Single Market, Single Price, Many Data Bases

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In this issue of *Intertax*, we publish an English translation of the recently issued German transfer pricing regulations together with brief Explanatory Notes by Ulrich Ransch and Alexandra John. A significant part of the regulations lays out documentation requirements. Although it was expected that the requirements coming from Germany would be 'gründlich' and comprehensive, the sheer size and detail of them astonished even most German observers. They certainly contribute to 'a tendency among EU Member States, fearing manipulation of transfer prices and double non-taxation, to impose increasingly onerous transfer pricing requirements'. No wonder then that 'business representatives strongly express the view that transfer pricing documentation requirements in the EU create unduly high compliance costs'.¹ As a matter of fact, it is safe to say that by now these ever increasing compliance costs are becoming an excessive burden on pan-European business thereby seriously hindering the development of a true Single Market.

A feature of almost all national documentation requirements is that they consider a properly conducted database research as a minimum although they frequently do not formally insist on the use of database searches for comparables, nevertheless, in practice, it is almost inevitable that the results of a search are provided. Moreover, the Member States give a strong preference to local searches. Pan-European searches frequently will not do although the new German regulations are silent on this issue.

Prior to the introduction of the Euro in 1999, price differences among the Member States of the EU were largely masked for many consumers by different currencies. Once the Euro was introduced, the differences would be clear to see and prompt, it was assumed, an 'approximation' or even 'equalization' of prices across Europe. European firms would no longer be able to maintain the cosy segmentation of the continent into different markets in which prices are set according to what the locals will pay. Rather, a single market would develop – as the American model, where

interstate trade creates some of the lowest prices and fiercest competition in the world. Eventually, it should be almost as difficult for one company to sell at widely different prices in two European countries as in two American states. That would not mean a single price. It was recognized that even in a fully integrated market like the US regional market differences might still cause prices to differ. For companies the new environment would represent a chance to make pan-European pricing strategies possible both for purchasing and for sales.

In 1997, *The Economist*² predicted:

'The single currency – assuming as most European businesses do, that it goes ahead – will make the single market much more transparent. The 12 likely participating countries exclude Britain but include continental Europe's three biggest economies: Germany, France and Italy. In this new Euro zone customers of all kinds will be able to pick from the prices on offer, without worrying that a foreign supplier's advantage will be wiped out by a change in the exchange rate. Manufacturers will try to keep their prices up; retailers to haggle them down.'

The weekly was confident that, as a result:

'for most products, most companies look likely to move towards a single price for Europe, expressed in Euros. Some prices, mainly of luxuries in poorer countries may rise. But overall, prices will fall in the more expensive European countries, and so will average prices for goods and services across Europe.'

Six years later, the same publication³ noted and was somewhat disappointed that studies demonstrate that though price gaps narrowed in the Euro's first three years, no significant convergence took place in the following two years. Clearly a significant convergence occurred in smaller consumer goods that can easily be shipped across borders. As expected, this did not

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¹ European Commission, Revised Secretariat Discussion Paper On Documentation Requirements (Draft), EU Joint Transfer Pricing Forum, 31 August, 2004 (Doc: JTTF/019/REV3/2003/EN), p. 5.

² *The Economist*, 'When the walls come down', 5 July 1997, p. 63.

³ *The Economist*, 'The flaw of one price', 18 October 2003, p. 77.

happen for non-tradable services. The disappointment concerned a significant basket of goods where convergence seemed to have come to a halt. As a result, price dispersion within the Euro area was still roughly twice as large as in America. The journal suggested three possible reasons: different tax rates, especially on alcohol; national tastes (e.g. bottled water is seen as a basic good in some countries, but a luxury in others – leading to price differentiations of over 100 per cent) and differences in market structure. With respect to the latter reason: the absence of a large pan-European wholesaler or retailer such as America's Wal-Mart is clearly still a big barrier. Studies of the European Commission showing price convergence during the 1990s but a decelerated convergence process echoed the findings in *The Economist* article since 1997.

However, recent studies show a different picture even outside the Euro block countries. A 2004 paper prepared by Deloitte for the EU Joint Transfer Pricing Forum 'Is Europe one market? A Transfer Pricing Economic Analysis of Pan-European comparables sets' comes to the conclusion:

'If one compares the degree of price dispersion in the United States to that of the European Union, the European Union seems to have come very close to the degree of price conversion found in the United States. For most goods, the overall price dispersion is much larger in the United States than in the European Union.'

As a matter of fact 'price differences within Member States appear, in many cases, as high or even higher than price differences between Member States (especially the UK).'⁴ These findings, of course, are important for transfer pricing documentation as required now by almost all Member States in their enthusiastic pursuit of 'a fair share of the cake'. It implies that the application of the transaction-based methods for goods should be allowed on an EU-wide basis, and certainly within the Euro block, unless there are clear indications that significant regional differences exist.

However, the question remains as to what the implications are for the increasingly more important transactional net margin method (TNMM). This

method, and related transfer pricing methods, compare the operating profits of a related company to an arm's length range of operating profits developed from third party comparable companies. In answering this question, it is important to determine whether, as a result of increased market integration, the returns of European companies are converging. Here again, the Deloitte paper concludes:

'that the variance of profitability in the European Union is not generally higher than that of other markets fully integrated, particularly Japan. Therefore there is no reason to conclude that company profits in the European Union are more dispersed than in other fully integrated markets.'

An even more recent academic study focusing on the valuation of European groups confirms this view.⁵ The study aimed at finding comparables for company valuation purposes, but the extension of their findings to the transfer pricing area – when applying profit oriented methods – is obvious. The authors, working with a comprehensive example consisting of more than 67,000 companies, found that their valuations are more accurate when based on a pan-European set of comparables rather than a more narrow set of comparables from within a Member State. By diminishing the influence of outliers, the larger pan-European set simply outperforms smaller, more narrowly chosen sets. As expected, exceptions are the UK but also and more surprisingly, Denmark and Greece.

It is true that in certain cases there may still be geographical and business segment differences in existence. However, as a general rule, and acknowledging that transfer pricing is not an exact science, 'the outcome of a comparables search performed on the basis of a pan-European database should be accepted as information/documentation to support the arm's length remuneration of inter-company transactions'.⁶ The Commission has largely adopted this approach and promotes actively the acceptance of EU-wide documentation. The proliferation of excessive national documentation requirements like the new German regulations should remind us of the practical importance of these proposals. They deserve active support.

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⁴ Peter Meenan, Roman Dawid and Jörg Hülshorst, 'Is Europe One Market? A Transfer Pricing Economic Analysis of Pan-European Comparables Sets', Brussels, 24 February 2004 (Doc: JTPF/007/BACK/2004/EN), p. 9.

⁵ Ingolf Dittmann and Christian Weiner, 'Selecting Comparables for the Valuation of European Firms', January 2005, working paper Humboldt-Universität, Berlin.

⁶ Dirk van Stappen, 'Pan-European Versus Country-Specific Databases: Not a Clear Cut Issue', Brussels, 12 January 2004 (Doc: JTPF/006/Back/2004/EN), p. 8.