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# European Commission proposes to simplify transfer pricing rules 2/41/23

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On 12 September 2023 the European Commission published its proposal for a transfer pricing (TP) directive to align TP requirements across the EU. While most of the member states, including Latvia, are to some extent applying recommendations made by the OECD TP guidelines, the European Commission is proposing the directive and calling on the member states to adopt the same TP standards in order to secure a level playing field. If the new rules are approved in their current version, they will be passed into the member states' national law by 31 December 2025 and applicable from 1 January 2026.

## An overview

The proposed directive aims to enhance tax certainty, reduce costs incurred in preparing TP files, and mitigate the risk of double taxation. The member states currently have wide discretion in interpreting and applying recommendations made by the OECD TP guidelines, which poses tax obstacles and risks for companies. The proposal has another key purpose of aligning TP requirements by introducing a definition of the arm's length principle into EU law and defining the role of the OECD TP guidelines.

Let's take a look at some of the directive's key aspects and potential effects on taxpayers.

## The definition of related parties

Latvian law recognises related parties as an entity directly or indirectly holding 20% or more shares in another entity. The directive would make certain changes to the Latvian definition of related parties, with TP requirements affecting a narrower range of subjects than currently because a "related entity" under the directive is an entity related to another in one of the following ways:

- An entity takes part in another entity's management, in a position capable of significantly influencing that other entity.
- An entity controls another entity through voting power that exceeds 25% of total voting power on its executive body (board).
- An entity directly or indirectly holds 25% or more shares in another entity.
- An entity is entitled to 25% or more of another entity's profit.

In addition, a permanent establishment under the directive will be considered a party related to the company it represents. Thus, a TP file will have to demonstrate that prices applied in their mutual transactions are arm's length.

## Accelerated prevention of double taxation

One part of the proposal is to introduce an "accelerated" corresponding adjustment that would allow an appropriate corresponding adjustment to be made in Latvia, for example, if the primary TP adjustment has been made in another member state. The proposal states that once the taxpayer files a request for a corresponding adjustment, the member state should ensure that it accepts or rejects the request within 180 days. The member state should, of course, agree that the primary adjustment is arm’s length.

Latvian law currently makes no provision for a corresponding adjustment, and so the only way of preventing double taxation is to launch a time-consuming procedure known as the mutual agreement procedure. Statistics published by the OECD show that this procedure rarely achieves a positive outcome for the taxpayer. The proposal states that if a member state refuses a request for an accelerated corresponding adjustment, the taxpayer will still be able to use the mutual agreement procedure.

## An arm’s length range

Compared to the OECD TP guidelines, the proposal takes a more stringent stance on the arms's length range by stating that this will be the interquartile range. If a transaction’s results fall outside the interquartile range, the company should make an adjustment. This requirement will also modify the understanding of the arm’s length principle in Latvia, in a way that is undetermined in the local TP law so far. In their TP analysis, taxpayers are allowed to use the full arm’s length range from the minimum to the maximum value if the facts and circumstances of the transaction warrant this.

The proposal also states that taxpayers may adjust their TP only if the results fall outside the interquartile range. An adjustment will have to be made to the median, unless the taxpayer can demonstrate that the facts and circumstances of the particular case warrant a different value being applied for the adjustment.

## The takeaway

While it remains to be seen whether the member states will accept the European Commission’s proposal, companies should be monitoring its progress to spot any modifications capable of affecting their TP methodology. Multinational enterprises should carry out a preliminary analysis of their structures and TP based on the current proposal and evaluate how any new proposals will affect their business.