on, for instance, whether the tested party is a service provider, production facility or sales organization. Generally, the TP Guidelines provide the profit-level indicators on the most common base, including return on sales, return on cost and return on capital/assets. The selection of the denominator should be consistent with the comparability (including functional) analysis of the controlled transaction, and in particular, it should reflect the allocation of risks between parties. The denominator should focus on the relevant indicator(s) of the value of the functions performed by the tested party in the transaction under review, considering the assets used and risks assumed. Typically, after reviewing the facts and circumstances of the case, the sales or distribution operating expenses may be an appropriate base for distribution activities, full costs or operating expenses may be an appropriate base for a service or manufacturing activity, and operating assets may be an appropriate base for capital-intensive activities such as certain manufacturing activities or utilities (see Table 2.4).

Instead of the abovementioned denominators and profit-level indicators, the TP Guidelines (para 2.105, OECD 2017) recommend other possible net profit-level indicators, depending on the circumstances of the case. For instance, depending on the industry sector and the controlled transaction under consideration, it may also be useful to look at other denominators where independent data may exist, such as the floor area of retail points, weight of products transported, number of employees, time, and distance. The TP Guidelines also endorse applying Berry ratios[42] in situations where a taxpayer as a sales agent purchases goods from an associated enterprise and sells them to other associated enterprises. In such cases, the resale price method and cost plus method may not be applicable. Furthermore, the Berry ratio may be suitable for service providers, contract or toll manufacturers with low capital intensity. Depending on the facts and circumstances of the case, a Berry ratio may be an appropriate indicator.

With respect to the economic perspective, King (2010) and Kratzer (2008) mention that the TNMM method is based on the economic theory that the

Table 2.4 Denominators of net profit level indicators (OECD TP Guidelines 2017, own processing)

	Different activities		
	Distribution activity	Manufacturing activity or service providers	Capital-intensive activity
Denominators of net profit level indicators	$\frac{\text{Operating profit}}{\textbf{Sales}}$	$\frac{\text{Operating profit}}{(\textbf{cost of goods sold+operating expenses})^{a}}$	$\frac{\text{Operating profit}}{(\textbf{total assets} - \textbf{non-operating assets incl.cash})^{b}}$
	$\frac{\text{Operating profit}}{\textbf{Distribution operating expenses}}$	$\frac{\text{Operating profit}}{\textbf{Operating expenses}}$	
	$\frac{\text{Gross operating profit}}{\textbf{Operating expenses}}$		

[a]Cost of goods sold + operating expenses define Total costs
[b]Non-operating assets covers cash and equivalents, financial assets and other financial investments, tax receivables and deferred tax assets
Note: Denominators are highlighted

[42]Berry ratios are defined as ratios of gross profit to operating expenses. For more details see Chapter II, part III, section B.3.5, TP Guidelines, OECD 2017.

profitability rates earned by enterprises operating under similar conditions and in the same market and industry sector are equalized (i.e., tend to become more equal after some time) in broadly similar product markets, which are generally competitive and in equilibrium. However, as King (2010) emphasizes, there is no market mechanism that would equalize profitability rates (profit level indicators) among enterprises, which results in there being no reason to expect that similar situated enterprises should earn the same profitability rates, even in competitive markets. Further, the author adds that the assumption about the general competitiveness of product markets and its long-run equilibrium is invalid, namely, in the context of the current economic reality of business where product markets are almost invariably in a state of disequilibrium. There is no sense to use the calculated profitability rates in such a way to determine the tax liability in the context of transfer pricing issue (if the controlled transaction is not at arm's length), as different profit-level indicators and different samples of companies can produce significantly different profits across countries. In this respect, the TP Guidelines (in para 2.77 and 2.78, OECD 2017) also state that profit-level indicators may be directly affected by new entrants, competitive position, market shares, management efficiency, business strategies, substitute products, cost structures, differences in the cost of capital, nature of business, whether the business is in a start-up phase, and the degree of business experience. Therefore, even if two enterprises act in exactly the same industry, their profitability may differ depending on the above-mentioned factors.

Although from the economic perspective, there cannot be find a reason for the application of this method, the practice shows that it is frequently used by both tax payers and tax authorities.

Generally, the application of all types of transfer pricing methods (except for the Profit split method) requires information on uncontrolled transactions that may not be available when the transfer prices are determined, examined and/or documented. Therefore, based on the TP Guidelines (para 3.30, OECD 2017), the taxpayer should apply the data that are available when the transfer prices are determined. Further, in most cases, multiple year data may be used to better understand the controlled transaction and provide useful information on the comparables. Kratzer (2008) adds that the multiple year data should eliminate the temporary accounting differences, business and product/intangible life cycles, anomalies, and discrepancies in short-term economic conditions and long-term arrangements that impact the profitability of controlled and/or uncontrolled transactions. Nevertheless, a number of OECD member countries have the rule of examining the fiscal years separately if multiple year data are used. However, as EU JTPF (2016) mentions, complete and accurate data should be available for the entire period, and the use of average values is recommended to improve the reliability of analysis. Further, during the analysis, the principles of transparency, proportionality and consistency should be respected.

The identification of external comparables[43] requires the search process, which depends on the type of database used and screening criteria used to identify

[43]For more details about the recommended steps of the selection of external comparables, see Fig. 2.1, Sect. 2.2.

potential comparable enterprises as well as the qualitative analysis. To ensure a high degree of comparability, statistical tools such as interquartile range,[44] percentiles or averages are commonly used to narrow a range of results. However, the EU JTPF (2016) adds that this practice is not necessary if the range comprises results of equal and high reliability (this regards all the comparability factors). In this context, the possibility of accepting only one or two comparables should not generally be excluded.

The issues of comparability adjustments are stressed in case of all types of transfer pricing methods because they can affect the reliability of the method applied to determine the arm's length price/margin. Therefore, comparability adjustments were the subjects of interest of the EU JTPF,[45] which released in 2016 the most often comparability adjustments performed by taxpayers or tax authorities. The list covers the following:

- *Working capital adjustments*—related to account payables, account receivables and inventories—to ensure that the net margins reflect the same level of financing activity
- *Accounting adjustments*—namely, addressing foreign exchange difference adjustments, type of costs covering in the cost base for the determination of gross margins, local/international standards of financial reporting and/or treatment for income tax purposes
- *Market adjustments*—related to volume of sales, terms of conditions of sales and payments, credit terms
- *Other type of adjustments*—such as balance sheet adjustments, asset intensity adjustments
- *Risk related adjustments*—namely, linked to the how potential comparables include the same level of risks and management of risks.

The performance of comparability adjustments should also be considered in light of the costs and compliance burden, as it is not desirable to provide an exhaustive list of all types of adjustments, as state the TP Guidelines and EU JTPF. Moreover, for uncontrolled transactions (namely, on external comparables), the information may be limited, resulting in the impossibility of making accurate adjustments. Further, comparability adjustments should be made only to improve the comparability results. All comparability adjustments that were made should be explained with respect to how the conditions affect the price/margin and how the potential comparables were adjusted, and they should be properly documented.

For the business models and appropriate transfer pricing methods, to accurately delineate a controlled transaction with the conditions and economically relevant

[44]Range from the 25th to the 75th percentile of the results derived from the uncontrolled transactions resulted into the 50% of observations which are closest to the median are considered as a reliable range of arm's length results. The extreme results (first 25% and last 25% of observations) are excluded from the results.

[45]For more details, EU JTPF report available at: https://ec.europa.eu/taxation_customs/sites/taxation/files/jtpf0072017encomps.pdf

circumstances of comparable transactions between independent enterprises, how the business model operates in practice should be considered with the selection of the most appropriate transfer pricing method. There are different types of business models in practice; however, through the core functions performed, it is possible to categorize the business model on manufacturers, distributors and service provider, as states Bakker (2009).

For the manufacturing entities or service providers performing routine functions,[46] the arm's length price/margin is usually determined using the COST+ method (assuming that the CUP method cannot be applied). However, in practice, benchmarking difficulties may require the application of the cost-based TNMM method. This method is based on a modified COST+ method at the operating profit level, considering the return on total costs rather than the return on cost of goods sold, which is measured if the COST+ method is applied at the gross profit level. Generally, it is considered that the mark-up on total costs[47] based on the TNMM method is the most reliable indicator of the arm's length profits earned by independent manufacturers, as mentioned by Clark et al. (2008) and Bakker (2009). Furthermore, Bakker (2009) states that if a full-fledged manufacturer does not use valuable intangible assets, it is also possible to apply the COST+ or TNMM methods. However, when valuable intangible assets are used, it is difficult to identify comparable independent manufacturers owning comparable intangible assets. In this case, as Bakker (2009) and Kratzer (2008) further mention, it is better to test only the distribution companies involved in transactions with full-fledged manufacturer where full-fledged manufacturer would be evaluated based on the residual profits. In the case of distributing entities performing routine functions, the application of the COST+ method and cost-based TNMM method is usually unsuitable. Thus, the RPM method under which the transfer price is determined after deducting the gross margin from the sales price or the sales-based TNMM method, under which the transfer price is equal to the selling price minus cost of sales and net profit margin (in case of commissionaire, zero costs of sales enter the calculation because the commissionaire never owns the goods, i.e., never purchases it), should be applied.

To summarize the recommendations of the TP Guidelines on transfer pricing methods, Table 2.5 presents the selection of the most appropriate method to the circumstances of the case, as presented by Cottani (2016). It is necessary to highlight that selection of the most appropriate method is very complex issue, as is its application in practice; furthermore, "general" recommendations and guidance of the TP Guidelines refer to all enterprises, regardless of their size.

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[46]The routine entities do not assume complex functions and risks within the group, respectively bear little or no risk, perform a few functions and generate stable operating profit, see Bakker (2009).

[47]Total cost ratio is determined as *Operating profit or loss/Total costs*. Total costs are calculated by subtracting *Operating profit and loss* from *Operating Revenue/Turnover*.

Table 2.5 Selection of the most appropriate method according to the circumstances of the case (Cottani 2016)

<table>
<tr><td>If CUP and another method can be applied in an equally reliable manner</td><td colspan="2">→ CUP</td></tr>
<tr><td colspan="3">If not:</td></tr>
<tr><td>Where one party to the transaction performs benchmarkable functions (e.g. manufacturing, distribution, services) with no valuable, unique intangible asset/risk</td><td colspan="2">→ One-sided method
→ Choice of the tested party (seller/purchaser)</td></tr>
<tr><td>The tested party is the seller (e.g. contract manufacturing or provision of services)</td><td>→ Cost-plus
→ Cost-based TNMM
→ Asset-based TNMM</td><td>→ If cost-plus and TNMM can be applied in an equally reliable manner: cost-plus</td></tr>
<tr><td>The tested party is the buyer (e.g. marketing/distribution)</td><td>→ Resale price
→ Sales-based TNMM</td><td>→ If resale price and TNMM can be applied in an equally reliable manner: resale price</td></tr>
<tr><td>Where each of the parties to the transaction contributes valuable unique intangibles/risks</td><td colspan="2">→ Two-sided method
→ Profit split</td></tr>
</table>

2.4 Transfer Pricing Documentation: Proof of the Arm's Length Standard

Transfer pricing documentation generally refers to a report justifying the setting of the transfer prices in uncontrolled transactions between associated enterprises and the fact that the transfer pricing price/margin is set at arm's length. To prepare transfer pricing documentation, the statutory documentation requirements are usually in place in almost all EU Member States, in contrast to the few of them that prefer the preparation transfer pricing documentation on a voluntary basis, i.e., that statutory documentation requirements are not in place.[48]

The existence of different set of documentation requirements in the EU is one of the major tax obstacles to cross-border economic activities in the Internal Market. The preparation of separate and unique transfer pricing documentation in different EU Member States is considered uneconomic, as EU JTPF (2005) highlights. Moreover, this tax obstacle is perceived negatively by both LEs and SMEs. In this context, in a study[49] on company taxation in the internal market, the European Commission (2001) identified that high compliance costs of taxation are related to transfer pricing, specifically to a preparation of transfer pricing

[48]For more details about EU Member States with/without statutory documentation requirements see Sect. 2.5.

[49]For more details see https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/company_tax_study_en.pdf

documentation and finding of comparables.[50] Commission (2001) concluded that better coordination between EU Member States in the area of transfer pricing documentation requirements, namely, a more uniform approach, would eliminate the tax obstacles. Consequently, in 2005, the EU JTPF released the *Report on the Activities of the EU Joint Transfer Pricing Forum in the Field of Documentation Requirements*[51] and introduced the transfer pricing documentation requirements on an EU-wide common basis. The EU JTPF proposed implementing its proposal through "soft law", not through a European directive, leaving freedom for the EU Member States to determine how it could be implemented. Therefore, in 2006, the EU Council adopted the *Code of conduct on transfer pricing documentation for associated enterprises in the EU*[52] (hereafter EU TPD). The EU TPD combines aspects of the standardized approach and the centralized documentation approach. Based on it, a group generally prepares one set of transfer pricing documents comprising two main parts: (i) one set of documentation containing common standardized information relevant for entire EU group, known as a master file and (ii) several sets of standardized documentation containing country-specific information at the country level, known as country-specific documentation (see Tables 2.6 and 2.7). Since that time, in accordance with the main purpose of the EU TPD (i.e., to standardize transfer pricing documentation requirements that associated enterprises must provide to the European tax authorities), the compliance costs of transfer pricing are reduced for EU groups. Moreover, associated enterprises from EU groups receive more certainty with respect to documentation requirements and protection against penalties.

Addressing the issue of documentation, after almost 11 years, the OECD also introduced a standardized approach to the transfer pricing documentation in the 2017 update of TP Guidelines as a result of the BEPS project. The TP Guidelines (Section C, Chapter V, OECD 2017) now recommend adopting a three-tiered standardized approach to transfer pricing documentation. This three-tiered approach includes (i) a master file containing standardized information relevant for entire group, (ii) a local file containing country-specific information for local associated enterprises, and (iii) a Country-by-Country Report containing certain information relating to the global allocation of group's income and taxes and economic activity within the group (see Tables 2.6 and 2.7).

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[50]Similar results were found in the case of SMEs, for details about compliance costs of transfer pricing see Chap. 4.

[51]For details see: https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/12th-legis_rep_en.pdf

[52]For details see: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:42006X0728(01)&from=EN

Table 2.6 Transfer pricing documentation requirements—OECD and EU perspective—Master file (TP Guidelines, OECD 2017; EU Council 2006/C176/01—EU TPD)

OECD 2017—Chapter V	EU TPD
Master file—soft law	Master file—soft law
(a) Organisational structure (b) Description of MNE's business(es) a. Important drivers of business profit; b. A description of the supply chain for the group's five largest products and/or service plus any other products and/or services amounting to more than 5% of group turnover; c. A list and brief description of important service arrangements between members of the MNE group; d. A description of the main geographic markets for the group's products and services; e. A brief written functional analysis describing the principal contributions to value creation by individual entities within the group; f. A description of important business restructuring transactions (c) MNE's intangibles (as defined in Chapter VI of these Guidelines) a. A general description of the MNE's overall strategy for the development, ownership and exploitation of intangibles b. A list of intangibles or groups of intangibles c. A list of important agreements among identified associated enterprises related to intangibles, including cost contribution arrangements, principal research service agreements and licence agreements d. A general description of the group's transfer pricing policies related to R&D and intangibles e. A general description of any important transfers of interests in intangibles among associated enterprises (d) MNE's intercompany financial activities a. A general description of how the group is financed, including important financing arrangements with unrelated lenders b. The identification of any members of the MNE group that provide a central financing function for the group c. A general description of the MNE's general transfer pricing policies related to financing (e) MNE's financial and tax positions a. The MNE's annual consolidated financial statement	(a) General description of the business and business strategy (b) The group's organisation, legal and operational structure (c) General identification of the associated enterprises engaged in controlled transactions (d) General description of the controlled transactions—flows of transactions, invoice flows and amounts of transaction flows (e) General description of functions and risks (f) Ownership of intangibles and royalties paid or received (g) Inter-company transfer pricing policy (h) List of cost-contribution agreements, APAs and rulings (i) Undertaking by the taxpayer to provide additional information upon request

(continued)

Table 2.6 (continued)

OECD 2017—Chapter V	EU TPD
Master file—soft law	Master file—soft law
b. A list and brief description of the MNE group's existing unilateral advance pricing agreements (APAs) and other tax rulings relating to the allocation of income among countries	

Further, the TP Guidelines identify three objectives of transfer pricing documentation requirements (para 5.5, OECD 2017):

- to ensure that taxpayer's transfer pricing policy is at arm's length;
- to provide tax authorities with the information necessary to perform transfer pricing risk assessment; and
- to provide tax authorities with the information required to conduct a thorough audit of the transfer pricing practices.

From the taxpayer's perspective, the primary purpose of the transfer pricing documentation creation is the penalty protection and protection from transfer pricing adjustments. In accordance with the arm's length standard, the tax authority has a right to make a primary adjustment (i.e., to adjust the associated enterprise's taxable profits) if the commercial or financial relations in controlled transaction differ from those that would be made between independent enterprises. However, other benefits from the preparation of transfer pricing documentation can be identified:

- a higher degree of certainty with respect to penalty protection and primary adjustment;
- a useful proof-tool of the arm's length standard during tax proceedings, which increases the nature of the taxpayer's approach in the area of transfer pricing and in the case of MAP[53] or APA[54] procedures;
- it can eliminate problems during transfer pricing audits; and
- better cooperation with tax authorities, resulting in shorter tax audits.

[53]Mutual agreement procedure—For more details see TP Guidelines, Chapter IV, OECD 2017. The MAP procedure can be opened through the Model Tax Convention on Income and on Capital 2014, Article 25, 2014, or EC Arbitration Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/463/EEC).

[54]Advance pricing arrangements—Through an APA the taxpayer provides detailed information regarding the proposed transaction and its proposed transfer price to the tax authorities, and in return, if the tax authorities approve the proposed transfer price, the taxpayer can be certain not to be subject to primary adjustments of transfer prices and consequently of double taxation. APAs can be unilateral (where agreed between one tax administration and a taxpayer), bilateral (where agreed between two tax administrations with the taxpayer) and multinational (involving more than two tax administrations). The world's first APA as a prevention of disputes was concluded between the United States and Australia for Apple in 1991. For more details see also TP Guidelines, Chapter IV, OECD 2017.

Table 2.7 Transfer pricing documentation requirements—OECD and EU perspective—Local file (TP Guidelines, OECD 2017, EU Council, 2006/C176/01—EU TPD)

OECD 2017—Chapter V	EU TPD
Local file—soft law	Country specific documentation—soft law
(a) Local entity a. A description of the management structure of the local entity, a local organisation chart b. A detailed description of the business and business strategy c. Key competitors (b) Controlled transactions a. A description of the material controlled transactions b. The amount of intra-group payments and receipts for each category of controlled transactions involving the local entity c. An identification of associated enterprises involved in each category of controlled transactions, and the relationship amongst them d. Copies of all material intercompany agreements concluded by the local entity e. A detailed comparability and functional analysis f. An indication of the most appropriate transfer pricing method g. An indication of which associated enterprise is selected as the tested party h. A summary of the important assumptions made in applying the transfer pricing methodology i. If relevant, an explanation of the reasons for performing a multi-year analysis j. A list and description of selected comparable uncontrolled transactions (internal or external) k. A description of any comparability adjustments performed l. A description of the reasons for concluding that relevant transactions were priced on an arm's length basis m. A summary of financial information used in applying the transfer pricing methodology n. A copy of existing unilateral and bilateral/multilateral APAs and other tax rulings (c) Financial information a. Annual local entity financial accounts for the fiscal year concerned b. Information and allocation schedules c. Summary schedules of relevant financial data for comparables used	(a) Detailed description of the business and business strategy (b) Information on country specific controlled transactions—flows of transactions, invoice flows and amounts of transaction flows (c) Comparability analysis (d) Explanation about the selection and application of the transfer pricing method(s) (e) Relevant information on internal and/or external comparables if available (f) Description of the implementation and application of the group's transfer pricing policy

Despite the benefits that the transfer pricing documentation can bring, the preparation of transfer pricing documentation is considered burdensome, time-consuming and expensive, particularly for small and medium sized enterprises (SMEs), which are usually less well-equipped than large enterprises (LEs) in terms of financial and human resources. SMEs usually use tax consultancy not only for the compliance of arm's length standard but also for all tax and accounting matters, which increase the compliance costs of taxation. Chittenden et al. (2000) state that SMEs bear 100 times higher taxation compliance costs than do LEs. OECD adds that compliance cost of taxation in case of SMEs represent 46% of incurred costs (OECD 2001).[55]

However, the transfer pricing documentation is one of the required documents in the case of dispute prevention in the form of APA or in the case of dispute resolution mechanisms in the form of MAP through the OECD or EC procedure mechanisms, which can be used to eliminate the double taxation that could arise from a transfer pricing adjustment (primary adjustment).

As mentioned above, the OECD introduced another documentation requirement in the form of Country-by-Country reporting (hereafter CbCR) together with transfer pricing documentation requirements (master and local files), in accordance with the BEPS Action 13 minimum standard.[56] It focuses on corporate groups with a worldwide consolidated net turnover higher than EUR 750 million, which will share information with the tax authorities in each country in which they have a tax presence. This form of CbCR is considered a non-public CbCR and should help achieve transparency on corporate income taxes for tax administrations by providing them with adequate information (see Table 2.8) to assess high-level transfer pricing and other BEPS-related risks (namely, corporate tax avoidance, aggressive tax planning and double-non taxation). It is worth highlighting that the OECD recommendations are voluntary guidelines; thus, their implementation into domestic legal framework is deeply dependent on the willingness of each country. Currently, more than 30 jurisdictions[57] have signed over 700 bilateral exchange relationships committed to exchanging CbCR, with the first exchanges scheduled to occur in 2018. Moreover, other jurisdictions have been working on agreeing on bilateral competent authority agreements (hereafter CAAs) for the automatic exchange of CbCR under Double Tax Conventions or Tax Information Exchange Agreements.

From the EU perspective, the EU TPD does not currently provide any mechanism for the provision of a CbCR. However, CbCR will be exchanged newly and automatically between EU Member States under Directive 2016/881 on the mandatory automatic exchange of information in the field of taxation.[58] To minimize the costs and administrative burdens for both tax administrations and corporate

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[55]For more details about compliance costs of transfer pricing in case of SMEs, see Chap. 4.

[56]For more details see http://www.oecd.org/tax/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm

[57]At 4 May 2017. For more details see http://www.oecd.org/tax/beps/country-by-country-exchange-relationships.htm

[58]European Commission (2016b), for more details see http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016L0881&from=en

groups, the CbCR is in line with the international developments of the OECD, i.e., an eligible corporate group having total consolidated group revenue higher than EUR 750 million. The first CbCR will be communicated for the fiscal year 2016, which will occur within 18 months of the last day of that fiscal year. Furthermore, other CbCR requirements for companies were established for specific sectors, for extractive industries and logging or primary forests under the Accounting Directive 2013/34/EU,[59] and for financial institutions under the Capital Requirements Directive 2013/36/EU, known as CRD IV.[60]

However, the EU intends to go further than the OECD and establish a public CbCR, with the aim of ensuring public accountability and transparency. In this context, the proposal for a directive on the disclosure of income tax information by certain undertakings and branch (COM(2016) 198 final)[61] providing for the public CbCR was released on 12 April 2016 and the report on CbCR was adopted by the European Parliament on 4 July 2017, which covers recommendations to amend the Commission's proposal. Based on it, corporate groups with a consolidated net turnover of EUR 750 million or higher will publicly provide, on an annual basis, information related to taxes paid at the place where profits are actually made (see Table 2.8). The CbCR will be published in a common template that is available for free by the public on the company's website in at least one of the EU's official languages and filed in a public registry managed by the Commission. With respect to the OECD CbCR requirements, the public CbCR requirements are similar.

This new obligation mainly requires eligible corporate groups to carefully explain the difference between the taxes accrued and the taxes paid for the public audience. Murphy (2012), as an architect of CbCR, highlights that CbCR can be considered a new and innovative form of accounting for globalization locally.[62] The business community has expressed concerns that public CbCR could damage investment (by additional compliance requirements and costs on companies, and by forcing disclosure of sensitive information) contrary to civil society organizations, such as US NGOs, which called for the public CbCR. From the view of SMEs, the public CbCR generally targets only multinational enterprises (with the potential being engaged into the potentially aggressive tax planning transactions and whose consolidated net turnover exceeds EUR 750 million); thus, public CbCR would be a significant toll for preventing tax evasion and transferring the profits of those enterprises and would thus ensure a fairer distribution of fiscal pressure between SMEs and LEs.[63] However, many SMEs or branches

[59]For more details see http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0034&from=EN

[60]For more details see http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:En:PDF

[61]European Commission (2016a), for more details see http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0198&from=EN

[62]For more details see http://www.taxresearch.org.uk/Documents/CBC2012.pdf

[63]For more details see: http://www.eurodad.org/files/pdf/1546745-eight-reasons-why-public-country-by-country-reporting-is-good-for-business-in-europe-1493799184.pdf. And Impact assessment of public CbCR http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016SC0117&from=EN

Table 2.8 CbCR—OECD and EU perspective (TP Guidelines, OECD 2017; EU Council 2006/C176/01—EU TPD, Directive 2016/881 and Proposal Directive COM(2016)198)

OECD 2017—Chapter V	EU
Country-by-Country Report—soft law Overview of allocation of income, taxes and business activities by tax jurisdiction (a) Tax jurisdiction (b) Revenues (c) Profit (Loss) before income tax (d) Income tax paid (on cash basis) (e) Income tax accrued (current year) (f) Stated capital (g) Accumulated earnings (h) Number of employees (i) Tangible assets other than cash and cash equivalents List of all the Constituent Entities of the MNE group included in each aggregation per tax jurisdiction (a) Constituent entities resident in the tax jurisdiction (b) Tax jurisdiction of organisation or incorporation if different from tax jurisdiction of residence (c) Business activities a. Research and development b. Holding or managing intellectual property c. Purchasing or procurement d. Manufacturing or production e. Sales, marketing or distribution f. Administrative, management or support services g. Provision of services to unrelated parties h. Internal group finance i. Regulated financial services j. Insurance k. Holding shares or other equity instruments l. Dormant m. Other	*Non-public Country-by-Country Report*[a]—via *Directive 2016/881* The CbCR contain the following information with respect to the MNE Group: (a) aggregate information relating to: a. Amount of revenue, b. Profit (loss) before income tax, c. Income tax paid, d. Income tax accrued, e. Stated capital, f. Accumulated earnings, g. Number of employees, and h. Tangible assets other than cash or cash equivalents with regard to each jurisdiction in which the MNE Group operates (b) An identification of each: a. Constituent Entity of the MNE Group setting out the jurisdiction of tax residence of that Constituent Entity and, where different from that jurisdiction of tax residence, b. The jurisdiction under the laws of which that Constituent Entity is organised, and c. The nature of the main business activity or activities of that Constituent Entity. *Public CbCR* via *proposal of Directive COM (2016) 198 final*[b] (a) The name of the ultimate mother-company and, where applicable, the list of all its subsidiaries, (b) A brief description of the nature of their activities and their respective geographical location; (c) The number of employees on a full-time equivalent basis; (d) Fixed assets other than cash or cash equivalents; (e) The amount of the net turnover, including a distinction between the turnover made with related parties and the turnover made with unrelated parties; (f) Stated capital; (g) Details of public subsidies received and any donations made to politicians, political organisations or political foundations; (h) Whether companies, subsidiaries or branches benefit from a preferential tax treatment from a patent box or equivalent regimes

[a]CbCR is not a part of the EU TPD
[b]Currently, CbCR is introduced through the proposal of Directive COM(2016) 198 final, the report on CbCR was adopted by the European Parliament at July 2017. A vote in the Council has not yet been scheduled

fall into the group of multinational enterprises; thus, they will have new obligations, resulting in higher taxation compliance costs.

To summarize, the OECD recommendations represent voluntary guidelines, soft law legal instruments, which recommend preparing the transfer pricing documentation based on the three-tiered approach (i.e., a master file, a local file and non-public CbCR). A similar approach can be identified in the area of the European Union, where the EU TPD is recommended via the Code of Conduct, covering a master file and country specific documentation. As shown in Tables 2.6 and 2.7, the scope of information needed for the preparation of the transfer pricing documentation is similar in both cases. However, a completely different way is applied for the CbCR, where the directive was used for the implementation of disclosure of income tax information by certain undertakings and branches in the European Union. The objective of new obligations is to ensure greater public transparency and the fight against base erosion and profit shifting. Therefore, the application of soft law legal instruments would not be appropriate. In contrast to the OECD, the EU developed the CbCR tool further. As the EU is closer to adopt the public CbCR on top of the non-public CbCR to publicly disclose information about the taxes paid at the place where profits are actually made. However, as is obvious from Table 2.8, the scope of disclosed information is similar for the CbCR. SMEs are excluded from the obligation of the CbCR, but some of them are members of eligible corporate groups; thus, they may be subjected to those obligations.

2.5 Simplified Transfer Pricing Rules for SMEs

Concerning the primary purpose of the TP Guidelines, it is clear that it sets treatments of transfer pricing issues with respect to multinational enterprises. However, the TP Guidelines make no direct distinction between the types or sizes of multinational enterprises; i.e., all enterprises, regardless of their size, are subject to the same principles and recommendations. The transfer pricing rules are complex, and applying the arm's length principle can be a resource-intensive process because it may impose heavy compliance costs. Moreover, those costs can be disproportionately large for SMEs in comparison to LEs. This fact is recognized in the TP Guidelines several times[64]*...compliance burden may be disproportionate to the size of the taxpayers, its functions performed, and the transfer pricing risks inherent in its controlled transactions...although the arm's length principle applies equally to SMEs and transactions, pragmatic solutions may be appropriate in order to make it possible to fide a reasonable response to each transfer pricing case*. Therefore, in the case of SMEs, the "one size fits all" approach is not suitable because SMEs are usually less well-equipped with financial and human resources than LEs and are usually not engaged in the aggressive tax planning, as states the

[64]TP Guidelines, OECD 2017, namely in section C, Chapter III., section E, Chapter IV. and section B and D, Chapter V.

European Commission (2016c).[65] Moreover, they usually use tax consultancy not only for the compliance of arm's length standard but also for all tax and accounting matters, which increases the compliance costs of taxation.[66] In the case of SMEs, greater simplicity in transfer pricing administration and improving the efficiency and effectiveness of transfer pricing enforcement are essential. Many countries are aware of this fact, and therefore, SMEs can apply simplified transfer pricing measurements.[67] This approach is also supported by the EU JTPF, which in its reports[68] recommends the use of the simplified transfer pricing measurements, namely, in the form of safe harbours as a way to provide a measure of simplification for SMEs and to save on administrative resources and reduce the compliance burden. A similar approach can also be found in the UN Transfer Pricing Manual, which contains a comprehensive and pragmatic discussion of safe harbour provisions. Based on the general practice of countries and with the aim to ensure a globally consistent approach of simplified transfer pricing measurements, the OECD relaunched the safe harbours[69] provisions through the partial update of TP Guidelines in 2013 and further in 2017.[70] It has to be mentioned that until that time,

[65]There is highlighted that SMEs as companies with no cross-border activities have often neither the means nor the possibilities to develop a tax optimization strategy at the international level and therefore their aggressive tax planning possibilities are fewer. Moreover, they pay on average 30% higher tax than similar companies with the international activities. For more details see Impact assessment of public CbCR, SWD(2016) 117final. http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016SC0117&from=EN

[66]For more details about compliance costs of taxation, namely transfer pricing see Chap. 4.

[67]In accordance with the OECD survey from 2011 and 2012 was emerged that 80% of respondent countries have transfer pricing simplification measures in place and 75% of measurements are directed to SMEs, small transactions and low value adding intra-group services. For more details see OECD: Multi-country analysis of existing transfer pricing simplification measures, 2011, 2012, available at:

http://www.oecd.org/tax/transfer-pricing/48131481.pdf

http://www.oecd.org/tax/transfer-pricing/50517144.pdf

[68]Safe harbour approach was mentioned in reports *Transfer Pricing and Small and Medium-Sized Enterprises*, 2011 and *Guidelines on Low Value Adding Intra-Group Services*, 2010. Available at:

http://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/company_tax/transfer_pricing/forum/jtpf/2011/jtpf_001_final_2011_en.pdf

https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/jtpf_020_rev3_2009.pdf

[69]Based on the para 4.102 of TP Guidelines, OECD 2017, safe harbour is defined as "*A safe harbour is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simple obligations, for those under the general transfer pricing regime. Such a provision could, for example, allow taxpayers to establish transfer prices in a specific way,* e.g. *by applying a simplified transfer pricing approach provided by the tax administration. Alternatively, a safe harbour could exempt a defined category taxpayers or transactions from the application of all or part of the general transfer pricing rules. Often, eligible taxpayers complying with the safe harbour provision will be relieved form burdensome compliance obligations, including some or all associated transfer pricing documentation requirements.*" For more details about safe harbor see Chap. 5.

[70]At 16 May 2013 the OECD Council approved the Revised Section E on Safe Harbours in Chapter IV of the TP Guidelines as a partial solution of the project about administrative aspects and compliance issues of transfer pricing.

the view of the OECD on the safe harbours was generally negative, and its application was considered to be incompatible with the arm's length principle.

In the EU, specific-size indicators are commonly used for transfer pricing. As is obvious from Fig. 2.2 and Table 2.9, specific-size indicators can be identified in four basic forms:

- company-size indicators—which prevails in the EU, namely, in Austria, Belgium, France, Estonia, Ireland, Italy, Lithuania, Portugal, Spain and the United Kingdom. In this case, the same or different thresholds described in the definition of SMEs through EC Recommendation 2003/361 are used.
- transaction-size indicators are used in Germany, Poland, Romania and Sweden.
- combination of company-size and transaction-size indicators—cumulatively or alternatively—Bulgaria, Greece and Latvia cumulatively use both indicators, company- and transaction-size indicators, and Denmark, Finland and Hungary use both indicators alternatively, i.e., company- or transaction-size indicators.
- no formal size-indicators are applied in Croatia, the Czech Republic, Luxembourg, Netherlands, Slovak Republic and Slovenia.

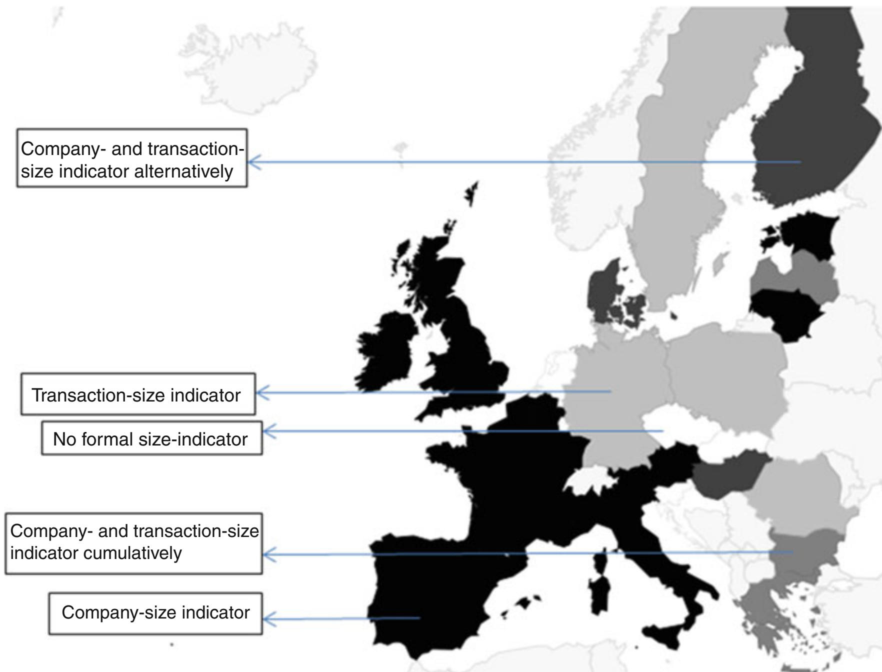

Fig. 2.2 Current application of size indicators in the EU for transfer pricing purposes (own compilation through Google Charts)

Table 2.9 Transfer pricing documentation requirements and exemption from the transfer pricing rules—SMEs and small transaction perspective (Deloitte 2016; PwC 2015; IBFD 2017)

	Statutory documentation requirements		Documentation			
MS	Yes	No	Full	Simplified	Exemption	Exemption from TP rules
AT	✓			B[1]		
BE	✓				B[1]	
BG		✓		B[2,3]	A[1]	
CZ		✓				
DK	✓				A[1], B[3]	
DE	✓				B[4], E	
EE	✓				B[3]	
EL	✓			B[1]	A[1], B[4]	
ES	✓			B[1],	A[1], E	
FI	✓			A[1]	B[1]	
FR	✓		B[3]			
HR		✓				
HU	✓				A[1], B[4], E	
IE		✓				B
IT	✓			B[1]		
LV	✓				B[1]	
LT	✓				B[1]	
LU	✓		B			
NL	✓		B			
PL	✓				A[1], B[1,4]	E
PT	✓				B[1]	
RO	✓		B[1]		A[1]	
SI	✓			B		
SK	✓			B[3]		
SE	✓			A[1]		
UK		✓			E	B[3]

Note: Malta and Cyprus were excluded from the research
A—small transaction, B—SMEs, E—other situation
1) Based on the statutory thresholds related to revenue, costs or turnover 2) for micro entities 3) under special conditions 4) for micro and small entities

In addition, Member States often combine the above-mentioned indicators with qualified indicators, such as not being counterparty to transaction in tax havens.

Furthermore, with respect to SMEs or small transactions, several forms of simplified transfer pricing measurements can be identified in the EU: whole or partial exemptions from transfer pricing documentation requirements (i.e., simplified transfer pricing documentation), simplified APA procedures or reduced APA charges, different penalty regimes, or full exemptions from transfer pricing rules through specific-size indicators established for transfer pricing purposes by Member States.

2.5.1 Simplified Transfer Pricing Measurements: Documentation

The transfer pricing documentation is necessary to prove to the tax authorities that a transfer pricing policy is at arm's length. Therefore, almost all EU Member States (21 Member States) introduced a statutory transfer pricing documentation requirements following the TP Guidelines or EU TPD in their legal framework, in contrast to the five EU Member States that kept different approaches—the taxpayer should maintain evidence to justify the relevant transfer pricing policy, so no statutory transfer pricing documentation requirements is needed (for more details, see Table 2.9 and Fig. 2.3). This approach gives flexibility in terms of the form of the transfer pricing documentation produced and reduces the compliance costs of taxation. However, although no statutory transfer pricing documentation requirements are in place, it is recommended to follow non-legally binding documents

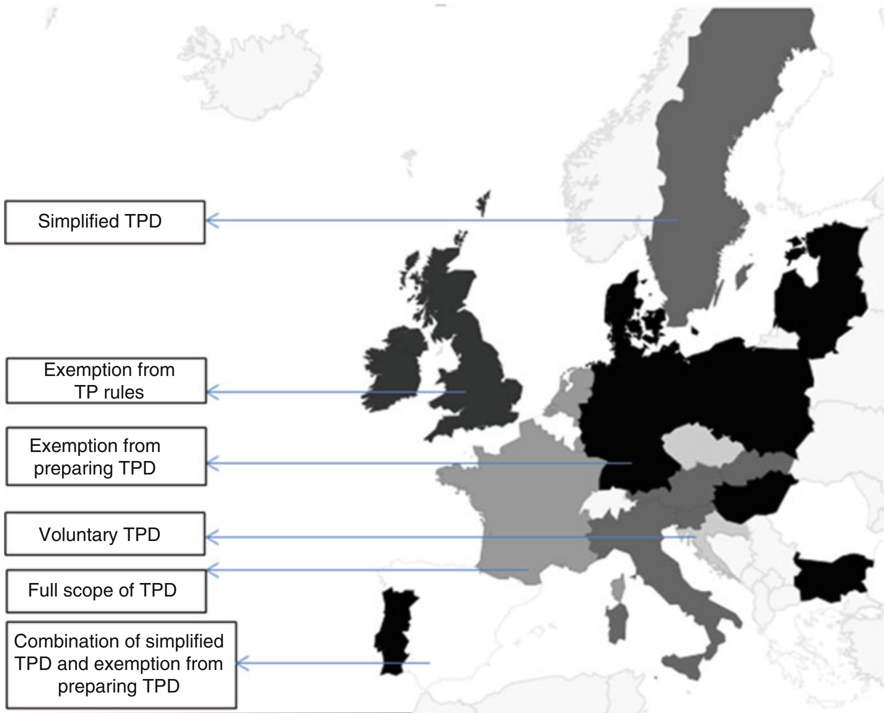

Fig. 2.3 Documentation requirements in relation to size in the EU (own compilation through Google Charts)

reflecting the TP Guidelines or EU TPD, as in the Czech Republic,[71] Croatia[72] and Bulgaria,[73] and to submit transfer pricing documentation upon the request of tax authorities, usually during a tax audit. It is necessary to note that two EU Member States wholly exclude SMEs from transfer pricing rules—the United Kingdom and Ireland.

If we look at the details on the specific measurements for SMEs or small transactions in the case of transfer pricing documentation requirements, we can distinguish six different groups among Member States (see Fig. 2.3):

1. Member States exempt from transfer pricing rules
2. Member States exempt from TPD
3. Member States provide voluntary TPD
4. Member States provide full scope TPD
5. Member States provide simplified TPD
6. Member States exempt from TPD and simplified TPD

The *first group* covers only two Member States—Ireland and the United Kingdom, which apply a voluntary approach to transfer pricing documentation requirements and allow a full exemption of SMEs from the transfer pricing rules. In the case of *Ireland*, SMEs are outside the scope of transfer pricing legislation,[74] whose definition is based on the EC Recommendation (2003), i.e., company-size indicators. In the case of the *United Kingdom*, the SMEs[75] are excluded from the transfer pricing legislation, provided that their counterparty to the transaction is a resident in a qualifying territory,[76] and in the case of Ireland, company-size indicators are applied through the EC Recommendation (2003). Furthermore, the United Kingdom allows companies that were qualified as dormant[77] as of 31 March 2004 to be excluded from the preparation of TPD. For more details, see Table 2.9 and Fig. 2.3.

The *second group* covers nine Member States (Belgium, Denmark, Estonia, Germany, Hungary, Latvia, Lithuania, Poland and Portugal) and allows an exemption of SME and/or small transactions from the obligation to prepare the transfer pricing documentation. In the case of *Belgium*, since 2016, every Belgian entity or permanent establishment (hereafter PE) has been exempt from the obligation of TPD in accordance with the company-size indicators, particularly if (i) operational and financial revenues do not exceed EUR 50 million, (ii) a balance sheet total does not exceed EUR 1 billion, or (iii) the annual average number of employees do not

[71] *Decree 334—Communication by the Ministry of Finance in respect of the scope of transfer pricing documentation.*

[72] *Guidelines for auditing transfer prices for tax inspectors* issued in 2014.

[73] *Transfer Pricing Manual Guidelines.*

[74] Based on the Taxes Consolidation Act 1997, section 35A inserted by the Irish Finance Act 2010.

[75] Via definition stated in the EC Recommendation 2003.

[76] Based on the Taxation (International and Other provisions) Act 2010. A list of qualifying territories is available in International Manual at INTM412090.

[77] The term of dormant is defined in section 1169 of the Companies Act of 2006.

exceed 100 full-time equivalents. In the case of *Denmark*, SMEs[78] are exempt from the obligation, provided they do not have controlled transactions with companies and other party to transactions in tax havens, as is the case of Estonia. In *Germany*, tax authorities exclude small enterprises from the obligation to prepare TPD through a transaction-size indicator, particularly if the remuneration for inter-group deliveries of tangible goods is less than EUR 5 million and is less than EUR 500,000 for other transactions. Moreover, taxpayers generating income from business relationships other than profit income are excluded. In the case of *Lithuania*, SMEs are excluded from the obligation to prepare TPD if they are not financial and credit institutions or insurance companies or if they are entities or PE with revenues exceeding EUR 2,896,200. In *Latvia*, a combination of company- and transaction-size indicators are used, and SMEs are exempted from TPD if their turnover does not exceed EUR 1.43 million and they do not have a controlled transaction with an associated enterprise in an amount exceeding EUR 14,300. In *Portugal,* only the company-size indicator is used; SMEs not exceeding the turn-over threshold in the amount of EUR 3 million per year are excluded from the obligation to prepare TPD. In the case of *Hungary*, SMEs are not required to prepare TPD[79]; however, there are further exemptions through Article 18(1), (3) or (5) of the Corporate Income Tax.[80] In *Poland*, transaction-size indicators are used; however, SMEs are not obliged to prepare TPD[81] if transactions do not exceed thresholds (i) EUR 100,000, if the value of the transaction does not exceed 20% of the share capital, (ii) EUR 30,000 in the case of performance of services, sale or marketing available of intangible assets and legal values, or (iii) EUR 50,000 in the remaining cases of transactions. However, all entities that are nevertheless associated or non-related must prepare TPD if a transaction is made directly or indirectly for benefits of tax havens resident and exceeding EUR 20,000. Further, since 2015, groups of fruits and vegetables producers and agricultural producers have been wholly excluded from the transfer pricing rules. For further details, see Table 2.9 and Fig. 2.3.

The *third group* covers only two Member States, the *Czech Republic* and *Croatia*, which maintain a different approach in the form of non-legally binding transfer pricing documentation requirements that follow TP Guidelines and EU

[78]Defined as companies that (i) employ fewer than 250 persons and (ii) have an annual turnover not exceeding DKK 250 million or an annual balance sheet not exceeding DKK 125 million.

[79]According to the Corporate Income Tax, Article 18(3) and 18(5). Further, definition of small enterprise is mentioned in the Act on Small and Medium-sized Enterprises and the Support Provided to Such Enterprises known as SME Act.

[80]Such as, a transaction with the APA decision, cost recharge transactions under specific conditions, transaction not exceeding the threshold of HUF 50 million, stock exchange transactions, or transaction with the state-dictated prices or any prices determined in a legal regulation, transactions between domestic PE and its associated party if tax base is determined on the basis of tax treaties, and in entity in which the Hungarian state has direct or indirect majority control or public-benefit non-profit organizations.

[81]In accordance with new Corporate Income Tax Act effecting from 1 January 2017.

TPD. In both countries, no special rules for SMEs or small transactions are applied. For further details, see Table 2.9 and Fig. 2.3.

The *fourth group* covers three Member States, *France, Netherlands and Luxembourg*, which provide a full scope of transfer pricing documentation requirements, regardless of the size of entity or transactions. However, in the case of *France*, SMEs[82] outside the scope of the new rules under Article L13 AA and L13AB of the Tax Procedure Code (i.e., they follow rules under L13 B of Tax Procedure Code), are subject to less strict deadlines for the submission of TPD and penalties. For further details, see Table 2.9 and Fig. 2.3.

The *fifth group* covers five Member States, Austria, Italy, the Slovak Republic, Slovenia and Sweden, that allow simplified transfer pricing documentation to be submitted for SMEs or small transactions under special conditions. In *Austria*, the company-size indicator is applied, and SMEs not exceeding a turnover threshold of EUR 50 million (in each of the two preceding years) can prepare simplified TPD through administrative guidelines (i.e., without obligation to prepare a master file and local file). The same approach is applied in *Italy,* where SMEs[83] can prepare the simplified TPD, which will be updated on a 3-year basis, rather than on an annual basis, as is the case for other enterprises. In the case of the *Slovak Republic*, the simplified TPD can be prepared if SMEs report in Slovak GAAP; otherwise (when reporting under IFRS), the full scope TPD must be prepared. For *Slovenia*, in accordance with the Tax Procedure Act and the principle of proportionality, smaller and less complex enterprises should be subject to the simplified TPD. In *Sweden*, the transaction-size indicator is used, and based on it, the simplified TPD can be prepared for inter-group transactions of limited value.[84] For further details, see Table 2.9 and Fig. 2.3.

The *last group* covers five Member States, Bulgaria, Greece, Finland, Romania and Spain, which exempt SMEs or small transactions from the obligation to prepare TPD and/or allow simplified transfer pricing documentation to be prepared. In *Greece*, the simplified procedure for very small and small enterprises as well as exemptions from the TPD for very small enterprises are allowed.[85] Furthermore, Greece uses a combination of company- and transaction-size indicators to determine exemptions from transactions for TPD obligation, particularly if the transactions do not exceed EUR 100,000 in total, the gross revenues per year do not exceed EUR 5 million, and if transactions do not exceed EUR 200,000 in total and gross revenues per year exceed EUR 5 million. In addition, Interpretative

[82]SMEs are defined as an entity having less than 250 employees, turnover lower than EUR 50 million or total assets less than EUR 43 million via EC Recommendation 2003/361.

[83]SMEs defined as enterprises with an annual turnover of less than EUR 50 million.

[84]In accordance with Tax Agency regulations (SKVFS 20017:1) transactions relating to the sale or purchase of goods with a total market value of a max. SEK 27 million (630 basis), and other transactions of a total aggregated market value of a max. SEK 5 million (125 basis).

[85]For more details see amendment of the Income Tax Code by law 4410/2016.

Circulars[86] published by the Ministry of Finance provide additional exemptions. In the case of *Spain*, the Royal Decree provides (through the company-size indicator) a simplified TPD to entities with a turnover of less than EUR 45 million. The exemption from the TPD is allowed[87] in the case of transactions taking bid or a public stock offering, in the case of transactions conducted with the same related individual or entity when the aggregate consideration for all the transactions does not exceed EUR 250,000, for transactions between companies that are involved in a tax consolidation group and for joint ventures under special conditions. In the case of *Romania*, SMEs must submit the full scope of TPD if the minimum thresholds of controlled transactions are reached: (i) EUR 50,000 (EUR 200,000 in the case of LEs) in the case of interest received or paid for financial services, (ii) EUR 50,000 (EUR 250,000 in the case of LEs) with respect to transactions or services received or provided, or (iii) EUR 100,000 (EUR 350,000 in the case of LEs) with respect to transactions for purchases of sales of tangible and intangible assets. In *Bulgaria*, the taxpayer is obliged to hold only the evidence that proves that its relations with associated enterprises are in line with the arm's length principle. The preparation of TPD is on a voluntary basis. Based on the Transfer Pricing Manual, transactions are exempted from the evidence through the transaction-size indicator, particularly if they do not exceed (i) BGN 200,000 in the case of delivery of goods, (ii) BGN 200,000 in the case of providing services, (iii) BGN 400,000 in the case of granting intangible assets, and (iv) BGN 400,000 in the case of interest charged, where loans are granted. The simplified TPD (evidence) should be performed for a (i) taxpayer not exceeding thresholds above which the other party is a non-resident person from a non-EU Member States, under specific conditions, and (ii) taxpayer not exceeding thresholds above which the rate of operating profits is more than 20% lower than the average for the relevant economic sector, under specific conditions. Moreover, based on the Bulgarian Transfer Pricing Manual, micro enterprises should be exempted from the evidence of transfer prices; however, due to the different definitions mentioned in the Small and Medium-Sized Enterprises Act and Accountancy Act, it is recommended that they prepare the simplified TPD (evidence). In the case of *Finland*, SMEs[88] are excluded from the obligation to prepare TPD. The simplified TPD can be prepared in the case of insignificant transactions through the Law on Tax Procedure based on the transaction-size indicator—the amount of the transaction does not exceed EUR 500,000. For further details, see Table 2.9 and Fig. 2.3.

[86] See No. 1093/22.4.2015 at 22.4.2015 and 1142/2015 providing that legal entities that are exempted from income tax are also exempted from transfer pricing documentation obligations e.g. portfolio investment companies.

[87] In accordance with Article 18.3 of the Corporate Income Tax Law 27/2014 of 27 November 2014.

[88] Via EC Recommendation 2003/361.

2.5.2 Other Simplified Transfer Pricing Measurements

Other simplified transfer pricing measurements that can be identified in the EU with respect to small transactions or SMEs include a simplified APA procedure, reduced APA charge or different penalty regime through specific-size indicators established for transfer pricing purposes by Member States. For further details, see Table 2.10.

As regard APAs, *Romania* offers a reduced APA charge, i.e., one-half of the general APA fee for micro entities,[89] as does Germany. However, in *Germany*, the reduced APA charge[90] is offered only for small entities[91] performing small transactions, particularly intercompany tangible goods transactions below EUR 5,000,000 and other intercompany transactions below EUR 500,000. As is obvious, Germany applies the combination of company- and transaction-size indicators, contrary to Romania, which uses only company-size indicators. In *France*, the simplified APA procedure[92] is available for SMEs[93] whose capital or voting rights are held for 25% or more by one or several companies. Through the simplified APA procedure, tax authorities offer assistance in the area of an economic analysis, the finding of comparables and definition of transfer pricing policy. A similar approach for SMEs is offered in the *Netherlands* to help SMEs find comparables through simplified the APA procedure.[94]

Table 2.10 Other transfer pricing simplified measurements—SMEs and small transaction perspective (Deloitte 2016; PwC 2015; IBFD 2017)

Type of simplified measurement	Member States	Small transactions	SMEs
APA	DE	A	B—fee
	FR		B—procedure
	NL		B—procedure
	RO[a]		B[a]—fee
Penalty	FR, SI		B

A—small transaction, B—SMEs
[a]for micro entities
Note: Malta and Cyprus were excluded from the research

[89]Based on the Article 17.1. of the Government Decision 529/2007 concerning the APA, the APA fee is normally EUR 10,000 and EUR 20,000 in the case of large taxpayers. For more details about APA see Government Decision 529/2007 and Romania Tax Procedure Code.

[90]Based on the section 178a of the General Tax Code, the APA fee is normally EUR 20,000.

[91]It is defined in section 6 para 2 of the Decree Law on transfer pricing documentation issued in 2003.

[92]Based on the Official bulletin of the tax administration SJ-REC-20-30-20,120,912.

[93]SMEs are defined as an entity having less than 250 employees, turnover lower than EUR 50 million or total assets less than EUR 43 million via EC Recommendation 2003/361.

[94]For more detail see Decree of the State Secretary – DGB 2014/3098 dated 3 June 2014.

For the penalty regime, only *France* and *Slovenia*[95] offer an alleviated penalties regime for SMEs. Moreover, in France, less strict deadlines for the submission of TPD or other information during the tax audit are offered to SMEs.

2.6 Conclusion and Recommendations

To summarize, the TP Guidelines are a key pillar of the practical application of the arm's length principle and focus on transfer pricing issues with respect to multinational enterprises, which are generally LEs rather than SMEs. Moreover, in theory, all enterprises, regardless of their size, are subject to the same principles and recommendations, so there is no direct distinction between the types or sizes of entities. However, the compliance activities performed by SMEs generate higher compliance costs of taxation than faced by LEs. In respect of SMEs, we consider that the application of transfer pricing rules in accordance with Article 9 of the OECD Model Convention and with the recommendations included in the TP Guidelines is very complex and that its application for SMEs is connected to certain difficulties. These difficulties are compounded by the fact there is neither a common definition of SMEs for tax purposes in the EU nor symmetry of treatment for this issue. Furthermore, the costs associated with transfer pricing matters can be disproportionally large for SMEs in comparison to LEs for both the taxpayer and the tax administration. Therefore, we believe that a "one-size fits all" approach is not possible for SMEs facing transfer pricing issues.

Because SMEs are not able to ensure all required information related to transfer pricing issues (specifically comparable and functional analysis due to the lack of human and financial capital) and use tax and accounting consultancy experts, which result in ever-higher compliance costs[96] of taxation than LEs, the introduction of simplified transfer pricing measurements can be a suitable solution. As proven by the analysis of simplified measurements in the EU for SMEs or small transactions, several Member States use whole or partial exemption from transfer pricing documentation requirements, simplified APA procedures or reduced APA charges, different penalty regimes, or full exemption from transfer pricing rules. However, after the relaunching of the safe harbour provision in the TP Guidelines, the application of safe harbour[97] in the form of the arm's length range for SMEs in different industry activities should be strongly considered. This approach can eliminate the considerable burden of compliance costs of taxation and make transfer pricing issues easier for SMEs. As a result, SMEs would not be required to perform the comparable and functional analyses that are needed to determine the arm's length prices or margins. As is obvious, the identification of potential

[95]For more details see Article 397 a 398 of Tax Procedure Act.

[96]For more details about compliance costs of taxation see Chap. 4.

[97]For more details about safe harbours, see Chap. 5.

comparables depends on a deep analysis of the taxpayer's controlled transaction and the relevant comparability factors, whose process should be consistent, transparent, systematic and verifiable, with the aim of selecting an appropriate transfer pricing method and concluding whether the controlled transaction is consistent with the arm's length principle.

Currently, there is proof that income shifting between enterprises is occurring, regardless of the existence of the arm's length principle, because transfer pricing is used as a tax planning tool and because the arm's length standard does not reflect economic reality and cannot ensure the fairest and most reliable basis for the determination where profits are to be taxed, as state Avi-Yonah and Clausing (2007), Durst (2010, 2011), Avi-Yonah and Benshalom (2010), Keuschnigg and Devereux (2013), Taylor et al. (2015), Bartelsman and Beetsma (2000), Wells and Lowell (2014), Hines and Rice (1994), Huizinga and Laeven (2006), Swenson (2001) and others. Therefore, another alternative approach should be considered. One solution could be Common (Consolidated) Corporate Tax Base (which is considered in more detail in Chap. 6), which could better reflect the economic reality of corporate entities and, in its consolidated form, could help eliminate the problems inherent to transfer pricing issues.

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Chapter 3
Evaluating a Questionnaire on Transfer Pricing Issues of SMEs That Operate in the EU

This chapter evaluates a questionnaire regarding transfer pricing issues of SMEs that operate in the European Union. This questionnaire focuses on general transfer pricing concepts, such as transfer pricing methods, documentation, advance pricing agreements, a country-by-country report, the compliance costs of transfer pricing, the time needed for transfer pricing requirements and tools that decrease the compliance costs of transfer pricing. The evaluation is performed from several points of view. The evaluation is conducted first from the perspective of all EU Member States where SMEs operate, then from the perspective of parent companies and finally from the perspective of subsidiaries. Moreover, the questionnaire detects whether SMEs prefer to introduce simplified measurements for transfer pricing rules and specifies which type of measurement is preferred. In addition, the questionnaire determines whether SMEs prefer the implementation of a C(C)CTB system and whether they would welcome EU-comparable benchmarks for selected industries.

The questionnaire was distributed to SMEs that operate in the industry sectors NACE A (agriculture, forestry and fishing) to NACE S (other services) in the European Union, which includes industry sectors where SMEs perform their business activities. In accordance with the European Commission (2003), SMEs are categorised as micro, small and medium-sized enterprises. Medium-sized enterprises are defined as those "enterprises employing fewer than 250 persons and having an annual turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million". Small enterprises are defined as "enterprises having fewer than 50 employees and a turnover or balance sheet total of less than EUR 10 million". Microenterprises are defined as entities with fewer than ten employees and a balance sheet total or turnover less than EUR 2 million. Our representative sample[1] of SMEs aligns with this categorisation.

[1]Potential respondents were selected from each EU member state (with the exception of Cyprus and Malta due to the lack of data), and they include 100 SMEs from all industry sectors where

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Moreover, SMEs must own a branch or a subsidiary that represents between 25% and 100% of their capital, for only those SMEs are affected by the transfer pricing issues based on Article 9 "Associated Enterprises" and Article 7 para 2[2] "Business Profits" of the OECD Model Convention. The final representative sample includes 2600 entities from the EU28 with the exception of Malta and Cyprus.[3] The rate of return for the questionnaire is 5.5%[4] (144 respondents).

The questionnaire includes 34 questions that focus primarily on the description of basic characteristics of the company, including its size, its location and the nature of its operations. Second, the questionnaire focuses on investigating the transfer pricing measurements that are used, the compliance costs of transfer pricing, the time needed for transfer pricing requirements, and tools that decrease the compliance costs of transfer pricing issues (for details, see the annex—Questionnaire). The respondents were primarily tax residents of Poland (21.53%), the Czech Republic (20.14%), the Slovak Republic (15.28%), Austria and Hungary (4.17%), and Romania, Belgium and Spain (3.47%). Regarding the classification of SMEs, most respondents represented small enterprises (45.14%, i.e., 65 respondents). Moreover, from the perspective of inter-company relations, a large portion of respondents was represented by subsidiaries (54.17%, i.e., 78 respondents). In addition, the respondents primarily operated in sectors NACE C (manufacturing), NACE M (professional, scientific and technical activities) and NACE G (wholesale and retail trade and the repair of motor vehicles and motorcycles). The sectors of the questionnaire respondents correspond to the industry sectors where SMEs operate in accordance with the European Commission (2016). For more details, see Table 3.1 and Fig. 3.1.

The questionnaire was accessible online, and the link was sent in three waves during 2016 by tax advisors; tax and accounting committees; and other organisations, such as the Accountants Association in Poland, the Chamber of Certificated Accountants in the Czech Republic, the Spanish Institute for Fiscal Studies, the ACCA, the Proxy Czech Republic, Baker Tilly Czech Republic Accounting, the TPA Group, and BMB Leitner SK. The completed questionnaires were collected

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SMEs operate; the proportion of respondents is identical to that in the real economy. The overall representative sample includes 2600 entities.

[2]In accordance with OECD Model Convention, Article 7/2 – . . ."*the profits that are attributable in each Contracting State to the permanent establishment* . . ..*are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise*. "Similar to Article 9, Article 7 of the OECD Model Convention mentions the arm's length principle.

[3]Malta and Cyprus were eliminated from this study due to a lack of data. Furthermore, this analysis cannot be performed for Luxembourg because no responses were received from this location.

[4]The largest number of respondents were from the Czech Republic, the Slovak Republic and Poland (82 respondents); therefore, the return rate for the questionnaire for these areas was 27%.

Table 3.1 Classification of respondents across the EU (compiled by author)

Country	No. of SMEs			No. of parent companies	No. of subsidiaries	Portion of SMEs on total (%)
	No. micro	No. small	No. medium			
AT	3	1	2	1	5	4.17
BE	0	5	0	1	4	3.47
BG	2	0	0	0	2	1.39
CY	0	0	0	0	0	0.00
CZ	1	10	18	13	16	20.14
DE	0	2	2	3	1	2.78
DK	0	1	1	0	2	1.39
EE	1	1	1	2	1	2.08
ES	0	4	1	1	4	3.47
EL	0	1	0	1	0	0.69
FI	0	3	0	1	2	2.08
FR	1	2	1	2	2	2.78
HR	1	0	0	1	0	0.69
HU	1	4	1	1	5	4.17
IE	0	1	0	1	0	0.69
IT	0	0	1	1	0	0.69
LT	2	0	0	0	2	1.39
LU	0	0	0	0	0	0.00
LV	0	1	0	1	0	0.69
MT	0	0	0	0	0	0.00
NL	0	2	0	2	0	1.39
PL	11	9	11	22	9	21.53
PT	0	2	0	0	2	1.39
RO	0	2	3	1	4	3.47
SE	1	1	0	1	1	1.39
SI	1	1	1	1	2	2.08
SK	4	12	6	8	14	15.28
UK	0	0	1	1	0	0.69
Total	29	65	50	66	78	100.00
Portion (%)	20.14	45.14	34.72	45.83	54.17	–

online through GoogleApps. Altogether, we received 144 responses from SMEs that operate in the EU Member States.

The survey revealed that the respondents would appreciate the introduction of simplified transfer pricing documentation; safe harbour[5] rates for selected

[5]OECD: TP Guidelines (2017): A safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime. Further, safe

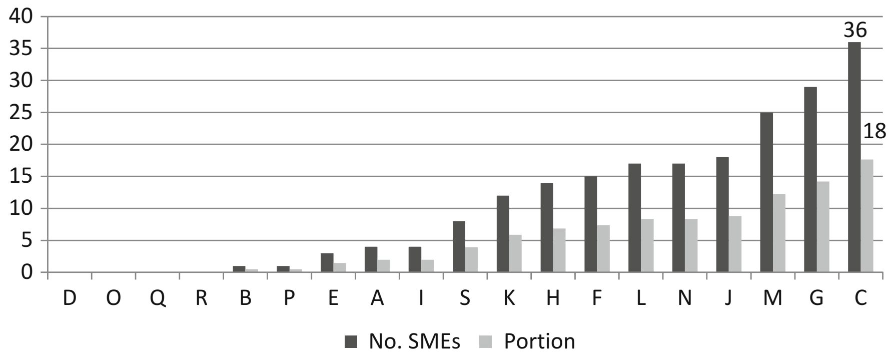


Fig. 3.1 Number and proportion of SMEs (respondents) across NACE sectors (*A* Agriculture, forestry and fishing, *B* Mining and quarrying, *C* Manufacturing, *D* Electricity, gas, steam and air conditioning supply, *E* Water supply; sewerage; waste management and remediation activities, *F* Construction, *G* Wholesale and retail trade; repair of motor vehicles and motorcycles, *H* Transporting and storage, *I* Accommodation and food service activities, *J* Information and communication, *K* Financial and insurance activities, *L* Real estate activities, *M* Professional, scientific and technical activities, *N* Administrative and support service activities, *O* Public administration and defence; compulsory social security, *P* Education, *Q* Human health and social work activities, *R* Arts, entertainment and recreation, *S* Other services activities) (compiled by author)

industries and types of transactions (i.e., manufacturer, distributor, and service provider); safe harbour rates for loans, royalties and intangibles; EU-comparable benchmarks for selected industries; and the introduction of a C(C)CTB system. Moreover, micro and small entities would appreciate being excluded from the obligation of transfer pricing issues or at least from requirements regarding transfer pricing documentation, which occurs in certain EU Member States.[6] Subsequent sections present the individual results from several perspectives, such as the perspective of all EU Member States where SMEs operate,[7] the perspectives of parent companies[8] and the perspectives of subsidiaries.[9]

harbour can exempt eligible taxpayers or transactions from the application of all or part of the general transfer pricing rules. However, safe harbour does not include administrative simplified measures which do not directly involve determination of arm's length prices.

[6]SMEs may be excluded from the obligation of transfer pricing rules under special conditions in Ireland and the United Kingdom. In addition, SMEs may be excluded from the obligation to prepare transfer pricing documentation under specific conditions in Belgium, Denmark, Estonia, Greece, Germany, Finland, Latvia, Lithuania, Hungary, Poland and Portugal. For more details, see Chaps. 2 and 5.

[7]This situation is presented in all figures as SMEs.

[8]This situation is presented in all figures as Parents.

[9]This situation is presented in all figures as Subsidiaries.

3.1 General Evidence from EU Member States

This survey provides deep insights into how SMEs address transfer pricing issues. Two-thirds of the respondents have addressed these issues, compared with one-third of the respondents who are not interested in these issues, although they are associated with other enterprises that have addressed these issues. Furthermore, approximately 86% of the respondents (SMEs) use tax consultant services for transfer pricing issues and all other tax matters, compared with 14% of the respondents who do not use this type of service. Fourteen percent of the respondents (SMEs) use tax consultant services solely for the preparation of transfer pricing documentation. Clearly, parent companies use tax consultant services for transfer pricing issues more often than subsidiaries. For more details, see Fig. 3.2.

The survey indicates that approximately 50% of the SMEs do not use simplified measurements for transfer pricing issues, 34% use simplified transfer pricing documentation requirements, 3% use a specific transfer pricing audit process and 1% of the SMEs use both a specific advance pricing agreement (hereinafter APA) and other measurements. Moreover, 12% of the respondents reported that they were excluded from transfer pricing rules. For more details, see Fig. 3.3 and Table 3.2.

Eighty-six percent of the respondents indicated that they have never used an APA. This result indicates that SMEs rarely use this tool; only 2% of the respondents (SMEs) have used an APA via a tax consulting service. Another consideration regarding the use of an APA via tax administration is that SMEs are generally charged a fee for these services, which increases the compliance costs of transfer pricing.

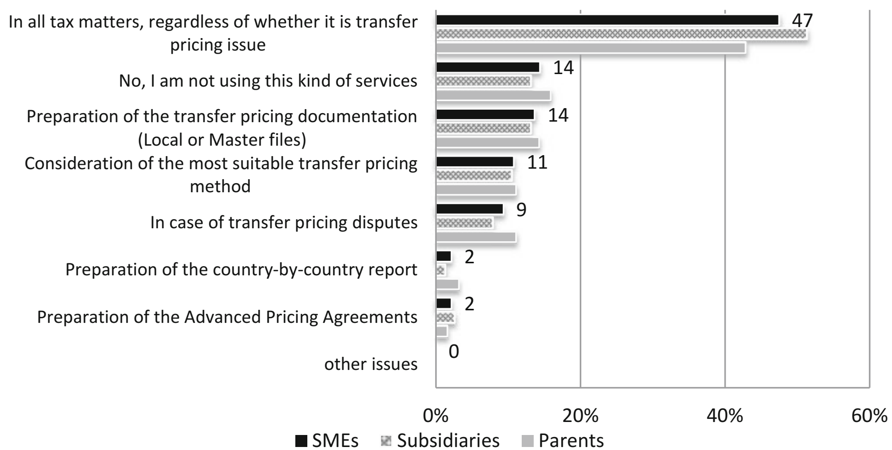


Fig. 3.2 Tax consultant services used by SMEs for transfer pricing issues (%) (compiled by author)

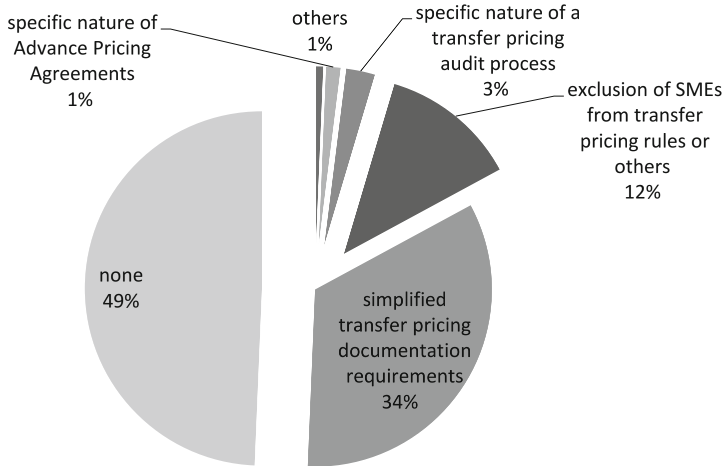


Fig. 3.3 Simplified measurements used by SMEs (compiled by author)

Table 3.2 Simplified measurements used by SMEs (For more details regarding transfer pricing rules and the simplified measurements that SMEs use, see Chaps. 2 and 5) (compiled by author)

Simplified measurements	None	Specific APA	Specific transfer pricing audit process	Excluded from transfer pricing rules or others[a]	Simplified transfer pricing documentation	Others
Country	HR, CZ, NL, and SE	NL, LT, DE, FR, and RO	PL and LT	PL, HU, EE, FI, FR, EL, IE, LV, LT, and UK	SK, ES, and DE	CZ[b]

[a]Includes the exclusion of SMEs from transfer pricing documentation
[b]Includes a recommendation for low value-added services

3.2 Compliance Costs and Duration

Another section of the survey focused on the compliance costs of transfer pricing and the time spent on transfer pricing requirements. The survey included respondents' estimated costs and time spent managing transfer pricing issues, such as considering transfer pricing methods, creating and translating relevant documents, preparing transfer pricing documentation (master files and/or local files), and completing a country-by-country report or APA and any required updates.

Because transfer pricing is a highly complex issue and, in the case of SMEs, requires the use of tax consultant services that offer a comprehensive solution to address the problem, we seek to estimate the costs and time that are involved in this

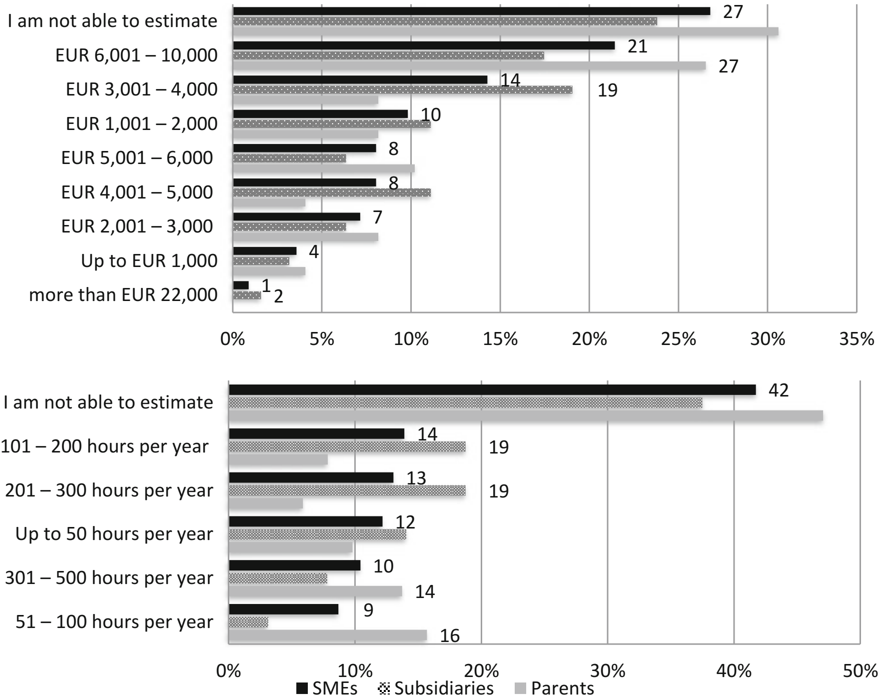


Fig. 3.4 Average costs and time per year spent managing the transfer pricing issue (%) (compiled by author)

complex transfer pricing issue (see Fig. 3.4) and other specific transfer pricing issues (see Figs. 3.5, 3.6, 3.7, and 3.8).

Figure 3.4 clearly indicates that the average costs for managing complex transfer pricing issues were difficult to estimate for approximately one-third of the respondents (SMEs). In addition, the time spent on this issue was difficult for 42% of the respondents to estimate. However, the remainder of the respondents identified how burdensome these issues are.[10] Approximately one-third of the parent companies and 21% of all respondents (SMEs) spent up to EUR 10,000 per year on transfer pricing issues. Nineteen percent of the subsidiaries spent up to EUR 4000 per year, and 2% of these firms spent up to EUR 22,000 per year. Furthermore, the survey indicated that costs related to transfer pricing issues are more burdensome for parent companies than for subsidiaries. This result may have occurred because parent companies generally administrate most issues related to transfer pricing. For example, they prepare master file transfer pricing documentation and intercompany agreements for intra-group transactions, select transfer pricing methods and perform controlling functions. The survey revealed that 19% of the subsidiaries spent

[10]For more details about compliance costs of transfer pricing see Chap. 4.

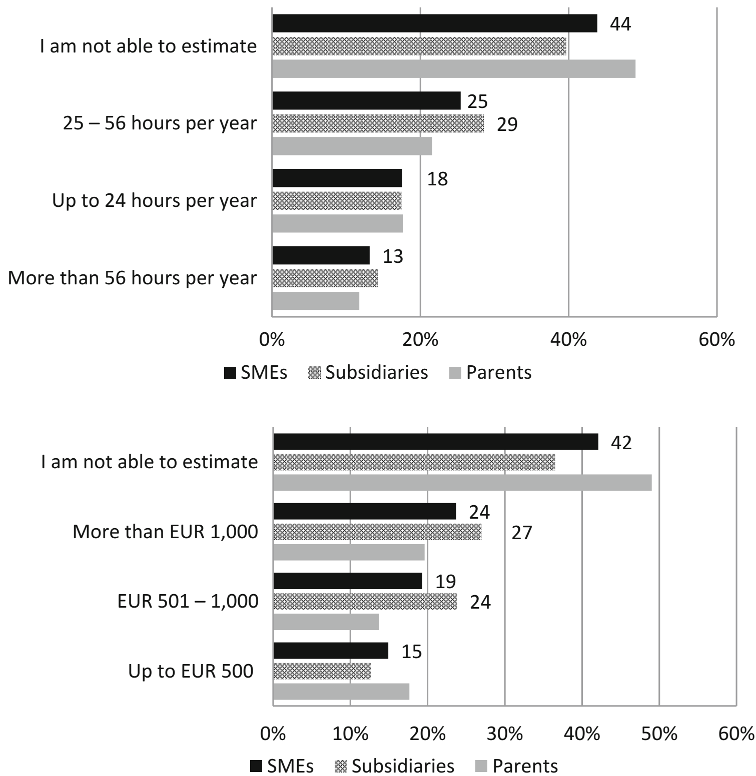
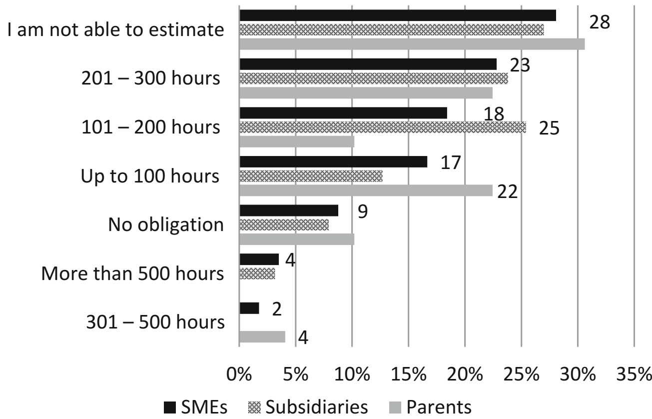


Fig. 3.5 Average time and costs per year necessary for the selection of the most suitable transfer pricing method (%) (compiled by author)

up to 200 or 300 h per year to manage transfer pricing issues, and 16% and 14% of the parent companies spent up to 100 and 500 h (approximately 63 working days), respectively, per year. Globally, the time that the respondents (SMEs) spent on this issue ranged from 50 to 500 h per year.

The survey revealed that if separate transfer pricing issues are considered, the majority of the time and costs needed to manager transfer pricing issues is related to the preparation of transfer pricing documentation. One-quarter of the subsidiaries spent up to 200 or 300 h per year. Twenty-two percent of the parent companies spent up to 100 or 300 h per year on this issue, and 4% of the parent companies spent up to 500 h per year. Globally, approximately one-quarter of the respondents (SMEs) spent up to 300 h per year (approximately 38 working days) and up to EUR 6000 per year on the preparation of transfer pricing documentation. Furthermore, the same amount of costs is borne by almost approximately one-third of the subsidiaries in contrast to one-quarter of the parent companies that incurred costs up to EUR 9000 for the preparation of transfer pricing documents. For more details, see Fig. 3.6.



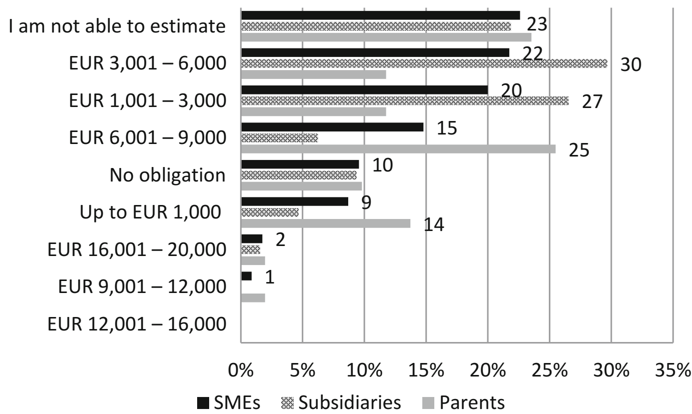


Fig. 3.6 Average time and costs per year necessary for preparation of transfer pricing documentation (%) (compiled by author)

Regarding other transfer pricing issues, namely, the selection of transfer pricing methods and preparation of a country-by-country report or a similar type of report (Figs. 3.5 and 3.7), the survey revealed that approximately half of the respondents are not able to estimate their time and costs that are related to this issue. Only 10% of the respondents have used APA; therefore, 86% of the respondents have never used this type of tool and cannot estimate their costs and time (Fig. 3.8). However, the remainder of the respondents (one-quarter of the SMEs) reported that they spent up to 56 h per year per transaction and incurred costs greater than EUR 1000 per year while considering the most suitable transfer pricing method. Similarly, regarding the preparation of the country-by-country report, 11 and 12% of the respondents (SMEs) respectively spent up to 24 and 56 h per year and incurred costs up to EUR 500 and EUR 1000 per year. In addition, almost one-third of the respondents were

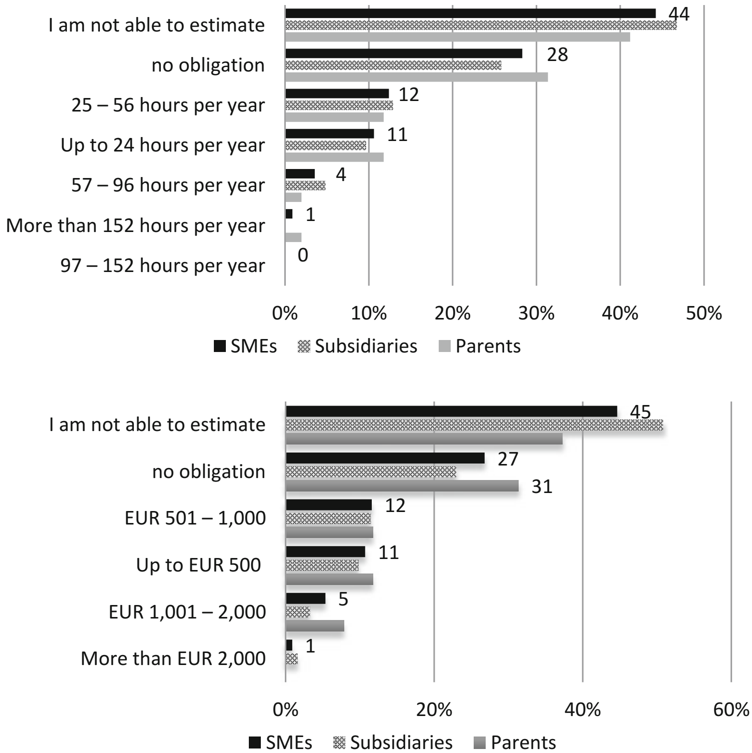


Fig. 3.7 Average time and costs per year necessary for preparation of country-by-country report (%) (compiled by author)

not obliged to prepare a country-by-country report. However, this situation regarding country-by-country reporting will change in accordance with OECD BEPS recommendations and EU activities,[11] which will increase the compliance costs of transfer pricing issues.

3.3 Suggestions

The final segment of the survey focused on proposing tools for decreasing the compliance costs of transfer pricing. The respondents suggested 217 simplified measurements for SMEs to use for transfer pricing issues (see Table 3.3). This large

[11]In both cases, the country-by-country report has set the threshold limit as EUR 750 million of consolidated revenue; i.e., multinational entities whose consolidated revenue is equal to or greater than EUR 750 million are obliged to file a country-by-country report for each jurisdiction in which the group operates.

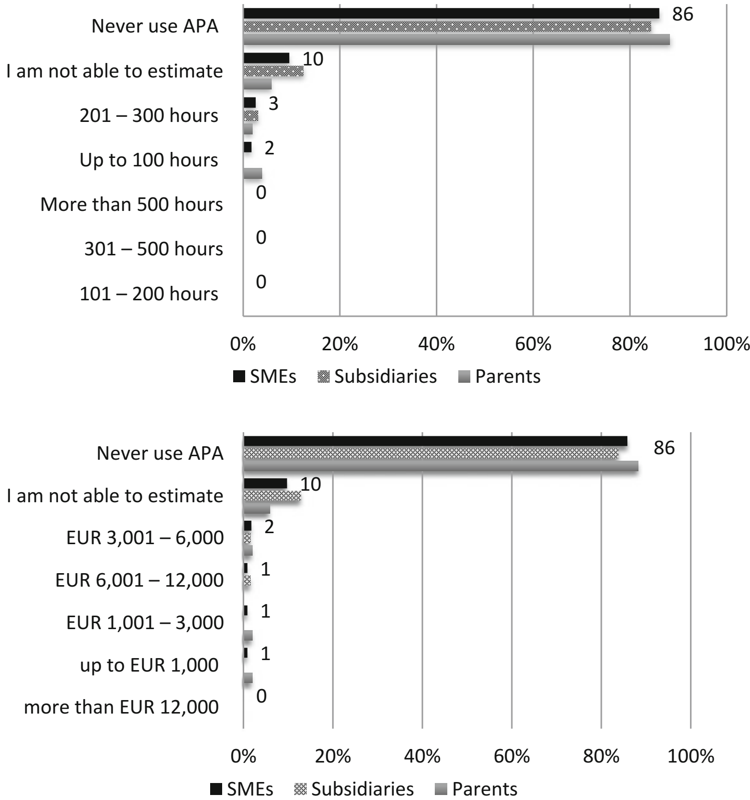


Fig. 3.8 Average time and costs per year necessary for preparation of APA (%) (compiled by author)

number of suggestions included simplified transfer pricing documents (29%), followed by smaller penalties (21%) and opportunities to apply for safe harbour (16%). Only 6% of the suggestions were related to specific APAs because only 24% of the respondents reported experience with this type of prevention tool and 86% of the respondents reported that they did not have any experience using APAs. Furthermore, 13% of the suggestions referred to the exemption of SMEs from transfer pricing rules.

Regarding safe harbour,[12] 81% of the respondents (SMEs) would appreciate the introduction of safe harbours for selected industries and types of transactions, such as manufacturing, distribution and service provision. Moreover, respondents would appreciate the introduction of safe harbours for intangibles (32%) and royalties and loans (28%). For details, see Fig. 3.9.

[12]For more details about safe harbours see Chap. 5.

Table 3.3 Suggested simplified measurements for SMEs (compiled by author)

Country	Simplified transfer pricing documentation requirements	Specific nature of a transfer pricing audit process	Lower penalties	Specific nature of advanced pricing agreements	Safe harbour rates	Exclusion of SMEs from transfer pricing rules or others	Others	Total
AT	6	2	5		1			14
BG	2		1			1		4
CZ	25	16	23	7	20	8		99
FI						2		2
FR						1		1
HR	1		1					2
HU	2	1						3
IT	1	1	1					3
NL	2		1	1	1			5
PL	12	1	2	1	2	10	7	35
RO	5	3	5	1	5	4		23
SE	2	1	1		1	1		6
SI	3		1		2			6
SK	2	2	4	2	2	2		14
Total	63	27	45	12	34	29	7	217
%	29	12	21	6	16	13	3	100%

Regarding the other suggestions, 84% of the respondents (SMEs) would appreciate the introduction of simplified transfer pricing documentation in contrast to 71% of the respondents who prefer the exclusion of micro and small entities from the obligation to prepare transfer pricing documentation. Moreover, 66% of the respondents (SMEs) would appreciate the full exemption of micro and small entities from the obligation to follow transfer pricing rules. In addition, 89% of the respondents would appreciate the imposition of smaller penalties for SMEs, particularly if SMEs are acting in good faith and are unable to supply the required documentation. For more details, see Figs. 3.10, 3.11, 3.12, and 3.13.

Moreover, 82% of the respondents (SMEs) would appreciate online access to comprehensive information related to transfer pricing issues, such as training materials, technical manuals, general information and other information. Furthermore, 44% of the respondents (SMEs) would appreciate transfer pricing guidelines for SMEs, such as the OECD TP Guidelines, which include comprehensive guidelines regarding transfer pricing issues in the context of SMEs. The current OECD TP Guidelines (2017) focus on multinational enterprises, which are usually large entities; therefore, the concepts mentioned are not suitable for SMEs. However, 54% of the respondents (SMEs) do not believe that this type of guidelines would be beneficial for SMEs (see Figs. 3.14 and 3.15).

Furthermore, 69% of the respondents (SMEs) would prefer the introduction of EU-comparable benchmarks for selected industries, i.e., comparable benchmarks used to determine intra-group prices under the transactional net margin method

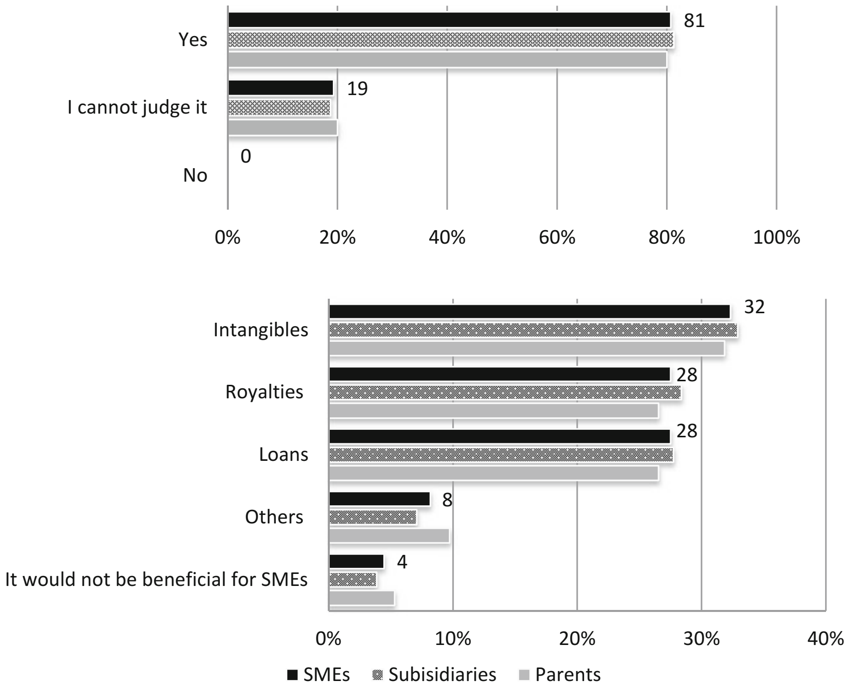


Fig. 3.9 Suggestions related to safe harbours (%) (compiled by author)

(TNMM) via different databases. Fifty-one percent of the respondents (SMEs) would appreciate introducing the C(C)CTB system in the EU because it would eliminate transfer pricing issues; however, 21% of the respondents would not prefer this system. For details, see Figs. 3.16 and 3.17. In addition, 50% of the respondents (SMEs) would prefer to communicate with tax authorities in another language, and 67% of the respondents (SMEs) would also appreciate the opportunity to submit a tax return in another language. For details, see Figs. 3.18 and 3.19.

3.4 Conclusion

In 2016, the questionnaire was sent to a representative sample of SMEs to analyse transfer pricing issues and compliance costs, including which tools might be used to decrease the time and funds spent on this issue. The sample included 2600 entities that operate in the EU28 (except for Malta and Cyprus). The classification of SMEs was based on the European Commission (2003) and considered transfer pricing issues based on Articles 7 and 9 of the OECD Model Convention. The overall return rate for the questionnaire was 5.5%.

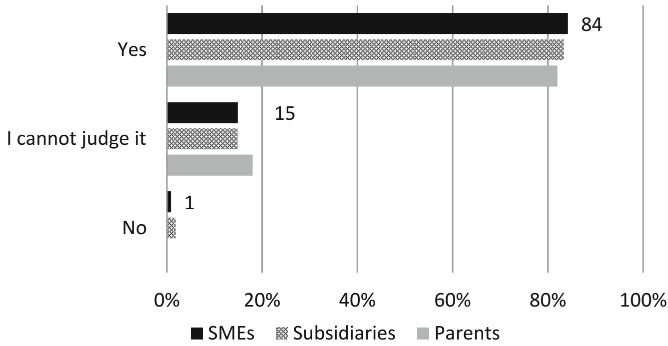


Fig. 3.10 The introduction of simplified transfer pricing documentation for SMEs (%) (compiled by author)

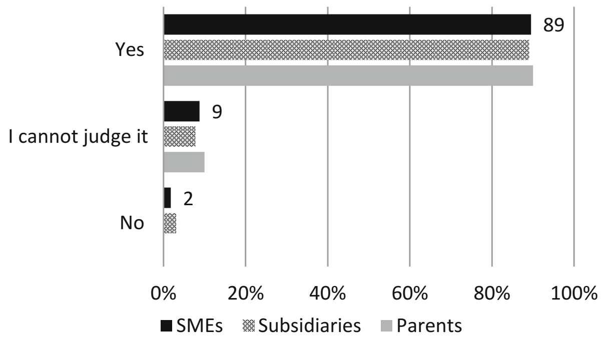


Fig. 3.11 The introduction of lower penalties for SMEs (%) (compiled by author)

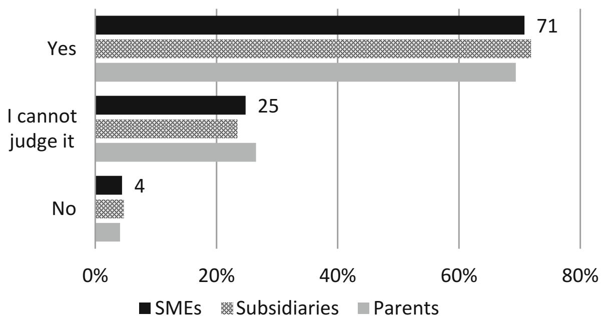


Fig. 3.12 The exclusion of micro and small enterprises from the obligation to prepare transfer pricing documentation (%) (compiled by author)

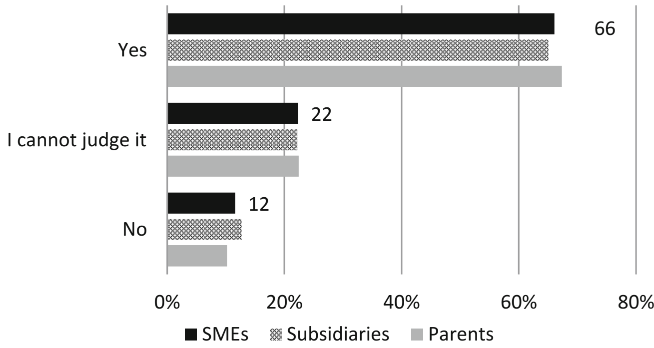


Fig. 3.13 The exclusion of micro and small enterprises from the obligation of transfer pricing issue (%) (compiled by author)

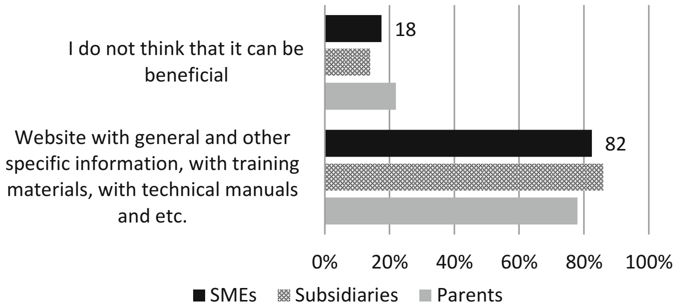


Fig. 3.14 Availability of complex information for SMEs (%) (compiled by author)

The survey revealed that almost 86% of the respondents (SMEs) use tax consultant services for transfer pricing issues and all tax matters. Moreover, the study demonstrated that transfer pricing issues are extremely burdensome for SMEs with respect to both costs and time. The respondents identified that the greatest portion of the time and costs required to manage transfer pricing issues was related to the preparation of transfer pricing documents. Globally, approximately one-quarter of the respondents (SMEs) spent up to 300 h per year (approximately 38 working days) and incurred costs up to EUR 6000 per year (for parent companies, up to EUR 9000) to prepare transfer pricing documentation.

The respondents suggested 217 simplified measurements as tools to decrease SMEs' compliance costs related to transfer pricing. Most of the suggestions represented simplified transfer pricing documentation (29%), followed by smaller penalties (21%) and opportunities to apply for a safe harbour (16%). The respondents (81%) would appreciate opportunities to apply for safe harbour for transactions, such as manufacturing, distribution and services; intangibles (32%); and

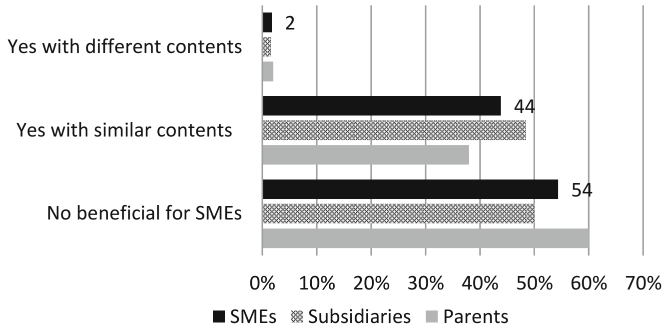


Fig. 3.15 The implementation of the C(C)CTB system in EU (%) (compiled by author)

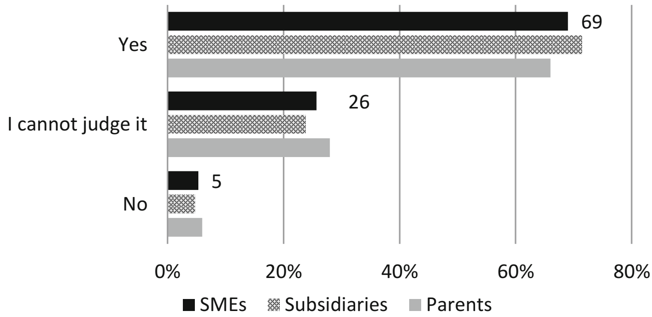


Fig. 3.16 The introduction of EU comparables (benchmarks) for selected industries (%) (compiled by author)

royalties and loans (28%). Eighty-four percent of the respondents (SMEs) would appreciate the introduction of simplified transfer pricing documentation, while 71% of the respondents preferred the exclusion of micro and small entities from the obligation to prepare transfer pricing documentation. Moreover, 82% of the respondents (SMEs) would appreciate online access to comprehensive information related to transfer pricing issues, the introduction of EU-comparable benchmarks for selected industries (69% of SMEs) and the introduction of a C(C)CTB system (51% of SMEs). In addition, the survey revealed that 13% of the suggestions referred to the full exemption of SMEs from transfer pricing rules.

Most suggestions can be considered realistic, as the largest number of simplified measurements for SMEs are offered in the EU and are related to documentation and

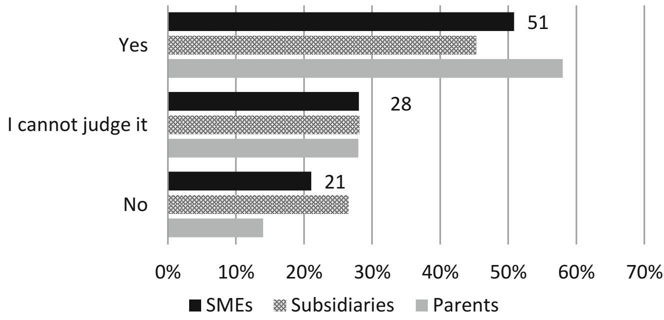


Fig. 3.17 The introduction of the transfer pricing guidelines for SMEs like as OECD TP Guidelines (%) (compiled by author)

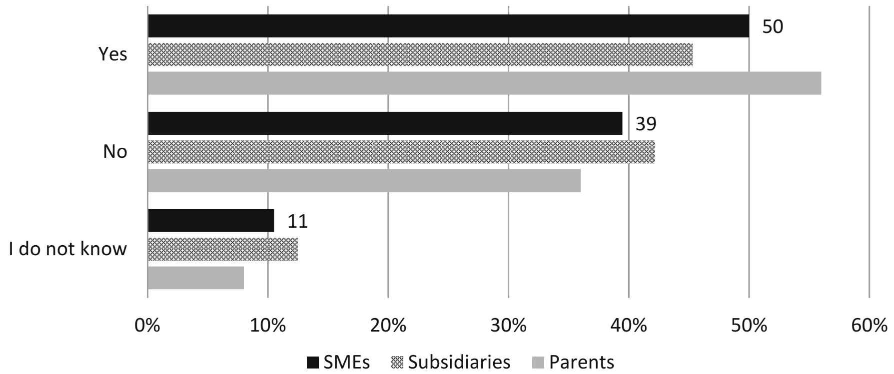


Fig. 3.18 The possibility of communication with tax authorities in other language (%) (compiled by author)

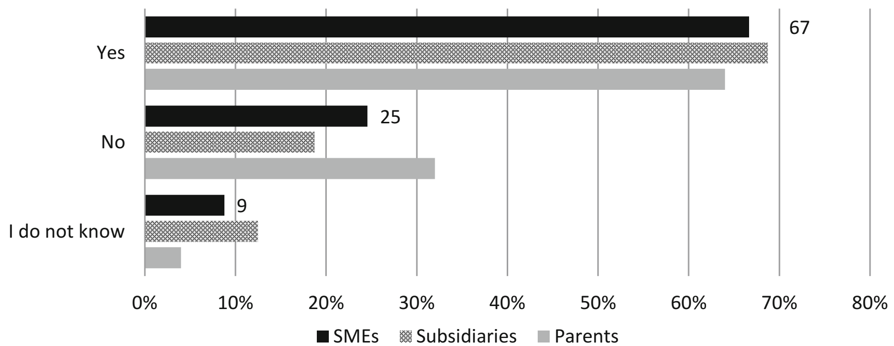


Fig. 3.19 The possibility of submitting a tax return in other language (%) (compiled by author)

the exemption from documentation requirements under specific conditions.[13] Applying for safe harbour is usually related to low value-adding services and loans in the EU (i.e., for specific activities), not to a specific type of business entity (i.e., it is applicable for all entities regardless of the size of the entity). However, the EU Member States have experiences with this type of measurement, and it is possible to consider this as an option for types of entities, such as SMEs. In October 2016, directive proposals were introduced regarding the introduction of the C(C)CTB system. Due to changes in the external environment in comparison to 2011, which have occurred since the first proposal of the C(C)CTB, the probability of adoption of this system has increased. This has occurred primarily because the system is perceived not as a toll for harmonisation but rather as a tool to prevent tax avoidance, tax fraud and profit shifting. For these reasons, we pay special attention to topics related to safe harbours and the C(C)CTB and devote a separate chapter to these issues. In Chaps. 5 and 6, we discuss safe harbours and the C(C)CTB system as possible solutions for SMEs in relation to transfer pricing issues.[14]

Acknowledgement The chapter is the result of the GA ČR no. 15-24867S "Small and medium size enterprises in global competition: Development of specific transfer pricing methodology reflecting their specificities".

Annex

Questionnaire
1. Please state the category to which your enterprise. If your enterprise is classified as large, please do not fill in the questionnaire. a. Large (staff headcount >250, turnover >40 million EUR or balance sheet total >20 million EUR) b. Medium-sized (staff headcount <250, turnover <40 million EUR or balance sheet total <20 million EUR) c. Small (staff headcount <50, turnover <8 million EUR or balance sheet total <4 million EUR) d. Micro (staff headcount <10, turnover <0.7 million EUR or balance sheet total <0.35 million EUR)
2. Please indicate the resident country of SME.
3. Are you a parent company or subsidiary?
4. If you are parent company, do you have a foreign subsidiary? If yes, please indicate the resident country of the subsidiary.
5. Please select the NACE sector in which SME is acting: A (01–03 NACE code)—Agriculture, forestry and fishing; B (05–09 NACE code)—Mining and quarrying; C (10–33 NACE code)—Manufacturing;

(continued)

[13] For more details about transfer pricing rules and simplified measurements see Chaps. 2 and 5.

[14] For more details, see Chaps. 5 and 6.

D (35 NACE code)—Electricity, gas, or steam and air conditioning supply; E (36–39 NACE code)—Water supply, sewerage, waste management and remediation activities; F (41–43 NACE code)—Construction; G (45–47 NACE code)—Wholesale and retail trade and repair of motor vehicles and motorcycles; H (49–53 NACE code)—Transporting and storage; I (55–56 NACE code)—Accommodation and food service activities; J (58–63 NACE code)—Information and communication; K (64–66 NACE code)—Financial and insurance activities; L (68 NACE code)—Real estate activities; M (69–75 NACE code)—Professional, scientific and technical activities; N (77–82 NACE code)—Administrative and support service activities; O (84 NACE code)—Public administration, defence and compulsory social security; P (85 NACE code)—Education; Q (86–88 NACE code)—Human health and social work activities; R (90–93 NACE code)—Arts, entertainment and recreation; or S (94–96 NACE code)—Other services
6. Does the country use a specific SME definition for transfer pricing purposes? If yes, please briefly indicate the key points
7. Are there any specific measures used for SMEs? For example: a. simplified transfer pricing documentation requirements b. specific nature of a transfer pricing audit process c. smaller penalties d. specific nature of advanced pricing agreements e. safe harbour rates (i.e., tax authorities predetermine the range of rates that can be used for specified transactions between SMEs) f. the exclusion of SMEs from transfer pricing rules or others g. others, or h. none
8. With respect to the previous question, if you selected "others", please briefly specify the measure and address the key points
9. With respect to question No. 7, if there are not any specific measures for SMEs regarding transfer pricing in place, would you appreciate the introduction of some of these measures? Please indicate which one: a. simplified transfer pricing documentation requirements b. specific nature of a transfer pricing audit process c. smaller penalties d. specific nature of advanced pricing agreement e. safe harbour rates (i.e., tax authorities predetermine the range of rates that can be used for specified transactions between SMEs) f. the exclusion of SMEs from transfer pricing rules or others, or g. others
10. Are you dealing with transfer pricing issues in your company? If not, please do not continue filling out the questionnaire
11. Are you using the services of a tax consultant for transfer pricing issues? If yes, please indicate for which of the following activities: a. consideration of the most suitable transfer pricing method b. preparation of the transfer pricing documents (local or master files) c. preparation of the advanced pricing agreements d. preparation of the country-by-country report

(continued)

e. transfer pricing disputes
f. all tax matters, regardless of whether it is a transfer pricing issue
g. Other issues
h. no, I do not use this kind of service

12. Please estimate the time range necessary for managing transfer pricing issues (this includes the creation of relevant documents, translation of documents, consideration of transfer pricing methods, preparation of transfer pricing documents (master file or local file), completion of the country-by-country report as an annex of an income tax return and preparation of other documents).
a. Up to 50 h per year
b. 51–100 h per year
c. 101–200 h per year
d. 201–300 h per year
e. 301–500 h per year
f. 501–700 h per year
g. 701–900 h pear year
h. More than 900 h per year
i. I am not able to estimate

13. With respect to the previous question, please estimate the average costs per year related to this issue.
a. Up to EUR 1000
b. EUR 1001–2000
c. EUR 2001–3000
d. EUR 3001–4000
e. EUR 4001–5000
f. EUR 5001–6000
g. EUR 6001–10,000
h. EUR 10,001–12,000
i. EUR 12,001–14,000
j. EUR 14,000–16,000
k. EUR 16,001–18,000
l. EUR 18,001–20,000
m. EUR 20,001–22,000
n. more than EUR 22,000
o. I am not able to estimate

14. Please estimate the time necessary for considering the most suitable transfer pricing method.
a. Up to 24 h per year
b. 25–56 h per year
c. More than 56 h per year
d. I am not able to estimate

15. With respect to the previous question, please estimate the costs related to this issue.
a. Up to EUR 500
b. EUR 501–1000
c. More than EUR 1000
d. I am not able to estimate

16. Please estimate the time necessary for preparing transfer pricing documents. When doing the estimation, please take into account the time necessary for updating any transfer pricing documents.
a. Up to 100 h
b. 101–200 h
c. 201–300 h

(continued)

d. 301–500 h e. More than 500 h f. I am not able to estimate g. There is no obligation to prepare transfer pricing documents in our country
17. With respect to the previous question, please estimate the costs related to this issue. a. Up to EUR 1000 b. EUR 1001–3000 c. EUR 3001–6000 d. EUR 6001–9000 e. EUR 9001–12,000 f. EUR 12,001–16,000 g. EUR 16,001–20,000 h. more than EUR 20,000 i. I am not able to estimate j. There no obligation to prepare transfer pricing documents
18. If your enterprise has the obligation to complete a country-by-country report as an annex of an income tax return, please estimate the time necessary for its preparation. a. Up to 24 h per year b. 25–56 h per year c. 57–96 h per year d. 97–152 h per year e. More than 152 h per year f. I am not able to estimate g. There is no obligation to prepare a country-by-country report
19. With respect to the previous question, please estimate the costs related to this issue. a. Up to EUR 500 b. EUR 501–1000 c. EUR 1001–2000 e. More than EUR 2000 f. I am not able to estimate g. There is no obligation to prepare a country-by-country report
20. Have you ever used an advance pricing agreement in your enterprise? If yes, please estimate the time necessary to prepare the advance pricing agreement. When doing the estimation, please take into account the time necessary for updating the advanced pricing agreement. a. Up to 100 h b. 101–200 h c. 201–300 h d. 301–500 h e. More than 500 h f. I am not able to estimate g. I have never used an advance pricing agreement
21. With respect to the previous question, please estimate the costs related to this issue. a. Up to EUR 1000 b. EUR 1001–3000 c. EUR 3001–6000 d. EUR 6001–12,000 e. more than EUR 12,000 f. I am not able to estimate g. I have never used an advance pricing agreement
22. Do you think that the availability of complex information for SMEs regarding transfer pricing issues can be beneficial? If yes, would you prefer:

(continued)

a. A website with general and specific information b. Training materials Technical manuals, etc. c. I do not think that it would be beneficial
23. Would you appreciate communications with tax authorities in languages other than your country's official language? a. Yes b. No c. I do not know
24. Would you appreciate the option to submit a tax return in other languages? a. Yes b. No c. I do not know
25. Would you appreciate the implementation of the common consolidated corporate tax base in the EU, which would introduce the concept of one-stop shop? a. Yes b. No c. I do not know
26. Would you appreciate the introduction of transfer pricing guidelines for SMEs that considers the different approaches used for SMEs? If yes, do you prefer guidelines that are similar to the OECD Transfer Pricing Guidelines? a. I do not think that it would be beneficial for SMEs b. I think that it would be beneficial for SMEs, and I prefer similar guidelines c. I think that it would be beneficial for SMEs, but I do not prefer similar guidelines
27. Would you appreciate the introduction of simplified transfer pricing documents for SMEs? a. Yes b. No c. I do not know
28. Would you appreciate the exclusion of micro and small enterprises from the obligation to prepare transfer pricing documents? a. Yes b. No c. I do not know
29. Would you appreciate the exclusion of micro and small enterprises from the obligation of transfer pricing issues? a. Yes b. No c. I do not know
30. Would you appreciate the introduction of a simplified advance pricing agreement procedure for SMEs? (This could include simplified transfer pricing documentation requirements, no or reduced fees, a shortened verification process) a. Yes b. No c. I do not know; I have never used the advance pricing agreement
31. Would you appreciate the introduction of smaller penalties for SMEs, particularly if SMEs are acting in good faith and are not able to supply the required documentation? a. Yes b. No c. I do not know
32. Would you appreciate the introduction of a safe harbour range of rates for selected industries and types of transactions (i.e., manufacturer, distributor, or service provider; the system is

(continued)

currently applied in the case of low value-added services in the EU)? a. Yes b. No c. I do not know
33. Would you appreciate the introduction of a safe harbour range of rates for the following transactions? Please indicate which one: a. Loans b. Royalties c. Intangibles d. Others—please specify e. No, I do not think that it will be beneficial for SMEs
34. Would you appreciate the introduction of EU-comparable benchmarks for selected industries and guidelines covering the selection and use of data that are comparable to the EU and practices of other EU Member States? a. Yes b. No c. I do not know

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Chapter 4
Compliance Costs of Transfer Pricing for SMEs

This segment of the book contains an analysis of compliance costs of taxation with respect to SMEs[1] and transfer pricing issues as well as critiques of current approaches. The last part of the chapter includes a case study on the determination of compliance costs of transfer pricing with respect to SMEs in the Czech Republic, the Slovak Republic and Poland, which represent countries from the Visegrad Group,[2] and the European Union, as based on the results of our questionnaire. To determine the compliance costs of transfer pricing, cost and time approaches were used.

4.1 Introduction

SMEs are usually less well-equipped than LEs with financial and human resources. Therefore, SMEs usually cannot benefit from tax planning strategies or from the application of tax planning instruments. One such tax planning instrument is that of transfer pricing, which helps reduce tax risks and overall tax liability. In this respect, the OECD estimates annual losses between 4 to 10% of global corporate income tax revenues, i.e., USD100 to 240 billion annually as a result of mispricing. To avoid certain tax planning and transfer pricing practices and to ensure the correct application of the separate entity approach, the OECD and G20 countries launched a project on base erosion and profit shifting (hereinafter, BEPS) in February 2013. The project includes 15 action plans related to tax planning strategies and profit shifting to low or no-tax locations, thus resulting in little or no overall corporate tax

[1]Based on the definition of the European Commission, Recommendation 2003/361/EC.

[2]The reason for the selection of those countries is that those countries belong to Visegrad group (Hungary is omitted as micro and small enterprises are excluded from the obligation to prepare transfer pricing documentation in that country, and no data available for that country). Moreover, those countries cover the highest amount of respondents from the research.

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being paid. The final reports of the project were published on 5 October 2015. Consequently, the TP Guidelines, providing detailed guidelines on the application of the arm's length principle, were updated and released on 10 July 2017, reflecting the recommendations from the BEPS project.

To avoid the divergent implementation of the BEPS by each EU member state and disruption of the functioning of the internal market, the European Commission published the draft of the directive, *laying down rules against tax avoidance practices that directly affect the functioning of the internal market*, also known as the Anti-Tax Avoidance Directive, on 28 January 2016. The fact that it was adopted after only five months by the council as Directive 2016/1164 indicates how important this topic is to the EU Member States. The Anti-Tax Avoidance Directive contains five legally binding anti-abuse measures[3] that all member states should apply to avoid common forms of aggressive tax planning.[4] It also creates minimum protection of all member states' corporate tax systems by transposing the OECD BEPS measures into their national systems in a coherent and coordinated fashion to ensure a fairer and more stable environment for businesses.

It is obvious that both published documents and their implementation will have significant effects on the enterprises and their corporate tax liability. However, currently, SMEs face numerous disadvantages due to their size, a factor that can have distorted impacts on their commercial decisions, business forms and business activities. According to (Cordova-Novion and De Young 2001; Slemrod 2006; Shaw et al. 2008; Obermair et al. 2008 and others), the disproportionately high impact of regulatory requirements also creates disproportionately high compliance costs of taxation, which have a regressive character with regard to firm size. Further, the OECD states that compliance costs of taxation in the case of SMEs represent 46% of incurred costs (OECD 2001). Moreover (Slemrod 2006), adds that compliance costs of taxation usually depend, inter alia, on the size of the business (in a regressive way), the economic sector, and the degree of internationalization. Therefore, taxation and other obligations should be carefully designed so they can address the disproportionately high tax compliance burdens faced by SMEs.

Currently, there are no studies determining compliance costs of transfer pricing in the case of SMEs. Therefore, based on data collection through questionnaires, we conduct a determination of the compliance costs of transfer pricing in the case of SMEs in the following sections.

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[3]Controlled foreign company (CFC) rule, switchover rule, exit taxation, interest limitation, general anti-abuse rule.

[4]Member States should apply these measures as from 1 January 2019.

4.2 Theoretical Background

4.2.1 Transfer Pricing Issue

The concept of transfer pricing and the arm's length principle (hereinafter, standard) for taxation purposes is originated in 1932 when the first tax treaty[5] was signed and included an allocation norm for business income between associated enterprises in the form of the arm's length principle, as state by Solilová and Steindl (2013). Another reference is found in the Carroll Report (Carroll 1933), which recommends the arm's length principle as a suitable allocation norm. The classification of articles dealing with the arm's length principle was changed several times before 1963, when the first OECD Model Convention was published. This publication included Article 9(1), which was based on the London model[6] of 1946. However, as mentioned in (Solilová and Steindl 2013), the current form of the standard (i.e., Article 9(1) and (2)) was added to the OECD Model Convention in 1977 during its first revision.

Under this standard, associated entities must set transfer prices for any intercompany transaction as if they were unrelated entities, while all other aspects of the relationship were unchanged. Applying and testing the arm's length principle requires a deep understanding of the circumstances, i.e., the commercial and financial relationships, in which associated enterprises make transactions and agree on their transaction prices. In this sense, the principle should reflect the economic reality of how enterprises work. However, there is evidence that the standard does not reflect both economic reality and fact as to whether a third party would enter into the transaction. Rather, it is proved that income shifting between enterprises occurs (Keuschnigg and Devereux 2013; Taylor et al. 2015; Bartelsman and Beetsma 2000; Wells and Lowell 2014; Hines and Rice 1994; Huizinga and Laeven 2006). This claim of income shifting fully corresponds with the fact that transfer pricing represents an instrument that is used as a tax planning tool, i.e., properly chosen transfer pricing strategies can enable the distribution of tax risks and profits resulting in the reduction of the overall tax liability (Buus 2009; Solilová and Nerudová 2012, 2013; Swenson 2001; Rojíček 2012). As previously indicated, to avoid this practice and ensure the correct application of the separate entity approach and the standard, the BEPS project was launched and the Anti Avoidance Directive was consequently introduced in EU.

With respect to the transfer pricing issue, only two deliverables of the BEPS project address this topic. The first is action plans 8 through 10, "Aligning Transfer Pricing Outcomes with Value Creation", and the second is action plan 13, "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting". Based on action plan 13, all enterprises are required to report information relating

[5]The arm's length principle was implemented in the U.S-France treaty of 1932 for the first time.

[6]London Model Tax Convention (1946) was used as the predecessor to the OECD draft model convention in 1963.

to their economic activity, such as revenues, profits, taxes paid and certain measures of economic activity, and to articulate their consistent transfer pricing positions through this standardized approach of reporting. A new reporting obligation is required for the current transfer pricing documentation. Based on action plans 8 through 10, regarding transfer pricing analysis and the determination of transfer prices, a correct application of the standard demands an understanding of the value drivers and the relevant risks involved. An understanding of how the responsibility for those risks is attributed among the associated enterprises in the context of their commitment to jointly create value is also required. In this context, the level and assumption of risk are economically relevant characteristics that can be significant in determining the outcome of a transfer pricing analysis. Thus, an understanding of the risks is crucial. Currently, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995, 2010, 2017) (hereinafter, TP Guidelines) identifies five economically relevant and comparable factors, namely, characteristics of property transferred or services provided, functional analysis, contractual terms of the transaction, economic circumstances of the parties and the market in which the parties operate, and business strategies. These factors were further supplemented by a nine-step process of comparability analysis (in 2010) and by a six-step process to analysing the risks (based on the BEPS recommendations, in 2017), which resulted in the accepted good practice of applying the recommendations of the revised TP Guidelines in 2010 and 2017.

On the one hand (Pris et al. 2014), state that because the functions, assets and risks are not systematically aligned in a clear and easily defined pattern of entities and locations, the concept of the comparability analysis without new six-step process can lead to incorrect inferences about non-compliant behaviours. Therefore, the recommendation of the BEPS highlights (based on value creation) that the understanding of the risks and the mapping of the responsibilities of the individual associated enterprises with respect to the different risk categories by accurately delineating functional analysis can help fully assess the respective contributions of these enterprises to the joint value created and derive the relative bargaining position of each enterprise. Bargaining power is essential for drawing conclusions as to whether third parties would enter, or would have entered, into the transactions under the prevailing terms and conditions, and for determining whether the transactions are at arm's length. On other hand, according to (Lohse and Riedel 2013; Wells and Lowell 2014) there is also evidence that bargaining power is also critical to the recommendations of the BEPS and its solution with respect to the elimination of profit shifting and the correct application of the standard. They further highlight that problems with transfer pricing are mainly rooted in the long-standing TP Guidelines and the statement of the standard in the OECD Model Convention. A possible solution lies in the modification of these documents, rather than in the more complex transfer pricing documentation, and in transparency, which will result in higher compliance costs of taxation.

4.2.2 *Compliance Costs of Taxation*

Regarding the current perspective, compliance costs were first defined by Sandford (1995) as the burden imposed upon the taxpayer as a result of their taxation obligation. There are numerous international comparative studies based on this definition of compliance costs of taxation. Herein, however, four major global findings on compliance costs of taxation are highlighted. First, compliance costs are significant and high. Based on the OECD survey, compliance costs represent 46% of the incurred costs of SMEs (OECD 2001). Second, compliance costs are regressive, i.e., SMEs face disproportionately high compliance costs of taxation compared to LEs (Slemrod 2006; Shaw et al. 2008; Obermair et al. 2008; Cordova-Novion and De Young 2001; Chittenden et al. 2000 and others). Third, compliance costs are not reduced over time (Obermair et al. 2008; Evans 2003). Finally, compliance costs of taxation usually depend, in alia, on size, sector and multinationality (Slemrod 2006). Chittenden et al. (2000) adds that SMEs bear one-hundred times higher compliance costs of taxation than do LEs.

Compliance costs represent one of the tools for measuring the complexity of the tax system, a system whose measurement is problematic in the area of economics (Pavel and Vítek 2015). This is mainly due to the afore-mentioned reasons; however, it is also because the compliance costs can support tax evasion/avoidance for it increases for businesses with cross-border activities, i.e., compliance costs of taxation are significantly higher for enterprises with foreign branches or subsidiaries than they are for enterprises that are not internationalized as offered by Nerudová et al. (2009) and Cressy (2000). Based on the last reason proffered, it can be presumed that compliance costs represent the inefficient use of scarce resources in the economy.

With respect to the drivers of compliance costs of taxation (KPMG 1996, 2006; Evans 2003; Green 1994), identified significant drivers in the form of changes in tax systems and taxes and in the complexity of tax systems and tax regulations. Shaw et al. (2008) add that lower compliance costs of taxation are usually in countries that have relatively simple taxes and tax systems. Accordingly, tax policymakers should decide between complexity and simplicity and between more frequent change or more consultative change.

With respect to compliance costs of transfer pricing, the current literature is remiss on measuring those compliance costs. Rather, the transfer pricing issue is covered within the field of corporate taxation, and thus, it is assumed that compliance costs of transfer pricing are incorporated with the compliance costs of corporate taxation. The compliance costs of corporate taxation in the case of the Czech Republic were determined by Vítek and Pavel (2008) to be 5.5% and by Pudil et al. (2004) to be 5.3% of the corporate tax collected. The European Commission recognizes that high compliance costs in the field of transfer pricing can negatively affect the internal market, and therefore, the EU Transfer Pricing Forum produced

EU transfer pricing documentation in the form of a code of conduct[7] with the aim to harmonize transfer pricing documentation obligations and requirements in Europe. However (Solilová and Nerudová 2016; Silberztein 2013), also recommend the introduction of simplified measurements with respect to transfer pricing. Further, in the long-run, the European Commission recommends shifting from the separate entity approach (to which the arm's length principle is connected) to the single entity approach with an allocation mechanism i.e. in the form of CCCTB as a comprehensive approach, where transfer pricing transactions would have no impact on the group's tax base due to their elimination.

As previously indicated, there exists no literature on the separate measurement of compliance costs of transfer pricing. Therefore, the following section presents the results of the case study on the determination of compliance costs of transfer pricing in selected EU Member States.

4.3 Determination of Compliance Costs of Transfer Pricing: The Czech, Polish and Slovak Cases

4.3.1 Data Description and Processing

The compliance costs of transfer pricing of the SMEs were determined through the results of a questionnaire[8] administered in select countries, namely, the Czech Republic, the Slovak Republic and Poland. We received 82 responses from SMEs whose tax residences are the Czech Republic (29 answers), the Slovak Republic (22 answers) and Poland (31 answers), i.e., Czech, Slovak or Polish parent companies with subsidiaries in the EU, and Czech, Slovak or Polish subsidiaries with parent companies in the EU.

With respect to the Czech Republic, of the 29 respondents, 3.4% represent micro entities, 34.5% represent small entities and 62.1% represent medium-sized entities. Additionally, 55.2% represent Czech subsidiaries with parent companies in the EU, and 44.8% represent Czech parent companies with subsidiaries in the EU, namely, in the Czech Republic, Germany, Romania, Hungary and Bulgaria. Furthermore, those entities are operating primarily in the industry sectors NACE C and G (19.5%), the industry sectors NACE M (17.1%) and the industry sectors NACE F, H, J, K, L, N and S (under 10%).[9]

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[7]The Council of the EU approved the Code of Conduct on the EU TPD on 6 June 2006. The EU TPD consists of the Masterfile providing a uniform and standardized information relevant for all corporate group members; and a country-specific documentation providing all information that is relevant only in a specific EU Member State.

[8]The questionnaire contains 33 questions covering general transfer pricing issues, compliance costs of transfer pricing and tools for decreasing of those compliance costs.

[9]A—Agriculture, forestry and fishing, B—Mining and quarrying, C—Manufacturing, D—Electricity, gas, steam and air conditioning supply, E—Water supply; sewerage; waste management

With respect to the Slovak Republic, of the 22 respondents, 18.2% represent micro entities, 54.5% represent small entities and 27.3% represent medium-sized entities. Further, 63.6% represent Slovak subsidiaries with parent companies in the EU, and 36.4% represent Slovak parent companies with subsidiaries in the EU, namely, in the Czech Republic and Romania. In addition, those entities are operating primarily in industry sectors NACE G (21.2%), NACE C and H (15.1%), NACE F (12.1%), NACE M (9.09%) and NACE A, I, J, K, L, M, N and S (less than 6%). Moreover, 22.7% of the respondents do not address transfer pricing issues.

With respect to Poland, 31 respondents represent 35.5% micro and medium-sized entities, 29.03% represent small entities and 3.2% represent large entities. The responses from large entities were omitted from the analysis as the focus of this study is on SMEs. Moreover, 38.7% of the respondents do not address transfer pricing issues, 29.03% represent Polish subsidiaries with parent companies in the EU and 70.09% represent Polish parent companies with subsidiaries in the EU, namely, the Czech Republic and Romania. In addition, the entities are operating primarily in industry sectors NACE K (22.8%), NACE C, J, L and S (11.4%) and NACE A, E, F, G, M, N and P (under 10%).

When determining the compliance costs of transfer pricing, the weighted average value of compliance costs was applied as can be seen in Eq. (4.1).

$$\bar{x} = \frac{\sum_{i=1}^{n} w_i x_i}{\sum_{i=1}^{n} w_i} \qquad (4.1)$$

where weight (w) represents the number of answers for each cost or time set in the questionnaire and x represents values from the individual spread of costs or time set in the questionnaire in three forms:

- A: Calculations based on the median values[10] of the individual spread of costs/ time set in the questionnaire,
- B: Calculations based on the highest values[11] of the individual spread of costs/ time set in the questionnaire, and

and remediation activities, F—Construction, G—Wholesale and retail trade; repair of motor vehicles and motorcycles, H—Transporting and storage, I—Accommodation and food service activities, J—Information and communication, K—Financial and insurance activities, L—Real estate activities, M—Professional, scientific and technical activities, N—Administrative and support service activities, O—Public administration and defence; compulsory social security, P—Education, Q—Human health and social work activities, R—Arts, entertainment and recreation, S—Other services activities.

[10]For example spread set in questionnaire is EUR 1001–2000, medium value is 1500 which is further multiplied by the number of answers for that spread of costs according to Eq. (4.1).

[11]For example spread set in questionnaire is EUR 1001–2000, the highest values is 2000 which is further multiplied by the number of answers for that spread of costs according to Eq. (4.1).

Table 4.1 Data for calculating compliance costs (own processing, Amadeus, Hays Salary Guide)

Country	Salary tax advisor	Cost per working hour[a]	No. SMEs	No. medium sized
Czech Republic	EUR 2383[b]	EUR 14.6 per hour	468,745	60,702
Slovak Republic	EUR 2000	EUR 12.26 per hour	235,936	30,874
Poland	EUR 4307[c]	EUR 26.4 per hour	1,337,233	124,599

[a]Total working hours for 2015 is 1957.5 per year in all three countries
[b]Average exchange rate CZK/EUR for 2015 is CZK 27.283 per 1 EUR
[c]Average exchange rate PLN/EUR for 2015 is PLN 4.18 per 1 EUR

- C: Calculations based on the lowest values[12] of the individual spread of costs/ time set in the questionnaire.

Moreover, as is evident from Eq. (4.1), two indicators, namely, costs and time, were applied to determine the compliance costs of transfer pricing. In the case of the time indicator for the final determination of compliance costs, the salaries of the tax advisors were applied for each country, as transfer pricing issues are usually resolved by tax advisory services (see Table 4.1).

Consequently, the compliance costs as determined using the aforementioned method were used to determine the compliance costs of transfer pricing for the whole category of taxpayer (SMEs) operating in the identified countries. According to the European Commission (2015) and its annual report on SMEs, there should be more than 1.01 million SMEs acting in the Czech Republic, 1.46 million SMEs acting in Poland and 388.3 thousand SMEs acting in the Slovak Republic. However, these numbers refer, for the most part, to micro enterprises, whereas only a small portion of these figures represent small and medium-sized enterprises. Therefore, the Amadeus database was used to estimate the number of SME acting in the researched countries (for details, see Table 4.1), and these data were applied to determine the compliance costs of the entire group of SMEs.

To identify the portion of compliance costs of transfer pricing that can be attributed to the paid corporate tax, the corporate tax collected by each select country was obtained from the website of the Ministry of Finance of each researched country.

4.3.2 Determination of Compliance Costs

For the purpose of our study, compliance costs of transfer pricing issues cover only the transfer pricing documentation that takes into account the most suitable transfer

[12]For example spread set in questionnaire is EUR 1001–2000, the lowest values is 1001 which is further multiplied by the number of answers for that spread of costs according to Eq. (4.1).

pricing methods and country-by-country reporting. Other activities related to advance pricing agreements (hereinafter APA), transfer pricing methods and transfer pricing audits are omitted from the analysis as almost 50% of the respondents were unable to estimate time and costs related to these activities.

With respect to tax consultancy regarding the transfer pricing issue, the survey indicates that 8% of the Czech respondents, 4% of the Slovak respondents and 35% of the Polish respondents do not use tax consultant services for transfer pricing issues. This is contrary to 58% (Czech), 65% (Slovak) and 4% (Polish) who use these services for all matters, regardless of whether it is a transfer pricing issue. Furthermore, approximately 14% of the Czech respondents, 10% of the Slovak respondents and 30% of the Polish respondents use such consultancy services for preparing transfer pricing documentation. Moreover, the respondents also use tax consultancy services when considering the most suitable transfer pricing method, resolving transfer pricing disputes, preparing country-by-country reports (CbCR) and advancing pricing agreements (APA) (for details, see Fig. 4.1).

To determine the compliance costs of transfer pricing, it is necessary to identify the cost and time related to such activity. According to Table 4.2, the managing of transfer pricing documentation, which includes considering the most suitable transfer pricing methods, requires up to 100 h/year in the case of Poland, between 101 and 200 h/year in the case of the Slovak Republic and between 201 and 300 h/year in the case of the Czech Republic. However, a huge portion of the respondents were unable to estimate the time required to manage transfer pricing issues. This may be because many of them use a tax advisory service for this type of tax compliance. Regarding borne costs to manage transfer pricing documentation, the survey revealed that in case of the Czech Republic, approximately 38% of the respondents spent up to EUR 6000/year and approximately 35% of the respondents spent up to EUR 9000/year in comparison to the Slovak Republic, where 41.2% of the respondents, and Poland, where 21.1% of respondents, spent between EUR 1000 and EUR 3000 (for more details, see Table 4.2).

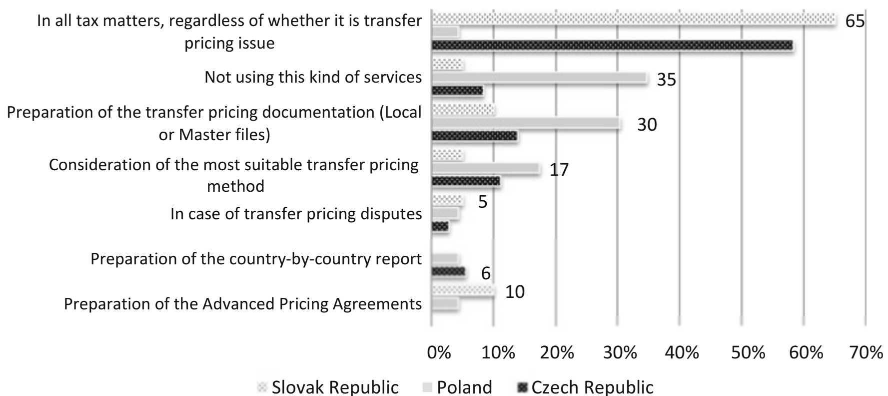

Fig. 4.1 Use of tax consultant services for transfer pricing issues (own processing, questionnaire)

Table 4.2 Transfer pricing documentation—costs and time (own calculation, questionnaire)

	Czech Republic		Slovak Republic		Poland	
	No.	%	No.	%	No.	%
15. Please estimate the time necessary for preparation of transfer pricing documentation. When doing the estimation, please take into account also the time necessary for up-date of transfer pricing documentation						
Up to 100 h	3	10.3	4	23.5	4	21.1
101–200 h	6	20.7	5	29.4	3	15.8
201–300 h	7	24.1	3	17.6	3	15.8
More than 500 h	–	–	2	11.8	–	–
I am not able to estimate	11	37.9	3	17.6	9	47.4
There is not an obligation to prepare transfer pricing documentation in our country	2	6.9	–	–	–	–
16. With respect to the previous question, please estimate the costs related to this issue						
Up to EUR 1000	1	3.4	3	17.6	1	5.3
EUR 1001–3000	4	13.8	7	41.2	4	21.1
EUR 3001–6000	11	37.9	2	11.8	1	5.3
EUR 6001–9000	10	34.5	2	11.8	1	5.3
EUR 9001–12,000	1	3.4	–	–	–	–
EUR 16,000–20,000	–	–	–	–	2	10.5
I am not able to estimate	–	–	3	17.6	10	52.6
There is not an obligation to prepare transfer pricing documentation	2	6.9	–	–	–	–

With respect to the country-by-country report, in case of the Czech Republic, 50% of the respondents spent between 25 and 56 h/year preparing the report, whereas 27% of the respondents spent up to EUR 500/year and another 38% spent between EUR 501 and EUR 1000/year. In case of the Slovak Republic, only two respondents estimated costs (EUR 500) and time (up to 24 h) to manage this issue. In case of Poland, approximately 48% of the respondents had no set obligation to complete the report, although more than 10% of the respondents estimated the time to be up to 24 h and between 57 and 96 h in the case of those obligated to complete the report with costs up to EUR 2000 (for details, see Table 4.3).

Consequently, according to the results of the survey, the weighted average time required for the transfer pricing issue, i.e., transfer pricing documentation and country-by-country reporting, and its related costs were determined in the select countries. The range of time determined is similar among the selected countries, i.e., between 143 and 276 h/year and entity[13] (18–35 work days) in the case of the Czech Republic; between 152 and 260 h/year and entity in the case of the Slovak Republic; and between 145 and 268 h/year and entity in the case of Poland.

[13]It is determined according to the median and the highest values of individual spread of time set in questionnaire.

Table 4.3 Country-by-country report—costs and time (own calculation, questionnaire)

	Czech Republic		Slovak Republic		Poland	
	No.	%	No.	%	No.	%
17. If your enterprise has the obligation to fill country-by-county report as an annex of income tax return, please estimate the time necessary for its preparation						
Up to 24 h per year	6	21.4	2	12.5	2	10.3
25–56 h per year	14	50.0	–	–	–	–
57–96 h per year	2	7.1	–	–	2	10.3
More than 152 h per year	–	–	–	–	1	5.3
I am not able to estimate	4	14.3	10	62.5	5	26.3
No obligation	2	7.1	4	25.0	9	47.4
18. With respect to the previous question (country-by-country report), please estimate the costs related to this issue						
Up to EUR 500	8	27.6	2	12.5	1	5.3
EUR 501–1000	11	37.9	–	–	2	10.3
EUR 1001–2000	4	14.3	1	6.3	1	5.3
More than EUR 2000	–	–	–	–	1	5.3
No obligation to prepare country-by-country report	2	6.9	5	31.3	8	42.1
I am not able to estimate	3	10.3	8	50.0	6	31.6

However, the weighted average of compliance costs per entity differs slightly by country. The lowest average determined was for the Slovak Republic and was between EUR 2121 and EUR 4857/year. The highest average determined was for Poland and was between EUR 5802 and EUR 8856/year. In the case of the Czech Republic, the weighted average of compliance costs was set between EUR 4341 and EUR 7704/year. Taking into account the assumed number of medium-sized enterprises acting in the researched countries (see Table 4.1), the compliance costs of transfer pricing determined using the costs indicator and presented as a portion of the corporate tax collected ranges between 2.48% and 5.67% (Slovak case), 7.22% and 12.81% (Czech case) and 12.32% and 18.80% (Polish case). It is evident that Poland's compliance costs for transfer pricing exceed those of the other two countries and that this result corresponds with the highest value of compliance costs for the representative sample, and as well, the Slovak Republic has the lowest compliance costs (for details, see Table 4.4).

However, when considering the time indicator, the compliance costs of transfer pricing differ (see Table 4.5). As is evident from the table, the compliance costs are lower than the compliance costs determined above using the costs indicator, but the position of the highest and lowest compliance costs is the same as in previous case. This may be caused by the average salaries of the tax advisors in each country, as this value was used as a valuation of the time needed to resolve transfer pricing issues. Furthermore, regarding the assumed number of medium-sized enterprises acting in the researched countries (see Table 4.1), the compliance costs of transfer pricing as determined using the time indicator and as presented as a portion of the

Table 4.4 Determination of compliance costs of transfer pricing for Medium-sized—based on the costs indicator (own calculation, questionnaire, MF Czech Republic, MF Slovak Republic, MF of Poland)

Country	Type	Compliance costs for entity (in EUR/per year)	Compliance costs for whole group of Medium-sized (in million EUR)[a]	Corporate tax collection in 2015 (in million EUR)	Portion of compliance costs to corporate tax collection (in %)
Processing		Eq. (4.1)	Eq. (4.1)* No. Medium-sized entities	Dataset of MF	Compliance costs of transfer pricing/corporate tax collection
Czech Republic	A	6430	390.3	3650.7[b]	10.69
	B	7704	467.6		12.81
	C	4341	263.5		7.22
Slovak Republic	A	3632	112.1	2640.5	4.25
	B	4857	149.9		5.67
	C	2121	65.4		2.48
Poland	A	7439	926.9	5868.4[c]	15.79
	B	8856	1103.4		18.80
	C	5802	722.9		12.32

A—Calculation based on the median values of individual spread of costs established in the questionnaire. See Tables 4.2 and 4.3. For example: a spread EUR 1001–2000, medium value is 1500 which is further multiplied by the number of answers for that spread of costs. For more details, see Eq. (4.1)

B—Calculation based on the highest values of individual spread of costs established in the questionnaire. See Tables 4.2 and 4.3

C—Calculation based on the lowest values of individual spread of costs established in the questionnaire. See Tables 4.2 and 4.3

[a]Compliance costs for the group of medium-sized entities were determined as compliance costs for one entity multiplied by the assumed number of medium-sized entities operating in the researched countries mentioned in Table 4.1

[b]Average exchange rate CZK/EUR for 2015 is CZK 27.283 per 1 EUR. Corporate tax collection for 2015 is CZK 99.6 billion

[c]Average exchange rate PLN/EUR for 2015 is PLN 4.18 per 1 EUR. Corporate tax collection for 2015 is PLN 24530 mil

corporate tax collected ranges between 2.18% and 3.73% (Slovak case), 3.47% and 6.70% (Czech case) and 8.13% and 15.02% (Polish case).

Previously in this chapter, the compliance costs of transfer pricing for medium-sized enterprises were determined. At this point, the entire group of SMEs acting in the select countries (see Table 4.1) is taken into account to determine the compliance costs of transfer pricing issues. As is evident in Table 4.5, Poland is omitted from the calculations as its current legal framework exempts them from transfer pricing documentation requirements in the case of small transactions up to a set limit. Based on this, we assumed that small enterprises would fulfil the legal condition for small transactions. Therefore, the compliance costs of transfer pricing for whole group of SMEs are determined only for the Czech and Slovak cases. As is

Table 4.5 Determination of compliance costs of transfer pricing for medium-sized—based on the time indicator (own calculation, questionnaire, MF Czech Republic, MF Slovak Republic, MF of Poland)

Country	Type	Compliance costs for entity (in EUR/ per year)	Compliance costs for group of medium-sized (in million EUR)[a]	Corporate tax collection in 2015 (in million EUR)	Portion of compliance costs to corporate tax collection (in %)
Processing		Eq. (4.1)	Eq. (4.1)* No. Medium-sized entities	Dataset of MF	Compliance costs of transfer pricing/corporate tax collection
Czech Republic	A	210*14.6 = 3066	186.1	3650.7[b]	5.10
	B	276*14.6 = 4029.6	244.6		6.70
	C	143*14.6 = 2087.8	126.7		3.47
Slovak Republic	A	205*12.26 = 2513.3	77.6	2640.5	2.94
	B	260*12.26 = 3187.6	98.4		3.73
	C	152*12.26 = 1863.5	57.5		2.18
Poland	A	204*26.4 = 5385.6	671.1	5868.4[c]	11.44
	B	268*26.4 = 7075.2	881.6		15.02
	C	145*26.4 = 3828.0	476.9		8.13

A—Calculation based on the median values of individual spread of time established in the questionnaire. See Tables 4.2 and 4.3. For example, a spread of 101–200, medium value is 150, which is further multiplied by the number of answers for that spread of time. For more details, see Eq. (4.1). Time determined this way is then multiplied by the costs per working hour as mentioned in Table 4.1

B—Calculation based on the highest values of individual spread of time established in the questionnaire. See Tables 4.2 and 4.3

C—Calculation based on the lowest values of individual spread of time established in the questionnaire. See Tables 4.2 and 4.3

[a]Compliance costs for group of medium-sized entities were determined as compliance costs for one entity multiplied by the assumed number of medium-sized entities operating in the researched countries mentioned in Table 4.1

[b]Average exchange rate CZK/EUR for 2015 is CZK 27.283 per 1 EUR. Corporate tax collected for 2015 is CZK 99.6 billion

[c]Average exchange rate PLN/EUR for 2015 is PLN 4.18 per 1 EUR. Corporate tax collected for 2015 is PLN 24530 million

evident, the compliance costs of transfer pricing are vastly different from the previous results. In the case of the Czech Republic, compliance costs as a portion of the corporate tax collected ranges between 55.7% and 98.9% (cost indicator) and between 26.8% and 51.7% (time indicator). These results are contrary to the Slovak case, where the ranges are between 18.9% and 43.4% (cost indicator) and 16.6% and 28.5% (time indicator) (for details, see Table 4.6).

Table 4.6 Determination of compliance costs of transfer pricing for SMEs (own calculation)

Country	Type	Cost indicator			Time indicator		
		Compliance costs for entity (in EUR/per year)	Compliance costs for group of SMEs[a] (in million EUR)	Portion of compliance costs to corporate tax collection (in %)	Compliance costs for entity (in EUR/per year)	Compliance costs for group of SMEs[a] (in million EUR)	Portion of compliance costs to corporate tax collection (in %)
Processing		Eq. (4.1)	Eq. (4.1)* No. SMEs	Compliance costs of transfer pricing/corporate tax collection	Eq. (4.1)	Eq. (4.1)* No. SMEs	Compliance costs of transfer pricing/corporate tax collection
Czech Republic	A	6430	3014.1	82.6	3066	1437.2	39.4
	B	7704	3611.2	98.9	4029.6	1888.9	51.7
	C	4341	2034.8	55.7	2087.8	978.6	26.8
Slovak Republic	A	3632	856.9	32.5	2513.3	529.9	20.1
	B	4857	1145.9	43.4	3187.6	752.1	28.5
	C	2121	500.4	18.9	1863.5	439.7	16.6

A—Calculation based on the median values of individual spread of costs/time established in the questionnaire. See Tables 4.2 and 4.3. For example, a spread of 101–200, medium value is 150, which is further multiplied by the number of answers for that spread of time. For more details, see Eq. (4.1). Further, Time determined this way is then multiplied by the costs per working hour as mentioned in Table 4.1

B—Calculation based on the highest values of individual spread of costs/time established in the questionnaire. See Tables 4.2 and 4.3

C—Calculation based on the lowest values of individual spread of costs/time established in the questionnaire. See Tables 4.2 and 4.3

[a]Compliance costs for group of SMEs were determined as compliance costs for one entity multiplied by the assumed number of SMEs operating in the researched countries mentioned in Table 4.1

4.4 Determination of Compliance Costs of Transfer Pricing for EU Member States

4.4.1 Data Description and Processing

The compliance costs of transfer pricing for SMEs were determined using the results of the questionnaire distributed to entities having a parent or a subsidiary in the European Union. Of the questionnaires distributed, 144 were returned (distribution is presented in Fig. 4.2). Of those returned, 20.1% represented micro entities, 45.2% represented small entities and 34.7% represented medium-sized entities. The entities are operating primarily in the following industrial sectors: industry sector NACE[14] C (26%), industry sector NACE G (19.9%), industry sector NACE M (17.8%), industry sector J and L (12.3%), industry sector NACE N (11.6%) and industry sector NACE A, B, E, F, H, I, K, P and S (under 10%).

With respect to determining the compliance costs of transfer pricing, the weighted average value of compliance costs was applied as can be seen in Eq. (4.2).

$$\bar{x} = \frac{\sum_{i=1}^{n} w_i x_i}{\sum_{i=1}^{n} w_i} \tag{4.2}$$

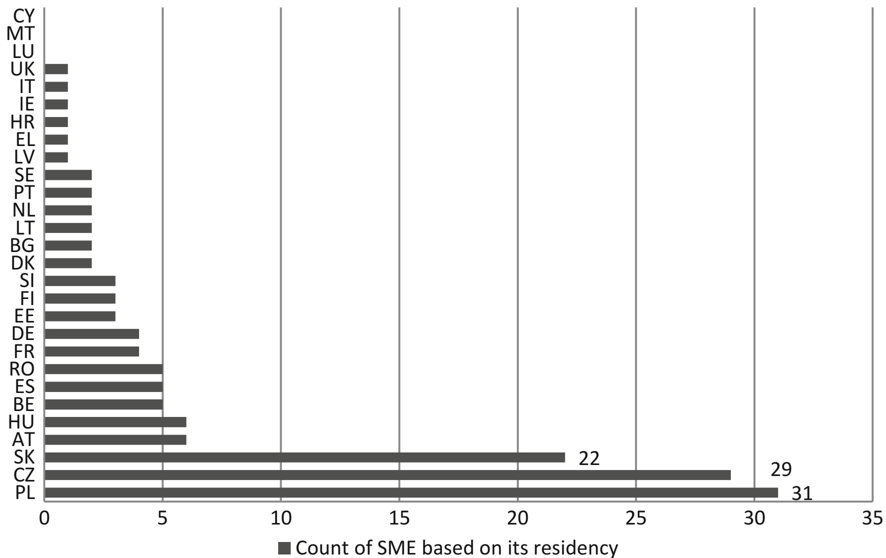

Fig. 4.2 SMEs based on residency (own processing, questionnaire)

[14]See note 8.

where weight (w) represents number of answers for each cost or time set in the questionnaire and x represents the values of the individual spread of costs or time set in the questionnaire. The calculations take three forms:

- A: Calculation based on the median values[15] of individual spread of costs/time set in questionnaire,
- B: Calculation based on the highest values[16] of individual spread of costs/time set in questionnaire and
- C: Calculation based on the lowest values[17] of individual spread of costs/time set in questionnaire.

Consequently, the compliance costs as determined using this method were used for the determination of the compliance costs of transfer pricing for the category of SME taxpayers operating in the European Union. Based on the annual report of European Commission (2015), there are 22.3 million SMEs active in the non-financial business sector across the EU28. However, these numbers include primarily micro enterprises (93%). Thus, the compliance costs of transfer pricing issues as determined represents a relatively small portion, i.e., 1.56 million, of the SMEs. To identify the portion of compliance costs of transfer pricing to the corporate tax paid, the corporate tax collected for the EU28, as obtained from the Eurostat statistics,[18] was used.

4.4.2 Determination of Compliance Costs

For the purpose of this study, compliance costs of transfer pricing issues cover only the managing of transfer pricing documentation, which includes the consideration of the most appropriate transfer pricing methods. Contrary to the previous section, i.e., 4.3, compliance costs of country-by-country reporting were not determined as approximately 73%[19] of the respondents were unable to estimate those costs or they were not obligated to do so according to the CbCR. Other activities related to advance pricing agreements (hereinafter, APA), transfer pricing methods and transfer pricing audits are omitted from the analysis because approximately 50% of the respondents were unable to estimate the time and costs related to these activities.

[15]For example spread set in questionnaire is EUR 1001–2000, medium value is 1500 which is further multiplied by the number of answers for that spread of costs according to Eq. (4.2).

[16]For example spread set in questionnaire is EUR 1001–2000, the highest values is 2000 which is further multiplied by the number of answers for that spread of costs according to Eq. (4.2).

[17]For example spread set in questionnaire is EUR 1001–2000, the lowest values is 1001 which is further multiplied by the number of answers for that spread of costs according to Eq. (4.2).

[18]Main national accounts tax aggregates [gov_10a_taxag]—taxes on the income or profits of corporations including holding gains.

[19]The rest of the respondents' answers from the Czech Republic, Slovak Republic and Poland. For results, see the previous chapter.

With respect to tax consultancy services for transfer pricing issues, the survey indicates that 15% of the respondents do not use tax consultant services for transfer pricing issues, which is contrary to the 47% who use tax services for all matters, regardless of whether it is a transfer pricing issue. Furthermore, almost 14% of the respondents use a tax service when preparing transfer pricing documentation, and 11% of respondents claim to use tax services when considering various transfer pricing methods. Moreover, respondents also use tax consultants when settling transfer pricing disputes (9%), preparing country-by-country reports (CbCR) and creating APA (see Fig. 4.3 for details).

To determine the compliance costs of transfer pricing, it is necessary to identify the costs and time related to such activities. As indicated in Table 4.7, the managing of transfer pricing documentation includes determining the most suitable transfer pricing methods, a process that takes between 100 and 300 h/year. However, 28.7% of the respondents were unable to estimate the time needed to manage transfer pricing issues. This may be because many of the respondents use tax advisory services for this type of tax compliance. With respect to the borne costs for managing transfer pricing documentation, the survey revealed that in the case of the European entities, approximately 20% of the respondents spent up to EUR 3000/year and almost 22% of the respondents spent up to EUR 6000/year (for more details, see Table 4.7).

Consequently, according to the results of the survey, the weighted average of the compliance costs was determined. Accordingly, the compliance costs were found to range between EUR 3090/year and EUR 4179/year for an entity operating in the EU28. These costs equate to between 18 and 30 work days/year to managing transfer pricing issues. Furthermore, by taking into account the number of SMEs acting in the EU28, the compliance costs of transfer pricing were determined using the cost indicator range of EUR 4.8 billion to EUR 6.5 billion, which indicates a range between 1.32% to 2.38% of the corporate tax collected in the EU28 (for more details, see Table 4.8).

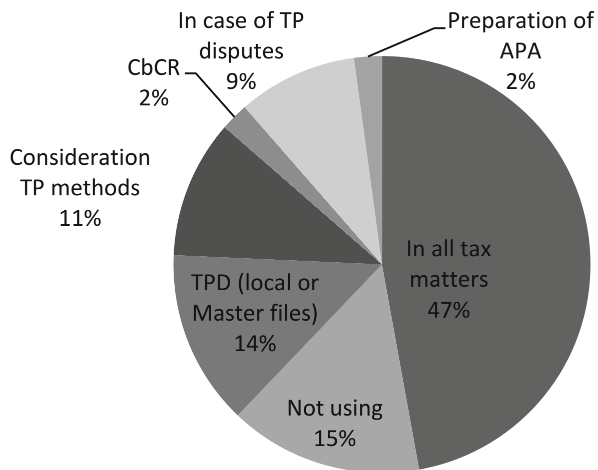

Fig. 4.3 Using of tax consultancy in the respect of transfer pricing issues (own processing, questionnaire)

Table 4.7 Transfer pricing documentation—costs and time—European Union (own calculation, questionnaire)

15. Please estimate the time necessary for preparation of transfer pricing documentation. When doing the estimation, please take into account also the time necessary for up-date of transfer pricing documentation	No.	%
Up to 100 h	19	16.5
101–200 h	21	18.3
201–300 h	26	22.6
301–500 h	2	1.7
More than 500 h	4	3.5
I am not able to estimate	33	28.7
There is not an obligation to prepare transfer pricing documentation in our country	10	8.7
16. With respect to the previous question, please estimate the costs related to this issue		
Up to EUR 1000	10	8.6
EUR 1001–3000	23	19.8
EUR 3001–6000	25	21.6
EUR 6001–9000	17	14.7
EUR 9001–12,000	1	0.9
EUR 16,001–20,000	2	1.7
I am not able to estimate	27	23.3
There is not an obligation to prepare transfer pricing documentation	11	9.5

Table 4.8 Determination of compliance costs of transfer pricing for SMEs—European Union—cost indicator (own calculation)

Type	Compliance costs for entity (in EUR/per year)	Compliance costs for group of SMEs[a] (in million EUR)	Corporate tax collection in 2015 in the EU28[b] (in million EUR)	Portion of compliance costs to corporate tax collection (in %)
Processing	Eq. (4.1)	Eq. (4.1)* No. SMEs	Dataset of MF	Compliance costs of transfer pricing/ corporate tax collection
A	4179.5	6520.0	363,990.2	1.79
B	5564.1	8679.9		2.38
C	3090.7	4821.5		1.32

A—Calculation based on the median values of the individual spread of costs established in the questionnaire. See Table 4.7. For example, spread EUR 101–200, medium value is 150, which is further multiplied by number of answers for that spread of costs. For more details, see Eq. (4.2)
B—Calculation based on the highest values of individual spread of costs established in the questionnaire
C—Calculation based on the lowest values of individual spread of costs established in the questionnaire
[a]1.56 million SMEs are operating in the EU. Compliance costs for group of SMEs was determined as compliance costs for one entity multiplied by the number of SMEs operating in the EU
[b]Source: Eurostat

4.5 Conclusions

The survey of compliance costs of transfer pricing for SMEs reveals that transfer pricing usually requires tax consultancy, which increases the compliance costs of taxation and thus the compliance costs of transfer pricing. SMEs bear the costs for managing transfer pricing issues, primarily in the form of transfer pricing documentation and country-by-country reporting. These costs range from EUR 4341 to EUR 7704, and time spent ranges from 18 to 35 work days/year in the case of the Czech Republic. Similar costs are found for the Polish entities, which range from EUR 5802 to EUR 8856 and from 19 to 34 work days/year. Similarly, for the Slovak entities, the costs range from EUR 2121 to EUR 4857 and the time ranges from 19 to 33 work days/year. Taking into account the assumed amount of SMEs acting in the Czech and Slovak Republic and the overall corporate tax collected in these countries, the compliance costs of transfer pricing represent between 26.8% and 98.9% of the corporate tax collected in the Czech Republic and between 16.6% and 43.4% of the corporate tax collected in the Slovak Republic according to the indicators used for the determination of compliance costs. However, European SMEs bear the costs for managing transfer pricing issues, primarily in the form of transfer pricing documentation, and these costs range between EUR 3090 and EUR 5564/year, an amount equivalent to between 18 and 30 work days/year. Accordingly, when considering the entire group of SMEs acting in the EU28, the costs represent a portion of the overall EU28 corporate tax collected of between 1.32% and 2.38%.

In comparison with the results of previous studies, it is evident that transfer pricing generates huge compliance costs of taxation. Based on the results of the Paying Taxes report, which focuses on standardized small- and medium-sized entities, for the management of three major taxes, such as VAT, corporate taxes and labour taxes, an amount of time similar to that needed transfer pricing issues is required. Further, when comparing the results of the studies conducted by Vítek and Pavel (2008) and Pudil et al. (2004), it is evident that the portion of compliance costs for transfer pricing to that of corporate tax collection is several times higher (for details, see Table 4.9). It may be because the current transfer pricing issue represents the actual situation, and hence, tax administrators are more focused on this area now than they were before. In this respect, entities recognize this pressure and are more interested in the area of transfer pricing and its consequences on higher compliance costs.

Based on the conducted research, it is recommended that tax policymakers carefully design new tax obligations in the area of transfer pricing and address the disproportionately high tax compliance burdens faced by SMEs. In this respect, we recommend the application of some simplified measurements of transfer pricing to decrease the compliance costs of such pricing. These recommendations include simplified transfer pricing documentation, the exclusion of micro entities from the

Table 4.9 Comparison of compliance costs (own processing, World Bank Paying Taxes 2017)

Type	Studies	Time indicator	Compliance costs/corporate tax collection (in %)
Transfer pricing	Own study		
	Czech Republic	143–276 h per year	26.8–51.7[a]
	Slovak Republic	152–260 h per year	16.6–28.5[a]
	Poland	145–268 h per year	–
	European Union	139–235 h per year	1.32–2.38[b]
Corporate taxation	Vítek et al. (2008)	–	5.5
	Pudil et al. (2004)	–	5.3
Three major taxes	Paying Taxes report (2017) for 2016/2015		
	Czech Republic	234 h per year	–
	Slovak Republic	188 h per year	–
	Poland	271 h per year	–
	EU and EFTA	232.7 h per year	–

[a]Based on the time indicator
[b]Based on the costs indicator

transfer pricing requirements and the implication of safe harbour[20] for selected industries and types of transactions (i.e., for loans, royalties, intangibles, among others).

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[20]Safe harbour is determined usually as a range of arm's length rate, which is accepted by tax administrators. Then, taxpayers may not incur costs and time for the determination of arm's length rate/margin resulting in lower compliance costs of taxation. For more details about safe harbour, see the following Chap. 5 and Solilova and Nerudova (2016) "The Proposal of Safe Harbours in the Area of Transfer Prices for Small and Medium Sized Enterprises", Politická Ekonomie, vol. 64, no. 5, p. 559–572. DOI: 10.18267/j.polek.1075.

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Chapter 5
Safe Harbour as an Alternative Approach to Transfer Pricing of SMEs

This segment of the book contains the history of development of safe harbours from the perspective of transfer pricing issues, advantages and disadvantages of safe harbours, recommendations for the form and scope of safe harbours and the current situation of safe harbours in the European Union. The last part of the chapter includes our proposal on safe harbours as an alternative approach to the transfer pricing of SMEs in the European Union.

5.1 Relaunching of Safe Harbours

Applying the arm's length principle can be a resource-intensive process because it may impose a heavy administrative burden on taxpayers and tax administrations, as was proved in the previous chapter. It may require collection and analysis of data that may be difficult or costly to obtain and/or evaluate. Moreover, such compliance burdens may be disproportionate to the size of the taxpayer, the functions it performed, and the transfer pricing risks assumed in its controlled transactions. Furthermore, multinational enterprises have been faced daily by conflicting rules and approaches to applying the arm's length principle, burdensome documentation requirements, inconsistent audit standards and unpredictable competent authority outcomes. However, the OECD TP Guidelines[1] emphasize that documentation requirements should be reasonable and should not impose costs and burdens on taxpayers disproportionately to their circumstances. Therefore, greater simplicity in transfer pricing administration and improving the efficiency and effectiveness of transfer pricing enforcement are essential. These facts led the OECD, namely, the

[1]OECD 2017: TP Guidelines, namely section C—chapter III. Section E—chapter IV, and Section B and D—chapter IV.

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Committee on Fiscal Affairs, to launch a project to improve the administrative aspects of transfer pricing and compliance issues in 2010.

The project started with a survey of the transfer pricing techniques that may be implemented by countries to optimize the use of taxpayers' and tax administrations' resources. The main findings from the survey were released in 2011 and were updated in 2012 and present an analysis of existing transfer pricing simplification measures (including safe harbours[2]) in existence in OECD and non-OECD member countries.[3] The key findings are as follows:

- 33 out of 41 respondent countries (more than 80%) have transfer pricing simplification measures in place.
- 75% of available simplification measures are directed to small and medium-sized enterprises (hereinafter SMEs), small transactions, and low value adding intra-group services.
- Out of 33 respondent countries that have simplification measures, 16 countries have safe harbours.
- Of those 16 countries, 10 countries have simplified transfer pricing methods, the safe harbour arm's length range/rate and safe harbour interest rates.[4]

The results of the survey were surprising. When the OECD TP Guidelines were adopted in 1995 and further revised in 2010, the view on safe harbours was generally negative. It was suggested that safe harbours may not be compatible with the arm's length principle, and therefore safe harbours are not advisable and recommended. However, based on the results of the survey, this negative tone does not accurately reflect the practise of OECD and non-OECD member countries. Moreover, safe harbours were explicitly endorsed in the EU Joint Transfer Pricing Forum (hereinafter EU JTPF) report "Transfer Pricing and Small and Medium-Sized Enterprises" as a means of providing a measure of simplification for SMEs as well as saving on administrative resources and reducing compliance burdens.[5] Furthermore, in another EU JTPF report, "Guidelines on Low Value Adding Intra-Group Services", a safe harbour approach is also mentioned. Based on this

[2]In accordance with para 4.100 (4.102) TP Guidelines, OECD 2013 (2017): A safe harbour in a transfer pricing regime is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simpler obligations for those under the general transfer pricing regime. Further, safe harbour can exempt eligible taxpayers or transactions from the application of all or part of the general transfer pricing rules. However, safe harbour does not include administrative simplified measures which do not directly involve determination of arm's length prices.

[3]Namely, Argentina, Australia, Austria, Belgium, Canada, Chile, China, Colombia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Russia, Singapore, Slovak Republic, Slovenia, South Africa, Sweden, Switzerland, Turkey, the United Kingdom and the United States, as well as the European Union.

[4]OECD: Multi-country analysis of existing transfer pricing simplification measures, 2011, 2012.

[5]EU JTPF: Transfer Pricing and Small and Medium-Sized Enterprises, 2011.

approach, low value-added services are evaluated by mark-ups in the range of 3–10%, often approximately 5%.[6]

The Committee on Fiscal Affairs started to work on the review of the current guidance on safe harbours in Chapter IV of the TP Guidelines. On 6 June 2012, a discussion draft on safe harbours was released for public comments. The discussion draft included proposed revisions of section E on safe harbours in Chapter IV of the TP Guidelines and associated sample memoranda of understanding for competent authorities to establish bilateral safe harbours, which was not introduced in the current Chapter IV. Public comments on safe harbours were submitted by 35 private sector organizations, totalizing 237 pages and presenting the importance of the proposal for the business community. During the November 2012 meeting received public comments were discussed and finally on 16 May 2013 the OECD Council approved the Revised Section E on Safe Harbours in Chapter IV of the TP Guidelines as a partial solution for the project about administrative aspects and compliance issues of transfer pricing. Revised Section E brings a new clearer, albeit narrow definition of safe harbours including benefits and concerns. Moreover, OECD released updated TP Guidelines on 10 July 2017 reflecting the BEPS[7] recommendations. However, in respect of Safe harbours, the chapter remained unchanged.

Based on the TP Guidelines (Chapter IV, section E, OECD 2013, 2017) *safe harbours* are defined as follows: *A safe harbour is a provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country's general transfer pricing rules. A safe harbour substitutes simple obligations for those under the general transfer pricing regime. Such a provision could, for example, allow taxpayers to establish transfer prices in a specific way, e.g. by applying a simplified transfer pricing approach provided by the tax administration. Alternatively, a safe harbour could exempt a defined category taxpayers or transactions from the application of all or part of the general transfer pricing rules. Often, eligible taxpayers complying with the safe harbour provision will be relieved form burdensome compliance obligations, including some or all associated transfer pricing documentation requirements.*

According to the new definition, it is obvious that thin capitalization rules, advance pricing arrangements and other administrative simplification measures that do not directly involve the determination of arm's length prices are not within the scope of the safe harbours discussion.

In addition, is important to mention that the current UN Transfer Pricing Manual also contains a comprehensive and pragmatic discussion of safe harbour provisions. Thus, policy-makers and tax administrations across developed and developing countries try to ensure a globally consistent approach to safe harbour provisions.

[6]EU JTPF: Guidelines on Low Value Adding Intra-Group Services, 2011.

[7]The project on Base Erosion and Profit Shifting was launched in February 2013 by the OECD and G20 countries.

5.2 Advantages and Disadvantages of Safe Harbours

The tone on the benefits of safe harbours is slightly more positive compared with guidance in 1995 or in 2010. Safe harbours should be now appropriate for taxpayers and/or transactions that involve low transfer pricing risks and those adopted on a bilateral or multilateral basis.

Generally, safe harbours would result in less stringent documentation requirements for eligible taxpayers or transactions with the result of simplified administration and compliance processes. Safe harbours can provide a useful means of reducing the administration burden for taxpayers and tax authorities. Complying with transfer pricing requirements is a time-consuming and expensive consideration for taxpayers, mainly for SMEs. The availability of safe harbours may provide an opportunity to reduce the compliance cost for taxpayers, as well as permitting tax authorities to focus their limited resources on areas with the most significant transfer pricing risks. Further, safe harbours may enable tax authorities to increase the efficiency of their yield from transfer pricing enquiries. In this case, the tax administrations can shift audit and examination resources from smaller taxpayers and less complex transactions to more complex, higher-risk cases. Safe harbours would result in a greater administrative simplicity for tax administrations mainly due to minimal examination requirements with respect to the transfer prices of controlled transactions qualifying for the safe harbours. Moreover, from the taxpayers' perspective, they can file their tax returns with more certainty and with lower compliance burdens. Furthermore, safe harbours could serve to simplify transfer pricing rules across jurisdictions, thereby aiding business competitiveness on regional and global scales.

However, it must be highlighted that safe harbours have the potential to significantly reduce the compliance burden on taxpayers and the resource dedication of tax authorities, provided they are well-designed in line with the arm's length principle and applied based on a careful evaluation of the facts and circumstances.

Considering taxpayers, the benefits of safe harbours are potentially greatest for SMEs/small multinational enterprises or for those in the early stages of cross-border expansion. These businesses may not possess the resources for detailed transfer pricing studies in multiple territories but have the same desire for the certainty that comes from effective compliance. In particular, there are two benefits for taxpayers in having bilateral safe harbours offered by tax authorities: lower compliance costs and certainty. These are mainly in the areas of low transfer pricing risk, where compliance costs are perhaps disproportionately high and there remains no certainty that transfer prices will not be subjected to tax authority audits in one or more countries. The use of bilateral or even multilateral agreements has the potential to significantly decrease the number of transfer pricing disputes, audit and MAP cases. However, unilateral rulings do provide benefits in that they are less time-consuming and simpler to manage. Moreover, the unilateral safe harbours have also a role to play for small transactions and SMEs for which a bilateral/multilateral process may be overly costly. Furthermore, countries have different attitudes, different effective tax rates and/or unbalanced taxing powers in

the relationship with taxpayers, a unilateral safe harbour may be the most practical and beneficial instrument both to taxpayers and tax authorities to achieve certainty, respectively, on tax burdens and collections. On the other hand, unilateral safe harbours only protect taxpayers from adjustments by one of the two or more tax authorities with an interest in a transfer pricing transaction. Under such circumstances, mandatory unilateral safe harbours may lead to a high risk of double taxation and/or the need to seek resolution in competent authority.[8]

However, based on these circumstances, safe harbours should be optional for taxpayers because a taxpayer should have a choice as to whether to apply a safe harbour or to follow the general principles of the arm's length standard when demonstrating that related party transactions are correctly priced. Only such an optional approach would achieve the desired compliance relief for taxpayers and allow for sufficient flexibility, especially in case of unilateral safe harbours. However, bilateral safe harbours offer more protection against double taxation, and therefore have advantages over unilateral safe harbours. Further, in respect to the risk of double taxation and abusive tax planning, safe harbours should be introduced by a progressive development, e.g., starting with small companies first in order to test the concept before expanding it to larger taxpayers, and withdrawn or amended if taxpayers are found to be abusing them.

In the respect of divergence from the arm's length principle, the degree of approximation could be improved by collecting, collating, and frequently updating a pool of information regarding prices and pricing developments of transactions between uncontrolled parties, although such efforts could erode the administrative simplicity of the safe harbours. Furthermore, it is desirable to set detailed conditions under which a taxpayer is eligible for the safe harbour. Safe harbours should be introduced as an option to either choose the safe harbour or general transfer pricing rules.

In addition, as transfer pricing is not an exact science, any unilateral safe harbour, if based on arm's length principles and ranges, should not lead to major exposure to double taxation or non-taxation by, thus, achieving an effective balance between certainty, compliance simplicity, risk management, and tax revenue collection. However, the safe harbours outcomes can never be exactly the same as with a full transfer pricing analysis.

To summarize, for taxpayers and tax administrators, safe harbours mainly simplified transfer pricing approaches that can reduce compliance costs and administration costs. Further, it also means higher certainty for taxpayers and improved effectiveness of tax administration, mainly by decreasing the number of transfer pricing disputes, audit and MAP cases for tax administrators. Alternatively, there are some disadvantages, namely, an application for specific categories of taxpayers or transactions that can create discriminations or some distortions e.g., trade or competition; risk of double taxation or non-taxation; inappropriate tax planning and transfer pricing manipulation with results of lower tax revenues and so on (for details see Table 5.1).

[8]In this respect, it is essential that the opportunity to apply for mutual agreement procedure (MAP) is not reduced in the case of a safe harbour.

Table 5.1 Advantages and disadvantages of safe harbours (OECD, Multi-country analysis of existing transfer pricing simplification measures, 2012. OECD, The comments received with respect to the discussion draft on the revision of the safe harbours section of the transfer pricing guidelines, 2012. OECD, TP Guidelines, 2013 and 2017. Own analysis and processing)

Taxpayers	
Advantages	Disadvantages
Simplified transfer pricing approach	Application only for defined category of taxpayers or transactions. Potential discrimination and competitive, investment or trade distortions
Non-obligation to apply a country's general transfer pricing rules	It does not cover advance pricing agreements, thin capitalization rules, simplification of documentation as safe harbours
More certainty that transfer prices will be accepted by the tax administrations	Risk of double taxation from the possible incompatibility of the safe harbours with the arm's length principle or with the practises of other countries in the case of a mandatory unilateral form of safe harbours
Lower burdensome compliance obligations/ costs	
Bilateral or multilateral form of safe harbours with the result of protection against double taxation	
Optional	
Potential tax planning opportunity	
Application of MAP is not reduced for safe harbours in the case of double taxation	
Tax authorities	
Advantages	Disadvantages
Transfers of administrative resources to the examinations of more complex and/or higher-risk cases	Detailed setting of safe harbour's conditions under which a transaction or taxpayer is eligible for safe harbour
Greater administrative simplicity for tax administrations	Potential divergence from the arm's length principle provided that safe harbours are not optional
Minimal examination requirements for control of transfer prices in the safe harbours	Potential for inappropriate tax planning and transfer pricing manipulation resulting in lower tax revenues
Lower tax administration costs	Risk of double non-taxation in the case of a unilateral form of safe harbours
Limited audit or non-audit of safe harbours provided that a taxpayer has met all conditions of the safe harbour provision	Potential for the oversimplification of the characterization of the entity's functions and activities due to access to safe harbours with the results of inconsistency with TP Guidelines
Bilateral or multilateral form of safe harbours	Potential discrimination, competition, investment or trade distortions
Commonly used for low value-added services, SMEs and loans. Further suitable for low-risk transactions	Updating of information regarding prices and pricing developments of uncontrolled transactions for updating safe harbour's provisions—the monitored going-forward approach

(continued)

Table 5.1 (continued)

Tax authorities	
Advantages	Disadvantages
Higher efficiency and effectiveness of the tax administration activities	
Potential to decrease the number of transfer pricing disputes, audit and MAP cases provided that the bilateral or multilateral form of safe harbour will be used	

5.3 Recommendations of the Form and Scope of Safe Harbours

Transfer pricing compliance and administration is often complex, time consuming and costly. Therefore, safe harbours can be considered as simplified measures (as taxpayers should always have the option to apply the arm's length principle instead of any safe harbour), which could fulfil their benefits and advantages, provided that they are properly and clearly designed with conditions and details under which a taxpayer/transaction is eligible for the safe harbour provision. Further, for elimination of a negative impact on the tax revenues of the country implementing the safe harbour as well as on the countries whose associated enterprises engage in controlled transactions, we recommend using a bilateral form of the safe harbour or a non-mandatory unilateral safe harbour. Moreover, we recommend using a safe harbour provision, mainly for less complex transactions, small transactions, routine transactions with lower risks or low value adding transactions, and for SMEs. This approach is consistent with work done by the European Commission and EU JTPF on such enterprises or transactions.

Further, we recommend setting safe harbour provisions in a way that allows tax authorities to challenge a taxpayer's use of the sale harbour if that use is abusive or inconsistent with the purpose of the safe harbour. In this respect, as was mentioned above, it is highly recommended to put safe harbours in place by a progressive development.

In respect to the form and scope of safe harbours, safe harbours can be either qualitative or quantitative, e.g., setting margins or de minimums thresholds below which a country's transfer pricing regulations would not apply. Before a determination of safe harbour, each tax jurisdiction should analyse its administration of transfer pricing transactions along the following lines:

- Number of transfer pricing audits undertaken in a year (including audits resulting in no adjustments).
- Number of hours spent by auditors, appeals officers, competent authority staff and attorneys in finalizing transfer pricing audits, and related costs (including external costs).
- Type of transaction and transfer pricing methodology used by the taxpayer.

- The taxpayer's filing position vs. final resolution of case.

Further, the above information shall be broken down into various categories such as size of taxpayer, size of transaction and type of transaction. Then a matrix should emerge indicating where most of the risk lies and, conversely, which areas are not worth the tax authorities' time. Thus, it should indicate areas which are better for investing both the tax authorities' and taxpayers' resources in by implementing safe harbour rules.

Moreover, the design of safe harbour provisions may need to take into account industry specificities and reflect industry comparability. The potentially influencing business and product cycles should also be taken into account and therefore a multi-year approach testing weighted average results should be applied.

Only well-designed, appropriate safe harbours should not distort taxpayer behaviour, but should provide administrative certainty.

5.4 Current Situation of Safe Harbours as Simplified Measurements in European Union[9]

In the respect of simplified measurements and safe harbours we analyzed:

- whether there are available exemptions from transfer pricing rules and transfer pricing adjustment,
- whether there are available exemptions from documentation requirements and from disclosure requirement, and simplified documentation,
- whether there are available simplified transfer pricing methods, safe harbour arm's length range/rate and safe harbour interest rate,
- whether there are available simplified APA procedures and reduced APA charge, and
- whether there are available exemptions from penalty and alleviated penalties.

From the SMEs perspective, as it is obvious from the results (see Table 5.2), the largest part of simplified measurements for SMEs is offered in case of documentation, particularly in 18 cases in 18 EU Member States. Exemption from documentation requirements represents almost 14% (in 11 cases) and simplified documentation represents more than 9% (in 7 cases). Further, only Ireland and the United Kingdom exclude SMEs from transfer pricing rules (for more details see Table 5.2). As regard APAs, only Romania offers reduced APA charges for micro entities. In Germany, reduced APA charges for small entities performing small

[9] For more details about simplified measurements see Chap. 2—Transfer pricing rule for SMEs in the EU.

Table 5.2 Transfer pricing rules in EU Member States (Deloitte (2016), PwC (2015), IBFD (2017))

MS	Type of simplified measurement						Safe harbour			Scope of safe harbour				
	APA	Penalty	TP rules	TP methods	Documentation: Simplified	Documentation: Exemption	Arm's length rate range	Exemption from TP rules	Simplified TP method	Small transactions A	SMEs B	Low value adding services C	Loans D	Others E
AT				✓	B[a]		C		C		✓	✓		
BE				✓		B[a]	C		C		✓	✓		
BG					B[b,c]	A[a]				✓	✓			
CZ				✓	C		C		C			✓		
DK				✓		A[a], B[c]	C		C	✓	✓	✓		
DE	A,B			✓		B[d], E	C		C	✓	✓	✓		✓
EE						B[c]					✓			
EL					B[a]	A[a], B[d], E				✓	✓			✓
ES				✓	B[a], C	A[a], E	C		C	✓	✓	✓		✓
FI				✓	A[a]	B[a]	C		C	✓	✓	✓		
FR	B	B		✓			C		C		✓	✓		
HR	None													
HU			✓	✓	C	A[a], B[d], E	C		C	✓	✓	✓		✓
IE			✓					B			✓			
IT					B[a]						✓			
LV						B[a]					✓			
LT						B[a]					✓			
LU				✓			C		C			✓		
NL	B			✓	C		C		C		✓	✓		
PL					C	A[a], B[a,d]		E		✓	✓	✓		✓
PT						B[a]					✓			

(continued)

Table 5.2 (continued)

	Type of simplified measurement						Safe harbour			Scope of safe harbour				
					Documentation					Small transactions	SMEs	Low value adding services	Loans	Others
MS	APA	Penalty	TP rules	TP methods	Simplified	Exemption	Arm's length rate range	Exemption from TP rules	Simplified TP method	A	B	C	D	E
RO	B[b]			✓		A[a]	C		C	✓	✓	✓		
SI		B		✓	B		D,C		C		✓	✓	✓	
SK					B[c]						✓			
SE				✓	A[a]		C		C	✓		✓		
UK			✓	✓		E	C	B[c]	C		✓	✓		✓

Note: Malta and Cyprus were excluded from the research
[a]Based on the statutory thresholds related to revenue, costs or turnover
[b]For micro entities
[c]Under special conditions
[d]For micro and small entities

transactions[10] are also available. Furthermore, in France and the Netherlands,[11] the simplified procedures of APA are offered for SMEs. Regarding a penalty, only Slovenia and France use an alleviated penalties regime for SMEs. Altogether, simplified measurements for SMEs were introduced in 26 cases in 22 EU Member States that account for almost 34%.

However, no simplified transfer pricing method or safe harbour arm's length range/rate is available for SMEs in EU Member States. This type of measurements is usually related to low value adding services and loans.

Further, small transactions cover the second largest part of simplified measurements (used 10 times, in 10 EU Member States). In addition, Croatia did not introduce any simplified measurements. Therefore, it is recommended to introduce at least some simplified measurements for low value added services that should reflect the TP Guidelines or the EU Joint Transfer Pricing Forum Guidelines on Low Value Adding Intra-Group Services.

However, based on the results it is further debatable whether in case of documentation requirements for SMEs, they should be harmonized in the whole EU or left in its current form. In case of the harmonization, this should mean that the Czech Republic, Croatia, France, Luxembourg, Netherlands, Romania and Sweden should also introduce documentation simplified measurements for SMEs or exempt under special conditions SMEs form the obligation to prepare transfer pricing documentation and follow current trend in the rest of European Union.

Finally, it was found that the EU Member States use a different definition of SMEs for transfer pricing purposes, notwithstanding, that there is a general EU definition for SMEs stated in Article 2 of European Commission Recommendation 2003/361/EC. It makes a situation even more complicated and increases compliance costs of taxation. However, every EU Member States has to take special care regarding the process of defining SMEs so that no LEs are classified as SMEs in the country. Hence, different SMEs definitions for transfer pricing purposes can occur so that no LEs apply simplified measurements.

According to the fact that SMEs are not able to ensure all required information related to transfer pricing issues, specifically comparable and functional analysis due to the lack of human and financial capital and born higher compliance costs[12] of taxation than LEs, the introduction of safe harbour in the form of an arm's length range can be seen as a suitable solution.

[10]For small taxpayers (those with intercompany tangible goods transactions below EUR 5,000,000 and other intercompany transactions below EUR 500,000) the filing fee is half of the general APA fee.

[11]To simplify the process of APA, the tax authorities assist the taxpayer to find comparables.

[12]For more details about compliance costs of taxation see Chap. 4—*Compliance Costs of Transfer Pricing for SMEs.*

5.5 Proposal for Safe Harbours for SMEs

As was mentioned above, SMEs bear high compliance costs for taxation. Usually, they are not able to ensure all required information related to the transfer pricing issues, such as comparable and functional analysis needed for the determination of the arm's length prices or margins. Usually, they use tax advisors for these kinds of services as was proven by questionnaires between SMEs.[13] Therefore, we believe that by using safe harbours, it is possible to eliminate burdensome compliance costs of taxation and make transfer pricing issues easier.

To determine safe harbours, individual SMEs were analysed, which were taken from the Amadeus database.[14] Key characteristics of SMEs were:

- SMEs without branches or subsidiaries owned more than 25% of capital
- SMEs not being a subsidiary owned by other enterprise more than 25% of capital
- operating in the European Union across industry NACE A to NACE S
- had data about profits, sales (turnover) and operating expenditures in their financial statements

The dataset covers together more than 11 thousand SMEs and presents a representative dataset of independent SMEs operating in Europe for whom the arm's length ranges will be determined (see Table 5.3). This dataset was analysed from the respect of profitability of entities, namely, profit margins, operating profit margins (hereinafter EBIT margins), earnings before interest, taxes, depreciation and amortization (hereinafter EBITDA) margins and mark-up profit margins. All of them were analysed for the period between 2005 and 2014 and are defined as can be seen in Eqs. (5.1–5.4).[15,16]

Profit margin:

$$\textit{Profit or loss before taxation/Sales or Operating revenue} \times 100 \qquad (5.1)$$

[13]For more details about the questionnaire, see Chap. 3.

[14]The Amadeus database contains comprehensive financial and basic textual information on European companies across Europe (44 European countries). The Amadeus database used for the research covers very large, large, medium and small companies, altogether 21,815,160 companies, version 11.01, release 244, January 2015.

[15]Profit or loss before taxation represents the sum of the operating profit and financial profit.

[16]In the case where the states have defined an indicator of Sales, which is more accurate because it includes only sales of goods sold and sales of own products and services, unlike Operating revenue, it is necessary to use this indicator. In that case, the United Kingdom and Denmark do not specify this indicator, therefore operating revenue, which is more comprehensive, has to be used.

Table 5.3 Profitability of independent SMEs between 2005 and 2014 for all industry sectors (Amadeus (2015), own processing)

	Profit margin % 2014–2005										
No. 11073	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005	2014–2005
10th Pct	−6.27	−6.56	−6.96	−4.15	−3.86	−5.75	−2.80	−1.11	−1.36	−2.16	−4.10
25th Pct	0.09	−0.04	−0.39	0.24	0.35	0.14	0.56	1.06	0.95	0.73	0.34
30th Pct	0.42	0.32	0.15	0.58	0.69	0.49	0.95	1.48	1.39	1.16	0.71
40th Pct	1.10	0.96	0.73	1.28	1.43	1.27	1.77	2.33	2.24	2.02	1.48
50th Pct	1.86	1.71	1.45	2.10	2.30	2.13	2.67	3.34	3.28	2.92	2.36
60th Pct	2.86	2.64	2.47	3.17	3.41	3.25	3.91	4.76	4.52	4.15	3.51
75th Pct	5.50	5.26	5.12	5.94	6.24	5.99	6.85	7.91	7.55	7.06	6.38
80th Pct	6.99	6.64	6.59	7.37	7.78	7.51	8.48	9.41	9.15	8.58	7.93
90th Pct	12.46	12.12	12.14	13.24	13.84	13.37	14.36	15.48	14.93	14.38	13.73
Average	2.38	2.09	2.05	3.45	3.76	3.21	4.39	5.41	5.09	4.54	3.64
	EBIT margin % 2014–2005										
No. 11073	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005	2014–2005
10th Pct	−4.74	−5.07	−5.22	−2.92	−2.58	−3.99	−1.27	−0.03	−0.28	−1.04	−2.63
25th Pct	0.67	0.54	0.35	0.89	0.99	0.83	1.52	2.04	1.81	1.53	1.08
30th Pct	1.19	1.01	0.84	1.38	1.45	1.35	2.08	2.55	2.33	2.04	1.58
40th Pct	2.06	1.93	1.72	2.26	2.41	2.35	3.13	3.60	3.37	3.07	2.57
50th Pct	3.05	2.87	2.69	3.23	3.39	3.40	4.19	4.73	4.49	4.13	3.60
60th Pct	4.21	3.98	3.82	4.44	4.58	4.62	5.45	6.08	5.76	5.39	4.85
75th Pct	6.77	6.56	6.44	7.26	7.41	7.43	8.41	9.25	8.76	8.31	7.69
80th Pct	8.22	7.89	7.84	8.77	8.95	8.94	10.11	10.83	10.43	9.81	9.26
90th Pct	13.83	13.34	13.55	14.61	15.06	15.08	16.26	17.10	16.56	15.91	15.21
Average	3.68	3.40	3.43	4.76	4.98	4.68	6.05	6.84	6.42	5.84	5.01

(continued)

Table 5.3 (continued)

	Mark-up profit margin % 2014–2005										
No. 10753	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005	2014–2005
10th Pct	−4.55	−4.85	−5.04	−2.89	−2.65	−3.89	−1.30	−0.05	−0.33	−1.07	−2.64
25th Pct	0.64	0.50	0.31	0.86	0.92	0.78	1.47	2.03	1.80	1.51	1.04
30th Pct	1.14	0.97	0.81	1.34	1.40	1.31	2.05	2.56	2.34	2.04	1.55
40th Pct	2.04	1.90	1.67	2.24	2.38	2.30	3.13	3.64	3.39	3.07	2.55
50th Pct	3.03	2.86	2.66	3.24	3.39	3.38	4.21	4.81	4.54	4.18	3.61
60th Pct	4.23	3.98	3.80	4.43	4.59	4.63	5.50	6.24	5.90	5.50	4.90
75th Pct	6.88	6.61	6.48	7.34	7.52	7.49	8.64	9.67	9.04	8.55	7.85
80th Pct	8.33	8.02	7.84	8.90	9.10	9.13	10.46	11.35	10.81	10.19	9.45
90th Pct	13.97	13.40	13.64	14.78	15.39	15.50	16.99	18.07	17.32	16.82	15.70
Average	4.20	3.86	3.83	5.01	5.23	4.97	6.33	7.26	6.80	6.24	5.37
	EBITDA margin % 2014–2005										
No. 10753	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005	2014–2005
10th Pct	−1.23	−1.36	−1.50	0.24	0.50	−0.29	1.16	1.74	1.63	1.27	0.47
25th Pct	2.48	2.39	2.21	2.91	3.10	3.01	3.73	4.21	4.01	3.76	3.16
30th Pct	3.14	3.03	2.91	3.60	3.77	3.72	4.41	4.95	4.73	4.44	3.85
40th Pct	4.42	4.33	4.20	4.90	5.16	5.10	5.77	6.31	6.09	5.89	5.22
50th Pct	5.89	5.78	5.50	6.33	6.60	6.59	7.34	7.96	7.56	7.30	6.69
60th Pct	7.55	7.40	7.22	8.06	8.45	8.45	9.07	9.80	9.43	9.15	8.49
75th Pct	11.46	11.14	11.17	11.90	12.37	12.48	13.23	13.94	13.73	13.25	12.48
80th Pct	13.51	13.13	13.16	13.89	14.54	14.71	15.42	16.14	15.70	15.35	14.61
90th Pct	20.85	20.63	20.59	21.82	22.77	22.88	23.45	23.71	23.45	23.40	22.48
Average	8.07	7.86	7.87	9.15	9.59	9.37	10.32	10.99	10.71	10.30	9.42

Operating margin:

$$Operating\ profit\ or\ loss/Sales\ or\ Operating\ revenue \times 100 \quad (5.2)$$

Earnings before Interest, Taxes, Depreciation and Amortization margin:

$$EBITDA/Sales\ or\ Operating\ revenues \times 100 \quad (5.3)$$

Mark-up profit margin:

$$Operating\ profit\ or\ loss/total\ operating\ costs \times 100 \quad (5.4)$$

Furthermore, as with many tax administrations and the OECD (2017) in TP Guidelines, the application of interquartile range was used for the elimination of extreme results and increasing the reliability of the comparison of the results. The interquartile range represents a range from the 25th to the 75th percentile of the results derived from the uncontrolled transactions of unrelated entities (independent entities). Only the 50% of observations that are closest to the median are considered a reliable range of arm's length results. However, it is also suitable to determine the 10th percentile and 90th percentile as a lower and upper limit to ensure a larger range of results. The arm's length principle is met, if the margin of the tested party (associated enterprise) falls within this determined range.

In respect to the profitability of SMEs from the dataset, it is obvious (see Table 5.3) that there was little change over the last decade, specifically between 1% and 1.5%. Profitability of independent SMEs operating in the European Union appears stable without significant deviations and ranges from 0.34% to 12.48%, depending on the type of profitability.

However, the situation is quite different if one takes into the account the size of companies and the specifics of individual sectors in the economy, i.e., analysis of profitability by sector in which is SME operating (see Tables 5.4 and 5.5). The previous analysis indicated that the median value of EBIT margin beyond the 10th year period is 3.60% and the Mark-up profit margin is 3.61%. As is obvious from Tables 5.4 and 5.5, those values are not generated in NACE sectors G—Wholesale and retail trade; repair of motor vehicles and motorcycles, H—Transporting and storage, and R—Arts, entertainment and recreation by medium sized entities or small entities. Further, medium sized entities are not able to generate those median values in the case of industry NACE N—Administrative and support service activities and P—Education, as well as small entities in NACE D—Electricity, gas, steam and air conditioning supply. Moreover, there is a visible difference between the size of entities operating in some specific industry sectors and profitability, such as in sector D, where medium sized entities generate a much higher median value of margin than small entities (for more details see Table 5.4).

Further, as is obvious in Tables 5.4 and 5.5, profitability of small entities is in most cases higher than in cases of medium sized entities, namely, in the case of NACE E—Water supply; sewerage; waste management and remediation activities, G—Wholesale and retail trade; repair of motor vehicles and motorcycles, H—Transporting and

Table 5.4 Profitability of independent SMEs across industry and time—median values (Amadeus (2015), own processing)

NACE[a]	Median—Mark-up profit margin %—across time											2005–2014 median
	Entity	2014	2013	2012	2010	2009	2008	2007	2006	2005	2004	
A	Medium	4.45	3.98	4.63	4.24	4.20	3.79	4.61	5.11	4.17	3.24	4.25
	Small	4.03	2.27	3.97	4.79	3.27	3.88	5.50	5.13	4.34	4.29	4.15
B	Medium	3.89	3.58	2.76	4.72	4.58	6.31	6.74	7.44	6.18	4.35	5.33
	Small	2.49	4.83	4.59	3.17	4.01	5.53	7.70	7.23	7.29	5.95	5.28
C	Medium	3.51	3.22	2.95	3.46	3.41	3.27	4.45	5.04	4.92	4.54	3.88
	Small	3.24	3.02	2.66	3.29	3.34	3.08	4.42	5.59	5.30	4.89	3.81
D	Medium	12.33	14.26	12.16	13.49	16.70	17.19	13.32	10.43	13.81	11.54	13.63
	Small	2.28	4.66	1.36	3.49	3.25	2.81	5.31	3.29	2.37	3.74	2.93
E	Medium	3.52	2.28	2.12	4.45	4.77	3.65	4.45	5.79	4.36	5.72	4.09
	Small	5.47	1.98	6.10	7.40	7.96	6.68	5.82	8.46	5.64	6.07	6.52
F	Medium	3.35	3.07	2.94	3.52	3.96	4.92	6.32	6.34	6.37	5.61	4.49
	Small	3.41	3.70	3.06	3.50	4.01	4.18	5.26	5.78	5.53	5.12	4.35
G	Medium	2.10	2.04	1.88	2.25	2.41	2.49	3.01	3.24	3.09	2.90	2.53
	Small	2.17	2.16	1.89	2.37	2.68	2.83	3.39	3.80	3.38	3.30	2.76
H	Medium	2.52	1.92	1.27	1.91	2.41	1.92	2.53	2.91	2.77	2.21	2.27
	Small	3.53	3.02	3.52	3.05	4.00	2.45	2.68	4.33	4.57	3.61	3.44
I	Medium	4.51	4.37	3.64	5.45	5.63	5.28	6.29	7.49	7.00	5.38	5.55
	Small	3.18	2.42	2.56	3.87	3.29	3.42	4.23	4.39	4.86	4.25	3.63
J	Medium	3.64	3.59	3.58	4.35	5.19	4.57	5.52	6.49	6.25	5.64	4.68
	Small	3.36	4.50	3.68	4.50	5.27	4.99	5.39	6.72	6.22	6.16	5.10
K	Medium	11.50	8.28	5.90	8.60	3.91	5.21	6.24	7.99	8.34	4.17	6.55
	Small	4.76	3.60	3.40	5.22	4.65	2.39	3.41	5.15	9.52	6.28	4.88
L	Medium	7.44	9.55	9.97	14.37	11.59	13.17	16.70	17.76	14.86	15.61	12.81
	Small	6.57	4.41	7.74	7.79	9.16	10.21	10.56	11.64	10.74	10.28	9.14
M	Medium	4.43	3.94	4.14	4.77	5.22	4.90	6.11	6.67	6.36	6.25	5.20
	Small	3.66	3.88	3.26	3.76	4.17	4.51	5.54	6.29	6.05	6.22	4.70

N	Medium	3.61	2.40	2.19	3.59	3.00	3.90	3.69	4.38	4.57	3.94	3.59
	Small	3.73	3.09	2.75	3.58	3.89	4.35	4.18	4.93	5.86	4.51	4.12
P	Medium	1.89	2.50	2.21	2.71	3.44	2.91	2.69	3.44	2.93	2.63	2.77
	Small	2.59	3.66	4.19	4.35	2.80	5.03	5.13	3.44	4.23	5.38	3.99
Q	Medium	6.60	7.03	6.35	6.69	6.68	7.75	8.62	9.13	9.24	7.72	7.43
	Small	2.82	3.56	4.28	4.39	4.64	5.00	4.46	5.30	6.13	5.80	4.89
R	Medium	1.98	2.11	1.82	2.50	3.45	2.38	2.84	4.93	3.66	3.07	2.76
	Small	0.60	1.83	1.53	2.92	1.51	3.51	2.88	4.53	3.92	3.25	2.74
S	Medium	3.70	4.24	4.05	6.50	5.08	6.13	5.44	5.53	4.89	4.66	5.06
	Small	4.36	3.28	3.86	4.52	4.39	5.90	5.95	5.98	6.46	5.69	4.93
Total	Median	3.03	2.86	2.66	3.24	3.39	3.38	4.21	4.81	4.54	4.18	3.61
	Median—EBIT Margin %—across time											
NACE[a]	Entity	2014	2013	2012	2010	2009	2008	2007	2006	2005	2004	2005–2014 median
A	Medium	4.25	3.81	4.39	4.17	4.21	3.66	4.57	5.02	4.07	3.14	4.17
	Small	4.39	2.73	4.24	4.60	3.64	3.74	5.21	4.97	4.16	4.11	4.17
B	Medium	3.75	3.46	2.68	4.50	4.38	5.93	6.32	6.92	5.82	4.17	5.06
	Small	2.61	5.05	4.43	3.54	4.06	5.51	7.19	7.46	8.45	5.91	5.14
C	Medium	3.39	3.11	2.86	3.34	3.29	3.17	4.27	4.80	4.69	4.36	3.74
	Small	3.14	2.94	2.62	3.21	3.24	3.00	4.25	5.33	5.04	4.68	3.69
D	Medium	13.29	13.20	10.84	14.88	21.11	22.05	15.98	12.66	21.77	12.54	15.12
	Small	2.94	7.45	1.93	5.76	4.96	3.36	6.14	4.78	2.70	4.11	4.57
E	Medium	3.40	2.23	2.08	4.26	4.55	3.52	4.27	5.48	4.17	5.41	3.93
	Small	5.19	1.94	5.75	6.89	7.38	6.26	5.50	7.80	5.34	5.72	6.12
F	Medium	3.32	3.34	3.28	3.72	4.11	4.76	5.92	6.02	5.69	5.07	4.57
	Small	3.35	3.64	2.97	3.41	3.91	4.03	5.04	5.48	5.26	4.90	4.22
G	Medium	2.07	2.01	1.85	2.21	2.38	2.44	2.95	3.15	3.01	2.83	2.48
	Small	2.15	2.19	1.87	2.33	2.66	2.79	3.31	3.71	3.32	3.21	2.72
H	Medium	2.55	1.92	1.31	1.94	2.46	1.96	2.59	2.97	2.83	2.37	2.29
	Small	3.51	3.05	3.40	2.95	3.93	2.54	2.64	4.43	4.53	3.53	3.50

(continued)

Table 5.4 (continued)

NACE[a]	Median—EBIT Margin %—across time											2005–2014 median
	Entity	2014	2013	2012	2010	2009	2008	2007	2006	2005	2004	
I	Medium	4.36	4.19	3.55	5.17	5.37	5.01	5.91	6.97	6.55	5.11	5.27
	Small	3.32	2.50	2.60	3.94	3.20	3.47	4.25	4.22	4.65	4.16	3.60
J	Medium	3.54	3.48	3.57	4.19	4.97	4.51	5.27	6.19	6.29	5.35	4.56
	Small	3.28	4.31	3.52	4.27	5.05	4.77	5.16	6.31	5.89	5.86	4.87
K	Medium	10.31	7.63	5.57	7.89	3.76	4.96	5.87	7.40	7.70	4.01	6.14
	Small	4.75	2.51	4.31	5.68	4.83	2.84	3.29	4.90	9.86	5.47	4.81
L	Medium	13.96	15.80	17.50	21.61	21.09	21.87	26.15	24.40	23.71	24.20	20.77
	Small	11.97	8.47	14.85	16.11	16.61	18.21	15.79	16.15	17.27	14.80	15.31
M	Medium	4.28	3.83	4.03	4.70	4.98	4.73	5.85	6.32	6.09	6.00	5.04
	Small	3.53	3.80	3.28	3.73	4.35	4.69	5.81	6.29	6.19	6.06	4.72
N	Medium	3.58	2.42	2.18	3.58	2.94	3.75	3.56	4.24	4.39	3.81	3.58
	Small	3.60	3.00	2.68	3.46	3.75	4.17	4.01	4.70	5.54	4.32	3.96
P	Medium	1.86	2.44	2.17	2.64	3.33	2.82	2.62	3.33	2.84	2.56	2.70
	Small	2.60	3.61	4.02	4.28	2.62	4.95	5.00	3.45	4.12	5.22	3.99
Q	Medium	6.20	6.57	5.97	6.27	6.26	7.20	8.13	8.56	9.04	7.22	6.96
	Small	3.27	3.57	4.66	5.08	4.49	4.92	5.11	5.39	6.40	5.55	4.92
R	Medium	2.09	2.21	1.87	2.60	3.51	2.45	2.83	5.11	3.76	3.06	2.81
	Small	0.59	1.80	1.51	2.84	1.49	3.39	2.80	4.34	3.77	3.15	2.67
S	Medium	3.65	4.40	4.04	6.12	5.03	5.80	5.60	5.33	4.71	4.54	5.04
	Small	4.25	3.29	4.37	4.37	4.46	5.63	5.81	5.65	6.41	5.41	4.87
Total	Median	3.05	2.87	2.69	3.23	3.39	3.40	4.19	4.73	4.49	4.13	3.60

[a] A—Agriculture, forestry and fishing, B—Mining and quarrying, C—Manufacturing, D—Electricity, gas, steam and air conditioning supply, E—Water supply; sewerage; waste management and remediation activities, F—Construction, G—Wholesale and retail trade; repair of motor vehicles and motorcycles, H—Transporting and storage, I—Accommodation and food service activities, J—Information and communication, K—Financial and insurance activities, L—Real estate activities, M—Professional, scientific and technical activities, N—Administrative and support service activities, O—Public administration and defence; compulsory social security, P—Education, Q—Human health and social work activities, R—Arts, entertainment and recreation, S—Other services activities

Table 5.5 Profitability of independent SMEs across industry sectors between 2005 and 2014 (Amadeus (2015), own processing)

NACE	No.	Mark-up profit margin % 2014–2005				No.	EBIT margin % 2014–2005		
		SMEs	25th Pct	75th Pct	Average		25th Pct	75th Pct	Average
A	152	Medium	0.99	9.86	6.29	157	0.94	9.40	5.11
	69	Small	−0.82	9.94	4.55	75	−0.75	10.17	3.33
B	44	Medium	2.02	9.99	5.88	44	1.98	9.08	4.53
	24	Small	1.66	11.19	6.22	25	1.80	10.77	5.80
C	2271	Medium	1.51	7.50	5.21	2280	1.49	7.00	4.38
	839	Small	0.70	8.08	4.40	844	0.70	7.51	3.18
D	11	Medium	5.14	24.33	17.13	15	7.52	31.52	19.40
	6	Small	1.08	5.47	3.45	9	1.64	26.63	17.42
E	51	Medium	1.12	10.45	7.82	51	1.11	9.46	5.69
	21	Small	1.70	12.31	8.35	21	1.67	10.96	6.01
F	679	Medium	1.68	9.02	6.35	713	1.76	8.93	6.44
	482	Small	1.21	9.08	5.82	489	1.21	8.50	4.62
G	2037	Medium	0.94	5.02	3.40	2057	0.93	4.83	3.15
	930	Small	0.49	5.90	3.28	941	0.51	5.68	2.79
H	325	Medium	0.39	5.60	3.60	335	0.42	5.67	3.68
	134	Small	−0.13	8.46	4.54	140	−0.08	8.30	4.24
I	286	Medium	1.43	12.28	7.72	290	1.39	10.97	5.95
	269	Small	−0.99	9.13	4.97	274	−0.94	8.73	3.56
J	163	Medium	1.78	10.64	7.25	166	1.78	9.94	6.29
	225	Small	1.76	10.27	7.01	228	1.68	9.40	5.38
K	20	Medium	2.25	15.83	6.99	20	2.20	13.67	4.46
	22	Small	0.81	13.30	8.99	24	0.81	12.66	6.89
L	159	Medium	2.23	32.14	18.65	256	5.78	41.02	23.76
	100	Small	1.83	24.29	14.78	152	4.13	35.82	19.30
M	260	Medium	1.74	10.38	7.28	263	1.73	9.58	6.37
	265	Small	1.10	10.76	7.27	281	1.19	10.96	6.40
N	172	Medium	0.84	8.35	6.19	174	0.85	7.86	5.30
	122	Small	0.93	8.61	5.22	122	0.92	7.93	3.79
P	34	Medium	0.49	7.38	5.25	34	0.49	6.87	4.24
	27	Small	0.98	8.06	6.83	28	1.10	7.62	5.66
Q	165	Medium	2.07	15.68	10.50	167	2.07	13.82	8.45
	98	Small	1.06	10.83	6.79	103	1.20	10.99	6.46
R	83	Medium	−0.62	8.75	4.59	85	−0.49	8.64	3.95
	91	Small	−1.95	8.56	3.40	91	−1.99	7.88	1.69
S	46	Medium	2.19	13.31	9.98	47	2.31	12.36	7.95
	65	Small	1.61	9.99	5.88	67	1.66	9.69	5.60
All	10,747		1.04	7.85	5.37	11,068	1.08	7.69	5.01

storage, J—Information and communication, N—Administrative and support service activities, and P—Education. In other industry sectors, there is a visible negative trend of profitability of small entities in comparison with the medium sized entities. However, the analysis of profitability did not prove that small enterprises generate lower profits than medium sized entities.

Furthermore, the analysis of profitability across industry sectors showed that the lowest EBIT margin from independent small enterprises beyond the 10th year period is generated in the NACE R—Arts, entertainment and recreation (interquartile range −1.99 to 7.88%, average 1.69%) and the highest one in NACE L—Real estate activities (interquartile range 4.13–35.82%, average 19.30%) in comparison with the independent medium sized enterprises, which generated beyond the 10th year period the lowest EBIT margin in NACE R—Arts, entertainment and recreation (interquartile range −0.49 to 8.64%, average 3.95%) and the highest one in NACE L—Real estate activities (interquartile range 5.78–41.02%, average 23.76%). A similar situation is also found in the case of mark-up profit margin. Further, the second highest profitability sector is NACE D and K—Financial and insurance activities in dependence on the type of entity (small or medium sized). For more details see Table 5.5.

The abovementioned analysis confirms that safe harbours should be set for each sector and size of the entity to take into account not only the specifics of the industry but also the general comparability.

Based on the annual reports on European SMEs[17] it was indicated that the most important sectors, where SMEs operate, are "manufacturing—NACE sector C", "construction—NACE sector F", "professional, scientific and technical activities—NACE sector M", "accommodation and food—NACE sector I". "Wholesale and retail trade, repair of motor vehicles and motorcycles—NACE sector G" was the largest one. Those five sectors represent 78% of all SMEs in the EU (or 16,536 million SMEs), generating 71% of value added, accounting for approximately 79% of the total EU28 SMEs employment. There is no doubt that they are crucial for the European economy and any decrease of compliance costs of taxation would be desirable for this group of entities.

To determine safe harbours, EBIT margin and Mark-up profit margin were applied, as both mentioned margins are not influenced by financial losses from the financial part of businesses and moreover are related to the operating activities and their profit. Further, an interquartile range, such as 25pct and 75pct, and currently known safe harbours were taken into account, namely, mark-ups of 5% for all low value-added services based on the OECD TP Guidelines (2017) and mark-up between 3% and 10% for low value-adding services based on the Guidelines on Low Adding Intra-Group Services issued by the EU Joint Transfer Pricing Forum.

As is obvious in the case of small entities, they are not able to generate greater profitability than 10% in almost all selected industries, except NACE M. Further, a lower limit of safe harbours is not higher than 5% or 3%, as in currently known safe

[17]European Commission, Annual reports on European SMEs 2013/2014 and new ones.

Table 5.6 Proposal of safe harbours for selected sectors—small entities (Amadeus (2015), own processing)

NACE	No.	Mark-up profit margin % 2014–2005				Safe harbours %	
		SMEs	25th Pct	75th Pct	Median	25th Pct	75th Pct
C	839	Small	0.70	8.08	3.81	1	9
F	482		1.21	9.08	4.35	2	10
G	930		0.49	5.90	2.76	1	6
I	269		−0.99	9.13	3.63	1	10
M	265		1.10	10.76	4.70	2	11
		EBIT margin % 2014–2005					
C	844	Small	0.70	7.51	3.69	1	8
F	489		1.21	8.50	4.22	2	9
G	941		0.51	5.68	2.72	1	6
I	274		−0.94	8.73	3.60	1	9
M	281		1.19	10.96	4.72	2	11

harbours. The lowest safe harbour was determined for sector G, where small entities generate the lowest mark-up and/or EBIT margin, in comparison with sector M, generating the highest margin (for more details see above Table 5.6).

In case of medium sized entities (see Table 5.7), the lower limit of 3% or 5% was not reached as in the case of small entities. Sector G again represents the industry with the lowest profitability contrary to the industries with the highest ones, such as industry M—Professional, scientific and technical activities and I—Accommodation and food service activities.

Based on the results it should be highlighted that SMEs usually generate lower EBIT or mark-up profit margins for their core business activities than entities applying current known safe harbours for low value-adding intra group services, where there is a limit of 5% or a range between 3% and 10%. This circumstance highlights the importance of the determination of an arm's length price or margin based on the type of entity (small, medium or large entity) and the sector where the subject is operating.

In addition, proposed safe harbours (based on the general analogy resulting from the generality and therefore any inaccuracy) can accept such a simplified approach for SMEs. This approach is based on the fundamental principles of transfer pricing rules and corresponds with the profitability of independent SMEs in the European Union. Its simple application should lead to the reduction of compliance costs of taxation, as well as the administrative burden of the tax administrator. SMEs would not have to perform time consuming comparable and risks analysis resulting into the determination of arm's length profit margin or mark-up, but they could apply for publicly presented safe harbours, which should save time, financial capital and human resources and altogether reduce compliance costs of taxation. However, safe harbours should be introduced as an option for the general transfer pricing rule and should be well-designed.

Table 5.7 Proposal of safe harbours for selected sectors—medium sized entities (Amadeus (2015), own processing)

		Mark-up profit margin % 2014–2005				Safe harbours %	
NACE	No.	SMEs	25th Pct	75th Pct	Median	25th Pct	75th Pct
C	2271	Medium	1.51	7.50	3.88	2	8
F	679		1.68	9.02	4.49	2	10
G	2037		0.94	5.02	2.53	1	6
I	286		1.43	12.28	5.55	2	13
M	260		1.74	10.38	5.20	2	11
		EBIT margin % 2014–2005					
C	2280	Medium	1.49	7.00	3.74	2	7
F	713		1.76	8.93	4.57	2	9
G	2057		0.93	4.83	2.48	1	5
I	290		1.39	10.97	5.27	2	11
M	263		1.73	9.58	5.04	2	10

5.6 Conclusion

The OECD has been focused on improving the administrative aspects of transfer pricing and compliance issues since 2010. A partial result is the revision of Section E on Safe Harbours in Chapter IV of the OECD TP Guidelines at 16 May 2013, subsequently at 10 July 2017 reflecting BEPS recommendations. New guidance on safe harbours includes a new, clearer definition of safe harbours with a more positive tone. Moreover, many countries use safe harbours as simplified transfer pricing measurements, namely, for exemptions from transfer pricing rules, simplified transfer pricing methods, safe harbour arm's length range/rates, and safe harbour interest rates. Further, all safe harbours used are optional and usually cover low value added intra-group services, loans, SMEs and small transactions.

For taxpayers and tax administrators, safe harbours mainly simplified transfer pricing approaches that can reduce compliance costs and administration costs, increase certainty for taxpayers and improve the effectiveness of tax administration, mainly by decreasing the number of transfer pricing disputes, audit, and MAP cases for tax administrators. On the other hand, there are some disadvantages, namely, an application for specific category of taxpayers or transactions that can create discriminations or some distortions e.g., trade or competitive; the risk of double taxation or non-taxation; inappropriate tax planning and transfer pricing manipulation, resulting in lower tax revenues. However, almost all concerns can be eliminated by both clearly and carefully designing criteria and conditions, under which a taxpayer/transaction is eligible for safe harbours, and by bilateral or multilateral forms of safe harbours.

At the end of the paper, a simplified transfer pricing rule in the form of safe harbours as an alternative approach was determined for the selected NACE sectors, namely, sectors C, F, G, I and M, which represent the five most important sectors

where SMEs are operating. The determination of safe harbours was performed based on the analysis of profitability of independent SMEs operating in the European Union. Specifically, EBIT margin and Mark-up profit margin were used. Generally, in the case of small entities the proposed safe harbours range between 1 and 11%, and in the case of medium sized entities between 1 and 13%, depending on the indicator of profitability used (EBIT margin or Mark-up profit margin) and the industry where the SME is operating.

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Chapter 6
CCCTB as a Suitable Solution?

This chapter analyses the impacts of the fundamental change in corporate taxation in the EU recently proposed by the EC especially in relation to small and medium-sized enterprises (SMEs). It begins by discussing the history of harmonization efforts of corporate taxation, the current situation of corporate taxation in the EU and the recent proposal of the Common Corporate Tax Base (CCTB) and Common Consolidated Corporate Tax Base (CCCTB) Directives. The core part of the chapter presents the results of research on the impacts of the introduction of the directive proposals on the performance of SMEs acting in the EU.

6.1 History of the Efforts to Harmonize Corporate Taxation in the EU

In the field of direct taxation, there have been many attempts to coordinate or harmonize the corporate taxation systems of EU Member States. First, in 1962, the Neumark Report[1] proposed the creation of an economic area without obstacles to the creation of the functional Common Market. Further, regarding corporate taxation and the elimination of double taxation, the report recommended the centralization of the calculation of total taxable income for taxes on overall income and on company profits in the state, which would normally be the state of the tax domicile or the state in which the greater part of the business activities are performed, as the most appropriate method reflecting the requirements of a real common market. The tax base determined in such a way would be allocated between the respective

[1]Report "Tax Harmonization in the European Economic Community" of the Fiscal and Financial Committee chaired by prof. Fritz Neumark established by the European Commission in 1960. Available at: http://www.steuerrecht.jku.at/gwk/Dokumentation/Steuerpolitik/Gemeinschaftsdokumente/EN/Neumark.pdf

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Member States in analogously to the German business tax, where several municipalities share the yield of this tax. The concept is very similar to the CCCTB proposals introduced in 2011 and 2016. In addition, among other suggestions, to harmonize company tax systems, the Neumark Report also recommended an imputation system that split corporate tax rates for retained and distributed profits.

Second, in 1970, the Tempel report[2] went in a different direction and suggested the implementation of a classical system of corporate taxation in EU Member States, which would best meet the community's needs. Both reports proposed a number of initiatives and recommendations with the aim of achieving a limited degree of harmonization of the corporate tax system, corporate tax base and corporate tax rates. Based on the recommendations suggested in both reports, in 1975, the European Commission introduced a directive proposal[3] on the harmonization of corporate tax systems covering an imputation credit system to shareholders for the taxation of dividends distributed by a subsidiary of a parent company situated in one of the Member States. Moreover, in all other cases, a withholding tax of at least 25% on dividends would be imposed, and corporate tax rates would be between 45% and 55%, with a minimum corporate tax rate of 30%. However, the directive proposal was never adopted and was withdrawn in 1990.

Third, in 1984/85 and 1990, the European Commission proposed a directive on the carry-over of losses and consolidation of foreign branch/subsidiary losses[4] as another step for removing distortions in competition within the EU. The proposal introduced a 3-year period for carrying back losses and an unlimited period for carrying forward losses, as well as the consolidation of foreign branch/subsidiary losses. However, none of these proposals have been adopted. While Council discussed the proposal in 1985, it was later withdrawn along with the proposal from 1990.

Fourth, in 1988, the European Commission introduced a draft proposal on the harmonization of rules for determining the taxable profits of enterprises[5] as an important step for the establishment of the Internal Market. However, it was never tabled, owing to the reluctance of most Member States.

This initiative, as well as previous one, was not entirely successful, and by the end of the 1980s, little progress could be seen at the European Community with respect to corporate tax harmonization. Therefore, the European Commission focused on a different approach, i.e., instead of harmonizing corporate taxation, it proposed transitioning measures to complete the Internal Market. Although company taxation is likely to engender economic distortions, the European Commission

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[2]Prof. Dr. A.J. van den Tempel (1970). Corporation Tax and Individual Income Tax in the European Communities. http://aei.pitt.edu/40293/1/A4688.pdf

[3]Draft Directive concerning the harmonization of systems of company taxation and of withholding tax on dividends. COM(75) 392 final.

[4]Proposed Directive on Company Losses, COM(1984) 404 final, OJ 1984 C253, as amended, OJ 1985 C170. Proposed Directive on Loss Consolidation, COM(1990) 595 final, OJ 1991, C53.

[5]Preliminary draft proposal for a Directive on the harmonization of rules for determining the taxable profits of undertakings, XV/27/88-EN.

accepted that Member States are free to determine their own tax, except in cases where taxes led to major distortions, and focused on measures to achieve the functioning of the forthcoming Internal Market. Consequently, the Commission abandoned its 1975 proposal for the harmonization of corporate tax systems. Further, in its Communication on company taxation[6] in 1990, the Commission suggested that subject to the principle of subsidiarity, all initiatives should be defined through a consulting process with the Member States. On this basis, three Commission proposals that originated in the late 1960s, namely, the Merger Directive,[7] the Parent Companies and Subsidiaries Directive,[8] and the Arbitration Procedure Convention,[9] were finally adopted in July 1990.

Moreover, the European Commission announced an additional study designed to identify the extent to which differences in the corporate tax systems of Member States distorted the development and operation of the Single Market. The Committee of Independent Experts, under the Chairmanship of Dr. Onno Ruding, was appointed in December 1990. The Ruding Committee was mainly asked to research whether differences in corporate taxation are important for business decisions with respect to the location of investments and the international allocation of profits between enterprises and whether they cause major distortions that affect the functioning of the Internal Market and to suggest ways to overcome this problem. The Ruding Committee produced its report[10] in 1992, and its main findings were that tax differences can affect the location of investments and cause distortions in competition, as the nominal corporate tax rate represents an important decision factor. Further, it recommended both the substantial harmonisation of the corporate tax base and the harmonisation of tax rates within a 30–40% range, as well as full transparency and the elimination of double taxation. Although the report included detailed findings and recommendations with respect to double taxation, effective taxation, and the prevention of tax evasion, among and others, it received merely limited support.

Based on the Ruding Committee's results, the European Commission proposed uniform tax base rules and a maximum corporate tax rate of 40%.[11] However, these

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[6]Commission Communication to Parliament and the Council: Guidelines on company taxation. SEC(90)601.

[7]Directive 90/434/EEC—now 2009/133/EC on a common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States.

[8]Directive 90/435/EEC—now 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

[9]Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

[10]Report of the Committee of Independent Experts on Company Taxation, Commission of the European Communities, Official Publications of the EC, ISBN 92-826-4277-1, March 1992.

[11]Instead of this proposal the European Commission proposed amendments to the directives on mergers and parent/subsidiaries and drew attention to two proposals, namely carry-over of losses and loss consolidation, that had already been tabled some time before.

harmonization efforts were again unsuccessful. The main reasons for the failure in harmonizing corporate taxation are as follows: (1) the Member States perceived the harmonization process to be an effort to restrict their fiscal sovereignty rather than an advantage where companies could fully benefit from the existence of the Internal Market; (2) harmonization measures need to be introduced in the form of directives that require unanimous voting, i.e., the directive has to be adopted by all EU Member States. This very often resulted in a situation where harmonization measures were blocked by one or two Member States. Therefore, the European Union continued to have not an integrated European tax system but rather a collection of different national tax systems.

The European Commission decided to harmonize only the provisions affecting the smooth functioning of the Internal Market, which is understood as the main benefit of the harmonization of corporate taxation. In 1996/1997, the European Commission launched a new approach to taxation[12] known as "tax package", which aimed to address three main challenges:

- restoring tax-raising capacities
- completing the realization of the Single Market, notably by removing the tax obstacles
- restructuring taxation systems by reducing the tax burden on labour.

Through the work on the "tax package", the Code of Conduct for Business Taxation was adopted as a Council resolution in 1998. Moreover, the Council also established a Code of Conduct Group (known as the 'Primarolo Group') to examine cases of unfair business taxation. One year later, based on the results of their research, they identified 66 harmful tax practices to be abolished within 5 years. Further, a new version of the proposal on a common system of taxation that applied to interest and royalty payments made between parent companies and subsidiaries in different Member States that had already been tabled in 1991 appeared in 1998 as a part of the "Monti package", and it was adopted as the Interest and Royalty Directive.[13] In addition, through the work on the "tax package", another directive, namely, the Saving Directive,[14] was adopted in 2003.

However, the implementation of the Code of Conduct opened very substantial discussion in terms of tax competition, which resulted in the mandate of the Commission to study both the level of effective rates of taxation and the tax obstacles encountered by companies in their cross-border economic activities, known as the "Company taxation study".[15] Further, in 2000, the Council requested

[12]Communication from the Commission to the Council Towards tax co-ordination in the European Union—A package to tackle harmful tax competition COM(97) 495.

[13]Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

[14]Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments.

[15]Company taxation in the Single Market—Commission Staff Working Paper SEC(2001) 1681 of October 23, 2001. Company Taxation in the Internal Market COM(2001) 582 final.

that the Commission carry out a comprehensive study on company taxation, but it gave a new perspective for the mandate; specifically, the European Union should become the most competitive and dynamic knowledge-based economy in the world that is capable of sustainable economic growth with more and better jobs and greater social cohesion.[16] In other words, company taxation should contribute to higher economic welfare in the EU, as was already mentioned in the Ruding Report and as was line with one of the objectives of the Treaty of Rome from 1959. The comprehensive study on company taxation[17] was published in 2001, and it suggested a new methodology for taxing companies. Moreover, the study describes tax obstacles to cross-border economic activities, compliance costs that companies incur owing to doing business in more than one Member State and barriers to cross-border trade, establishment and investment, such as transfer pricing, capital gains taxation, cross-border off-setting of losses, taxation of cross-border flows of income, tax rules governing mergers and acquisitions and others. In its communication,[18] the European Commission highlighted the main problem faced by companies in the form of the existence of separate national tax systems and financial accounting rules, laws and arrangements for the collection and administration of tax in the Internal Market, which caused additional tax and excessive compliance costs of taxation. To effectively address the situation, the European Commission devised a two-track strategy, which should remove the obstacles resulting from the co-existence of different tax systems and ensure the full potential of the Internal Market.

First, targeted measures were introduced to help address the most pressing problems in the short and medium term, such as the revision of the Merger and Parent-Subsidiary Directive, the introduction of an EU model tax treaty, and the establishment of an EU Joint Transfer Pricing Forum, among others. Second, a second track—which has been defined as the long-term goal—represents a more ambitious initiative in the form of corporate tax harmonization for the EU-wide activities of EU companies. Thus, the European Commission proposed the following four possible models of corporate income tax harmonization:

- Home State Taxation (HTS)—under this system, for the taxation of companies with "European" activities, corporations would adopt the rules valid in the home country in which the headquarters is situated
- Common Consolidated Tax Base (CCTB)—the system supposes the existence of common rules for tax base constructions

[16]Lisbon European Council 23 and 24 March 2000, Presidency Conclusions, pt. 5.

[17]Company taxation in the Single Market—Commission Staff Working Paper SEC(2001) 1681 of October 23, 2001. Company Taxation in the Internal Market COM(2001) 582 final.

[18]Commission communication Towards an internal market without tax obstacles: A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities, COM (2001) 582.

- European Union Company Tax (EUCIT)—under this system, large multinational corporations would use the uniform consolidated tax base and unified corporate income tax rate within the EU
- Compulsory Harmonized Corporate Tax Base—this system would introduce a uniform tax base for every company in the EU.

The proposals were discussed at a conference held in 2002 in Brussel, and consequently, in 2003, in its Communication,[19] the Commission presented the ongoing work on the two comprehensive corporate tax policies—Home State Taxation for SMEs and a common (consolidated) corporate tax base as a general solution. In 2005, the Commission presented the pilot scheme for possible Home State Taxation.[20] However, no Member State has expressed interest in introducing a HTS pilot project. Therefore, the Commission has focused only on the C(C)CTB.

To design the C(C)CTB system, the European Commission established a working group in 2004. The task of this group was to elaborate a common definition of the tax base for corporations with European activities and to design basic tax principles, the structure of the common consolidated tax base and the apportionment mechanism. Although the draft of the text of the directive was already finished in 2008, the public discussion after its publication showed that there were still areas that need detailed definitions, and therefore, the draft was sent back to the working group to amend the text. In connection with the change in Commissionaire responsible for taxation, the CCCTB was granted the highest priority, and after more than 10 years of work, the Commission published the CCCTB Directive proposal[21] on March 16, 2011. Subsequently, in April 2012, the European Parliament adopted its legislative resolution[22] to this proposal.

The CCCTB Directive proposal represents one of the most ambitious projects in the history of the harmonization efforts in the area of corporate taxation. The uniqueness of the project lies in the fact that, on one hand, it suggests unified rules for the construction of the corporate tax base and allows for "one-stop-shop" in filling tax returns and consolidating profits and losses within the EU; on the other hand, it does not breach the national sovereignty of EU Member States to independently apply a corporate tax rate. The aim of the Commission was to reduce the compliance costs of taxation, to eliminate transfer pricing within the group of companies and to introduce the possibility of cross-border loss offsetting. This all should, according to the Commission, lead to fair tax competition and higher

[19]Commission, COM(2003) 726 final, "An Internal Market without company tax obstacles—achievements, ongoing initiatives and remaining challenges", at 24 November 2003.

[20]COM(2005) 702 final—Tackling the corporation tax obstacles of small and medium-sized enterprises in the Internal Market—outline of a possible Home State Taxation pilot scheme.

[21]Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121 final.

[22]P7_TA(2012)0135—European Parliament legislative resolution of 19 April 2012 on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM (2011)0121—C7-0092/2011—2011/0058(CNS)).

economic growth. Although the CCCTB proposal was considered a unique tool, since it composed the basic framework for the CCCTB's functioning in the European Union, it raised considerable discussion again. The implementation of the CCCTB is connected not only with grouping for taxation purposes and consolidation but also with the problem of the tax-sharing mechanism. In this respect, the directive proposal suggests the allocation formula through which the consolidated tax base should be shared among the members of the group based on micro factors. This new allocation rule would affect EU Member States' budgets,[23] and it therefore turned out to be the most difficult part of the negotiation of the CCCTB Directive. Consequently, the directive proposal was blocked by Member States as well as previous attempts to coordinate the corporate taxation systems of EU Member States.

However, as is obvious, the current rules for corporate taxation no longer fit the modern context. Current corporate tax systems applied within the European Union were conceived mostly in the 1930s, when cross-border transactions were limited and when business structures were not as complex and complicated. Moreover, the corporate income is taxed at the national level, and the economic environment and business models have become more globalized, mobile and digital. Therefore, profit shifting is performed more easily, and the divergence of national corporate tax systems has allowed aggressive tax planning.[24] The international tax rules and tax systems have shown to be inefficient and non-transparent, and they are not able to react to the sophisticated tax planning of companies. Further, the lack of harmonization has left space for companies to escape from taxation. In addition,

[23]This issue was a subject of many studies aimed at the simulation of budgetary impacts on individual EU Member States as well as on welfare and basic macroeconomic indicators e.g. Fuest, C., Hemmelgam, T., & Ramb, F. (2007). How would the introduction of an EU-wide formula apportionment affect the distribution and size of the corporate tax base? An analysis based on German multinationals. International Tax and Public Finance 14(5), 605–626. Van Der Horst, A., Bettendorf, L., & Rojas-Romagosa, H. (2007). Will corporate tax consolidation improve efficiency in the EU? CPB Documents 141, CPB Netherlands Bureau for Economic Policy Analysis. Devereux, M. & Loretz, S. (2008) Increased Efficiency through Consolidation and Formula Apportionment in the European Union? Oxford: Oxford University, Centre for Business Taxation. Working Paper No. 12. Cline, R. Neubig, T. Phillips, A., Sanger, C., & Walsh, A. (2010). Study on the economic and budgetary impact of the introduction of a Common Consolidated Corporate Tax Base in the European Union, Ernst & Young LLP., Domonkos, T., Domonkos, Š., Dolinajcová, M., Grisáková, N. (2013). Effect of the formulary apportionment of the Common Consolidated Corporate Tax Base on the tax revenue in the Slovak Republic. Ekonomický časopis 61(5): 453–467. Nerudová, D., Solilová, V. (2015a). The impact of the CCCTB introduction on the distribution of the group tax bases across the EU: The study for the Czech Republic. Prague Economic Papers 24(6): 621–637. Nerudová, D. & Solilová. (2015b). Quantification of the impact on the total corporate tax basis in the Czech Republic caused by the CCCTB implementation in EU28. Politická ekonomie 63(4), 456–773, and others.

[24]Aggressive tax planning consists in taking advantage of the technicalities of a tax system or of mismatches between two or more tax systems for the purpose of reducing tax liability. For more details see Commission Recommendation of 6th December 2012 on aggressive tax planning, COM(2012) 8806 final.

from the EU perspective, companies still face a very complex patchwork of 28 national systems with high compliance costs of taxation and risks of double taxation. Such mismatches create risks of double taxation and double non-taxation and thereby distort the functioning of the Internal Market. As shows the study by Dover et al. (2015), at present, the revenue losses for the European Union owing to the aggressive tax planning scheme are estimated at about EUR 50–70 billion per annum. The lack of coordinated action in this area forces Member States to adopt unilateral measures, which are ineffective.

To eliminate the gaps and mismatches in tax rules that allow firms to artificially shift profits to low or no-tax locations and to apply tax avoidance strategies, the OECD announced the Base Erosion and Profit Shifting (BEPS)[25] Action Plan in July 2013. Under the inclusive framework, over 100 countries and jurisdictions collaborate to implement the BEPS measures and tackle BEPS. Given the BEPS framework and Europe's priority to promote sustainable growth and investment within a fair and better integrated market, a new framework is needed for fair and efficient taxation of corporate profits. In this context, in June 2015, the European Commission introduced the Action Plan for Fair and Efficient Corporate Taxation,[26] announcing the following five key areas for action:

1. re-launching of the CCCTB system for the common corporate tax base (CCTB) system
2. ensuring fair taxation where profits are generated
3. creating a better business environment
4. increasing transparency
5. improving EU coordination, with aim to establish new approach to corporate taxation. This means that companies should pay taxes, where they generate profits; taxation should be more growth friendly and should not be compromised by tax competition in the area of mobile tax bases. The introduction of a preferential tax regime in one country should not lead to losses of revenues in another country, and there should not be the opportunity to shift profits outside the EU.

One of the main elements of the introduced Action Plan represents the re-launching of the Common Consolidated Corporate Tax Base. The revamped proposal of the C(C)CTB, taking into account the work done by the OECD in the BEPS project, could also address tax avoidance by closing regulatory gaps between national systems and thus ending common tax-avoidance arrangements. Therefore, the action plan identified the CCCTB as a potentially effective tool for making corporate taxation fairer and more efficient. However, being aware of the fact that the most discussed and explosive issue still represents the consolidation regime and mechanism for sharing of the tax base, the Commission suggested implementing

[25]For more details see http://www.oecd.org/tax/beps/beps-actions.htm

[26]A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, COM(2015) 302 final, at 17 June 2015.

the system through a step-by-step approach. First, to implement only mandatory common rules for the corporate tax base (hereinafter CCTB[27]) construction (i.e., unified rules for tax base construction), the full CCCTB[28] should be introduced only in a second step. Having in mind that the most attractive part of the project represented by the consolidation scheme remained missing in the first step, the Commission suggested as a temporary solution the introduction of the possibility of cross-border loss offsetting. Further, during the interim period between mandatory CCTB implementation and full CCCTB implementation, the Commission planned to introduce a set of measures for reducing profit shifting (mainly through transfer pricing). Globally, the Commission has considered the C(C)CTB proposal to be a directive against tax avoidance practices, as it includes most of the elements of the BEPS project and establishes a coordinated approach to implementing certain common minimum standards against tax avoidance in the EU.

Although the CCCTB represents a major reform proposal to address current challenges in the area of corporate income taxation, its negotiation in the Council will need time. Therefore, to address the most pressing issues, the Anti-Tax Avoidance Package was introduced in January 2016, including legally binding anti-avoidance measures to reduce aggressive tax planning, notably the Anti-Tax Avoidance Directive (hereinafter ATAD) proposal from 28 January 2016, which was adopted by the Council on 20 June 2016.[29] Very quick adoption of the directive among the Member States represents the willingness of Member States to create a minimum level of protection against corporate tax avoidance throughout the EU and to ensure a fairer and more stable environment for businesses. Currently, there are many loopholes stemming from the existence of 28 national corporate taxation systems, enabling multinational corporations to apply aggressive tax-planning techniques. The ATAD, with its five legally binding anti-abuse measures, namely, controlled foreign company (CFC) rules, switchover rules, exit taxation, interest limitations and general anti-abuse rules, represents a very important tool in the fight against common forms of aggressive tax planning, tax evasion and tax fraud within the EU.

The new C(C)CTB proposal falls within the ambit of the Commission's initiatives for fair, efficient and transparent taxation within the EU and represents a framework for the implementation of many of the new standards agreed upon through the OECD in the BEPS project. Moreover, the C(C)CTB should contribute to the elimination of obstacles that create distortions that impede the proper functioning the Internal Market. With a common tax base, all EU Member States would apply the same rules for tax base construction; therefore, structural

[27]Proposal for Council Directive on a Common Corporate Tax Base, COM(2016) 685 final, at 25 October, 2016.

[28]Proposal for Council Directive on a Common Consolidated Corporate Tax Base, COM(2016) 683 final, at 25 October 2016.

[29]The Directive (EU) 2016/1164 lays down rules against tax avoidance practices that directly affect the functioning of the internal market, known as ATAD. Member States should apply these measures as of 1 January 2019.

harmonization in the area of corporate taxation would be reached. This should help EU Member States in the fight against base erosion and profit shifting.

However, as was mentioned above, the negotiation of the directive proposal will need time as well as the unanimity of all Member States. In December 2016, the Council adopted its conclusion[30] on "building a fair, competitive and stable corporate tax system for the EU", where it welcomed further discussions on the C(C)CTB proposals and gave its support to the approach that the work on the CCTB should be a priority. Moreover, tax consolidation should be examined without delay once the discussion on CCTB has been concluded. Currently, the CCCTB proposal has been awaiting the committee's decision.[31]

6.2 Current Situation of Corporate Taxation in the EU

6.2.1 Separate Entity Approach Versus Single Entity Approach

The current situation in the area of corporate taxation in the European Union, where companies are facing 28 different corporate taxation systems, has two very important impacts. First, the loopholes between the national corporate taxation systems are often used by multinational groups for aggressive tax planning, resulting base erosion and profit shifting in the European Union. Second, they are increasing the compliance costs of taxation for both tax administration and companies themselves. The complexity of current taxation systems hinders the expansion of SMEs on foreign markets as mentioned by Chen et al. (2002) and Solilová and Nerudová (2016). Taking into account the fact that SMEs represent over 99% of all companies and two-thirds of total employment in the Internal Market (European Commission 2016e),[32] the European Commission has always aimed to structurally harmonize the area of corporate taxation, though with only very limited success.

With respect to the determination of corporate tax base of the group of multinational companies, there are two basic approaches: the *separate entity approach* and *single entity approach with an allocation mechanism*. The majority of Member States in the European Union tax the members of the group as separate entities, even though from an economic perspective, they are members of one group (Kumpf

[30]Communication from the Commission to the European Parliament and the Council: Building a fair, competitive and stable corporate tax system for the EU, COM(2016) 682 final, 25 October, 2016.

[31]For more details see EP Legislative Observatory, Procedure file on the common consolidated corporate tax base (CCCTB), 2016/0337(CNS). Available at: http://www.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2016/0336(CNS)&l=en

[32]European Commission. (2016). Annual Report on European SMEs 2015/2016, SME recovery continues. https://www.isme.ie/assets/Annual-Report-on-European-SMEs-2015-2016.pdf

1976). Moreover, each entity has to create an appropriate tax base in line with the arm's length principle[33]—i.e., group entities must be taxed as if they were dealing with independent parties, free from the conditions arising from their special relationship that may lead to a distortion of prices. In other words, the price has to be set as if the transaction were to be carried out between the independent companies. However, Jacobs (2011) underlines that the allocation of profits in line with this standard to the branch of the entity or associated entity, which is an independent company from a legal point of view, is sometimes complicated. Moreover, Solilová and Nerudová (2013) add that the changes in economic environment have forced governments and multinational entities (MNEs) to define the transfer prices more precisely; otherwise, the tax administration can adjust the tax base of the entity to better reflect the open market conditions (Picciotto 1992), with an impact on taxable profits, tax revenues of Member States and compliance costs of taxation overall. Further, during the last decade and mainly in connection with the BEPS project, the question whether the allocation of tax revenues between Member States on the basis of the arm's length principle and separate accounting (separate entity approach) can be still considered to be the most appropriate method within the EU arose. The current implementation of the arm's length standard, which was first introduced during the 1930s,[34] does not reflect the current economic realities of integrated multinational enterprises and markets, the digital environment and an environment dependent on intangibles. In this respect, Gammie (2003) underlines that a higher degree of integration for businesses makes the arm's length fiction appear increasingly artificial. Hence, the arm's length standard is not sufficient to prevent profit shifting through the manipulation of transfer prices, which is now resolved through the BEPS recommendation. Sullivan (2002, 2004) adds that a large part of opportunities for tax avoidance exist under the current international separate entity approach and arm's length standard.

A second approach to the calculation of the tax base of the groups is a single entity approach with an allocation mechanism. Under this principle, all group members are treated as one single entity, i.e., all operations except those involved in the intra-group transactions of the individual members of the group are integrated into the single unit. Further, this approach is usually related to the minimal threshold of common stock ownership. Another element connected to the single entity approach is the allocation mechanism. As mentioned by Weiner (1999) and Weiner and Mintz (2002), the application of such a system requires the establishment of mechanisms for sharing the tax base between jurisdictions in which the members of the group are residents. The taxation theory offers several mechanisms for the sharing of the tax base. Some have already been implemented, e.g., in the

[33]The arm's length standard is mentioned in Article 9 of the OECD Model Convention, and its practical application is followed by OECD TP Guidelines published in 1995, last update 2017. For more details about the arm's length principle, OECD TP Guidelines and transfer pricing rules, see Chap. 2.

[34]The arm's length principle was implemented in the U.S.-France treaty in 1932 for the first time.

USA and Canada. Generally, allocation mechanisms can be distinguished into two groups: the first group is based on macrofactors (usually aggregated at the national level—i.e., GDP or national VAT tax base), and the second group is based on microfactors (i.e., Value Added or selected indicators from the financial statements of the entities). Lodin and Gammie (2001) add that the selection of the individual method of formulary apportionment, as well as the selection of factors, significantly influences the size of the allocated group tax base. McDaniel (1994) underlines that the allocation mechanism is based on different assumptions from those of the separate entity approach; therefore, it has different economic impacts and generates different technical problems. Moreover, the OECD TP Guidelines[35] clearly reject the application of global formulary apportionment as a method for allocating profits between associated entities and consider it to be a non-arm's length approach. In contrast, some authors prefer and support the introduction of formulary apportionment, as it takes into account the economic reality of integrated entities and markets; it is not such a compliance burden, and it is more stable against international tax avoidance (Miller 1995; McIntyre 2003; Harvard 1976; Mintz and Smart 2004; Obermair and Weninger 2008, and others). Contrary to the separate entity approach, formulary apportionment is able to eliminate some of the most common methods of profit shifting.

Formulary apportionment represents the tool traditionally used for tax base sharing in the USA and Canada. The history of formulary apportionment in the USA dates back to the 1870s, where it had been first applied in the area of property taxation. As mentioned in the literature (Weiner 2005), instead of measuring a company's property in an individual state, companies measured their property, and the tax base was distributed to individual states based on the share in railways in each individual state. For income taxation purposes, the formulary apportionment was first applied in Wisconsin. At the end of the 1930s, nearly all states in the USA had already applied the three-factor formula with equally weighted factors. This formula is known as the Massachusetts Formula in taxation theory, and it can be expressed as Eq. (6.1).

$$P_i = P_t\left(\frac{1C_i}{3C_t} + \frac{1L_i}{3L_t} + \frac{1S_i}{3S_t}\right) \tag{6.1}$$

where P_i represents the profit allocated to state i, P_t is the profit of the companies, C stands for capital and S represent sales. As mentioned in the literature (Mayer 2009), since the 1980s, states have moved from equally weighted factors to the allocation formulae, where higher weight is put on the sales factor, while the weight in the case of payroll and capital has been decreased.

The development of allocation mechanisms in Canada has been slightly different from its development in the USA. As mentioned by Weiner (2005), originally, the allocation rules allocated income to the state where the permanent establishment of

[35]OECD TP Guidelines, part C, notably para 1.32, 2017.

the company was situated. If the company possessed a permanent establishment in more provinces, income was allocated based on the company's accounting or according to the share of the permanent establishment in the total income of the company. As mentioned in the literature (Mintz 2004), while this system was widely criticized, the discussion of the possible implementation of the US model raised fears that it could allocate too much income to exporting provinces. Therefore, the formulary apportionment was modified to a two-factor formula with equally weighted factors. The Canadian formula can be expressed as Eq. (6.2).

$$P_i = P_t \left(\frac{1GI_i}{2GI_t} + \frac{1L_i}{2L_t} \right) \tag{6.2}$$

where P_i represents the profit allocated to province i, P_t is the profit of the companies, GIt represents the gross income of the company, and L is labour. The main difference between the US formulary apportionment and the Canadian formulary apportionment lies in the fact that federal allocation rules comprise specific rules for specific industry sectors—e.g., the insurance industry or road transportation.

According to Petutschnig (2010), the most-used factors represent payroll, capital and sales. These factors are used in the allocation formulae in different combinations and with different weights. The key element of the CCCTB proposal[36] is formulary apportionment based on the microfactors that comprise three equally weighted factors—sales, labour and assets—as can be seen in Eq. (6.3).

$$ShareX = \left(\frac{1}{3}\frac{S^X}{S^{group}} + \frac{1}{3}\left(\frac{1}{2}\frac{P^X}{P^{Group}} + \frac{1}{2}\frac{E^X}{E^{Group}} \right) + \frac{1}{3}\frac{A^X}{A^{Group}} \right) \times CCCTB \tag{6.3}$$

where S represents the sales of goods and services, P is payroll (comprising wages and salaries, bonuses and other compensation), E represents the number of employees (employed for the period of 3 months at least) and A denotes assets (including fixed assets, buildings, aircraft, boats and machines).

The tax sharing mechanism in the conditions of the EU based on the CCCTB proposal has been extensively discussed in literature. McLure (1997), Hellerstein and McLure (2004) recommend learning from the US and Canadian experience with formulary apportionment. Weiner (2005) and Mintz (2004) also stipulate several problems from the US and Canadian experience that may be useful for EU corporate taxation. The problem with the sharing mechanism within the EU and possible proposals has been also discussed by Sorensen (2004), Devereux (2004) and Agúndez-García (2006). Other authors, such as Lodin and Gammie (2001), have focused on value added-based apportionment.

[36]Proposal for Council Directive on a Common Consolidated Corporate Tax Base, COM(2016) 683 final, at 25 October 2016.

6.2.2 *Corporate Taxation Systems Within the EU*

Corporate taxation systems applied throughout the European Union can be categorized into four basic groups according to the consolidation method or the rules for the group taxation. Table 6.1 presents the classification.

As is obvious from Table 6.1, the only country applying a *full consolidation system* (i.e., where the group is treated as one single entity) is the *Netherlands*. Since January 2013, if a resident company directly or indirectly holds at least 95% of the share capital and the voting rights of one or more other resident companies, upon a joint request, these companies can apply a system of fiscal unity.

The second group is represented by the corporate tax systems of nine EU Member States, under which each group member computes taxable income separately and the total is accumulated by the parent company. This system is called *pooling*. In *Denmark,* resident-group related subsidiaries of non-resident companies may apply for international consolidation, which means that either all group entities (both resident and non-resident) are included in the tax consolidation scheme or none of them are. Under this scheme, losses of one company are currently set off against the profits of the other companies. *Spain* defines a group for consolidation purposes as a resident parent company and subsidiaries owned 75% or more (directly or indirectly) by the parent company. *Germany* allows a group of different legal entities to form one single unit for tax purposes. The profits are pooled in the hands of a controlling company—i.e., losses are set off against the profits realized within the group. *France* allows companies to apply a group tax regime (tax consolidation) for the income and losses of resident companies within the group (the threshold is set at 95%). Income and losses may be aggregated and taxed in the hands of the parent company of the group. *Italy* enables two types of consolidation—domestic and worldwide. The group may enter into the system only when consolidation covers all controlled companies. The effect of the worldwide consolidation is that the income of the controlled companies is imputed to the controlling company in proportion to its profit entitlement of the other resident controlled companies. The threshold for fiscal consolidation in *Luxembourg* is set at 95%.

Table 6.1 Consolidation regimes in the European Union (IBFD research platform 2016)

Type of consolidation regime	Country
Full consolidation	Netherlands
Pooling	Denmark, Germany, Spain, France, Italy, Luxembourg, Austria, Poland, Portugal
Intra-group loss transfer	Ireland, Cyprus, Malta, Sweden,[a] Finland,[a] United Kingdom, Lithuania[b]
Group taxation scheme not available	Belgium, Bulgaria, Croatia, Czech Republic, Greece, Hungary, Slovak Republic, Latvia, Estonia, Romania, Slovenia

[a]Group contributions

[b]Lithuania introduced intra-group loss transfer in 2016, before that group taxation scheme was not available

Fiscal consolidation means that the taxable income or loss of the subsidiary is added to the taxable income of the parent company, which is taxed on the aggregate taxable income. In *Austria*, parent companies and their subsidiaries may opt for consolidated income taxation if the parent exercises financial control over the subsidiary, which is presumed if the parent owns 50% of the capital and voting power in the subsidiary. In *Poland*, the parent company must own 95% of the shares of the subsidiaries to form a tax group. The taxable base of the tax group represents the difference between the aggregated profits and aggregated losses of all companies. The threshold for creating a qualifying group of companies, which may elect to be taxed under a special regime for group tax treatment, is set at 75% in *Portugal*. Under the group regime, all profits and losses of each member of the group are pooled.

Third group includes six countries. Under *intra-group loss transfer*, group members may transfer losses to a profitable member of the group for immediate offset. However, *Sweden* and *Finland* apply intra-group loss transfer through group contributions. These payments constitute taxable income for the recipient and tax-deductible costs for the payer, which means that the offset of the loss is connected with cash flow. *Ireland* distinguishes types of groups according to the ownership level. Losses can be transferred only when a consortium exists, which is defined as five of fewer companies owning at least 75% of the ordinary share of capital of a trading company or holding company with 90% of subsidiaries in Ireland or in the EU. *Cyprus* allows offsetting of group losses, provided that there is a 75% parent-subsidiary relationship. *Malta* is a country with the lowest threshold for creating a group for taxation purposes. It is set at 51%. The *United Kingdom* enables a transfer of losses only when consortia consist of 20 or fewer resident companies, which together own 75% of a company.

The fourth group covers the majority of EU Member States, where *offsetting of losses or group taxation schemes are not available* to businesses. In this case, the mandatory introduction of the C(C)CTB system within EU will change the amount of the tax base in each jurisdiction owing to the possibility of tax consolidation or the possibility of cross-border loss offsetting.

6.2.3 Cross-Border Loss Offsetting

As already indicated, as compensation for the lack of a consolidation possibility in the first C(C)CTB implementation step, the EU Commission suggests the possibility of cross-border loss offsetting with recapture. Based on this, the parent company in one Member State will be able to receive temporary tax relief for the losses of the subsidiary in other Member States. This proposal is similar to the previous directive proposals on the carry-over of losses and consolidation of foreign branch/subsidiary losses during 1984/1985 and 1990. Through the re-launching of the cross-border loss offsetting, the European Commission aims to eliminate another obstacle to the functioning of the Internal Market.

Table 6.2 The application of domestic and cross-border loss relief (IBFD tax research platform 2016)

Type of the loss relief	Domestic loss relief	Cross-border loss relief
Within one company ("permanent establishment")	Automatically available in all 28 member states	Available in most cases
		Belgium, Bulgaria, Czech Republic, Netherlands, Austria, Portugal, Romania, Slovenia, Slovak Republic, Finland, Sweden, United Kingdom, Ireland, Italy, Croatia, Cyprus, Latvia, Lithuania, Luxembourg, Malta
Within a group of companies ("parent and subsidiary")	Available under specific rules in most member states	In principle not available, with very few exceptions
	Denmark, Germany, Spain, France, Ireland, Italy, Cyprus, Malta, Lithuania, Luxembourg, Netherlands, Austria, Poland, Portugal, Finland, Sweden, United Kingdom	Cyprus, Denmark, France, Italy, Lithuania, Luxembourg, Austria

In theory on loss relief, two basic models can be identified. The main characteristic of the first model is that *loss is offset within one company* (i.e., losses incurred by a branch or permanent establishment). The second model represents the situation when the *loss is offset in the group of companies* (parent and subsidiary). Both of the above-mentioned models allow loss offsetting either within one state (domestic relief of loss) or across borders. While the domestic relief of loss within one company and even within the group is commonly implemented in all EU Member States,[37] cross-border loss relief in case of the group of companies is very rare and causes substantial obstacles in cross-border business on the Internal Market. The situation is displayed in Table 6.2.

As is obvious from the above table, cross-border offset of losses between the parent and subsidiary company is possible only in seven EU Member States. This is perceived by the companies taking part in cross-border situations as an obstacle of prohibitive character that sometimes discourages companies from the cross-border business, not only in case of SMEs, but also in case of LEs. Basically, the losses are usually incurred by subsidiaries during the first years after establishment. In contrast to domestic losses, foreign losses cannot be offset against the profit of the parent in 21 EU Member States. There is also another aspect: when the subsidiary incurs losses every year and the parent in a different EU Member State always runs a profit, those losses cannot be offset as well. The first stage of C(C)CTB implementation (i.e., CCTB implementation with the indicated temporary cross-border loss offset regime) should address the above-stated issue.

[37]Based on the European Commission (2006), domestic relief within one company is available in all EU25. Currently, in 2016 in all EU Member States.

Table 6.3 Methods of cross-border loss relief used by member states that allow cross-border loss relief (IBFD tax research platform 2016)

Member state	Method of cross-border relief
Cyprus	Loss-offset only within the EU[a]
Denmark	System of consolidated profits
France	System of consolidated profits
Italy	System of consolidated profits
Luxembourg	System of consolidated profits
Lithuania[b]	Deduction (Transfer)
Austria	Deduction (Recapture)

[a]Under special conditions since 1 January 2015
[b]Cross-border loss relief is available since 2016

The European Commission (2006) mentions that the Member States that allow cross-border loss relief apply different methods than from those in the case of domestic relief. It would not be possible to apply the rules for domestic loss relief in cross-border situations, as they are not able to cover the needs of the cross-border situation. The methods used by Denmark, Italy, France, Cyprus, Lithuania, Luxembourg and Austria for cross-border loss reliefs are stated in Table 6.3.

According to the *system of consolidated* profit in tax theory, profits and losses in a given tax year for selected or all group members are taken into account over a certain period of time at the level of the parent company. The system is designed as a comprehensive scheme, since it includes all subsidiaries of the group. The economic result of the group is taxed in the country, where the parent company is a resident. This is very often connected with the compliance costs of taxation, as all income of the group members has to be recalculated according to the rules valid in the state where the parent company is resident. Moreover, as is obvious from Table 6.3, only Austria applies the *deduction (recapture) method*. Under this system, losses incurred by the subsidiary situated in another EU Member State, which were deducted from the results of the parent company, are subsequently recaptured when the subsidiary starts to run a profit. A similar system is suggested by the European Commission as a temporary solution, which would partially replace the consolidation regime, without the newly re-launched CCTB rules. Under suggested system, with respect to the scheme of temporary loss transfer (deduction/recapture), a loss incurred by a subsidiary situated in another Member State, which was deducted from the results of the parent company, is subsequently recaptured once the subsidiary returns to profitability. Such a system is relatively easy to operate. The losses are deducted at first and later, when the subsidiary returns to profit, the previous deducted loss is recaptured through a corresponding additional tax burden at the level of the parent company. In addition, Lithuania has also applied deduction method in the form of intra-group loss transfer, however, without recapture mechanism since 2016.

In case of the domestic loss relief within a group of companies, three models[38] applied within the European Union can be identified, as mention in Nerudová and Solilová (2015a, b). First, the model of *intra-group relief of loss* enables one group member to transfer its loss to a profitable group member. Under an intra-group contribution system, the profits from one group member can be transferred to a loss-making group member. In fact, the intra-group contribution system is used to eliminate losses; therefore, it has the same economic effect as system of intra-group loss transfer. The second applied model is the *pooling system*. It allows companies to aggregate all individual tax results (profit and losses) from the members of the group at the level of the parent company. The last model applied within the European Union is represented by *full tax consolidation*. This system goes far beyond the pooling system, since for tax purposes, the legal personality of the group members and any intra-group transactions are disregarded. The result of the group is determined on the basis of single profit and loss accounts.

6.3 Proposal of the CCTB Directive

The European Commission, in its Action Plan of June 2015, advocated a step-by-step approach to the C(C)CTB. First, after the implementation of a mandatory rule for CCTB[39] construction, only then, in a second step, should the full CCCTB[40] be introduced. The CCTB proposal is consistent with other Union policies and falls within the ambit of Article 115 of the Treaty on the Functioning of the EU. Further, it does not restrict Member State's sovereignty to determine their desired amount of tax revenues in order to meet their budgetary policy targets, and it does not affect Member State's right to set their own corporate tax rates. The CCTB proposal sets only unified rules for tax base construction and anti-avoidance rules to combat aggressive tax planning. Hence, companies still have to determine a corporate tax obligation and file a separate tax return in all Member States where they have a taxable presence. The following section will focus only on the basic rules and provisions that are the key elements of the CCTB proposal.

The determination of *tax base* is set in Article 7–10 as revenues less exempt revenues, deductible expenses and other deductible items. Thus, the tax base is designed very broadly. Taxable revenues will be reduced by following *exempt revenues* classified in Article 8 of the CCTB proposal as follows:

- subsidies directly link to the acquisition, construction or improvement of fixed assets that are subject to depreciation

[38]Their application within the EU is described in Sect. 6.2.

[39]Proposal for Council Directive on a Common Corporate Tax Base, COM(2016) 685 final, at 25 October, 2016.

[40]Proposal for Council Directive on a Common Consolidated Corporate Tax Base, COM(2016) 683 final, at 25 October 2016.

- proceeds from the disposal of pooled assets
- proceeds from the disposal of shares, provided that the taxpayer has maintained a minimum holding of 10% of capital or 10% of the voting rights during the 12 months preceding the disposal
- proceeds from received profit distributions, provided that the taxpayer has maintained a minimum holding of 10% of capital or 10% of the voting rights for 12 consecutive months
- income of a permanent establishment received by the taxpayer in the residence state.

Expenses are deductible only to the extent that they are incurred in the direct business interest of the taxpayer, such as all costs of sales and all expenses, net of deductible value added tax, including costs for research and development, gifts and donations to charitable bodies and costs incurred in raising equity or debt for the purposes of the business.

To support innovation in the economy, the CCTB proposal introduces a *super-deduction for R&D*.[41] According to Article 9, R&D costs will be fully expensed in the year incurred (with the exception of the situation, when immovable property was purchased or produced). Further, the taxpayer may also deduct, per tax year, additional extra-deduction for R&D, particularly with respect to the following:

- 25% of R&D costs—if R&D costs reach EUR 20 million, the taxpayer may deduct 25% of the exceeding amount
- 50% of the R&D costs—for R&D costs up to EUR 20 million, each tax year, the taxpayer may deduct 50% of the R&D costs incurred in that year, excluding cost related to movable tangible fixed assets
- 100% the R&D costs—for R&D costs up to EUR 20 million, the taxpayer may take an extra super-deduction of 100% of R&D provided that taxpayer meets all of the following conditions:
  - is an unlisted enterprise
  - has fewer than 50 employees
  - has an annual turnover and/or annual balance sheet total not exceeding EUR 10 million
  - has not been registered for longer than 5 years
  - has not been formed through a merger
  - does not have any associated enterprises.

[41] R&D is defined in Article 4(11) CCTB proposal as basic research (experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying foundations of phenomena and observable facts, without any particular application or use in view), applied research (original investigation undertaken in order to acquire new knowledge but directed primarily towards a specific, practical aim or objective) and experimental development (systematic work, drawing on knowledge gained from research and practical experience and producing additional knowledge, which is directed to producing new products or processes or to improving existing products or processes.

> This provision is aimed at SMEs, small and innovative entrepreneurship and small start-up enterprises to support the key policy initiatives relating to the functioning of the Single Market. Further, it is considered to be one of the motivations for entering into the CCTB system.

Other deductible items cover the *depreciation of fixed assets* referred to in Articles 30 and 40 of the CCTB proposal, which can be individually depreciated or depreciated together in one asset pool at an annual rate of 25% of the depreciated base.[42]

The CCTB proposal also defines *non-deductible items*[43] in Article 12, including the following:

1. profit distributions and repayments of equity or debt
2. 50% of entertainment costs
3. the transfer of retained earnings to a reserve that forms part of the equity of the company
4. corporate tax and similar taxes on profits
5. bribes and other illegal payments
6. fines and penalties, including charges for late payment
7. expenses incurred by a company for the purpose of deriving income that is exempt
8. gifts and donations other than those referred to in Article 9(4)
9. acquisition or construction costs or costs connected with the improvement of fixed assets that are deductible
10. losses incurred by a permanent establishment in a third country.

Having in mind that the most attractive part represented by the consolidation scheme is missing in the first step, the CCTB proposal introduces cross-border loss offsetting, which should eliminate the current distortion of Internal Market as only 7 Member States allow cross-border loss relief. The provision allowing *cross-border loss relief* is mentioned in Article 42 of the CCTB proposal. On this basis, losses incurred by an immediate or lower-tier subsidiary (i.e., in which the parent company holds more than 50% of the voting rights and has an ownership right amounting to more than 75% of the subsidiary's capital or owns more than 75% of the rights giving entitlement to profit—so-called qualifying subsidiary) or permanent establishment situated in other Member States may be carried forward and deducted in subsequent tax years. Further, Articles 42 and 43 stipulate conditions where it is possible to make a cross-border loss relief:

- a reduction of the tax base as a result of considering losses from previous tax years shall not result in a negative amount

[42]For more details see Article 33 and 37 of CCTB proposal.

[43]For more details see Article 12 of CCTB proposal.

- a resident taxpayer has to first deduct its own losses and then losses incurred by its immediate qualifying subsidiaries or by permanent establishment(s) situated in other Member States
- the oldest losses shall be deducted first
- no cascade effect is allowed
- loss relief shall be in proportion to the holding of the resident taxpayer in its qualifying subsidiaries and full for permanent establishment.

This relief will be temporary since the parent company (a resident taxpayer) will add back to its tax base, considering the amount of losses previously deducted, any subsequent profits made by its immediate subsidiaries or permanent establishments. Furthermore, if the incorporation does not occur within a certain number of years, the deducted losses will be reincorporated automatically anyway.

As one of the objectives of CCTB proposal is to establish a corporate tax system that facilitates cross-border trade and investments and that improves the functioning of the Internal Market, the proposal also introduces the *allowance for growth and investment* granting deductions for financing costs of debt and equity within limits to avoid abuse and tax planning. According to the Article 11 of the CCTB proposal, taxpayers will be given an allowance for growth and investment according to which increases in their equity will be deductible from their taxable base subject to certain conditions, such as measures against potential cascading effects and anti-tax avoidance rules.

As its second aim—anti-tax avoidance function—the CCTB proposal includes provisions related to interest limitation, exit taxation, a general anti-abuse rule (GAAR), a switch-over clause, controlled foreign company legislation (CFC) and hybrid mismatch rules. Through these rules, profits should be taxed in place of "real economic activities", which should combat aggressive tax planning.

Interest limitation rules mentioned in Article 13 of CCTB limit the deductibility of interest (and other financial) costs, in order to discourage practices of profit shifting towards low-tax countries. The rule aims to allow the full deductibility of interest (and other financial) costs to the extent that they can be offset against taxable interest (and other financial) revenues. Any surplus of interest costs will be subject to deductibility restrictions, as determined with reference to a taxpayer's taxable earnings before interest, tax, depreciation and amortization (EBITDA), particularly up to 30% of EBITDA or up to EUR 3 million, whichever limit is higher. The interest limitation shall not apply to financial undertakings, including those that are part of a consolidated group for financial accounting purposes.

Exit taxation mentioned in Article 29 of the CCTB proposal refers to the rule within the ATAD and ensures the taxation of the economic value of any capital gain created in Member States even though such a gain has not yet been realized at the time of the exit. The main objective is to prevent an arrangement whereby assets expected to generate high income are moved to low-tax jurisdictions for the purpose of being sold later and realizing capital gains that would be taxed at a low rate. Based on Article 29, exit taxation is applied on accrued increases in value upon the transfer of the following:

- assets from its head office to its permanent establishment in another Member State or in a third country
- assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country, to the extent that, owing to the transfer, the Member State of the permanent establishment no longer has the right to tax the transferred assets
- tax residence to another Member State or to a third country, except for those assets that remain effectively connected to a permanent establishment in the first Member State
- business carried out by its permanent establishment from a Member State to another Member State or to a third country, to the extent that, owing to the transfer, the Member State of the permanent establishment no longer has the right to tax the transferred assets.

The *GAARs*[44] mentioned in Article 58 of the CCTB proposal are set in line with the text featured in the ATAD. Specifically, arrangements or a series thereof having been put in place for the essential purpose of obtaining a tax advantage that defeats the object or purpose of the CCTB Directive should be considered, for the purpose of calculating the tax base, with reference to their economic substance. Further, it must be noted that GAARs in the CCTB proposal constitute absolute rules, contrary to the GAARs introduced in the ATAD Directive as a minimum level of protection. Moreover, to prevent discriminatory situations, it will be critical to ensure in practice that the GAARs apply to domestic situations, within the Union and vis-à-vis third countries in a uniform manner, so that their scope and results of application in domestic and cross-border situations do not differ.

The *Switch-over Clause* mentioned in Article 53 of the CCTB proposal is targeted at certain types of income originating in a third country; therefore, intra-EU situations are exempted from this rule. The aim of switch-over clause is to ensure that income is taxable in the European Union if it was taxed below a certain level in the third country. Specifically, a third country entity is subject, in its residence state, to a statutory corporate tax rate that is lower than half of the statutory tax rate that the taxpayer would have been subject to, in connection with such foreign income, in the Member State of its residence for tax purposes. In addition, if the switch-over clause is applied, a deduction of the tax paid in the third country shall be applied from its tax liability in the Member State where it is a resident for tax purposes. It must be underlined that the deduction shall not exceed the amount of tax, as computed before the deduction, which is attributable to the income that may be taxed.

Provisions related to the *CFC rules* are mentioned in Articles 59 (controlled foreign companies) and 60 (computation of the income of a controlled foreign company) of the CCTB proposal. They are in line the with ATAD and have the

[44]Generally, GAARs ensure that tax avoidance strategies that were not envisaged by the legislator can be addressed, by granting the authorities the power to deny taxpayers the benefit of aggressive tax-planning arrangements.

effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company in an effort to discourage profit shifting (i.e., to ensure that profits parked in low or no tax countries are effectively taxed in the European Union). Moreover, CFC rules extend to the profits of permanent establishments where those profits are not subject to tax or are tax exempt in the Member State of the taxpayer.[45]

With respect to the *hybrid mismatches*[46] mentioned in Article 61 of the CCTB proposal, hybrid mismatches should normally occur within the framework of the common base and national or third-country corporate tax systems. The CCTB lays down rules whereby one of the two jurisdictions in a mismatch deny the deduction of a payment or ensures that the corresponding income is included in the common base.

To sum, the CCTB proposal with respect to the first step aims to ensure the common rules for calculating the corporate tax base in the European Union, including certain provisions against tax avoidance. The initiative directly effects companies[47] falling under the mandatory scope, but there is also possibility for other companies to opt for the CCTB. However, all entities participating in CCTB system will subsequently participate in the CCCTB system. One of the motivations for entering into the system is a super-deduction of R&D costs as well as the possibility of cross-border loss relief. All these actions should bring economic benefits at least in the form of an increase in investment and employment of up to 3.6% and 0.5%, respectively in accordance with the impact assessment (2016).[48] In addition, the introduction of CCTB would, on average, save approximately 10% in compliance time and about 2.5% in compliance costs. However, about 60% of compliance costs remain unchanged, as they are related to transfer pricing, whose elimination is expected under the CCCTB regime through the second-step approach.

[45]For more details see Article 59 of CCTB proposal.

[46]Hybrid mismatches arise from differences in the legal characterisation of payments (financial instruments) or entities in different jurisdictions.

[47]It means a company meets all of the following conditions:

1. it takes one of the company forms listed in Annex I of CCT proposal;
2. it is subject to one of the corporate taxes listed in Annex II of CCTB proposal or to a similar tax subsequently introduced;
3. it belongs to a consolidated group for financial accounting purposes with a total consolidated group revenue that exceeded EUR 750,000,000 during the financial year preceding the relevant financial year;
4. it qualifies as a parent company or qualifying subsidiary and/or has one or more permanent establishment in other Member States.

[48]Commission staff working document, impact assessment, SWD(2016) 341 final.

6.4 Proposal of the CCCTB Directive

In the second step, after the approval of the CCTB Directive, tax consolidation covered in the proposal of the CCCTB Directive should be examined and discussed without delay. The CCCTB proposal, like the previous CCTB proposal, is consistent with other Union policies and falls within the ambit of Article 115 of the Treaty on the Functioning of the EU. Further, it does not restrict Member States' sovereignty to determine their desired amount of tax revenues in order to meet their budgetary policy targets, and it does not affect Member States' right to set their own corporate tax rates.

The following part will focus only on the basic rules and provisions that are the key elements of the CCCTB proposal. The CCCTB proposal provides a single set of rules for the determination of the consolidated corporate tax base via an apportionment formula, i.e., companies operating across borders in the EU would add up all profits and losses to determine their consolidated taxable profit and then shared it between the Member States according to an apportionment formula. On this basis, these companies would therefore no longer have to deal with 28 different set of national rules when calculating their taxable profits. Moreover, under the CCCTB, companies would be accountable to a single tax administration, the so-called "one-stop-shop".

The CCCTB proposal suggests making the tax system compulsory only for a subset of firms, based on their size. Thus, micro-enterprises and SMEs are exempted from the mandatory application of the CCCTB. According to Article 2 of the CCCTB proposal, *mandatory application* is set for groups with a consolidated turnover above EUR 750 million. This threshold is coherent with the approach taken in the other EU initiatives to counter tax avoidance. However, the CCCTB proposal also suggests the possibility to opt into the CCCTB system and benefit from the advantages of this system. Further, based on Article 5 of the CCCTB proposal, *eligibility for the consolidated tax group* will be determined in accordance with a two-part test based on (1) control (more than 50% of voting rights) and (2) ownership (more than 75% of capital) or rights to profits (more than 75% of rights giving entitlement to profit). The two-part test shall be met throughout the tax year; otherwise, the failing company will have to leave the group immediately. In addition, the threshold must be met for at least nine consecutive months for establishing group membership in order to prevent a manipulation of the tax results through companies entering and leaving the group in the short term.

The key element of the CCCTB proposal is the apportionment of the positive common consolidated corporate tax base, via an *apportionment formula*, which consists of three equally weighted factors: (1) a company's assets in the Member State, (2) the company's labour in the Member State, and (3) the company's sales in the Member State, as can be seen in Eq. (6.4).

$$ShareX = \left(\frac{1}{3}\frac{S^X}{S^{group}} + \frac{1}{3}\left(\frac{1}{2}\frac{P^X}{P^{Group}} + \frac{1}{2}\frac{E^X}{E^{Group}}\right) + \frac{1}{3}\frac{A^X}{A^{Group}}\right) \times CCCTB \qquad (6.4)$$

where S represents the sales of goods and services by destination, P is payroll (comprising wages and salaries, bonuses and other compensation), E represents the number of employees (employed for at least a period of 3 months) and A denotes assets (including fixed assets, buildings, aircraft, boats and machines). The choice of a three-factor formula is based on the extensive analysis conducted by the CCCTB Working Groups,[49] academic experts and stakeholders, which proved that the three-factor formula best fulfils the principles that have guided the design of the sharing mechanism. Moreover, the choice of three factors stems from the need to reflect both the state of production (i.e., supply side, measured by assets and/or labour payroll) and the state of demand (i.e., sales to destination) to describe the economic activity properly. Thus, this combination of factors should reflect a balanced approach to distributing taxable profits among eligible Member States and ensure that profits are taxed where they are actually earned.

With regard to individual factors of an apportionment formula, the CCCTB proposal sets different rules for their composition. To account for differences in the levels of wages across the European Union and thus allow for a fair distribution of the consolidated tax base, the *labour factor* is subdivided into two equally weighed components: payroll and number of employees as measured by year. Moreover, in accordance with Article 32 of the CCCTB proposal, where an individual employee is included in the labour factor of a group member, the payroll relating to that employee is allocated to the labour factor of the same group member. Pursuant to Articles 34 and 35 of the CCCTB proposal, the *asset factor* will consist of all fixed tangible assets owned, rented or leased by a group member, which are allocated to the economic owner or to the legal owner if the economic owner is not identifiable. Intangibles and financial assets are excluded from the formula owing to their mobile nature and the risks of circumventing the system. In accordance with Articles 37 and 38 of the CCCTB proposal, the *sales factor* consists of the proceeds from the total sale of goods and supplies of services of a group member, including permanent establishment, after discounts and returns, excluding value added tax, other taxes and duties. Exempt revenues, interest, dividends, royalties and proceeds from the disposal of fixed assets shall not be included in the sales factor, unless they are revenues earned in the ordinary course of trade or business. Intra-group sales of goods and supplies of services are excluded from the sales factor. The sales factor is attributed to group members on a “destination” basis, i.e., where the dispatch or transport of the goods to the person acquiring them ends. In case of the supply of services, they shall be included in the

[49]The results of CCCTB Working Group can be found at the following web-page: http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_3831_en.htm and http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_4381_en.htm

sales factor of the group members located in the Member State where the services are physically carried out or actually supplied.

Furthermore, the CCCTB proposal includes special apportionment rules[50] for four industry sectors (financial institutions,[51] insurance undertakings, oil and gas,[52] and transportation[53]), as the general scheme of the formulary apportionment cannot address the specificities of those types of industries and in order to better fit the needs of those sectors.

To sum up, the CCCTB apportionment mechanism constitutes a comparable system to what has been used in Canada and the US,[54] which is presented by a uniform formula and equally weighted factors, by the exclusion of intangible assets and the provision of sector-specific formulae.

With respect to *administrative procedures*, groups will deal with a single tax administration through the principal tax authority[55] in the EU. This system is called "one-stop-shop", which is considered to be one of the benefits of the CCCTB system. However, it is essential to lay down common procedural rules for its administration. After that, this approach should decrease compliance with taxation. Regarding audits, they should be conducted in accordance with the national legislation of the Member State in which they are carried out, but audits should be initiated and coordinated by the principal tax authority. Based on the CCCTB proposal, an audit may also be initiated at the request of a competent authority of Member States. Further, if disputes between taxpayers and tax authorities arise, they should be dealt with by an administrative body in the first instance, in order to reduce the number of cases that reach the courts. This body should be structured and operated in accordance with the law of the Member State of the principal tax authority and the body should be competent to hear appeals in the first instance.[56]

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[50]For more details see Article 40–43 of CCCTB proposal.

[51]Financial institutions and insurance undertakings have different approaches to the calculation of assets and sales factors; for more details, see Articles 40 and 41 of the CCCTB proposal.

[52]Based on the Article 42 of the CCCTB proposal, sales of a group member conducting its principal business in the field of the exploration or production of oil or gas shall be attributed to the group member in the Member State where the oil or gas is to be extracted or produced.

[53]In accordance with the Article 43 of CCCTB proposal, the revenues, expenses and other deductible items of a group member whose principal business is the operation of ships or aircraft in international traffic or the operation of boats engaged in inland waterways transport shall be excluded from the consolidated tax base and not be apportioned. Instead, those revenues, expenses and other deductible items shall be attributed to that group member on a transaction-by-transaction basis.

[54]For more details see Sect. 6.2.

[55]In accordance with Article 3(27) the principal tax authority means the competent authority of the Member State in which the principal taxpayer is resident for tax purposes or, where it concerns a permanent establishment of a non-resident taxpayer, the Member State in which that permanent establishment is situated.

[56]For more details about appeals see Article 60–62 of CCCTB proposal.

To sum up the CCCTB proposal, this system brings benefits in the form of a single set of corporate tax rules with a consolidation of corporate tax base,[57] which will be allocated through formulary apportionment. Another important benefit is the administration of a corporate tax system via a one-stop-shop approach that will result in a decrease in the compliance costs of taxation. Specifically, in accordance with impact assessment (2016), compliance costs are expected to decrease altogether in the amount of 10% in compliance time and 2.5% in compliance costs. Moreover, the cost of setting up a subsidiary would decrease by up to 67%, mainly owing to the elimination of transfer pricing issues and the establishment of common corporate tax rules, supporting companies (including SMEs) to become internationalized. In addition, the expected economic benefits of the CCCTB proposal would be an increase in investment (up to 3.4%), employment (up to 0.6%) and growth (up to 1.2%).[58]

6.5 Is the C(C)CTB Suitable?

6.5.1 Methodology

Because both C(C)CTB proposals suggest a mandatory obligation for entering into the C(C)CTB system only for the company fulfilling specific conditions,[59] entities that does not meet these conditions, such as micro-enterprises and SMEs, are exempted from the obligatory application of the C(C)CTB system, but they can opt for this system. The key requirement for the optional selection of the C(C)CTB system is the fulfilment of the two-tiered test[60] related to voting rights and rights to capital or profits based on Article 3 or Article 5 of the C(C)CTB proposal, which identify a “qualified subsidiary”. Moreover, the main motivation for entering into the C(C)CTB system is to gain a lower corporate tax obligation, i.e., for the CCTB, where cross-border loss offsetting results in lower corporate tax liability for the whole group; and for the CCCTB, where there is lower corporate tax liability for the whole group in comparison with the currently applied national tax system.

[57]Cross-border loss relief, which can apply through the CCTB Directive, would be an automatic outcome of consolidation. Moreover, transfer pricing rules would not apply within the group, as all intra-group transactions would be eliminated.

[58]For more details see Commission staff working document, impact assessment, SWD(2016) 341 final.

[59]A company that is subject to corporate taxes belongs to a consolidated group with a total consolidated group revenue that exceeds EUR 750 million and that is qualified as a parent company or subsidiary and/or that has permanent establishment in other Member States.

[60]A two-tiered test is related to voting rights and rights to capital or profits, i.e., the parent company has the right to exercise more than 50% of the voting, and has an ownership right amounting to more than 75% of the subsidiary’s capital or owns more than 75% of the rights giving entitlement to profit.

However, this requires the determination of corporate tax liability arising from the currently applied national tax systems and from the CCCTB system of taxation and its comparison.

This research on whether SMEs would opt for C(C)CTB system or not (i.e., staying in the current system of corporate taxation) is based on data from the Amadeus database, which includes standardized financial information on more than 21 million public and private companies in 43 European countries. In accordance with the requirement of being a qualified subsidiary, we found 1,138,599[61] SMEs in the Amadeus database possessing a foreign and/or domestic subsidiary across the European Union in 2014 and having information about profit before taxation in their financial statements.

This dataset was used for the consideration of the CCTB system with respect to cross-border loss offsetting based on Article 42 of the CCTB proposal. In accordance with the conditions set out in the Article 42, such as

- a reduction in the tax base owing to the consideration that losses from previous tax years may not result in a negative amount,
- loss relief must be in proportion to the holding of the resident taxpayer (parent company) in its qualifying subsidiaries, and
- no cascade effect is allowed;

we performed a simulation of re-distribution of cross-border losses at the level of parent company across the European Union. Then, we analysed the negative impact of cross-border losses on the corporate tax revenues in each Member State, i.e., how much corporate tax revenues would decrease if cross-border loss offsetting were introduced. Ultimately, we research whether the CCTB system would be suitable for SMEs.

With respect to the CCCTB system, the previous dataset was amended, as the dataset includes all relevant data for the calculation of apportionment formula, namely, tangible fixed assets, sales, number of employees, payroll costs and profit before taxation. Therefore, our dataset was reduced and covers 305,792 SMEs. Thus, we faced the problem of missing information, namely, with respect to number of employees and payroll cost. To eliminate the negative impacts of missing data, we decided to impute the missing data based on the methodology applied by Cline et al. (2010) and Nerudová and Solilová (2014). Specifically we used two methods for missing data imputation—a regression model and imputation model. In both models, the independent variable was tangible fixed assets (TFA). Therefore, SMEs without information about TFA were excluded from the dataset.

Regression methods are considered to be the basic methods for the estimation of missing data. The below-stated equations represent the linear regression model, which was employed to estimate the missing data regarding number of

[61] Based on the annual SME Report, there are 1,603,349 SMEs in the EU. Our dataset covers more than 71% of SMEs, as we have a limitation in the form of having associated enterprises.

employees, sales (operating revenue) and payroll. The model can be expressed as Eqs. (6.5)–(6.7).

$$No.Employees_imputed = koeficient\beta_0 + TFA * koeficinet\beta_1 \quad (6.5)$$

$$Operating_revenue = koeficient\beta_0 + TFA * koeficinet\beta_1 \quad (6.6)$$

$$Payroll = koeficient\beta_0 + No.Employees_imputed * koeficinet\beta_1 \quad (6.7)$$

As the independent variables were used tangible fixed assets (*TFA*), for the estimation of number of employees (*No.Employees_imputed*) and sales (*Operating_revenue*) and number of employees for the estimation of payroll (*Payroll*).

The second selected method, which was applied in case of missing data, was the *single imputation method*. This method allows us to impute the missing data by probable values and therefore allows us to avoid shrinking the dataset. The missing information on operating revenue (*Operating_revenue*) was added by the information on recorded assets (*TFA_reported*) and the ratio of average operational revenues (*AOperR*) to average fixed tangible assets (*ATFA*) in the case of companies (SMEs) from the same industry sector. The relation can be expressed by Eq. (6.8).

$$Operating_revenue = (AOperR \div ATFA) * TFA_reported \quad (6.8)$$

The missing data on number of employees (*No.Employees_imputed*) were added through the application of the information on recorded fixed tangible assets (*TFA_reported*) and the ratio of average number of employees (*ANoE*) to average tangible fixed assets (*ATFA*) in the case of companies (SMEs) from the same industry sector. The relation can be expressed by Eq. (6.9).

$$No.Employees_imputed = (ANoE \div ATFA) * TFA_reported \quad (6.9)$$

The missing data on payroll (*Payroll*) were added through the application of the recorded number of employees (*No. Employees_imputed*) and the ratio of average payroll (*APayr*) to average number of employees (*AnoE*) in case of companies (SMEs) from the same industry sector. The relation can be expressed by Eq. (6.10).

$$Payroll = (APayr \div ANoE) * No.Employees_imputed \quad (6.10)$$

To select the most suitable method for missing data imputation (i.e., the method that distorts the allocation of the group tax bases across the Member States the least, as it has a smaller standard deviation), a sensitivity analysis was performed. Based on the obtained results, a regression model was selected for the imputation of the missing data. Overall, dataset was increased by 78,524 entities covering 384,316 SMEs.

Consequently, after the imputation of the missing data into the dataset, we applied the apportionment formula (Sect. 6.4 Proposal of the CCCTB Directive, Eq. 6.4) on the tax bases of the qualified group of SMEs. Then, we determined the

Table 6.4 Nominal corporate tax rate and effective average tax rate in EU Member States, 2014 (Spengel et al. 2014)

Country[a]	Nominal corporate tax rates in %	Effective average tax rate in %	Country[a]	Nominal corporate tax rates in %	Effective average tax rate in %
CZ	19.0	16.7	LV	15.0	14.3
AT	25.0	23.0	LT	15.0	13.6
BE	34.0	26.7	LU	29.2	25.5
CY	12.5	15.2	MT	35.0	32.2
EE	21.0	16.5	NL	25.0	22.6
FI	20.0	18.4	PT	30.0	27.1
FR	38.9	39.4	PL	19.0	17.5
DE	31.0	28.2	RO	16.0	14.8
EL	26.0	24.1	SK	22.0	19.4
HR	20.0	16.5	SI	17.0	15.5
BG	10.0	9.0	HU	20.9	19.3
DK	24.5	22.2	ES	35.3	32.6
IE	12.5	14.4	SE	22.0	19.4
IT	30.9	24.0	UK	21.0	22.4

[a]*CZ* Czech Republic, *AT* Austria, *BE* Belgium, *CY* Cyprus, *EE* Estonia, *FI* Finland, *FR* France, *DE* Germany, *EL* Greece, *HR* Croatia, *BG* Bulgari, *DK* Denmark, *IE* Ireland, *IT* Italy, *LV* Latvia, *LT* Lithuania, *LU* Luxembourg, *MT* Malta, *NL* Netherlands, *PT* Portugal, *PL* Poland, *RO* Romania, *SK* Slovak Republic, *SI* Slovenia, *HU* Hungary, *ES* Spain, *SE* Sweden, *UK* Great Britain

amount of the tax base allocated to each Member State and finally determined a corporate tax obligation through the application of nominal corporate tax rate (see Table 6.4) on the tax base determined in the previous step. However, as mentioned above, the key motivation for the optional selection of the CCCTB system represents lower corporate tax liability for whole group in comparison with the current tax system. Therefore, to map the current situation regarding corporate tax base allocation and subsequently the current corporate tax liability in each Member State, we have applied four possible models of group taxation that are currently applied within the European Union (i.e., full consolidation, pooling, intra-group loss transfer and no group taxation scheme applied in the country)[62] according to the country of residency of the parent company. Consequently, the effective tax rate (see Table 6.4) was applied on the determined tax base in order to set the current corporate tax liability.

Based on the performance in the comparative analysis with respect to current situation, we were able to identify the possible increase or decrease in the allocated corporate tax bases in each Member State. Ultimately, we analysed the effects of

[62]For more details about the current group taxation regime, see Sect. 6.2, Table 6.1. Further, it must be highlighted that the research was performed based on the data available in 2014 as well as legal framework, therefore the changes in consolidation regimes and cross-border loss offsetting since 2015 are not taken into account.

the adoption of the CCCTB system on the corporate tax revenues in each Member State, i.e., how much tax revenues would decrease or increase if the CCCTB were introduced. Finally, the suitability of the CCCTB for SMEs was researched.

It is necessary to mention that there are also the following *limitations* of the results in the conducted research:

- the amount of the total tax base is considered not to change as a result of the adoption of the CCCTB system even if the C(C)CTB proposal suggests unified rules for corporate tax base construction;
- we consider profit or loss before taxation as a tax base of each subsidiary in the group available in the financial statements in the Amadeus Database;
- to determine corporate tax liability, the nominal and effective tax rates are applied (see Table 6.4);
- in the current situation, the effective tax rates of the country where the subsidiaries are situated were taken into account in order to determine the tax liability;
- when researching the situation of the CCCTB implementation, the nominal tax rates were applied because under the CCCTB, nominal tax rates are equal to effective tax rates[63];
- the offsetting of previous losses, tax incentives and another preferential tax regime resulting in the zero tax liability is not taken into account; therefore, the current corporate tax liability can reach higher values than the corporate tax revenues of the Member States presented in Taxation Trends in the European Union[64];
- no specific apportionment formula is applied for selected industries, as suggested in the CCCTB proposal;
- the CCCTB results are based on Eq. (6.4);
- the research is focused on SMEs only, i.e., large entities are omitted from the research.

Further, we assumed that entities do not change their behaviour in response to the tax reform. Moreover, we assumed that SMEs would opt for the C(C)CTB if it would offer them benefits, namely, in the form of lower corporate tax liability.

In the following sections, the results of the CCTB and C(C)CTB are presented in the context of SMEs.

[63]Due to the unified system of tax base construction.

[64]Taxation Trends in the European Union, Data for the EU Member States, Iceland and Norway, 2016. http://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2016/econ_analysis_report_2016.pdf

6.5.2 Results of the CCTB in the Context of SMEs

The CCTB system is suggested as mandatory for companies that are subject to corporate taxes, that belong to a consolidated group with a total consolidated group revenue that exceeds EUR 750 million and that are qualified (based on Article 3) as a parent company or subsidiary and/or that have permanent establishment in other Member States. Thus, other companies, such as micro-enterprises and SMEs, are exempted from the obligatory application of the CCTB system. However, these entities can opt for the CCTB system. The key requirement for the optional selection of the CCTB system is the fulfilment of the two-tiered test related to voting rights and rights to capital or profits based on Article 3 of the CCTB proposal. In accordance with this requirement, 1,138,599 SMEs were found in the Amadeus database, having a foreign and/or domestic subsidiary across the European Union in the calendar year 2014 and having the information on profit before taxation in their financial statements.

The distribution of SMEs qualified for entering into the CCTB system across the European Union is mentioned in Table 6.5. As is obvious, the highest portions of qualified SMEs are in Italy (29.64%), Romania (28.21%), Bulgaria (9.71%), Spain (5.42%), the Slovak Republic (4.59%), Latvia (4.37%) and the Czech Republic (4.06%).

Regarding losses, only 2.32% (26,465) of qualified SMEs are facing cross-border losses, whereas 35.27% (401,614) of SMEs are facing domestic losses, which can be currently offset within one company in each Member State. Moreover, it is evident that only a very small amount of qualified SMEs are doing business abroad, in our case 5.14% (for details, see Table 6.5). This finding is in line with current studies estimating that SMEs have a lower level of internationalization than LEs, in particular, only 5%[65] of SMEs are associated (have subsidiaries abroad) and involved in cross-border activities.

If we look at the classification of losses and profits based on the type of parent company (i.e., foreign and domestic parent company) in more detail, it is obvious that more than 56% of overall losses (EUR 16.5 billion) are incurred by subsidiaries (having a foreign parent company) situated in Portugal (24.25%), Luxembourg (12.76%), the United Kingdom (10.67%) and Romania (8.49%). A similar situation can be found in case of the domestic parent company—almost 57% of overall losses (EUR 41.3 billion) are generated by subsidiaries situated in Italy (27.89%), the United Kingdom (17.83%) and Austria (10.93%). With respect to profits (EUR 41.3 billion), the highest profits are generated by subsidiaries (with a foreign parent company) situated in the United Kingdom (19.86%) and Belgium (12.30%). In the case of domestic parent companies (EUR 160.7 billion), the highest profits are generated in the United Kingdom (31.05%), France (21.53%) and Italy (14.84%). For more details, see Table 6.6.

[65]European Commission, Observatory of European SMEs, analytical report, 2007. Directorate-General for Enterprise and Industry.

Table 6.5 Distribution of SMEs qualified for the CCTB system across the EU (own processing, Amadeus database)

Country of subsidiary	Foreign parent company		Domestic parent company			
	No. of subsidiaries recording losses	No. of subsidiaries recording profits	No. of domestic subsidiaries recording losses	No. of domestic subsidiaries recording profits	No. of subsidiaries	Portion of subsidiaries on total (%)
AT	94	273	197	564	1128	0.10
BE	865	1218	2145	3719	7947	0.70
BG	276	383	27,915	81,983	110,557	9.71
CY	2	3	0	5	10	0.00
CZ	1367	1918	15,638	27,338	46,261	4.06
DE	45	178	440	2159	2822	0.25
DK	382	694	8372	15,588	25,036	2.20
EE	432	741	858	1654	3685	0.32
ES	744	1371	21,945	37,597	61,657	5.42
EL	98	115	1294	2643	4150	0.36
FI	196	358	1101	2167	3822	0.34
FR	1464	2041	7288	10,864	21,657	1.90
HR	324	402	2376	5782	8884	0.78
HU	327	386	83	96	892	0.08
IE	191	257	161	267	876	0.08
IT	1705	2187	114,866	218,670	337,428	29.64
LT	26	117	275	1634	2052	0.18
LU	104	155	82	174	515	0.05
LV	1511	1340	23,180	23,770	49,801	4.37
MT	2	2	0	1	5	0.00
NL	323	321	167	335	1146	0.10
PL	537	1029	3734	8606	13,906	1.22
PT	668	926	8740	12,414	22,748	2.00

(continued)

Table 6.5 (continued)

Country of subsidiary	Foreign parent company		Domestic parent company		No. of subsidiaries	Portion of subsidiaries on total (%)
	No. of subsidiaries recording losses	No. of subsidiaries recording profits	No. of domestic subsidiaries recording losses	No. of domestic subsidiaries recording profits		
RO	9035	7962	134,370	169,868	321,235	28.21
SE	562	865	2966	4175	8568	0.75
SI	189	417	2412	7964	10,982	0.96
SK	3620	4361	15,250	29,070	52,301	4.59
UK	1376	2051	5759	9342	18,528	1.63
Total	26,465	32,071	401,614	678,449	1,138,599	100.00
Portion (%)	2.32	2.82	35.27	59.59	100.00	

Note: In case of Cyprus and Malta no more data were available

Table 6.6 Classification of losses and profits based on the type of parent company—assignment to the state of the tax residency of subsidiary (own processing, Amadeus database)

Country of subsidiary	Foreign parent company						Domestic parent company					
	No. of subsidiaries recording losses	Sum of losses[1] (in million EUR)	Portion of losses (%)	No. of subsidiaries in profits	Sum of profits (in million EUR)	Portion of profits (%)	No. of domestic subsidiaries recording losses	Sum of losses (in million EUR)	Portion of losses (%)	No. of domestic subsidiaries recording profits	Sum of profits (in million EUR)	Portion of profits (%)
AT	94	−56.04	*0.34*	273	2245.91	*5.58*	197	−4521.13	*10.93*	564	1326.36	*0.83*
BE	865	−211.96	*1.28*	1218	4956.16	*12.30*	2145	−1003.93	*2.43*	3719	4383.29	*2.73*
BG	276	−67.54	*0.41*	383	517.72	*1.29*	27,915	−653.27	*1.58*	81,983	1963.78	*1.22*
CY	2	−346.65	*2.09*	3	74.94	*0.19*	0	–	*0.00*	5	169.22	*0.11*
CZ	1367	−131.75	*0.79*	1918	2727.03	*6.77*	15,638	−327.05	*0.79*	27,338	1322.42	*0.82*
DE	45	−64.64	*0.39*	178	2331.51	*5.79*	440	−1335.90	*3.23*	2159	12,884.18	*8.01*
DK	382	−178.75	*1.08*	694	398.99	*0.99*	8372	−1452.03	*3.51*	15,588	2784.87	*1.73*
EE	432	−46.49	*0.28*	741	409.45	*1.02*	858	−57.08	*0.14*	1654	207.166	*0.13*
ES	744	−245.22	*1.48*	1371	764.54	*1.90*	21,945	−2464.71	*5.96*	37,597	4566.2	*2.84*
EL	98	−50.37	*0.30*	115	28.54	*0.07*	1294	−244.48	*0.59*	2643	553.81	*0.34*
FI	196	−66.75	*0.40*	358	94.25	*0.23*	1101	−172.00	*0.42*	2167	1875.89	*1.17*
FR	1464	−1149.36	*6.93*	2041	1205.30	*2.99*	7288	−2673.51	*6.47*	10,864	34,614.96	*21.53*
HR	324	−187.97	*1.13*	402	645.31	*1.60*	2376	−253.02	*0.61*	5782	775.75	*0.48*
HU	327	−1204.24	*7.26*	386	254.75	*0.63*	83	−893.68	*2.16*	96	163.59	*0.10*
IE	191	−669.66	*4.04*	257	3121.91	*7.75*	161	−172.78	*0.42*	267	1991.28	*1.24*
IT	1705	−552.64	*3.33*	2187	1421.92	*3.53*	114,866	−11,533.69	*27.89*	218,670	23,853.02	*14.84*
LT	26	−3.51	*0.02*	117	246.91	*0.61*	275	−31.56	*0.08*	1634	221.98	*0.14*
LU	104	−2115.71	*12.76*	155	3047.21	*7.56*	82	−347.04	*0.84*	174	467.12	*0.29*
LV	1511	−58.24	*0.35*	1340	283.93	*0.70*	23,180	−383.51	*0.93*	23,770	762.63	*0.47*
MT	2	−0.74	*0.00*	2	53.52	*0.13*	0	–	*0.00*	1	56.80	*0.04*
NL	323	−1265.82	*7.63*	321	1373.92	*3.41*	167	−140.07	*0.34*	335	4327.93	*2.69*
PL	537	−155.90	*0.94*	1029	2812.53	*6.98*	3734	−419.89	*1.02*	8606	1359.91	*0.85*
PT	668	−4021.43	*24.25*	926	885.40	*2.20*	8740	−1411.10	*3.41*	12,414	877.26	*0.55*
RO	9035	−1407.76	*8.49*	7962	812.94	*2.02*	134,370	−1565.87	*3.79*	169,868	3807.86	*2.37*
SE	562	−235.87	*1.42*	865	385.99	*0.96*	2966	−1097.16	*2.65*	4175	4428.49	*2.75*
SI	189	−116.10	*0.70*	417	93.09	*0.23*	2412	−411.46	*0.99*	7964	480.91	*0.30*
SK	3620	−202.69	*1.22*	4361	1091.57	*2.71*	15,250	−414.69	*1.00*	29,070	617.72	*0.38*
UK	1376	−1769.97	*10.67*	2051	7999.89	*19.86*	5759	−7372.89	*17.83*	9342	49,912.13	*31.05*
Total	26,465	−16,583.91	*100.00*	32,071	40,285.21	*100.00*	401,614	−41,353.64	*100.00*	678,449	160,756.66	*100.00*

Taking into account the provision of cross-border loss relief (Article 42 of the CCTB proposal) while allowing offsetting cross-border losses incurred by a qualified subsidiary at the level of the parent company, we perform a simulation of re-allocation of cross-border losses across the European Union under the following conditions set in the CCTB proposal:

- a reduction of the tax base as a result of considering losses from previous tax years shall not result in a negative amount,
- loss relief shall be in proportion to the holding of the resident taxpayer (parent company) in its qualifying subsidiaries, and
- no cascade effect is allowed.

The re-allocation of losses among SMEs across the European Union is presented in Fig. 6.1. As is evident, countries such as Austria, Belgium, Cyprus, Germany, Spain, Greece, Italy, Lithuania, Malta and the Netherlands face multiple magnifications of losses (highlighted in the values in Fig. 6.1) in contrast to the rest of the Member States, who face multiple reductions in losses. With respect to multiple magnifications, it has to be noted that Austria and Italy currently (in 2014) allow a reduction or consolidation of cross-border losses.[66] The Netherlands represent the only Member State that applies a full tax consolidation regime. Further, based on the comparison of losses in their absolute value (i.e., current losses compared with redistributed losses based on the CCTB proposal), which is presented in Figs. 6.2 and 6.3, the re-allocation of high losses from Portugal to Netherlands, Austria, Cyprus and Germany is obvious. Overall, losses in the amount of EUR 16.58 billion incurred among 26,465 SMEs are presented here.

The situation regarding how cross-border losses of qualified SMEs would be reallocated if the CCTB proposal were approved was presented on Figs. 6.2 and 6.3 (i.e., instead of loss relief at the level of subsidiary, the cross-border offsetting is applied at the level of parent company). The following section focuses on the impact of cross-border loss relief together with domestic loss relief, which is currently accessible in each Member State, on corporate tax revenue.

As domestic losses are currently allowed to be offset within one company in each Member State, the impact on the corporate income tax revenue can be considered as zero. However, in the case of cross-border loss relief, the zero effect cannot be considered as a new possibility based on the CCTB proposal. In this case, the corporate income tax revenue will decrease in each Member State, where the parent company is situated. The highest decrease would occur in the case of Cyprus (−171%), where cross-border losses are EUR 1.8 billion and the corporate income tax revenue is only EUR 1.1 billion, corresponding to the fact that Cyprus is often considered an onshore destination with respect to tax planning activities in the

[66]Austria uses a deduction (recapture) method that is similar to cross-border loss offsetting introduced by the CCTB proposal. Italy uses a system of consolidation of profit at the level of parent company, as do France and Denmark. Further, it must be highlighted that Cyprus (since 2015) and Lithuania (since 2016) allow also cross-border loss offsetting.

Country of subsidiary	No. of subsidiaries recording losses with foreign parent company	Sum of losses[1] (in million EUR)
AT	94	-56.04
BE	865	-211.96
BG	276	-67.54
CY	2	-346.65
CZ	1,367	-131.75
DE	45	-64.64
DK	382	-178.75
EE	432	-46.49
ES	744	-245.22
EL	98	-50.37
FI	196	-66.75
FR	1,464	-1,149.36
HR	324	-187.97
HU	327	-1,204.24
IE	191	-669.66
IT	1,705	-552.64
LT	26	-3.51
LU	104	-2,115.71
LV	1,511	-58.24
MT	2	-0.74
NL	323	-1,265.82
PL	537	-155.90
PT	668	-4,021.43
RO	9035	-1,407.76
SE	562	-235.87
SI	189	-116.10
SK	3,620	-202.69
UK	1,376	-1,769.97
Total	**26,465**	**-16,583.91**

Country of parent company	No. of foreign subsidiaries recording losses	Sum of losses[2] (in million EUR)	Change (in %)
AT	1,764	-1,999.25	+3,467
BE	848	-993.36	+369
BG	227	-11.51	-83
CY	735	-1,888.76	+445
CZ	896	-73.13	-44
DE	3,907	-1,494.08	+2,211
DK	502	-102.80	-42
EE	326	-18.38	-60
ES	1,351	-462.90	+89
GR	585	-145.69	+189
FI	404	-58.70	-12
FR	2,092	-1,119.81	-3
HR	68	-8.20	-96
HU	1,720	-93.02	-92
IE	431	-265.02	-60
IT	4,421	-1,089.80	+97
LT	454	-8.66	+146
LU	824	-539.60	-74
LV	55	-1.43	-98
MT	58	-35.33	+4,646
NL	1,050	-4,405.00	+248
PL	421	-34.12	-78
PT	202	-171.54	-96
RO	110	-10.74	-99
SE	710	-199.17	-16
SI	131	-12.59	-89
SK	307	-8.92	-96
GB	1,866	-1,332.27	-25
Total	**26,465**	**-16,583.91**	-

1) Current situation, when losses can be offset within one company in each Member State, except Denmark, France, Italy and Austria allowing cross-border loss offsetting at the level of the parent company, and Netherlands, with full tax consolidation.
2) Re-allocation based on the CCTB proposal—cross-border loss relief.

Fig. 6.1 Re-allocation of cross-border losses of SMEs across the EU based on the CCTB proposal (own processing, Amadeus database)

European Union. Another significant decrease of corporate income tax revenue would be reached in the case of Austria (27.39%), the Netherlands (25.76%) and Luxembourg (25.70%). For more details, see Table 6.7.

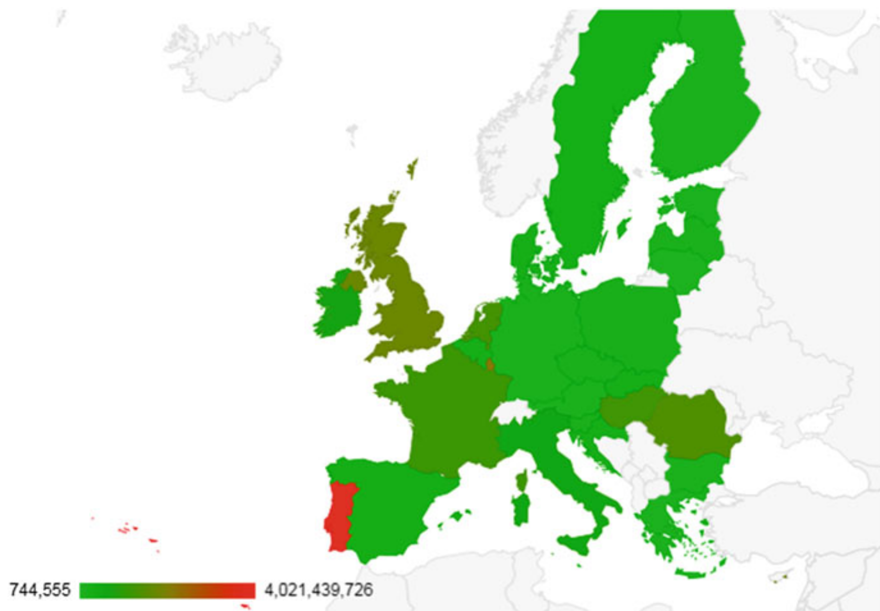

Fig. 6.2 Re-allocation of cross-border losses of SMEs across the EU—current situation (Fig. 6.2 represents the assignment of cross-border losses based on the tax residency of the subsidiary.) (in EUR) (own compilation through Google Charts, Amadeus database)

In addition, it must be highlighted that the CCTB proposal indicated that the possible cross-border off-set of losses will be accompanied by the later recapture of the level of the parent company once the subsidiary starts to run a profit or will be automatically reincorporated at the end of the fifth tax year after the losses becomes deductible. Therefore, we expect cross-border loss offsetting to have short-term negative impacts on corporate income tax revenues.

Although only 2.3% of SMEs face cross-border losses, these companies represent half of SMEs with foreign associated entities. Therefore, the issue of cross-border losses should be considered very serious, as it highlights the limitations of the internationalization of SMEs in the European Union. The implementation of the CCTB system would bring SMEs several advantages, including cross-border loss offsetting. Based on the common rules for corporate tax base construction, SMEs would not face the 28 different tax systems, resulting in high compliance costs of taxation. Other motivations for entering the CCTB system can represent a super-deduction for R&D, notably for SMEs and start-up companies. As is obvious micro and small entities incur similar amount of expenditure for research and development per employee as large companies (see Table 6.8). All these incentives should nevertheless bring economic benefits at least in the form of an increase in investment, employment, internationalization and smart, sustainable and innovative growth. Moreover, it is expected that SMEs would reach lower compliance costs of taxation owing to the easier administration of domestic and cross-border tax

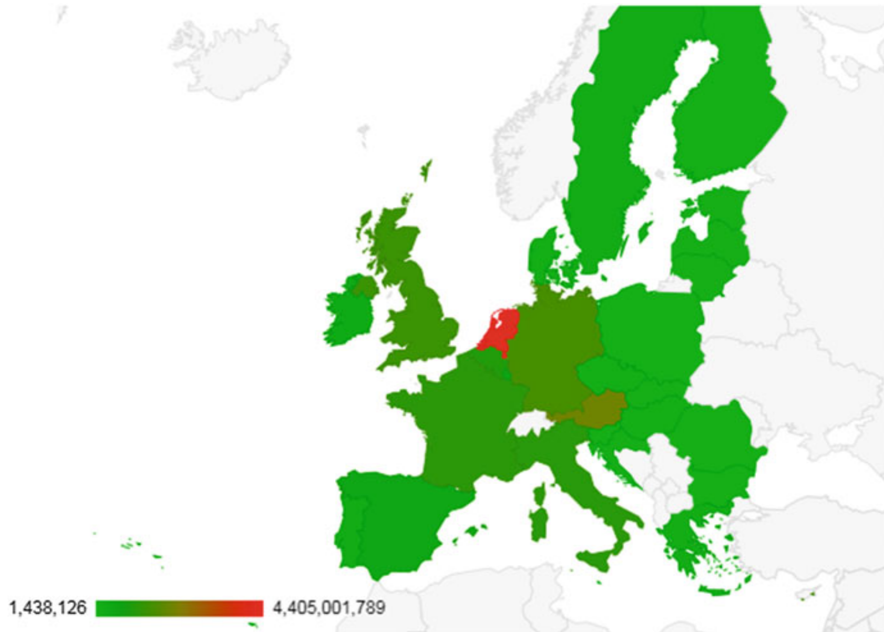

Fig. 6.3 Re-allocation of cross-border losses of SMEs across the EU—based on the CCTB (Fig. 6.3 represents the assignment of cross-border losses based on the tax residency of the parent company, where loss relief will be applied in accordance with the CCTB proposal.) (in EUR) (own compilation through Google Charts, Amadeus database)

issues. However, extensive benefits are expected under the CCCTB regime. This situation is presented in the following section.

6.5.3 Results of the CCCTB in the Context of SMEs

In the second step, after the approval of the CCTB Directive, tax consolidation covered in the CCCTB Directive proposal should be discussed. In accordance with the CCCTB proposal, the consolidated tax based would be allocated via an apportionment formula, i.e., companies operating across borders in the EU would consolidate all profits and losses to determine their consolidated taxable profit and the consolidated profit would then be allocated between the Member States according to an apportionment formula. Moreover, it has to be underlined that the CCCTB proposal does not restrict Member State's right to set their own corporate tax rates.

The CCCTB system is mandatory for companies that are subject to corporate taxes, that belong to a consolidated group with a total consolidated group revenue

Table 6.7 Loss relief and its impact on corporate tax revenue (own processing, Amadeus database)

Country	No. of domestic subsidiaries in losses	Sum of losses (in million EUR)	No. of foreign subsidiaries in losses	Sum of losses [a] (in million EUR)	Total losses (foreign and domestic) (in million EUR)	Corporate income taxes revenue (in billion EUR)[b]	Change of corporate income taxes revenues (in %)
AT	197	−4521.13	1764	−1999.25	−6520.39	7.3	−27.39
BE	2145	−1003.93	848	−993.36	−1997.29	12.8	−7.76
BG	27,915	−653.27	227	−11.51	−664.79	0.9	−1.28
CY	0	–	735	−1888.76	−1888.76	1.1	−171.71
CZ	15,638	−327.05	896	−73.13	−400.18	5.2	−1.41
DE	440	−1335.90	3907	−1494.08	−2829.98	71.1	−2.10
DK	8372	−1452.03	502	−102.80	−1554.84	7.0	−1.47
EE	858	−57.08	326	−18.38	−75.47	0.3	−6.13
ES	21,945	−2464.71	1351	−462.90	−2927.61	20.9	−2.21
EL	1294	−244.48	585	−145.69	−390.17	3.3	−4.41
FI	1101	−172.00	404	−58.70	−230.71	4.0	−1.47
FR	7288	−2673.51	2092	−1119.81	−3793.33	57.7	−1.94
HR	2376	−253.02	68	−8.20	−261.23	0.8	−1.03
HU	83	−893.68	1720	−93.02	−986.71	1.4	−6.64
IE	161	−172.78	431	−265.02	−437.81	4.7	−5.64
IT	114,866	−11,533.69	4421	−1089.80	−12,623.49	35.1	−3.10
LT	275	−31.56	454	−8.66	−40.23	0.5	−1.73
LU	82	−347.04	824	−539.60	−886.65	2.1	−25.70
LV	23,180	−383.51	55	−1.43	−384.95	0.4	−0.36
MT	0	–	58	−35.33	−35.33	0.5	−7.07
NL	167	−140.07	1050	−4405.00	−4545.07	17.1	−25.76
PL	3734	−419.89	421	−34.12	−454.02	7.2	−0.47
PT	8740	−1411.10	202	−171.54	−1582.65	4.9	−3.50
RO	134,370	−1565.87	110	−10.74	−1576.62	3.2	−0.34

SE	2966	−1097.16	710	−199.17	−1296.33	11.5	−1.73
SI	2412	−411.46	131	−12.59	−424.05	0.5	−2.52
SK	15,250	−414.69	307	−8.92	−423.62	2.4	−0.37
UK	5759	−7372.89	1866	−1332.27	−8705.17	54.7	−2.44
Total	401,614	−41,353.64	26,465	−16,583.91	−57,937.56	338.6	−4.90

[a] These losses would be offset at the level of the parent company based on the CCTB proposal
[b] The overall corporate income tax revenues in the country for 2014. Source: Taxation Trends in the European Union, 2016

Table 6.8 Employees and expenditures in R&D in business sector in the EU by size class in 2013 (own processing, Eurostat 2017)

Entities by size class	Expenditures per employees in R&D	No. of employees in R&D	R&D expenditure
		Full-time equivalent	million EUR
Micro (from 1 to 9 employees)[a]	0.05	58,607	2713
Small (from 10 to 49 employees)[b]	0.05	165,391	9087
Medium (from 50 to 249 employees)[c]	0.07	265,582	17,560
Large (from 250 to 499 employees)	0.08	141,149[b]	11,909[c]
Above 500 employees	0.13	787,145[d]	101,020[b]

[a]Except of Ireland, Luxembourg and Sweden—no data available
[b]Except of Ireland—no data available
[c]Except of Ireland and Bulgaria—no data available
[d]Except of Ireland and Finland—no data available

that exceeds EUR 750 million, and that are qualified (based on Article 5[67]) as a parent company or subsidiary and/or that have permanent establishment in other Member States. Companies that do not fulfil these requirements (micro-enterprises and SMEs) are exempted from the obligatory application of the CCCTB system. However, they can opt for the CCCTB system, as well as the CCTB system. Thus, in following chapter, we analyse how the CCCTB system would affect the performance of SMEs in the European Union. Our key assumption is that SMEs enter into the CCCTB system if it results in lower corporate tax liability than current national corporate taxation.

Our dataset covers 1,138,599[68] SMEs from the Amadeus database, with a foreign and/or domestic subsidiary in the European Union in calendar year 2014, being considered qualified subsidiaries and having information about profit before taxation in their financial statements. However, given the apportionment formula, the dataset has to include all relevant data for its calculation, namely, tangible fixed assets, sales, number of employees, payroll cost and profit before taxation. Therefore, our dataset had to be reduced and covers 5983 SMEs for which it would be advantageous to opt for the CCCTB system, as it would result into their overall lower corporate tax liability, and 299,809 SMEs that would probably not opt for

[67]The fulfilment of the two-tiered test related to voting rights and rights to capital or profits, i.e., the parent company has the right to exercise more than 50% of the voting rights and has an ownership right amounting to more than 75% of the subsidiary's capital or owns more than 75% of the rights giving entitlement to profits.

[68]The same dataset applied for the CCTB.

CCCTB, as it would result for them in higher corporate tax liability.[69] To preserve the extent of the dataset, we decided to impute missing data in order to maximize the number of companies in the analysis according to the methodology applied by Cline et al. (2010) and Nerudová and Solilová (2014).[70] Hence, our dataset covers 25,258 SMEs that would probably opt for the CCCTB system and 359,058 SMEs that would probably not opt for the CCCTB system. A large portion of subsidiaries that would probably not opt for the CCCTB are situated in Italy, Romania, Bulgaria, the Czech Republic, Latvia and the Slovak Republic, whereas the opposite group of subsidiaries (which would probably opt for the CCCTB) are situated in United Kingdom, Denmark, France, Italy, Bulgaria and Romania and in the previous group. For more details about the distribution of entities based on the above described classification, see Table 6.9.

The question is why would entering into CCCTB system for the majority of subsidiaries (93.4% from the imputed dataset and almost 98% from the real dataset) result in higher tax liability than under the domestic national corporate tax system. One of the reasons is that domestic national corporate tax systems do not allow SMEs to use tax planning schemes that are accessible for LEs owing to the lack of human and financial capital and the availability of skilled staff or experienced managers. Therefore, their current corporate tax base is similar to the CCCTB resulting in the higher sensitivity to the tax rate (see Table 6.4) i.e., for the purpose of our research, the current corporate tax liability was determined by using the effective tax rate rather than the nominal tax rate applied in case of CCCTB tax liability. As is visible in Table 6.4, there are differences in tax rates applied in the EU. It has an impact on the determination of corporate tax liabilities under both tax systems and results in the fact that only 6.5% of SMEs would opt for the CCCTB and that 93.4% would still apply the current corporate tax system (as entering into the CCCTB would result in higher tax liability for them). Moreover, it must be highlighted that the CCCTB system allocates the tax base of each member of the group for taxation purposes in accordance with the apportionment formula, i.e., based on the generated sales, fixed tangible assets used by entities, number of employees and their payroll cost. Thus, it allocates the tax base in accordance with the real substance of business activities.

Because SMEs not meeting the requirement of mandatory application of the CCCTB can opt for this system, we assume that those SMEs would decide to enter the system based on the key assumption that their corporate tax liability after the adoption of the CCCTB system would be lower than their current corporate tax liability. However, there are also other benefits connected with the adoption of the CCCTB system. In particular, they would benefit from the unified rules for corporate tax base construction and the elimination of transfer pricing issues, as all intra-group transactions within the group will be excluded from the tax base or one-shop-

[69]Hence, this implies lower corporate tax liability under the current national tax system in comparison with the CCCTB system. For more details, see Sect. 6.5.1.

[70]For more details see Sect. 6.5.1.

Table 6.9 Division of SMEs according to their motivation to opt for the CCCTB or not (own processing, Amadeus database)

Country of subsidiary	Comparison of corporate tax liability based on the CCCTB system and current domestic national corporate tax system							
	Imputed dataset				Real dataset			
	No. of entities which would opt for CCCTB[a]	Share in %	No. of entities which would not opt for CCCTB[b]	Share in %	No. of entities which would opt for CCCTB[a]	Share in %	No. of entities which would not opt for CCCTB[b]	Share in %
AT	245	*0.97*	349	*0.10*	85	*1.42*	427	*0.14*
BE	404	*1.60*	1016	*0.28*	106	*1.77*	396	*0.13*
BG	2897	*11.47*	34,357	*9.57*	764	*12.77*	31,135	*10.38*
CY	19	*0.08*	6	*0.00*	14	*0.23*	8	*0.00*
CZ	498	*1.97*	19,148	*5.33*	179	*2.99*	15,126	*5.05*
DE	597	*2.36*	1317	*0.37*	229	*3.83*	786	*0.26*
DK	1447	*5.73*	4215	*1.17*	29	*0.48*	236	*0.08*
EE	126	*0.50*	953	*0.27*	35	*0.58*	689	*0.23*
ES	163	*0.65*	78	*0.02*	86	*1.44*	123	*0.04*
EL	14	*0.06*	4	*0.00*	11	*0.18*	5	*0.00*
FI	123	*0.49*	1220	*0.34*	18	*0.30*	872	*0.29*
FR	3240	*12.83*	116	*0.03*	1871	*31.27*	188	*0.06*
HR	114	*0.45*	5028	*1.40*	44	*0.74*	4922	*1.64*
HU	40	*0.16*	83	*0.02*	21	*0.35*	96	*0.03*
IE	180	*0.71*	13	*0.00*	72	*1.20*	27	*0.01*
IT	9887	*39.14*	157,673	*43.91*	110	*1.84*	134,212	*44.77*
LT	37	*0.15*	29	*0.01*	10	*0.17*	37	*0.01*
LU	53	*0.21*	142	*0.04*	22	*0.37*	47	*0.02*
LV	380	*1.50*	15,266	*4.25*	21	*0.35*	878	*0.29*
MT	2	*0.01*	3	*0.00*	1	*0.02*	4	*0.00*
NL	175	*0.69*	131	*0.04*	82	*1.37*	121	*0.04*
PL	280	*1.11*	4311	*1.20*	80	*1.34*	257	*0.09*
PT	57	*0.23*	18	*0.01*	33	*0.55*	35	*0.01*
RO	1616	*6.40*	89,646	*24.97*	483	*8.07*	90,483	*30.18*
SE	364	*1.44*	359	*0.10*	46	*0.77*	575	*0.19*
SI	78	*0.31*	7466	*2.08*	19	*0.32*	7003	*2.34*
SK	262	*1.04*	15,921	*4.43*	91	*1.52*	10,852	*3.62*
UK	1960	*7.76*	190	*0.05*	1421	*23.75*	269	*0.09*
Total	25,258	100	359,058	100	5983	100	299,809	100
Total in dataset	384,316				305,792			

[a]Due to the fact that opting in would result in lower tax liability
[b]Due to the fact that opting in would result in the higher tax liability

stop approach. All these attributes will probably result in a decrease in compliance costs of taxation. Therefore, we further assume that even SMEs facing higher corporate tax liability will have the motivation to opt for the CCCTB system in order to be able to gain other benefits from this system.

Based on the comparison of corporate tax liability through both tax systems (see Tables 6.10 and 6.11), it is evident that the adoption of the CCCTB system brings both lower corporate tax liability by EUR 22.778 billion (by 58.68%) and higher corporate tax liability by EUR 1.865 billion (by 32.01%), i.e., total EUR 20.913 billion (by 46.05%) lower corporate tax revenues for the Member States. This amount of money (tax saving) can be used by SMEs to increase their business performance and the level of their internationalization in the European Union.

In this situation, when corporate tax liability is higher after the adoption of the CCCTB system (Table 6.11), a large increase is visible in the case of Poland (by 224.73%), Hungary (by 164.39%), Sweden (by 157.37%), Spain (by 130.99%) and other Member states. Overall, corporate tax revenues would increase by EUR 1.86 billion (by 32.01%). Although the CCCTB system brings a relatively large increase in corporate tax liability in contrast to a relatively low decrease in corporate tax liability (see Fig. 6.4), in absolute value, the result is negative in the amount of EUR 20.913 billion. Considering the overall amount for SMEs (384,316), there is a decrease in corporate tax liability on average by EUR 54,416 for each SME.

As mentioned above, the overall decrease in corporate tax liability of SMEs is EUR 20.913 billion, which means a decrease in total corporate tax revenues by 5.98%, covering tax liability of LEs and SMEs. Currently, the volume of total corporate tax revenues is EUR 338 billion for the entire EU, and after the adoption of the CCCTB, it would be EUR 318 billion[71] However, the situation is different at the level of Member States (see Table 6.12). Specifically, only Bulgaria, Denmark, Hungary and Latvia would face an increase in corporate income tax revenues, whereas the rest of the Member States would face a decrease in corporate income tax revenues, such as Austria (−25.39%), Ireland (−27.23%) and Romania (−16.41%). Moreover, it has to be highlighted that the results presented in column F in Table 6.12 represent a situation where only SMEs are taken into account. The large entities with mandatory obligation to enter into the CCCTB system will significantly change the result of corporate income tax revenues.[72]

[71]This amount covers the corporate tax liability of SMEs without taking into account the corporate tax liability of LEs.

[72]Fuest, C., Hemmelgam, T., & Ramb, F. (2007). How would the introduction of an EU-wide formula apportionment affect the distribution and size of the corporate tax base? An analysis based on German multinationals. International Tax and Public Finance 14(5), 605–626. Van Der Horst, A., Bettendorf, L., & Rojas-Romagosa, H. (2007). Will corporate tax consolidation improve efficiency in the EU? CPB Documents 141, CPB Netherlands Bureau for Economic Policy Analysis. Devereux, M. & Loretz, S. (2008) Increased Efficiency through Consolidation and Formula Apportionment in the European Union? Oxford: Oxford University, Centre for Business Taxation. Working Paper No. 12. Cline, R. Neubig, T. Phillips, A., Sanger, C., & Walsh,

Table 6.10 CCCTB and its impact on corporate tax revenue (Corporate tax revenue based on the CCCTB system allocated at the level of the subsidiary based on its tax residency.)—part A (own processing, Amadeus database)

Country of subsidiary	Dataset with imputed data through the regression method—tax liability based on the CCCTB is lower than current tax liability				
	No. of subsidiaries	CCCTB tax liability (in million EUR)	Current tax liability (in million EUR)	Difference A (in million EUR)	Change (in %)
AT	245	821.2	2687.67	−1866.47	−69.45
BE	404	602.95	1145.34	−542.39	−47.36
BG	2897	26.55	37.12	−10.57	−28.48
CY	19	472.63	1686.54	−1213.91	−71.98
CZ	498	585.77	752.81	−167.04	−22.19
DE	597	526.51	1640.35	−1113.84	−67.90
DK	1447	184.24	249.08	−64.84	−26.03
EE	126	17.33	39.32	−21.99	−55.93
ES	163	294.58	2711.59	−2417.01	−89.14
EL	14	2.46	5.87	−3.41	−58.09
FI	123	222.53	312.04	−89.51	−28.69
FR	3240	2701.21	4357.41	−1656.2	−38.01
HR	114	51.5	92.55	−41.05	−44.35
HU	40	50.83	70.84	−20.01	−28.25
IE	180	675.64	1961.95	−1286.31	−65.56
IT	9887	843.04	2222.74	−1379.7	−62.07
LT	37	223.05	332.94	−109.89	−33.01
LU	53	1339.73	5117.51	−3777.78	−73.82
LV	380	31.29	61.31	−30.02	−48.96
MT	2	220.95	332.47	−111.52	−33.54
NL	175	84.46	141.11	−56.65	−40.15
PL	280	3845.46	8967.1	−5121.64	−57.12
PT	57	32.26	64.25	−31.99	−49.79
RO	1616	607.25	1171.31	−564.06	−48.16
SE	364	161.54	330.32	−168.78	−51.10
SI	78	53.36	160.92	−107.56	−66.84
SK	262	136.93	400.94	−264.01	−65.85
UK	1960	1221.09	1761.19	−540.1	−30.67
Total	25,258	16,036.34	38,814.59	−22,778.3	−58.68

A. (2010). Study on the economic and budgetary impact of the introduction of a Common Consolidated Corporate Tax Base in the European Union, Ernst & Young LLP. Oestreicher von Andreas and Koch, Reinald. (2011). The Revenue Consequences of Using a Common Consolidated Corporate Tax Base to Determine Taxable Income in the EU Member States. FinanzArchiv 67: 64–102. Nerudová, D., Solilová, V. (2015a). The impact of the CCCTB introduction on the distribution of the group tax bases across the EU: The study for the Czech Republic. Prague Economic Papers 24(6): 621–637. Nerudová, D. & Solilová. (2015b). Quantification of the impact on the total corporate tax basis in the Czech Republic caused by the CCCTB implementation in

Table 6.11 CCCTB and its impact on corporate tax revenues (The corporate tax revenues based on the CCCTB system allocated at the level of subsidiary based on its tax residency.)—part B (own processing, Amadeus database)

Country of subsidiary	Dataset with imputed data through the regression method—tax liability based on the CCCTB is higher than current tax liability				Change (in %)
	No. of subsidiaries	CCCTB tax liability (in million EUR)	Current tax liability (in million EUR)	Difference B (in million EUR)	
AT	349	82.55	73.65	8.9	12.08
BE	1016	267.38	235.85	31.53	13.37
BG	34,357	131.29	118.09	13.2	11.18
CY	6	0.28	0.22	0.06	27.27
CZ	19,148	217.68	180.18	37.5	20.81
DE	1317	312.33	262.46	49.87	19.00
DK	4215	200.96	177.12	23.84	13.46
EE	953	30.34	22.44	7.9	35.20
ES	78	71.19	30.82	40.37	130.99
EL	4	6.39	4.8	1.59	33.13
FI	1220	58.39	51.26	7.13	13.91
FR	116	77.3	44.93	32.37	72.05
HR	5028	73.31	60.52	12.79	21.13
HU	83	33.63	12.72	20.91	164.39
IE	13	1.92	1.53	0.39	25.49
IT	157,673	3972.71	3122.22	850.49	27.24
LT	29	36.57	27.6	8.97	32.50
LU	142	122.58	97.67	24.91	25.50
LV	15,266	87.56	77.18	10.38	13.45
MT	3	20.47	18.73	1.74	9.29
NL	131	114.81	70.94	43.87	61.84
PL	4311	556.71	171.44	385.27	224.73
PT	18	30.18	17.21	12.97	75.36
RO	89,646	512.47	470.27	42.2	8.97
SE	359	183	71.38	111.62	156.37
SI	7466	129.29	109.67	19.62	17.89
SK	15,921	243.03	220.89	22.14	10.02
UK	190	117.56	74.92	42.64	56.91
Total	359,058	7691.88	5826.71	1865.17	32.01

EU28. Politická ekonomie 63(4), 456–773. Nerudova, D., Solilova, V., Bohušova, H. & Svoboda, P. (2015). Dopady zavedení společného konsolidovaného základu daně na příjmovou stránku rozpočtu České Republiky. Praha: Wolters Kluwer., Domonkos, T., Domonkos, Š., Dolinajcová, M., Grisáková, N. (2013). Effect of the formulary apportionment of the Common Consolidated Corporate Tax Base on the tax revenue in the Slovak Republic. Ekonomický časopis 61(5): 453–467. Solilová, V., Nerudová, D. (2016). Implementation of Common Consolidated Corporate Tax Base and its Implications for Non-participating Country: A Case Study for the Czech Republic. Ekonomický časopis 64(3): 282–298.

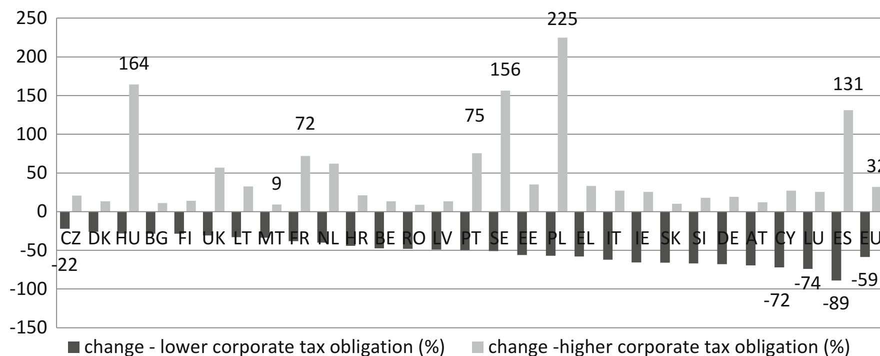

Fig. 6.4 Change in corporate tax liability after the adoption of the CCCTB system across the EU (in %) (own processing)

To sum up, the result regarding whether the corporate tax liability will be lower or higher after the adoption of the CCCTB system is affected by three aspects: the nominal[73] tax rate, variables from the apportionment formula and the amount of the tax base.[74] Member States have right to set their own *corporate tax rates*, and the CCCTB proposal does not affect this right; therefore, it is expected that Member States will change their nominal tax rates in order to meet their budgetary policy targets. Mintz (2008) highlights that Member States can impose their own tax rates to avoid the disruption of the fiscal sovereignty and to preserve the direct control of their tax revenues and tax administration. In contrast, Bettendorf et al. (2010) state that the most effective redistribution of capital, tax revenues and welfare will be reached through the CCCTB and the uniform tax rate.

Regarding the *apportionment formula*, according to Agúndez-García (2006), the most discussed allocation-formula factor represents assets due to the mobility of capital and investments. In contrast, as the most discussed allocation formula factors, Eberhartinger and Petutschnig (2014) highlight the number of employees and payroll costs. Differences in the level of payroll costs in the European Union and differences in the character of businesses (e.g., there are many services with seasonal characters mainly in relation to the tourism industry and high-knowledge industries that generate large profits with a minimal level of fixed tangible assets used but with emphasis on intangible assets (which are excluded from the apportionment formula)) can have a significant effect on the allocation of corporate taxes across Member States. Moreover, some Member States' tax profits do not have real substance of business activities, such as Cyprus, as a result of profit shifting and

[73]The nominal tax rate is applied on the corporate tax base determined through an apportionment formula, based on current tax law in each Member State where a subsidiary is situated, as the CCCTB proposal does not affect Member States' right to set their own corporate tax rates.

[74]For the purpose of our study, there is an assumption that the amount of the total tax base is considered not to change as a result of the adoption of the CCCTB system even though the C(C)CTB proposal suggests unified rules for corporate tax base construction.

Table 6.12 CCCTB and its impact on corporate tax revenue (The corporate tax revenue based on the CCCTB system allocated at the level of subsidiary based on its tax residency.)—part C (own processing, Amadeus database)

	Dataset with imputed data based on the regression method				Impact of CCCTB on corporate income taxes revenues		
	CCCTB tax liability	CCCTB tax liability	Total CCCTB liability	Current tax liability	Corporate income taxes revenue	Corporate income taxes revenue after CCCTB	Change in corporate income taxes revenues
	A	B	A + B	C	D	E = D–C + A + B	F = (E–D)/D*100
Country of subsidiary	(in million EUR)	(in million EUR)	(in billion EUR)	(in billion EUR)[c]	(in billion EUR)[d]	(in billion EUR)	(in %)
AT	821.20	82.55	0.90	2.76	7.3	5.45	−25.39
BE	602.95	267.38	0.87	1.33	12.8	12.34	−3.62
BG	**26.55**	**131.29**	**0.16**	**0.15**	**0.9**	**0.90**	**0.32**
CY*	472.63	0.28	0.47	1.70	1.1	−0.12	−111.22
CZ	585.77	217.68	0.80	0.91	5.2	5.10	−1.99
DE	526.51	312.33	0.84	1.80	71.1	70.14	−1.35
DK	**184.24**	**200.96**	**0.39**	**0.09**	**7**	**7.29**	**4.19**
EE	17.33	30.34	0.05	0.05	0.3	0.29	−1.77
ES	294.58	71.19	0.37	2.86	20.9	18.41	−11.93
EL	2.46	6.39	0.01	0.01	3.3	3.30	−0.05
FI	222.53	58.39	0.28	0.36	4	3.92	−2.04
FR	2701.21	77.3	2.78	4.38	57.7	56.10	−2.78
HR	51.5	73.31	0.12	0.15	0.8	0.77	−3.49
HU	**50.83**	**33.63**	**0.08**	**0.08**	**1.4**	**1.40**	**0.08**
IE	675.64	1.92	0.68	1.96	4.7	3.42	−27.23
IT	843.04	3972.71	4.82	5.07	35.1	34.85	−0.72
LT	223.05	36.57	0.26	0.36	0.5	0.40	−19.88
LU*	1339.73	122.58	1.46	5.19	2.1	−1.63	−177.69
LV	**31.29**	**87.56**	**0.12**	**0.05**	**0.4**	**0.47**	**16.73**

(continued)

Table 6.12 (continued)

Country of subsidiary	Dataset with imputed data based on the regression method				Impact of CCCTB on corporate income taxes revenues		
	CCCTB tax liability	CCCTB tax liability	Total CCCTB liability	Current tax liability	Corporate income taxes revenue	Corporate income taxes revenue after CCCTB	Change in corporate income taxes revenues
	A	B	A + B	C	D	E = D–C + A + B	F = (E–D)/D*100
	(in million EUR)	(in million EUR)	(in billion EUR)	(in billion EUR)[c]	(in billion EUR)[d]	(in billion EUR)	(in %)
MT	220.95	20.47	0.24	0.35	0.5	0.39	−21.96
NL	84.46	114.81	0.20	0.37	17.1	16.92	−1.03
PL*	3845.46	556.71	4.40	9.03	7.2	2.57	−64.33
PT	32.26	30.18	0.06	0.08	4.9	4.88	−0.42
RO	607.25	512.47	1.12	1.64	3.2	2.67	−16.41
SE	161.54	183	0.34	0.37	11.5	11.48	−0.21
SI	53.36	129.29	0.18	0.27	0.5	0.41	−17.38
SK	136.93	243.03	0.38	0.60	2.4	2.18	−9.22
UK	1221.09	117.56	1.34	1.98	54.7	54.06	−1.17
Total	**16,036.34**	**7691.88**	**23.73**	**43.98**	**338.6**	**318.35**	**−5.98**

[a]Results from Table 6.10—tax liability based on the CCCTB is lower than current tax liability
[b]Results from Table 6.11—tax liability based on the CCCTB is higher than current tax liability
[c]Current tax obligation is determined as a tax base of entity multiplied with effective tax rate
[d]The overall corporate income tax revenues in the country for 2014. Taxation Trends in the European Union, Data for the EU Member States, Iceland and Norway (2016)
*Cyprus, Luxembourg, Poland represent a very large change; however, it is affected by higher current tax liability in comparison (columns C) with corporate income tax revenues (columns D). Lower corporate income tax revenues are caused mainly by loss offsetting and tax incentives actually performed by individual SMEs in the country

aggressive tax planning. These specificities can be considered drivers of the decrease/increase in corporate tax liability when the apportionment formula is applied. However, for some industries, the assumed apportionment formula does not seem suitable—e.g., banking, insurance, mining and transport industries. Therefore, the CCCTB proposal includes amended allocation formulae for these industries. Krchnivá (2014) proves that the presence or proportion of allocation-formula factors can significantly affect a country's overall tax revenues. Thus, it is clear that the selection of variables entering into the apportionment formula will affect the re-distribution of tax bases between Member States, and this part of the CCCTB proposal will be subjected to considerable discussion. In this respect, Roggeman et al. (2012) underlines that allocation formula factors suggested by the European Commission are able to explain the creation of the corporate tax profit by 28%. A similar result was also found by Krchnivá and Nerudová (2015). They have arrived at the result that the factors are able to explain 35% of the variability in profitability of the Czech companies. Furthermore, Cobham and Loretz (2014) underline that the allocation of corporate tax profit based on the tangible assets and number of employees is beneficial in the case of low-income countries, in contrast to high-income countries, for which sales and employee costs are more beneficial factors.

Regarding *the tax base*, the rules for the construction are set by the CCTB proposal, which are common and simplified, comprising only the minimum level of deductible items with the aim of decreasing the compliance costs of taxation.

Taking into account all these aspects, it is very difficult to determine the effect of the CCCTB system on SMEs' performance and corporate tax liability without any limitations. Of course, any change in the limitation[75] of the research may affect the expected results. However, it is obvious that the re-distribution of the consolidated tax base in accordance with the apportionment formula and the subsequent amount of tax liability will be different from the current situation and will alter the map of the corporate tax system in the European Union (see Figs. 6.5 and 6.6). Moreover, it has to be highlighted that regardless the outcome, any tax savings can be used by SMEs to increase their business performance and the level of their internationalization in the European Union, which is desirable mainly in the context of smart, sustainable and innovative growth. In addition, qualified subsidiaries situated in Member States not allowing the group taxation scheme will welcome the introduction of the C(C)CTB system as the most attractive tool for addressing group taxation and loss offset within the group.

[75]The list of limitations is mentioned in Sect. 6.5.1.

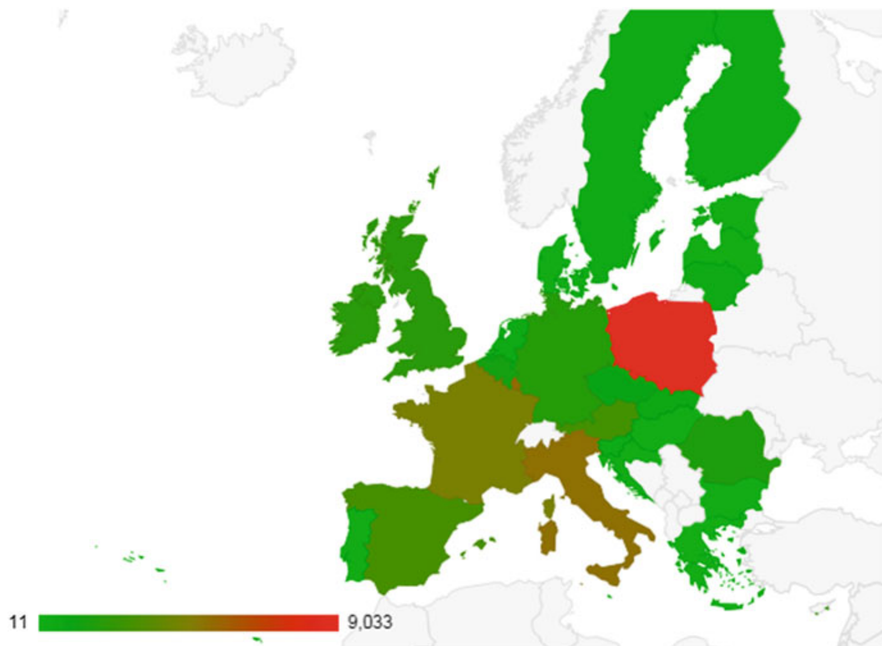

Fig. 6.5 Re-allocation of corporate tax liability of SMEs across the EU—current situation (This figure represents the assignment of corporate tax liability based on the tax residency of the subsidiary.) (in million EUR) (own compilation through Google Charts, Amadeus database)

6.6 Conclusion

The C(C)CTB represents one of the most ambitious projects in the history of corporate taxation in the European Union. The idea of the centralization of the total taxable income and profits of corporations in the state of tax domicile or those in which the greater part of business activities are performed and subsequently allocated with respect to the tax base in Member states first appeared in 1962 in the Neumark Report. After 44 years, the ideas of the Neumark Report were relaunched in the form of the proposals of the C(C)(CTB Directives, which introduced cross-border loss offsetting and the consolidation of profits or losses with apportionment between Member States via an apportionment formula.

The implementation of the C(C)CTB can bring the advantages on both sides—on the side of the taxpayer and on the side of the tax administration. The disappearance of the differences between the nominal and effective tax rate and the harmonization of the rules for tax base construction should lead to the establishment of fair tax competition (i.e., the situation in which all market subjects have the same information about the effective tax rate) and to the elimination of tax obstacles to mergers and acquisitions mainly in the areas of capital profit taxation, reduced compliance costs of taxation, the elimination of transfer pricing issues, and the establishment of

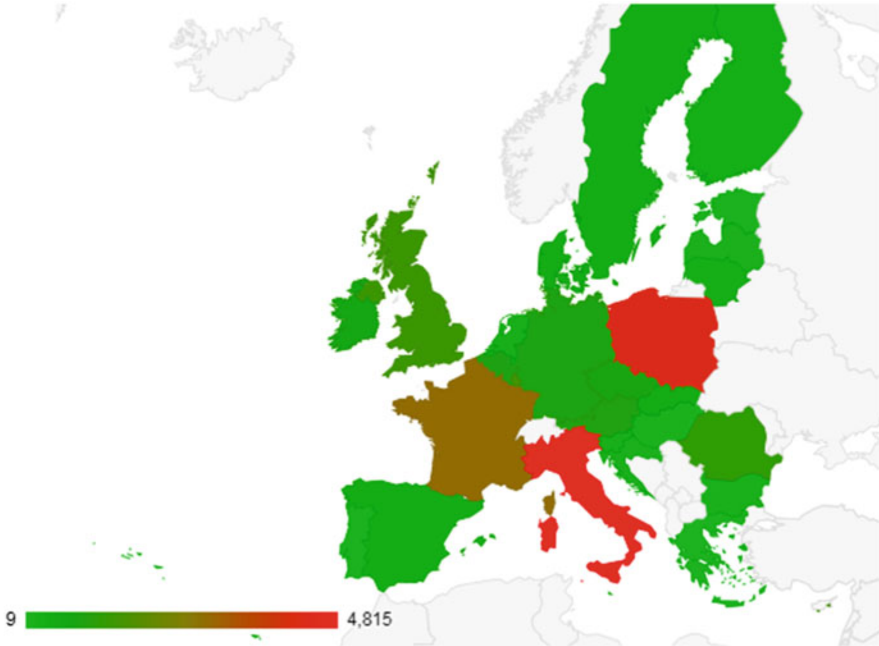

Fig. 6.6 Re-allocation of corporate tax liability of SMEs across the EU—based on the CCCTB proposal (This figure represents the assignment of corporate tax liability based on the tax residency of the subsidiary. The limitations of the study—the same tax base and the same nominal tax rate with the application of an apportionment formula—are considered.) (in million EUR) (own compilation through Google Charts, Amadeus database)

the possibility of cross-border loss offsetting. With respect to SMEs, the cross-border losses are considered to be very serious and to be a limitation of the internationalization of SMEs in the European Union; therefore, such offsetting represents one of the advantage of the CCTB system as the first implementation step of the CCCTB system. Based on our research, almost one-half of SMEs with foreign associated entities face this issue and welcome its solution via offsetting the losses at the level of the parent company. Further, another advantage represents the common rules for corporate tax base construction—SMEs would not face 28 different tax systems, which is connected with high compliance costs of taxation. A final important advantage concerns the super-deduction for R&D for the intensive support of companies, notably SMEs, and start-up companies. In the second step, through the introduction of the CCCTB system, lower corporate tax liability of SMEs (EUR 20.913 billion) would be achieved, as was proved in our research, which represents a decrease in total corporate tax revenues by 5.98% covering the tax liability of LEs and SMEs in the European Union. This tax saving altogether with the advantages of suggested tax systems can increase the business performance of SMEs and the level of their internationalization in the European Union. This might result into economic benefits at least in the form of an increase in investment,

employment and smart, sustainable and innovative growth. From this perspective, we can conclude that the C(C)CTB system is suitable for SMEs especially as a new form of corporate taxation, with the aim of eliminating the main distortions on the Internal Market.

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Chapter 7
Conclusion

The final chapter of this book presents general observations about transfer pricing issues, critical concerns about transfer pricing and compliance issues and suggestions for tools to decrease compliance costs in the context of SMEs. The results of our research presented in this book highlight the fact that reducing compliance costs and simplifying measurement in transfer pricing rules, or a different approach such as CCCTB, can significantly affect the economic performance of SMEs. The internationalization of SMEs can help to achieve the long-term goals of the EU2020 agenda, such as smart and inclusive growth in the EU.

According to the European Commission (2016), SMEs account for 99% (23 million entities) of all the companies in each European country and operate in a wide range of industry sectors. They provide more than 90 million jobs and contribute to a considerable proportion of created value-added (57%) and posting growth of 5.7% in 2015. There is no doubt that SMEs play a key role in the EU economy. However, with respect to large enterprises (LEs), the group of SMEs in the EU is very heterogeneous and differs significantly from LEs. They differ not only in their size, but they also perform different activities, have different needs and require different resources. Currently, SMEs already face special rules in the area of accounting and financial reporting in comparison with LEs; however, SMEs also face specific problems and have specific needs in the area of practical international taxation issues. Regarding the law and regulations, there are 28 different tax systems in the European Union, which may inherently disadvantage SMEs and may have distortive impacts on commercial decisions concerning the different business forms and different business activities. The disproportionately high impact of regulatory requirements also creates disproportionally high compliance costs in comparison with LEs. In 2007, the European Commission (2007a, b) highlighted that a large company spends one euro per employee to comply with a regulatory duty, whereas a medium-sized enterprise might have to spend approximately four euros, and a small business may spend up to ten euros. The European Commission (2013) provided evidence that the Value Added Tax and corporate taxation are the most burdensome legislative acts for SMEs in the European Union. The European

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Commission (2010) also highlighted that regardless of regulations and the law, the lack of human and financial capital, the lack of knowledge and information, the lack of experience and resource availability, and the lack of public support are crucial barriers for doing international business from the perspective of SMEs. According to the European Commission (2007c, 2016), only 5% of SMEs are associated (having subsidiaries abroad) and only 1.2 million of SMEs are exporting, 83% of which are within the EU. This proves two important facts: (1) very low cross-border activities of SMEs in contrast with LEs and (2) insufficient use of external market demand for goods and services. This results in lower performance and lower economic growth of SMEs in the EU.

With regards to corporate taxation regulations in each of the Member States and the internationalization of SMEs, another taxation issue should be highlighted, namely, transfer pricing. In the EU, transfer pricing compliance means adherence to the arm's-length principle stipulated in Article 9 of the OECD Model Convention and following OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter, TP Guidelines). However, it is clear from the name itself that these TP Guidelines set treatments of transfer pricing issues with respect to multinational enterprises, which are generally LEs. In addition, the TP Guidelines make no direct distinction between the types or sizes of enterprises. In theory, all enterprises, regardless of their size, are subject to the same principles and recommendations. Thus, all SMEs doing international business (but also domestic business through associated enterprises in some countries, as the arm's-length principle was also introduced for domestic intragroup transactions) face transfer pricing issues. With regards to SMEs, we consider the application of transfer pricing rules a very complex, resource-intensive process connected with certain difficulties.[1] It is compounded by the fact that there is neither a common definition of SMEs for tax purpose in the EU nor symmetry of treatment of this issue. Additionally, the costs associated with transfer pricing matters can be disproportionally large for SMEs in comparison to LEs. Therefore, we believe that a "one-size-fits-all" approach is not suitable in the case of SMEs facing transfer pricing issues. We believe that it is necessary to analyse transfer pricing issues in relation to SMEs across the EU Member States and to suggest alternative approaches as a suitable solution for transfer pricing issues of SMEs.

To analyse this issue, in 2016, a questionnaire was sent to a representative sample of SMEs (covering 2600 entities that operate in the EU26—excluding Malta and Cyprus), with an overall return rate of 5.5%. The survey revealed that almost 86% of the respondents (SMEs) use tax consultant services for transfer pricing issues and all tax matters. The study provided evidence that transfer pricing issues are extremely burdensome for SMEs with respect to both cost and time. The respondents identified that the greatest portion of the time and cost required to manage transfer pricing issues was related to the preparation of transfer pricing documents. In accordance with the results of the questionnaire, we determined the

[1]For more details about transfer pricing rules for SMEs, see Chap. 2.

compliance costs of transfer pricing for SMEs. European SMEs bear the costs for managing transfer pricing issues, primarily in the form of transfer pricing documentation, and these costs range between EUR 3090 and EUR 5564/year/entity, an amount equivalent to between 18 and 30 workdays/year. Accordingly, when considering the entire group of SMEs acting in the EU28, the costs represent a portion of the overall EU28 corporate tax collected between 1.32% and 2.38% (or EUR 4.8 to 8.7 billion).[2] There is no doubt that in the case of SMEs, greater simplicity in transfer pricing administration and improving the efficiency and effectiveness of transfer pricing enforcement are essential. Tax policymakers should carefully design new tax obligations in the area of transfer pricing and address the disproportionately high tax compliance costs faced by SMEs.

Furthermore, the respondents of the questionnaire suggested 217 simplified measurements as tools to decrease SMEs' compliance costs related to transfer pricing. Most of the suggestions represented simplified transfer pricing documentation (29%), followed by smaller penalties (21%) and opportunities to apply for a safe harbour[3] (16%). The respondents (81%) would appreciate opportunities to apply for a safe harbour for transactions, such as manufacturing, distribution and services; intangibles (32%); and royalties and loans (28%). Eighty-four percent of the respondents (SMEs) would appreciate the introduction of simplified transfer pricing documentation, while 71% of the respondents preferred the exclusion of micro and small entities from the obligation to prepare transfer pricing documentation. Sixty-nine percent of the respondents (SMEs) would appreciate an introduction to the EU-comparable benchmarks for selected industries and a C(C)CTB system (51% of SMEs). Based on the results of the questionnaire, this research was focused in more detail on simplified measurements (namely, on safe harbours) and on the new corporate system of taxation in the form of the C(C)CTB as a suitable solution for transfer pricing issues of SMEs.

Because SMEs are not usually able to ensure all required information related to transfer pricing issues (specifically comparable and functional analysis due to the lack of human and financial capital) and are using tax and accounting consultancy increasingly resulting in higher compliance costs of taxation than LEs, the introduction of simplified transfer pricing measurements can be seen as a suitable solution. As seen by the analysis of simplified measurements in the EU for SMEs or small transactions, several Member States are using whole or partial exemption from transfer pricing documentation requirements, simplified APA procedures or a reduced APA charge, a different penalty regime, or full exemption from transfer pricing rules.[4] However, after the relaunching of the safe harbour provision in the TP Guidelines, the application of safe harbour in other areas of transfer pricing

[2]For more details about compliance costs of taxation, see Chap. 4.

[3]A safe harbour is defined for a certain category of taxpayers or transactions and relieves eligible taxpayers from certain transfer pricing obligations, or exempts a defined category of taxpayers or transactions from the application of all or part of the general transfer pricing rules.

[4]For more details about transfer pricing rules for SMEs, see Chap. 2.

within the arm's length range for SMEs in different industry activities should be strongly considered.[5] Therefore, we try to determine safe harbours for the selected NACE sectors (C—Manufacturing, F—Construction, G—Wholesale and retail trade; repair of motor vehicles and motorcycles, I—Accommodation and food and M—professional, scientific and technical activities), representing five of the most important sectors where SMEs are operating. The determination of safe harbours was performed based on the analysis of profitability of independent SMEs (specifically EBIT margin and Mark-up profit margin) operating in the European Union. This follows the fundamental principle of the arm's-length standard of comparability, which is based on the theory that profitability rates earned by enterprises operating under similar conditions in the same market and industry sector are equalized in broadly similar product markets. Furthermore, it is based on the general analogy resulting from the generality of a simplified approach, which can generate some inaccuracies. As a result, in the case of small entities, we proposed a safe harbours arm's length margin range between 1 and 11%, and in the case of medium-sized entities, we proposed a margin range between 1 and 13%, in dependence on the indicator of profitability used (EBIT margin or Mark-up profit margin) and industry in which the SME is operating.[6] By the application of the suggested safe harbours arm's-length margin ranges, the compliance costs of taxation and transfer pricing should be reduced, as well as the administrative burden of the tax authorities. In particular, SMEs would not be required to perform time-consuming comparability analysis resulting in the determination of the arm's-length profit margin or mark-up. They could apply for publicly presented safe harbours, thus saving time, financial capital and human resources as well as reducing the compliance costs of taxation.

Considering the advantages and disadvantages of safe harbours, the benefits of safe harbours are potentially the greatest for SMEs/small multinational enterprises or those in the early stages of cross-border expansion. Safe harbours can reduce compliance costs of transfer pricing, make transfer pricing issues easier for SMEs, reduce administration costs, increase certainty for taxpayers and improve effectiveness of tax administration mainly by decreasing the number of transfer pricing disputes, audit and MAP cases for tax administrators. Some disadvantages of an application for a specific category of taxpayers or transactions include creating discriminations or some distortions (e.g., trade or competitiveness); risk of double taxation or non-taxation; inappropriate tax planning; and transfer pricing manipulation resulting in lower tax revenues. However, almost all of the concerns can be eliminated by both clearly and carefully designating criteria and conditions under which a taxpayer/transaction is eligible for safe harbours and by bilateral or multilateral forms of safe harbours.

The second suggested suitable solution for transfer pricing issues of SMEs is presented by the new corporate taxation system in the form of the C(C)CTB, which

[5] For more details about safe harbours, see Chap. 5.

[6] For more details about safe harbours, see Chap. 5.

was proposed by the European Commission during October 2016 to be a tool to prevent tax avoidance, tax fraud and profit shifting. The introduction of this corporate taxation system is welcomed by opponents of the arm's-length standard who perceive the standard negatively and consider it incompatible with today's global economy. With the current globalized economy, the many technological changes, the mobile and digital nature of business, and the more complex and complicated business models, it is absolutely erroneous to evaluate the results of associated enterprises based on the assumption that they were a group of unrelated enterprises transacting with one another at arm's length and then using this assumption to determine where profits fall to be taxed. Today, there is evidence that the arm's-length standard does not reflect economic reality and is not able to ensure the fairest and most reliable basis for the determination of where profits fall to be taxed and whether the third party would enter into the transaction (the basic premise of the arm's-length principle).[7] There is evidence that income shifting between enterprises is taking place irrespective of the existence of the arm's-length principle[8] because transfer pricing is used as a tax planning tool to enable the distribution of the tax risks and profits resulting in the reduction of the overall corporate tax liability. Due to the aggressive tax planning, the OECD estimates annual losses from 4 to 10% of global corporate income tax revenues (i.e., USD100–240 billion), and the EU estimates annual losses of tax revenues of approximately EUR 1 trillion. However, due to the profit shifting and inefficiencies of the corporate taxation system, the annual loss in the EU is assumed to be approximately EUR 50–190 billion. It is obvious that the international tax rules, including the arm's-length standards and the current tax systems, are proving to be inefficient, non-transparent and unable to react on increasingly sophisticated tax planning structures. Moreover, it is debatable whether the BEPS recommendations can help to ensure the fairest and most reliable basis for the determination where profits fall to be taxed with the objective to eliminate aggressive tax planning.

The absolute change in the corporate taxation system, for example, in the form of C(C)CTB, could ensure a better reflection of economic reality of corporate entities, and through the consolidation of total taxable income and profits, it could help to eliminate the problem with transfer pricing issues, as all intergroup transactions will be eliminated from the total taxable income of the group.

The implementation of the C(C)CTB can bring advantages to both sides—the taxpayer and the tax administration. The disappearance of the differences between the nominal and effective tax rate and the harmonization of the rules for tax base construction should lead to the establishment of fair tax competition (i.e., the situation in which all market subjects have the same information about the effective

[7]For more details, see Avi-Yonah and Clausing (2007), Durst (2010, 2011), Keuschnigg and Devereux (2013), Taylor et al. (2015), Bartelsman and Beetsma (2000), Wells and Lowell (2014), Hines and Rice (1994), Huizinga and Laeven (2006) and others.

[8]The arm's-length principle was introduced as a rule against the manipulation of transfer prices and should manage a fair taxation of profits between jurisdictions where engaged; associated enterprises are operating with the objective of mitigating economic double taxation.

tax rate). It would also facilitate the elimination of tax obstacles to mergers and acquisitions, mainly in the areas of capital profit taxation, reduced compliance costs of taxation, the elimination of transfer pricing issues, and the establishment of the possibility of cross-border loss offsetting. With respect to SMEs, the cross-border losses are considered to be very serious and a limitation of the internationalization of SMEs in the European Union. Therefore, such a possibility of offsetting represents one of the advantages of the CCTB system and is the first implementation step of the CCCTB system. Based on our research, almost one-half of SMEs with foreign associated entities face this issue and welcome its solution (via offsetting the losses at the level of the parent company). Another advantage is the common rules for corporate tax base construction; SMEs would not face 28 different tax systems, which is connected with the high compliance costs of taxation. Finally, the most important advantage concerns the super-deduction for R&D for the intensive support of companies, notably SMEs and start-up companies. In the second step, through the introduction of the CCCTB system, we provide evidence that SMEs would face a lower corporate tax liability. This tax savings, along with the advantages of the suggested tax systems, can increase the business performance of SMEs and the level of their internationalization in the European Union. This might result in economic benefits at least in the form of an increase in investment, employment and smart, sustainable and innovative growth. From this perspective, we can conclude that the C(C)CTB system is suitable for SMEs, especially as a new form of corporate taxation, with the aim of eliminating the main distortions on the Internal Market.

In summary, safe harbours or the C(C)CTB system can reduce compliance costs of taxation and transfer pricing. This tax savings can significantly affect the economic performance of SMEs and their internationalization. This can also help to achieve the long-term goals of the EU2020 agenda, such as smart and inclusive growth in the EU. Therefore, we recommend the introduction of safe harbours or the C(C)CTB system in the EU. We also recommend introduction of the C(C)CTB globally.

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