

Transfer Pricing in Spain

The Law 36/2006 on Measures for Preventing Tax Fraud

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Abstract

In order to prevent tax arbitrage, almost all OECD Member countries have agreed on implementing the arm's length principle as the international standard to be used for determining transfer prices for tax purposes. The recently approved Law 36/2006 on Measures for Preventing Tax Fraud includes an amendment to the article 16 CITL, which contains the basic Spanish rules concerning transfer pricing, in line with the international trend. In this working paper it will be outlined the basic international transfer pricing scenario as well as the new Spanish transfer pricing legislation.

Summary

- 1. What is transfer pricing?**
- 2. Transfer pricing in the international scenario**
 - 2.1. OECD Model Tax Convention and Guidelines**
 - 2.2. EU JTPF works**
- 3. Transfer pricing in the Spanish tax legislation**
 - 3.1. Law on Measures for Preventing Tax Fraud**
 - 3.2. Transfer pricing methods**
 - 3.3. Documentation requirements**
 - 3.4. Deductibility of charges for intra-group services**
 - 3.5. Deductibility of charges derived from cost sharing agreements**
 - 3.6. Advanced Pricing Agreements**
- 4. Transfer pricing economic analysis**
 - 4.1. Comparability analysis: industry and functional review**
 - 4.2. Economic analysis: transfer pricing methods**
 - 4.2.1. Comparable Uncontrolled Price (CUP)**
 - 4.2.2. Resale Price Method (RPM)**
 - 4.2.3. Cost Plus Method (CPM)**
 - 4.2.4. Profit Split Method (PSM)**
 - 4.2.5. Transactional Net Margin Method (TNMM)**
 - 4.3. Benchmarking analysis under the TNMM approach**
- 5. Documentation requirements**
 - 5.1. Penalty regime**
 - 5.2. EU-wide common approach to transfer pricing documentation**
- 6. Transfer pricing adjustment. Double taxation and international arbitration**
- 7. Conclusions**
- 8. Examples**
 - 8.1. Example 1: Tax arbitrage**
 - 8.2. Example 2: Benchmarking analysis under TNMM approach**
 - 8.3. Example 3: Transfer pricing adjustments and double taxation**
- 9. References**

1. *What is transfer pricing?*

In the current international market, a large share of trade consists of transfers of tangibles and intangibles, provision of services and loans between related parties taking part of the same multinational group. Given the differences in the tax regimes across jurisdictions, an important matter that multinational enterprises take into account in order to set the transfer prices in such related party transactions is the tax savings¹ (see example 1).

In this regards, in order to prevent such tax arbitrage and, consequently, a taxable income drain, almost all OECD Member countries have agreed on implementing the arm's length principle as the international standard to be used for determining transfer prices for tax purposes. The arm's length principle implies that transfer prices must be assessed like the ones that would have been agreed between independent entities and, if not, transfer pricing adjustments must be made.

Additionally, most of tax administrations have developed rules and procedures on transfer pricing documentation to be obtained from taxpayers in case of tax auditing. Therefore, the burden of proof is shifted to the taxpayers that, in a tax inspection, must be in position to provide documentary evidence that their related party transactions satisfy the arm's length principle. Moreover, these transfer pricing documentation requirements are usually enforced by means of tax penalties.

The different sections of this working paper will portray the following contents: (2) the international transfer pricing scenario emphasizing the works of the OECD and the Joint Transfer Pricing Forum of the European Union (hereinafter referred to as EU JTPF); (3) the Spanish transfer pricing legislation with special considerations for the recent transfer pricing modifications introduced by the Law 36/2006 on Measures for Preventing Tax Fraud²; (4) the economic analysis to be carried out by Spanish taxpayers in order to obtain an adequate arm's length valuation of their related party transactions; (5) the documentation requirements to be accomplished by Spanish taxpayers under the threat of severe tax penalties in case of non-fulfillment; and, finally, (6) some special considerations for double taxation and arbitration.

¹ As referred in BERNARD, JENSEN and SCHOTT (2006), CLAUSING (2003) in its working paper "Tax-motivated Transfer Pricing and US Intrafirm Trade Prices", *Journal of Public Economics*, 87, finds price responses in the expected directions: higher taxes abroad are associated with higher export prices and lower import prices for related-party transactions. It is estimated that a 1 percent drop in taxes abroad reduces U.S. export prices between related parties by 0.9 to 1.8 percent.

² Law 36/2006, 29 November, on Measures for Preventing Tax Fraud (BOE n. 286, 30 November 2006).

2. Transfer pricing in the international scenario

2.1. OECD Model Tax Convention and Guidelines

The authoritative statement of the arm's length principle is set forth in paragraph 1 of Article 9 OECD Model Tax Convention on Income and on Capital, which forms the basis of bilateral tax treaties involving OECD Member countries and an increasing number of non-Member countries, as follows: "*[when] conditions are made or imposed between the two [related] 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*".

Furthermore, the article 25 OECD Model Convention establishes a mutual agreement procedure aiming at the avoidance of the international double taxation that could derive from transfer pricing adjustments (see section 6). The article 25 states that "*1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention. 2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States. (...)*".

As explained in section 6 of this working paper, the OECD's Committee on Fiscal Affairs recently released a report entitled "Improving the Resolution of Tax Treaty Disputes", which modifies this mutual procedure agreement by introducing a second arbitral phase in case Tax Authorities would not agree in a period of two years. This reform is in line with the EU Arbitration Convention.

Apart from these model rules, the OECD has been working on transfer pricing issues since its report "Transfer Pricing and Multinational Enterprises" released in 1979, which was elaborated on the arm's length principle as set out in said article 9.

In 1995, the OECD released its reviewed version, "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (hereinafter referred to as OECD Guidelines), regarding the applicable principles for transfer pricing purposes. These Guidelines are intended to be a revision and compilation of previous reports by the OECD Committee on Fiscal Affairs addressing transfer pricing and other related tax issues with respect to multinational enterprises and, additionally, are

expected to be supplemented with additional chapters addressing other aspects of transfer pricing and will be periodically reviewed and revised on an ongoing basis.

Although soft law rules, the OECD Guidelines are intended to help tax administrations (of both OECD Member countries and non-Member countries) and multinational enterprises by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimizing conflict among tax administrations and between tax administrations and multinational enterprises and avoiding costly litigation. This is the reason why, OECD Member countries are encouraged to follow the Guidelines in their domestic transfer pricing practices, and taxpayers are encouraged to follow the Guidelines in evaluating for tax purposes whether their transfer pricing complies with the arm's length principle.

Finally, on 21 December 2006, the OECD Committee on Fiscal Affairs published new versions of Parts I, II and III of its "Report on the Attribution of Profits to Permanent Establishments". This report is aimed at achieving a greater consensus on the manner of attributing profits to permanent establishments under the article 7 OECD Model Convention and reflect the broad consensus of OECD member countries on attributing profits to permanent establishments based on the arm's length principle as stated in the OECD Guidelines.

2.2. EU JTPF works

The EU JTPF was formally established by the Council in June 2002 and, as stated in the Council conclusions, its work must be focused "on the basis of consensus and should produce pragmatic, non-legislative solutions within the framework of the OECD Transfer Pricing to the practical problems posed by transfer pricing practices in European Union".

The Forum is composed by one expert from the tax administrations of each Member State plus 10 independent experts specialized in this transfer pricing taxation. Representatives from applicant countries and the OECD Secretariat attend as observers.

Since its establishment, the EU JTPF has been working on resolving practical transfer pricing problems such as the elimination of double taxation in connection with the adjustment of profits of associated enterprises, the standardization of the documentation that multinationals must provide to tax authorities on their pricing of cross-border intra-group transactions and the dispute avoidance and resolution procedures including guidelines for Advance Pricing Agreements (APA). The EU JTPF outputs constitute soft law rules that are transmitted on a regular basis to the Council which will assess the need for appropriate action.

In its first term of activity, from October 2002 to December 2003, the conclusions and recommendations of the EU JTPF about the effective implementation of the EU Arbitration

Convention were taken as the basis for a Communication of the Commission including a proposal for a Code of Conduct that was finally adopted by the Council on 7 December 2004.

As conclusions of the works during its second term, from January 2004 to April 2005, the Council on 27 June 2006 adopted a Code of Conduct on transfer pricing documentation for associated enterprises in the European Union. This Code of Conduct, although a commitment that does not affect the spheres of competence of the Member States and the EU, standardizes the documentation that multinationals must provide to Tax Authorities on their pricing of cross-border intra-group transactions reducing significantly tax compliance costs.

Finally, the EU JTPF has been working in the field of dispute avoidance and resolution procedures including guidelines for Advance Pricing Agreements, which resulted in a Communication of the Commission on 26 February 2007. This communication is the third outcome achieved by the EU JTPF and its aim is at preventing transfer pricing disputes and associated double taxation from arising in the first place by laying down how an efficient APA process should work.

3. Transfer pricing in the Spanish tax legislation

3.1. Law on Measures for Preventing Tax Fraud

The 29 November 2006 was approved the new [Law 36/2006 on Measures for Preventing Tax Fraud \(LMPTF\)](#) that includes an amendment to the article 16 CITL, which contains the basic regulations concerning transfer pricing in Spain. Mainly, the reform establishes explicitly the general obligation for taxpayers to apply the arm's length principle for all³ transactions carried out with related companies and shifts the burden of proof to them. According to the new Spanish transfer pricing legislation, all taxpayers that carry out transactions with related parties qualified under article 16.2 CITL as such⁴, must comply with the arm's length principle.

The LMPTF came into force as from 1 December 2006, and will be applicable to fiscal years starting on and after this date, repealing the previous transfer pricing regime in force since 1 January 1995. The transfer pricing regime previously in force did not establish the obligation of the taxpayers to

³ This reform broadens the scope of the transfer pricing regime since it will be applicable also to domestic related party transactions. It is especially interesting how the regulations developing the law will cope with the high compliance costs imposed to small and medium enterprises and with the arm's length obligation dealing with Spanish tax consolidating groups.

⁴ The article 16.2 CITL contains an extensive description of cases and circumstances in which it is deemed to be an "association" between persons and/or companies for the purposes of the application of the transfer pricing regime. Since the LMPTF did not introduce significant modifications on the concept of associated entities, to further study about this topic see OLALDE MARTÍN (1999). For simplicity, at least note that all companies taking part of a group according to the article 42 Commercial Code and also companies holding a direct participation of 5% (or 1% if listed) or an indirect participation of 25% with respect to their subsidiaries are considered as related parties.

assess their related party transactions at arm's length, but the power of Tax Authorities in order to reassess the economic valuation made by the taxpayers dealing with their related party transactions. Nevertheless, since there was no obligation, there were no sanctions in case the taxpayer would not value their related party transactions at arm's length.

In the following sections the current transfer pricing regime, as amended by the LMPTF, will be sketched.

3.2. Transfer pricing methods

Taxpayers not only have to value their related party transactions at arm's length, but, in order to do so, must also comply with one of the transfer pricing methods laid down in the article 16.4 CITL.

The LMPTF modifies the hierarchy of methods previously in force. Under the old transfer pricing regime, the Comparable Uncontrolled Price (CUP) was the preferred method, the Cost Plus Method (CPM) and Resale Price Method (RPM) were at the second level of hierarchy and the Profit Split Method (PSM) was the last subsidiary method.

The new LMPTF, however, establishes as first choice CUP, CPM and RPM, all at the same hierarchy level. If one of these three cannot be finally applied then, the PSM and Transactional Net Margin Method (TNMM), which is newly introduced (and was already applied in practice before the transfer pricing reform), may be used by the taxpayer to value its related party transactions.

3.3. Documentation requirements

The LMPTF establishes new documentation requirements for the taxpayers that will be required to possess contemporaneous support documentation justifying the arm's length nature of their related party transactions. The specific contents of these documentation requirements shall be laid down in the regulations implemented under the law that are expected to be in line with the OECD Transfer Pricing Guidelines and the recommendations of the EU JTPF on transfer pricing documentation.

These documentation requirements will be in force by means of a stiff penalty regime in case of non-fulfillment, but the LMPTF provides for a specific transitory regime regarding the coming into force of the documentation requirements. Taking into account that the specific requirements will be specified by further regulation, the LMPTF sets forth that this compulsory regime will be applicable three months after said regulations being specified, which is expected to be during 2007.

However, the rest of the measures contained in the LMPTF came into force as from 1 December 2006 and will be applicable to fiscal years starting on and after this date. In this regard, in accordance with the aforementioned transitory regime, any assessment provided by the taxpayers that does not

comply with the transfer pricing methodology laid down in the law could constitute a tax infringement as of said date.

3.4. Deductibility of charges for intra-group services

Tax Authorities often devote extra vigilance to intra-group services by checking the nature of and the charges for these services. This emphasis is mainly due to two reasons: (i) unlike physical transfer of goods, it is more difficult to ascertain whether a service has in fact been provided, and (ii) many taxpayers still do not justify the charges for such services recording only a one-line invoice from the parent company to the subsidiary⁵.

The old transfer pricing regime set forth certain requirements in order to allow the deductibility of charges for intra-group management fees. In this regards, it was required a contract signed before the services were rendered. Furthermore, the law established that that contract might contain a description of the nature of the services to be rendered and the allocation methods to distribute expenses between the companies of the group following continuity and rationality criteria.

The new paragraph 5 of the article 16 mentions charges derived from all type of services and, as consequence, is not restricted only to charges for management fees. Additionally, the reform repeals the requirement of the contract previously signed, but requires, in order to allow the deductibility of charges for intra-group services, that the service provides or could provide and advantage or benefit for the taxpayer. The key point here is how to provide evidence of the advantage or the benefit for the taxpayer.

Besides this, the reform also provides the criterion of rationality in order to allocate expenses between different companies of the group when the service could benefit some of them. As a presumption, it is said that this criterion will be fulfilled when the expenses would be allocated in function of the benefits or potential benefits obtained for each company.

3.5. Deductibility of charges derived from cost sharing agreements

One of the most relevant changes in the global economy in general is the shift of funds towards businesses' intangible assets. Until recently, intellectual property was not even taken into consideration by most of business managers. However, nowadays intellectual property is increasingly being viewed as a strategic asset that is much more than a bundle of legal documents stored by companies. The increasing sums being paid for intellectual property rights in the market suggest that the values attaching to them are rising, and intellectual property rights should be viewed as a key factor in the worth of a company given substantial value in acquisitions, disposals, and in enforcement litigation.

⁵ KEK HEAN and SOH (2005).

Cost Sharing Agreements (CSA) are commonly entered into with regard to the joint development of intangible property, where two or more members of a group are engaged in a joint activity under an arrangement by which all of them have the economic ownership of the intangible. In order to prevent tax avoidance by means of these CSAs, Tax Authorities have been increasing their interest on this topic.

This is the reason why, the LMPTF sets forth some requirements in order to allow the deductibility of the charges derived from contributions to CSAs:

- (i) Entities taking part of the CSA must have access to ownership or any other right with similar economic implications with regards to the rights or assets developed.
- (ii) Contributions made by each member must be assessed in function of the expected advantages or benefits for each one following a rationality criterion.
- (iii) CSAs must foresee, to the extent is possible, any changes in circumstances affecting the agreement establishing compensatory payments if necessary.

3.6. Advanced Pricing Agreements

An Advanced Pricing Agreement (APA) is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time⁶.

An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations. So far, the Spanish Tax Authorities have shown a positive response in the processing and ruling of APAs. Furthermore, providing that no significant changes in the underlying conditions of the APA occur, a taxpayer may request an APA renewal. As an example, during 2004, twenty-five APAs regarding transfer pricing issues were filed to the AEAT (Agencia Estatal de la Administración Tributaria), thirteen of them were accepted, and the rest were rejected or waived by taxpayers⁷.

APAs offer legal certainty for taxpayers, who can see the provisions of the APAs as a safe harbour, and are intended to supplement the traditional administrative, judicial, and treaty mechanisms for

⁶ See paragraph 4.124 OECD Guidelines.

⁷ Memoria de la Administración Tributaria (2005)

resolving transfer pricing issues⁸. APAs may be most useful when traditional mechanisms fail or are difficult to apply.

Regarding the tax reform, the former three-year period covered by an APA would now be extended up to four years for the new agreements accepted by the Spanish Tax Authorities. It also may be established for the agreement finally reached with the Spanish Tax Authorities to be applicable for transactions carried out during the current tax period and to those transactions performed in the prior fiscal year (if the time limit to submit the correspondent Corporate Income Tax return has not expired).

The specific APA procedure will be developed by further regulations during 2007.

4. Transfer pricing economic analysis

The arm's length principle laid down in the Spanish tax reform implies, as said, the obligation for taxpayers to value the transactions carried out with related entities at market prices. Note that the application of this principle involves necessarily an economic and comparability analysis in order to identify independent transactions to be compared with the related party transactions in question.

The aim of the next paragraphs is to outline the steps followed by a transfer pricing analyst in order to obtain the arm's length range to compare whether the remuneration obtained by taxpayers in its related party transactions falls within.

4.1. Comparability analysis: industry and functional review

The application of the arm's length principle is generally based on a comparison of the conditions in the controlled transaction carried out by the target company with the conditions in transactions between independent enterprises. An adequate comparison needs an accurate review of the economically relevant characteristics of the industry and the target company in order to find potential comparables. To be comparable means that none of the differences, if any, between the situations being compared could materially affect prices or margins being examined (or that reasonably accurate adjustments can be made to eliminate the effect of any such differences).

A preliminary analysis of the market or industry where the company operates is necessary in order to identify the economic variables influencing the results of comparable companies within this economic sector as well as the identification of the industry's typical intangible assets.

⁸ In this regards, the EU Commission has adopted a Communication (IP/02/1105) based on the work carried out by the EU JTPF in which APAs are considered as an appropriate tool to increase legal certainty and to lessen transfer pricing burdens on taxpayers. Therefore the Commission has drafted guidelines for APAs which will make it easier for companies to avoid some of the problems caused by different transfer pricing rules in Member States.

After defining the scope of the market or industry where the company operates, the next step is to characterize the company via a functional analysis, which is aimed at well understanding the business of the target company that carries out related party transactions. This is the key point to carry out a further adequate transfer pricing economic analysis and research of comparables.

The functional analysis is commonly divided into three phases. The first one is the analysis of the functions and should consist of a comprehensive understanding of the activities and functions of the group and the specific functions and activities of the target company being analyzed (for example, it is very important to distinguish between manufacturers, toll manufacturers, limited risk distributors, fully fledged distributors, commissionaires and so on).

In the second phase, the assets owned by the target company must be analyzed. It is essential to know the level of assets owned by the company, especially, the intangible ones. It is normally expected that a company which possesses a great level of intangibles receives a greater return than a comparable company with a lower level of assets. Usually, it is thought that the company that owns the intangibles obtains an increase of expected return.

Finally, a risk analysis must be performed. In the open market, higher risks assumed result in a correlative increase in expected return.

This previous study allows determining whether independent entities are comparable to the target company or not. In general, it could be said that entities that carry out different functions, bore different risks or possess different assets could not be compared to the target company.

4.2. Economic analysis: transfer pricing methods

As said above, taxpayers not only have to value their related party transactions at arm's length, but also must comply with one of the transfer pricing methods laid down in the article 16 CITL. These transfer pricing methods are, as first choice, the Comparable Uncontrolled Price, Cost Plus and Resale Price methods (traditional or transactional based methods) and, if one of these three methods cannot be finally applied, the Profit Split and Transactional Net Margin methods (profit based methods) may be used by the taxpayer to value its related party transactions.

These methods are in line with the OECD Guidelines that provide detailed descriptions of them.

4.2.1. Comparable Uncontrolled Price (CUP)

According to the OECD Guidelines the CUP “compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a

comparable uncontrolled transaction in comparable circumstances”⁹. When using this method, the price established in the related party transaction must be compared with the price charged in comparable transactions undertaken between independent enterprises. If there is any difference between these prices, the company should directly substitute the price in the controlled transaction for the price in the comparable uncontrolled transaction in order to establish the arm’s length conditions.

Although the OECD establishes the CUP as the preferred method, it is not the most used since its application is very difficult in practice. In fact, comparability of prices is extremely sensible to product differences, which makes really difficult to find comparable transactions for transfer pricing purposes. The analysis of prices could be biased by any slight difference in products or contractual terms (in the limit, even same products with different brand names are incomparable since brand names embody different implicit warranties that must be compensated accordingly). The OECD Guidelines recognize the inherent difficulty to apply this method and, therefore, state that practical considerations dictate a more flexible approach and that certain adjustments could be made to enable the CUP method to be used.

Provided the aforementioned problems companies do not usually follow this method.

4.2.2. Resale Price Method (RPM)

The OECD Guidelines states that the RPM “begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit”¹⁰. In this case, comparability is based on gross margins provided the gross margins obtained by the reseller are compared with the gross margins obtained by independent entities selling similar products under similar conditions. This is the reason why this method is more appropriate when the target company performs distribution activities without adding a substantial value to the product by physically altering it before resale or through the use of intangible property.

Subtracting the gross margin from the resale price (sufficient to compensate the reseller for the functions performed) would result in an arm’s length price for the sale of the product between the related entities results. The appropriate resale margin can be determined where either the reseller purchases similar goods from both related and unrelated companies and resells the product in arm’s length transactions or a similarly situated reseller purchases similar goods from unrelated companies and resells them in an arm’s length transaction.

⁹ See paragraph 2.6 OECD Guidelines.

¹⁰ See paragraph 2.14 OECD Guidelines.

The application of the RPM, although not as clearly as in the CUP case mentioned above, is still very sensitive to product comparability. Also, as outlined by the OECD Guidelines, 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 business. Such differences could include those that affect the level of costs taken into account, which may well have an impact on the profitability of an enterprise but which may not necessarily affect the price at which it buys or sells its goods or services in the open market.

The RPM is also very sensible on the functions performed (taking into account assets used and risks assumed). It may become less reliable when there are differences between the controlled and uncontrolled transactions and the parties to the transactions, and those differences have a material effect on the attribute being used to measure arm's length conditions.

Finally, also where accounting practices differ, appropriate adjustments should be made to the data used in calculating the RPM in order to ensure that the same types of costs are used in each case to get the gross margin. Since this method is based on the gross margin, it is crucial that the costs of goods and other operating expenses would be accounted in a consistent manner by the target company and the independent entities to be compared with. This a particular drawback given the lack of information about the accounting criteria followed by the independent entities.

4.2.3. Cost Plus Method (CPM)

As explained in the OECD Guidelines, the CPM "begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions"¹¹. As in RPM case, the CPM comparability is carried out at gross margin level, but this method is more appropriate dealing with manufacturers or service renderers. CPM is only applicable where the manufacturer does not own or make use of valuable non-routine intangibles and the cost base being used serves as a reliable proxy of the market value of the products being produced. Under the CPM, the arm's length price of a certain sale of tangible goods¹² is determined by adding an appropriate gross profit percentage to the manufacturing costs.

¹¹ See paragraph 2.32 OECD Guidelines.

¹² It is worth of mention the practical problems that affect the transfers of intangibles provided the valuation difficulties in these cases. In this regards, the stiff transfer pricing methods often can not be applied and, therefore, it could be defended the application of special valuation techniques such as the present value of discounted cash flows among others.

The appropriate gross profit percentage is derived by referencing profit percentages earned by the target company in uncontrolled sales, or by the profit percentages earned by independent manufacturers operating under comparable circumstances in uncontrolled sales of products.

In order to compare transactions under this method, the problems are the same that in the RPM case: (i) sensibility to differences in products, (ii) sensibility to differences in functions performed and (iii) lack of information about the accounting criteria followed by the independent companies in order to assess gross margins. This is the reason why, either the RPM for distribution activities or the CPM for manufacturing ones cope with significant problems to be implemented in practice.

4.2.4. Profit Split Method (PSM)

According to the OECD Guidelines the PSM “first identifies the profit to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits those profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length”¹³. This method evaluates whether the allocation of the combined profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's value added contribution to that combined profit or loss. This method could be used when the parties contribute to the development of high value intangibles or both parties own significant amounts of intangible assets.

This method, although maybe the most fair, it is not commonly used since it implies segmenting the operating income obtained by the group in function of the value added contribution of each related party transaction, which would involve hugely valuation drawbacks.

Furthermore, since the PSM primarily relies on internal data rather than data derived from related entities, other methods ordinarily will provide more reliable testing measures of arm's length ranges where comparable independent entities can be identified, particularly when one of the parties to a transaction owns the intangibles.

4.2.5. Transactional Net Margin Method (TNMM)

The TNMM, as explained in the OECD Guidelines, “examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction”¹⁴.

Usually, when there are no unusual data problems or factual circumstances that could undermine the reliability of the TNMM, this method is chosen as the appropriate one since the traditional

¹³ See paragraph 3.5 OECD Guidelines.

¹⁴ See paragraph 3.26 OECD Guidelines.

transfer pricing methods nor the PSM are deemed to provide a more reliable measure of the arm's length result as explained above. As paragraph 3.27 of the OECD Guidelines states "net margins also may be more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins".

A TNMM approach operates similarly to CPM or RPM although at the net profit level. This similarity means that in order to be reliable, the TNMM must be applied in a way that is consistent with the manner in which the RPM or CPM were applied.

4.3. Benchmarking analysis under the TNMM approach

As said above, the TNMM is newly introduced by the LMPTF. Although the article 16 CITL previously in force did not set forth this method as valid for transfer pricing purposes, the Tax Authorities accepted the TNMM in practice as the most common method chosen by transfer pricing analysts in line with the European trend.

Nowadays, as amended, the article 16 CITL establishes a hierarchy of transfer pricing methods: as first choice the CUP, CPM or RPM, and, if one of these three cannot be applied, then the PSM or TNMM could be chosen. Although the TNMM occupies a subsidiary level, it is expected to be the most common method between transfer pricing analysts.

The TNMM evaluates the arm's length character of a related party transaction based upon objective measures of net profitability (known as profit level indicators, PLI)¹⁵ obtained by the target company compared to the ones obtained by comparable independent entities engaged in similar business activities under comparable circumstances.

Under a TNMM approach it is commonly applied a benchmarking analysis. The benchmarking analysis includes the following steps: (i) to establish the search strategy in Spanish and Pan-European databases of transactions/companies potentially comparable with the target company; (ii) to identify potentially comparable independent companies, based on the previous search strategy using Spanish and Pan-European databases and (iii) to select, among the previously identified companies, a set of comparable companies for each transaction analyzed based on the comparability criteria stated in the OECD Guidelines. It is worth to mention that, according to the Spanish Tax Authorities, local benchmarkings tend to prevail over Pan-European ones¹⁶.

¹⁵ For example, in case of distribution activities the most appropriate PLI is the Return on Sales calculated as Net Operating Income over Net Sales, but in case of manufacturing activities the adequate PLI is the Full Cost Mark Up calculated as Net Operating Income over Full Operating Costs or the Return on Assets (if the manufacturer is asset intensive) as Operating Net Income over Assets.

¹⁶ In Europe, the EU Joint Transfer Pricing Forum has discussed the use of database searches in several meetings. Arguments to promote the acceptability of non-domestic database comparable searches within the EU are first, the existence of a genuine European single market and second, the need to keep compliance costs of business at an

Once a final set of comparable independent entities has been identified, it should be assessed a weighted average for the corresponding PLI taking a multiple year approach. The weighted average method treats all years of reported income and cost data as occurring in one accounting period. This reduces significant time trends or anomalies in the data that may arise during atypical years of operations, such as adverse economic or market conditions.

Once the weighted average ratios are calculated and gathered for all companies, an interquartile arm's length range¹⁷ should be also calculated in order to be compared with the net remuneration (in terms of the adequate PLI) obtained by the target company (see example 3).

5. Documentation requirements

5.1. Penalty regime

Each taxpayer should attempt to determine transfer pricing for tax purposes in accordance with the arm's length principle, based upon information reasonably available at the time the transfer pricing policy is set. On the other hand, Tax Authorities may reasonably oblige taxpayers to produce contemporaneous documentation supporting their transfer prices, because without adequate information the Tax Authorities would not be able to examine their transfer pricing policy followed by the taxpayers properly. Therefore, the aim of these rules is to increase transparency about how transfer prices are set.

In some jurisdictions, where the taxpayer does not provide adequate documentation, there may be a shifting of burden of proof in the manner of a refutable presumption in favor of the adjustment proposed by the Tax Authorities. In Spain, however, the LMPTF, which established the general obligation to document all related party transactions carried out by taxpayers, sets forth a specific penalty regime that will be applicable three months after released further regulations developing the law. In this regards, failure to provide proper transfer pricing documentation will be a serious tax infringement, subject to penalties. The amount of these penalties will depend on:

acceptable level. However, most Tax Authorities (like Spanish ones) appear to have a bias towards the use of local comparables, in part because they are most likely to have access to local information.

Notwithstanding the above, as explained in "Is Europe One Market? A Transfer Pricing Economic Analysis of Pan-European Comparable Sets", EU JTPF White Paper, supported by various evidence it appears that a country-specific database comparable analysis and a Pan-European database comparable analysis result in interquartile ranges of results that are not statistically different at a 95 percent level of confidence.

¹⁷ The interquartile range is the spread that includes the middle 50% of the data and gives further insight into the central tendency and dispersion of the results of the comparable companies insulating abnormal outliers. Additionally, the median is also calculated instead of the mean since the median, as the middle observation, is not affected by the actual value of other observations but is determined by the number of observations that are higher and lower in value.

- In the event that the Tax Authorities do not correct the assessment provided by the taxpayers, the minimum penalty in this regard would be € 1,500 for each item or € 15,000 for a group of items referring to each one of the documentation requirements established that is omitted, imprecise, or incorrect, as per the regulations.
- In the event that the Tax Authorities correct the assessment provided by the taxpayers, the latter will be penalized with a fine proportional to 15% over the amount of the quantities resulting from corrections made, with a minimum amount of € 3,000 for each item or € 30,000 for a group of items referring to each one of the documentation requirements established that is omitted, imprecise, or incorrect, as per the regulations.

It is expressly stated that the insertion of corrections by the Tax Authorities will not constitute an infraction in the event that the taxpayer has complied with the transfer pricing documentation requirements, and the market value that is derived from said documentation is that which is filed in the Corporate Income Tax return.

5.2. EU-wide common approach to transfer pricing documentation

Although these sanctions will not be in force until the final content of the documentation requirements would be released, it is expected that they will be in line with the OECD Guidelines and the recommendations of the EU JTPF in this subject. Namely, Spanish documentation requirements would follow the proposal to an EU-wide common approach to transfer pricing documentation, included in the Code of Conduct, which would consist on two main elements: (i) the master file, and (ii) the country specific documentation.

The masterfile consists of a set of documentation containing common standardized information relevant for all European group members. The masterfile should follow the economic reality of the business and provide an outline of the multinational group and its transfer pricing system that would be relevant and available to all EU Member States concerned.

The masterfile should contain the following items:

- a) a general description of the business and business strategy, including changes in the business strategy compared to the previous tax year;
- b) a general description of the multinational group's organizational, legal and operational structure (including an organization chart, a list of group members and a description of the participation of the parent company in the subsidiaries);

- c) the general identification of the associated enterprises engaged in controlled transactions involving enterprises in the EU;
- d) a general description of the controlled transactions involving associated enterprises in the EU, i.e. a general description of:
 - (i) flows of transactions (tangible and intangible assets, services, financial);
 - (ii) invoice flows; and
 - (iii) amounts of transaction flows;
- e) a general description of functions performed, risks assumed and a description of changes in functions and risks compared to the previous tax year, e.g. change from a fully fledged distributor to a commissionaire;
- f) the ownership of intangibles (patents, trademarks, brand names, know-how, etc.) and royalties paid or received;
- g) the multinational group's inter-company transfer pricing policy or a description of the group's transfer pricing system that explains the arm's length nature of the company's transfer prices;
- h) a list of Cost Contribution Agreements, Advance Pricing Agreements and rulings covering transfer pricing aspects as far as group members in the EU are affected; and
- i) an undertaking by each domestic taxpayer to provide supplementary information upon request and within a reasonable time frame in accordance with national rules.

On the other hand, the country specific documentation consists of several sets of standardized documentation; each containing country-specific information. The content of the country specific documentation supplements the masterfile and, together, the two constitute the documentation file for the relevant EU Member State. The country specific documentation would be available to those tax administrations with a legitimate interest in the appropriate tax treatment of the transactions covered by the documentation.

The country specific documentation should contain, in addition to the content of the masterfile, the following items:

- a) a detailed description of the business and business strategy, including changes in the business strategy compared to the previous tax year;

- b) information, i.e. description and explanation, on country-specific controlled transactions including:
 - (i) flows of transactions (tangible and intangible assets, services, financial);
 - (ii) invoice flows; and
 - (iii) amounts of transaction flows;
- c) a comparability analysis, i.e.:
 - (i) characteristics of property and services;
 - (ii) functional analysis (functions performed, assets used, risks assumed);
 - (iii) contractual terms;
 - (iv) economic circumstances; and
 - (v) specific business strategies;
- d) an explanation about the selection and application of the transfer pricing methods, i.e. why a specific transfer pricing method was selected and how it was applied;
- e) relevant information on internal and/or external comparables if available; and
- f) a description of the implementation and application of the group's inter-company transfer pricing policy.

The contents above are especially relevant for Spanish parent companies of multinational groups and Spanish subsidiaries of foreign groups that nowadays must be planning how to tackle the new documentation requirements. As for Spanish parent companies, it is really important to prepare a transfer pricing documentation with the specifications of the masterfile and, as for the Spanish subsidiaries; it is advisable to follow the adaptations of the masterfile, which in principle must have been prepared abroad, with an appropriate country specific documentation.

6. Transfer pricing adjustments. Double taxation and international arbitration

One of the main problems arising when Tax Authorities carry out a unilateral transfer pricing adjustment in a country where one of the companies of the multinational group is established is the double taxation affecting the group (see example 3).

It is worth of mention that, apart from bilateral adjustments for the purposes of domestic related party transactions, this issue is specially relevant dealing with cross-border related party transactions

since the international double taxation, in this case, cannot be avoided by Spanish rules neither appealing against the domestic jurisdiction.

If, in case of transfer pricing adjustments, the main goal of the multinational group is to avoid a possible international double taxation, it is recommended to use international procedures such as the arbitration of the EU Arbitration Convention or the mutual procedure agreement laid down in the OECD Model Convention as recently amended.

The Arbitration Convention establishes a procedure to resolve disputes where double taxation occurs between enterprises of different Member States resulting from an upward adjustment of profits of an enterprise in one Member State. The case must be presented by the taxpayer to the competent authority of the Contracting State of which it is an enterprise or in which its permanent establishment is situated within three years of the first notification of the action which results or is likely to result in double taxation.

Once initiated, the procedure consists of two phases. A first one called mutual agreement phase in which the Tax Authorities involved in the case must try to reach an agreement as soon as possible and without imposing excessive costs to the taxpayers. If the Tax Authorities would not agree, a second arbitral phase could be started in which must be set up an Advisory Commission consisting of representatives of each competent authority concerned and independent persons. This Advisory Commission would rule in a period of six months and their conclusions might be adopted (except dissenting and motivated agreement) by the Tax Authorities concerned.

In line with the EU Arbitration Convention, the OECD has agreed to modify the mutual agreement procedure regulated in the article 25 OECD Model Tax Convention, which serves as a basis for most negotiations between countries on tax matters, by including the possibility of arbitration in cross-border disputes if they remain unresolved for more than two years.

According to said article, within three years of the first notification of the action which results or is likely to result in double taxation the taxpayer can present the case to the competent authority of the Contracting State of which it is an enterprise or in which its permanent establishment is situated, which might try to reach an agreement with the other Tax Authorities concerned. The mutual agreement procedure has worked well in the past, but in recent years both the number of cross-border disputes and the complexity of the cases involved have risen and unresolved issues have become more common leading to international double taxation cases.

Therefore, the OECD's Committee on Fiscal Affairs recently released a report entitled "Improving the Resolution of Tax Treaty Disputes", which pleads for the introduction of a fifth paragraph of said article that would establish a second arbitral phase in case Tax Authorities would not agree in a

period of two years. This reform imitates the two-phase model (mutual agreement and arbitration) of the EU Arbitration Convention.

Although the scope of this reform is not restricted to transfer pricing; this new arbitration procedure would be a powerful tool for the taxpayers in order to prevent international double taxation derived from unilateral transfer pricing adjustments.

The main advantage of this reform lies in the fact that its application is not restricted to the EU and, therefore, the reform is more interesting to those companies that carry out related party transactions with other companies not established in the EU.

Nevertheless, OECD Model Convention rules do not have direct application in domestic jurisdictions, but acts as a base model on which the Member States are based to bargain Double Tax Treaties. Hence, it urges that the Spanish Government would include this new fifth paragraph to the Double Tax Treaties signed in the future and, even, would review the ones signed in so far. In the meantime, Spanish taxpayers must wait to use this arbitration procedure.

In view of the facts, in order to avoid double taxation, it is advisable to use the mutual agreement and arbitration procedures regulated by the EU and the OECD. These procedures count on the following remarkable advantages: (i) the burden of proof is shifted to the Tax Authorities concerned, which should try to reach an agreement in a reasonable period; (ii) if not, the case would be resolved by arbitrators specialized in transfer pricing and the elimination of the double taxation is guaranteed in three years time from the initiation of the procedure; (iii) the tax collection would be suspended (provided the taxpayer guarantees the tax payable with delay interests and surcharges) until the resolution of the case according to the Non Resident Income Tax Law, as amended by the LMPTF.

7. Conclusions

In order to prevent transfer pricing tax arbitrage almost all OECD Member countries have agreed on implementing the arm's length principle, which implies that for tax purposes transfer prices must be assessed like the ones that would have been agreed between independent entities.

The recently approved Law 36/2006 on Measures for Preventing Tax Fraud (LMPTF) includes an amendment to the article 16 CITL in line with the OECD Guidelines and the EU JTPF recommendations in this field. Mainly, the reform establishes explicitly the general obligation for taxpayers to apply the arm's length principle for all transactions carried out with related companies and shifts the burden of proof to them.

The LMPTF also establishes the general obligation to document all related party transactions carried out by taxpayers and sets forth a specific stiff penalty regime that will be applicable three months after released further regulations developing the law.

In view of this reform, it is advisable that Spanish taxpayers (especially, Spanish parent companies of multinational groups and Spanish subsidiaries of foreign groups) would follow the EU JTPF documentation guidelines laid down in the Code of Conduct as for the master file and the country specific documentation.

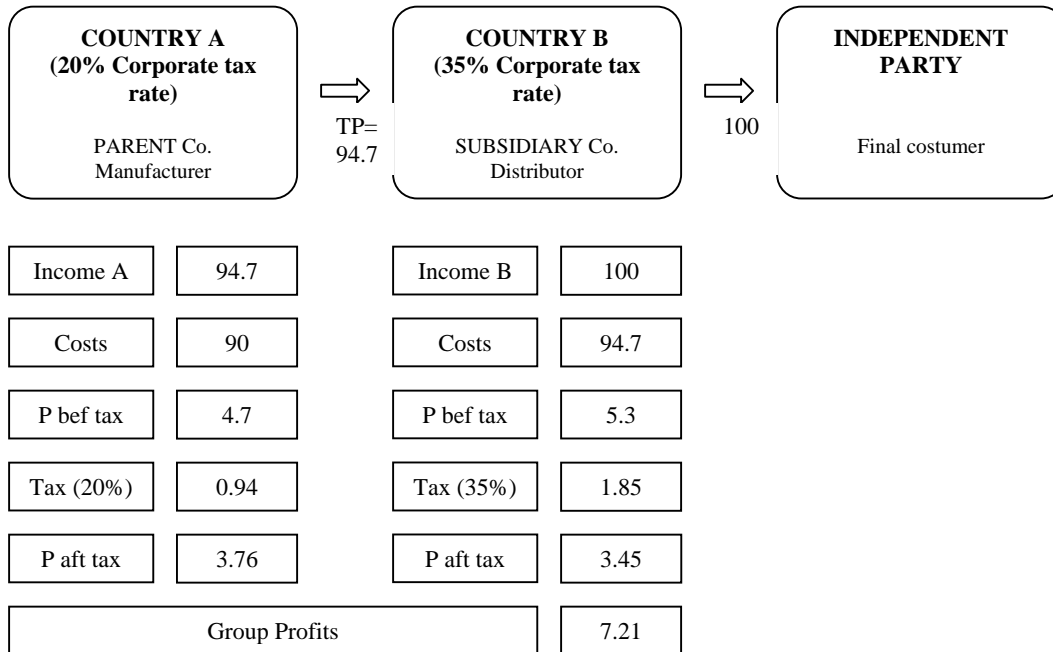
In addition, since the transfer pricing documentation is only a reflection of the transfer pricing methodology followed by the company, it is not enough only to have the transfer pricing documentation prepared when coming into force the new requirements, but also to have an accurate economic analysis and an adequate transfer pricing policy implemented from the beginning of the company's fiscal year.

Finally, note that, in case of transfer pricing adjustments, it is advisable to use the mutual agreement or arbitration procedures regulated by the EU and the OECD instead of the Spanish jurisdiction since the former procedures provide the Spanish taxpayers with remarkable advantages.

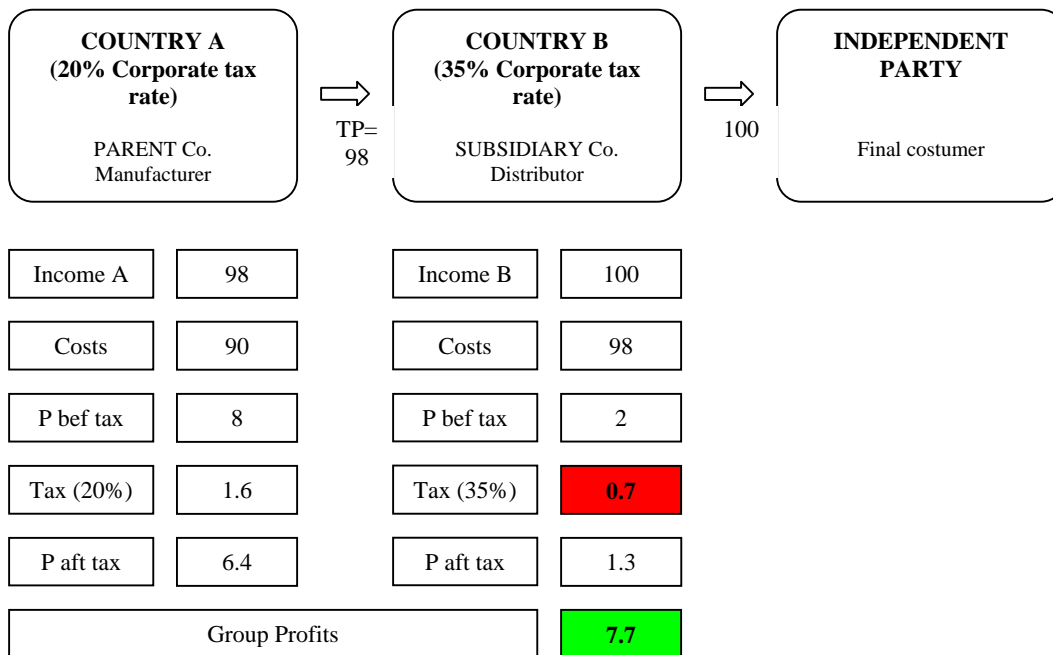
8. Examples

8.1. Example 1: Tax arbitrage

Scenario 1: Let's suppose the following supply chain under arm's length transfer prices (of € 94.7).



Scenario 2: note that how the group can alter their transfer prices (to € 98) in order to increase their profits after tax. The problem here is that it causes a tax drain in country B of €1.15 (per unit sold) with respect to the arm's length scenario.



8.2. Example 2: Benchmarking analysis under TNMM approach

Following the Scenario 2 of the example above, let's suppose that country B enacted transfer pricing rules establishing the arm's length principle and the OECD recommended transfer pricing methods. Tax Authorities in Country B could use a TNMM approach in order to test whether the arm's length remuneration obtained by the distributor could be considered at arm's length.

Please find an example of a set of comparable and independent companies and how, by means of statistical methods, an arm's length range could be obtained using a TNMM approach with the ROS (Return on Sales, defined as Net Operating Profit over Net Sales) as an appropriate profit level indicator for distributors.

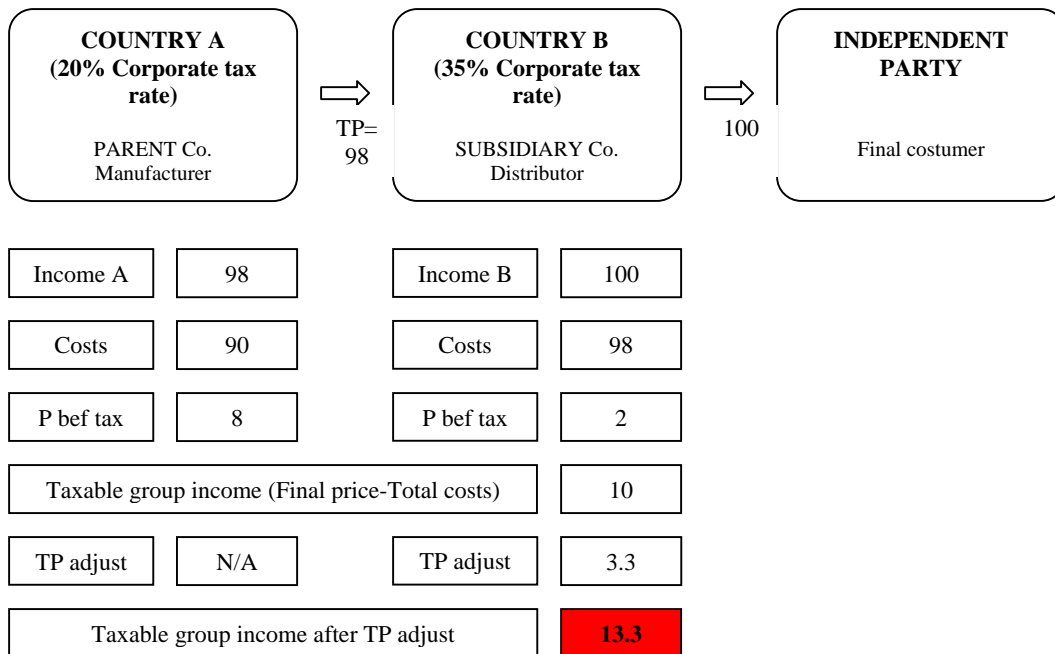
	Net sales 2003	Net sales 2004	Net sales 2005	ROS 2003	ROS 2004	ROS 2005	Av 03-05	Weighted av 03-05
Comp A	46,248	48,097	50,983	8.00%	4.00%	4.00%	5.33%	5.27%
Comp B	166,491	173,151	183,540	7.00%	4.00%	5.00%	5.33%	5.31%
Comp C	3,700	5,550	13,874	-2.00%	2.00%	8.00%	2.67%	4.96%
Comp D	46,248	48,097	50,983	4.00%	8.00%	4.00%	5.33%	5.32%
MIN				-2.00%	2.00%	4.00%	2.67%	4.96%
25% QRT				2.50%	3.50%	4.00%	4.67%	5.19%
MEDIAN				5.50%	4.00%	4.50%	5.33%	5.29%
75% QRT				7.25%	5.00%	5.75%	5.33%	5.31%
MAX				8.00%	8.00%	8.00%	5.33%	5.32%

Note that the remuneration obtained by the distributor resident in Country B is 2% in terms of ROS (assuming there were not other operating costs). Therefore, this remuneration would fall under the arm’s length range (5.19%; 5.31%).

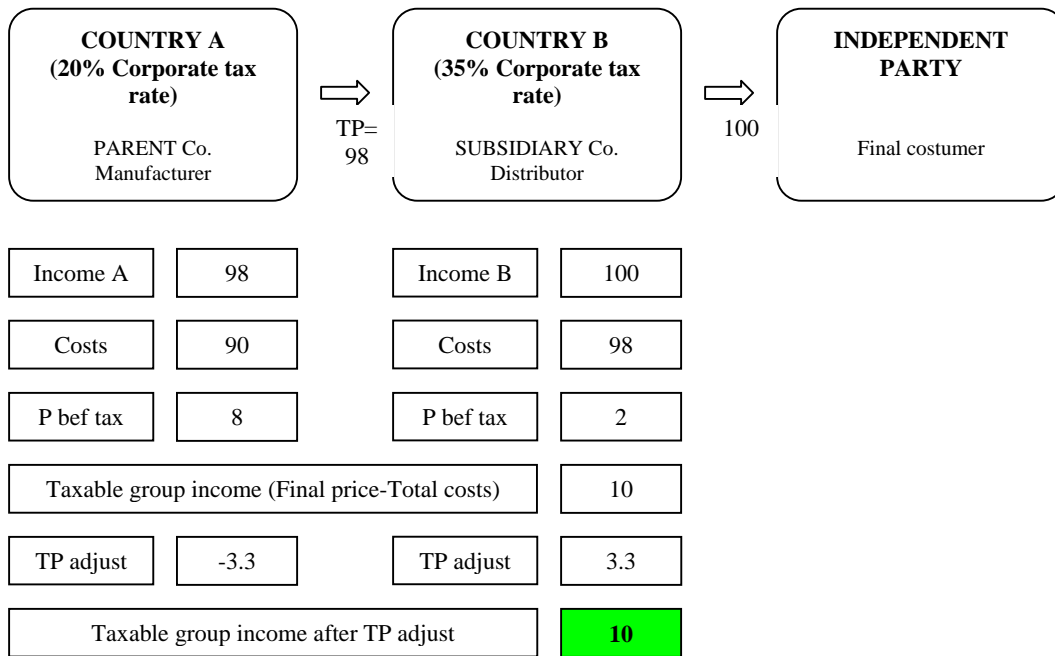
Under this approach Tax Authorities of country B could carry out a positive transfer pricing adjustment to the profits obtained by the distributor which would amount nearly 3.3% in terms of ROS, in order to get the median value of the arm’s length range.

8.3. Example 3: Transfer pricing adjustments and double taxation

Following the scenario before, if the transfer pricing adjustment would be unilaterally made by Tax Authorities in Country B, this would result in an international double taxation for the multinational group.



In order to avoid international double taxation, the transfer pricing adjustment should be bilateral: what is considered by taxable income in jurisdiction B; should be considered as losses in A.



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