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ARTICLE

Arbitration Convention 90/436/EEC: Inapplicability in Case of Serious Penalties

Prof. Piergiorgio Valente[*]

A tool for settling transfer pricing controversies is the EU Arbitration Convention No. 90/436/EEC. If a double taxation in transfer pricing occurs, the enterprise may submit its case to the competent authority of the state in which it resides, regardless of the remedies provided by domestic provisions. Where the claim is legitimate, the competent authority shall initiate a mutual agreement procedure (MAP) with the authority of the other state to settle the controversy. If no agreement is reached within two years, the controversy shall be submitted to an advisory Commission charged with the delivery of an opinion. The competent authority of a state shall not be obliged to initiate a MAP or set up an advisory Commission should the enterprise be liable to serious penalties.

1 Introduction

One of the tools adopted at international level for the settling of transfer-pricing controversies is the EU Arbitration Convention No. 90/436/EEC (hereinafter the 'Convention').[1]

Where an enterprise deems that the principles set forth under Article 4 of the Convention have not been duly observed (with regard to the arm's-length principle and attribution of profits to the permanent establishment (PE)), such enterprise may submit its case to the competent authority of the state in which it (or the PE) resides, irrespective of any remedy that might be provided by the internal legislature of the relevant state.

Should the claim be legitimate, the competent authority has the duty to initiate a settlement procedure with the state authority of the relevant state or states in order to settle the controversy by mutual agreement and, consequently, avoid double taxation. Where the said authorities fail to reach an agreement within two years from presentation of the case, the controversy shall be submitted to an advisory Commission, instituted ad hoc for the purpose and entrusted with the delivery of an opinion.

The Convention sets forth, under Article 8, a special provision relating to enterprises that are subject to serious penalties: the competent authority of a contracting state shall not be obligated to institute a mutual agreement procedure (MAP) or set up the advisory Commission once it is established that the enterprise is liable to serious penalties. Where judicial or administrative proceedings – instituted with a view to examining that one of the relevant enterprises is subject to serious penalties – are being simultaneously conducted with the proceedings referred to under Articles 6 (mutual agreement) and 7 (arbitration) of the Convention, the competent authorities may stay such latter proceedings up until conclusion of the judicial or administrative proceedings.

Contents of the Convention are provided herein below, with special reference to provisions involving serious penalties.

2 Mutual Agreement and Arbitration Procedure According to the Convention

The Convention is applicable:

– where, for taxation purposes, profits included in those of an enterprise of a contracting state are (or are likely) to be included also in the profits of the enterprise of another contracting state (Article 1 paragraph 1); the said provision also applies in case of losses (Article 1

Notes

[*] Valente Associati GEB Partners.

[1] Although the Directive proposed by the Commission goes as far back as 1976, it has become a Convention after years of negotiations, only as late as 1990, with the main purpose of eliminating double taxation engendered by transfer pricing adjustments between associated companies located in different Member States. Having entered into force in 1995, application of the EU Arbitration Convention No. 90/436/EEC (hereinafter 'Convention') was stayed from 1 Jan. 2000 to 31 Oct. 2004. In 1999, the amendment Protocol, which extended its effectiveness for a further five-year term – providing also for an automatic renewal clause for subsequent years – was signed. The last signatory state (Portugal) of the extension Protocol deposited its ratification tools on 4 Aug. 2004. The Convention, therefore, (re)acquired full force of law on 1 Nov. 2004. Its effects, however, are retroactive, starting from the date on which its application had been suspended. Cf. P. Valente, *Fiscalità sovranazionale* (*Supranational Taxation*) (Milan: 2008), 289 et seq.; *id.*, *Manuale del transfer pricing* (*Transfer Pricing Manual*) (Milan: IPSOA, 2009), 123 et seq.; *id.*, *Le Novità del transfer pricing* (*Transfer Pricing News*) (Milan: IPSOA, 2010), 10 et seq.

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paragraph 3); furthermore, PEs of EU enterprises are assimilated to the enterprises of the states in which the latter are located (Article 1 paragraph 2);

– to income tax (Article 2).

As to the concept of enterprise ex Article 1 paragraph 1 of the Convention, the said concept should be identified:

– in the first place, in the Double Tax Treaty signed by the two states that must apply the procedure;
– in the absence thereof, in the OECD Model.[2]

The fundamental assumption on which the application of the Convention is based lies in the cardinal principle, which enterprises ought to draw inspiration from when determining transfer prices, that is, the arm's-length principle, which may be inferred by provision ex Article 4 when it refers to 'conditions made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises'.

As to the phases and the time frame of the transfer pricing adjustment procedure, the Convention provides for:

– the obligation of the state intending to make the profit adjustment to inform the relevant enterprise in order for such enterprise to inform the other enterprise, so that the latter may, in turn, inform the other contracting state (Article 5);
– the possibility that between the interested enterprises and the relevant tax authorities, an agreement may directly be reached to avoid double taxation;
– a MAP to be initiated in the absence of any such agreement (Article 6);
– an arbitration procedure to be initiated if within two years, the competent authorities have not reached an agreement to eliminate double taxation (Articles 7 and 11).

Pursuant to Article 6 of the Convention, the enterprise has the option to submit its case to the competent authority of the contracting state in which it resides or in which its PE is a resident of or is located, irrespective of the remedies provided by the internal legislature of the contracting states involved. The case must be presented within three years from the first notification of the national measure. Should the claim be legitimate, the enterprise shall endeavour to reach settlement by mutual agreement with the competent authority of any other contracting state involved in order to avoid double taxation.

Should the competent authorities fail to reach an agreement to eliminate double taxation, Article 7 of the Convention provides that, within two years from the date on which the case was first submitted, the competent authorities shall institute an advisory Commission that is entrusted to deliver an opinion on the elimination of the double taxation.

Article 11 provides that the advisory Commission must issue an opinion within six months from the date in which it was pronounced.

Within those six months from the date on which the advisory Commission expressed its opinion, the competent authorities shall adopt a resolution aimed at eliminating double taxation, which must not be necessarily aligned with the decision reached by the Commission itself. If, on the other hand, no agreement is reached, the authorities are required to comply with such opinion.[3]

3 Inapplicability of the Convention in Case of Serious Penalties

The Convention sets forth a special provision, under Article 8, with regard to the enterprise that might be liable to serious penalties, with respect to which the competent authority shall not be obliged to initiate the MAP or to set up an advisory Commission:

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[2] The Convention finds application with reference to both multinationals as well as small and medium-sized enterprises. A. Voegele & F. Forster specify ('The Arbitration of Transfer Prices in Europe', in *Practical European Tax Strategy* 8, no. 1 (January 2006)) that *{t}he EU Arbitration Convention is suitable for a multitude of intra-European cases. The authors applied for arbitration in several cases. They also applied for arbitration in the case of a big cross border joint venture implicating France, Belgium and Germany. In this case the German tax authorities did not accept the long lasting losses of a German sales company and the French tax authorities did not accept that the French management company was not charging for all costs plus profit mark-up to Germany. The authors even applied for arbitration in a very small case of a North American parent company having a European holding in the Netherlands with a European management centre in Belgium and several subsidiaries in Germany and other European countries. In this case the German tax authorities did not allow the deduction of a part of expenses. The authorities argued that these expenses have been in the interest of the European holding. Since the case was prepared well for the prior tax audit by another tax consultant the costs for the arbitration are remote. This case illustrates that application of the EU Arbitration Convention may be also reasonable in small cases*. Cf. also Valente, 2008, *supra* n. 1; *id.*, 2009, *supra* n. 1, 123 et seq.; Valente, 2010, *supra* n. 1.

[3] Article 12 of the Convention provides that

1. The competent authorities party to the procedure referred to in Article 7 shall, acting by common consent on the basis of Article 4, take a decision which will eliminate the double taxation within six months of the date on which the advisory commission delivered its opinion. The competent authorities may take a decision which deviates from the advisory commission's opinion. If they fail to reach agreement, they shall be obliged to act in accordance with that opinion.

2. The competent authorities may agree to publish the decision referred to in paragraph 1, subject to the consent of the enterprises concerned.

The document of the EU Commission of April 2011 (cf. <http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transfer_pricing/forum/jtpf/2011/jtpf_004_back_2011.pdf>) identifies the number of cases that, according to the Convention, are still pending as at 31 Dec. 2009. Such number is on the increase with respect to 31 Dec. 2008.

> *1. The competent authority of a Contracting State shall not be obliged to initiate the mutual agreement procedure or to set up the advisory commission referred to in Article 7 where legal or administrative proceedings have resulted in a final ruling that by actions giving rise to an adjustment of transfers of profits under Article 4 one of the enterprises concerned is liable to a serious penalty.*
> *2. Where judicial or administrative proceedings, initiated with a view to a ruling that by actions giving rise to an adjustment of profits under Article 4 one of the enterprises concerned was liable to a serious penalty, are being conducted simultaneously with any of the proceedings referred to under Articles 6 and 7, the competent authorities may stay the latter proceedings until the judicial or administrative proceedings have been concluded.*

The concept of *serious penalty* is illustrated, for each of the contracting states, in special unilateral declarations annexed to the Convention.
As far as Italy is concerned, *the term 'serious penalties' means penalties laid down for illicit acts, within the meaning of the domestic law, constituting a tax offence.* Therefore, a serious penalty consists in any penalty provided for illicit acts, within the meaning of domestic law, constituting a tax offence. No distinction is made between administrative or criminal offences, although these latter might be deemed more serious than the former.[4]

Unilateral declarations clearly indicate how each contracting state provides its own distinct interpretation of the expression *serious penalties*. By way of example:

- for Belgium, the term *serious penalty* signifies a criminal or administrative penalty inflicted in cases of common offences committed for the purpose of perpetrating tax fraud or infringements of the provisions of the Income Tax Code or of decisions made for implementation purposes thereof, committed with the intention of causing injury;
- for Denmark, the concept of *serious penalty* consists in a penalty for the intentional infringement of Criminal Law provisions or of special laws in cases that cannot be regulated by administrative laws;
- for Germany, an infringement of tax laws punishable by *serious penalties* consists in any infringement of the tax laws punishable by detention, pecuniary or administrative penalties;
- for Spain, the term *serious penalties* means administrative penalties for serious tax infringements, as well as criminal penalties for offences perpetrated against the tax authorities;
- for France, *serious penalties* indicate criminal penalties, as well as penalties for omitted filing of tax return after receipt of notice of summons, for fraud, for fraudulent practices, for opposition to tax inspection, for covert payments or distribution, or for abuse of law;
- for Ireland, *serious penalties* include penalties for omitted filing of tax return, fraudulent tax return, failure to disclose documents and records for inspection purposes, false statement to obtain an allowance;
- for Luxembourg, a *serious penalty* connotes *what the other Contracting State considers to be so for the purposes of Article 8*;
- for the Netherlands, the expression *serious penalty* stands for a penalty inflicted by a court within the meaning of Article 68 of the General Law on taxation;
- for Portugal, the term *serious penalties* denotes criminal penalties, as well as any further tax penalties, that would be applicable in case of infringements committed with the intent to defraud or in the case where the applicable fine exceeds a certain amount;
- for the United Kingdom, *serious penalties* refer to *criminal sanctions and administrative sanctions in respect of the fraudulent or negligent delivery of incorrect accounts, claims or returns for tax purposes.*[5]

Notes

[4] Compare P. Valente's Blog, <http://piergiorgiovalente.postilla.it/2011/06/21/transfer-pricing-sanzioni-gravi-nella-convenzione-arbitrale-scritto-con-il-prof-ivo-caraccioli/>.

[5] The unilateral Greek declaration reports in detail cases that are subject to *serious penalties*:
Under Greek legislation governing taxation, an undertaking is liable to 'severe penalties':
1. if it fails to submit declarations, or submits incorrect declarations, in respect of taxes, charges or contributions which must be withheld and paid to the State under existing provisions, or in respect of value added tax, turnover tax or the special tax on luxury goods, in so far as the total amount of the above taxes, charges and contributions which should have been declared and paid to the State as a result of trade or other activities carried out over a period of six months exceeds an amount of six hundred thousand (600 000) Greek drachmas or one million (1 000 000) Greek drachmas over a period of one calendar year;
2. if it fails to submit a declaration of income tax, in so far as the tax due in respect of the income not declared is more than three hundred thousand (300 000) Greek drachmas;
3. if it fails to supply the taxation details laid down in the Code on Taxation Data;
4. if it supplies details as referred to under the previous case 3, which are incorrect as regards quantity or unit price or value, in so far as the inaccuracy results in a discrepancy which exceeds ten per cent (10 %) of the total amount or of the total value of the goods, the provision of services or the trade generally;
5. if it fails to keep accurately the books and records required by the Code on Taxation Data, in so far as that inaccuracy has been noted in the course of a regular check, the findings of which have been confirmed either by administrative resolution of the discrepancy or because the period allowed for an appeal has expired or as a result of a definitive decision by an administrative tribunal, provided that during the management period checked the discrepancy between gross income and the income declared is more than twenty per cent (20 %) and in any case not less than one million (1 000 000) Greek drachmas;
6. if it fails to observe the obligation to keep books and records as laid down in the relevant provisions of the Code on Taxation Data;
7. if it issues false or fictitious - or itself falsifies - invoices for the sale of goods or the supply of services or any other taxation details as referred to in case 3 above.

The provision set forth under Article 8 of the Convention has been subject to debates within the EU Joint Transfer Pricing Forum (hereinafter 'Forum').[6]

In the Communication relating to the work carried out by the Forum during the period March 2007–March 2009 and to a proposal connected thereto for the revision of the Code of Conduct concerning the effective implementation of the Arbitration Convention, of 14 September 2009,[7] the Commission points out that, although it may be true that the expression *serious penalty* is defined by the single states through a special unilateral declaration, certain Member States:

> now admit that their unilateral declarations do contain a description of the penalties to be considered serious. Furthermore, since 1995, Tax Authorities have acquired further experience in controversies involving transfer prices and, in practice, access to the Arbitration Convention has been denied in very few cases.

Pursuant to the Forum, serious penalties may only be inflicted in exceptional cases, such as fraud; the Commission, therefore, recommends that Member States modify their respective unilateral declarations with regard to the definition of *serious penalty* in order to restrict the scope of application, 'keeping account of the recommendation ... to inflict serious penalties only in exceptional cases such as fraud'.

In the Summary Report on Penalties, presented as a further support to the above Communication,[8] the Commission provides, first and foremost, a definition of *penalties*.

The purpose of the penalties is to create a *disincentive for non-compliance* so as to render *tax underpayments and other types of non-compliance more costly than compliance*. On the subject matter of transfer pricing, the concept of *compliance* refers to both, procedural aspects and requirements (i.e., filing of tax return within the terms set by law), as well as substantial aspects (i.e., substantive determination of tax liability). In particular, it is possible to identify the following penalty categories:

(1) *documentation-related penalties*: generally refer to administrative fines, applied for violation of rules relating to documentary requirements;

(2) *cooperation-related penalties*: generally refer to administrative fines, applied for the violation of specific rules that provide, for example, that supplementary documentation be submitted to the tax authorities, within certain time limits, in addition to documents set forth by law;

(3) *adjustment-related penalties*: refer to penalties applied for the application of the arm's-length principle, *usually levied in the form of a surcharge at a fixed amount or a certain percentage of the transfer pricing adjustment or the tax understatement.*[9]

The Commission points out that *criminal penalties* – differently from *administrative penalties*, generally applied by the tax authorities – are inflicted by the Criminal Courts for cases that involve *very significant fraud*.

With reference to *serious penalties* ex Article 8 of the Convention, the Summary Report on Penalties indicates that the Forum has reached the conclusion according to which:

> [t]he situation at the moment under the Arbitration Convention where 27 different definitions of a serious

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A taxation document is regarded as false if it has been perforated or stamped in any way without the proper authentication having been entered in the relevant books of the competent tax authority, in so far as failure to make such an entry has occurred in the knowledge that such authentication is required for the taxation document. A taxation document is also regarded as false if the content and other details of the original or the copy differ from those which are recorded on the counterfoil of that document.

A taxation document is regarded as fictitious if it has been issued for a transaction or part of a transaction, transfer or any other reason not recorded in the total or for a transaction carried out by persons different from those recorded in the taxation document;

8. if it is aware of the intention of the action taken and collaborates in any way in the production of false taxation documents or is aware that the documents are false or fictitious and collaborates in any way in their issue or accepts the false, fictitious or falsified taxation documents with the intention of concealing material relevant to taxation.

[6] In October 2002, the EU Council, as a result of the proposal submitted by the European Commission, instituted the EU Joint Transfer Pricing Forum (hereinafter 'Forum'), with the mission to analyse tax issues connected to double taxation deriving from transfer pricing adjustments. The Forum's mandate, which was initially set at two years, was extended for subsequent biennia. Twenty-seven representatives of Member States and ten experts in enterprise representation have been cooperating in the said project, in addition to – but only as observers – the representatives of candidate countries and to the OECD Secretary.

From the date of its establishment, the Forum held about thirty meetings, in the course of which its members dealt with the most significant issues relating to double taxation deriving from transfer pricing adjustments. For further details on the said activity carried out by the Forum, cf. Valente, 2009, *supra* n. 1, 129 et seq.; *id.*, 2010, *supra* n. 1.

[7] COM(2009)472. For further details, cf. Valente, 2010, *supra* n. 1.

[8] SEC(2009)1168 final of 14 Sep. 2009.

[9] For further details involving penalties on the topic of transfer pricing, cf. P. Valente, *Manuale di Governance Fiscale*, (*Manual of Tax Governance*) (Milan: IPSOA, 2011), 2470 et seq.; *id.*, 2009, *supra* n. 1, 799 et seq.; *id.*, *Valutazioni sulla comunicazione sul possesso della documentazione nel 'transfer pricing': casistica* (*Evaluations on the Communication Regarding Transfer Pricing Documentation: Cases*), in *Corriere Tributario* 26 (2011); *id.*, *Strategie di comunicazione sul possesso della documentazione nel 'transfer pricing'* (*Communication Strategies on Transfer Pricing Documentation*), in *Corriere Tributario* 25 (2011). Cf. also P. Valente's Blog, <http://piergiorgiovalente.postilla.it/2010/10/12/transfer-pricing-documentazione-slalom-tra-sanzioni-amministrative-e-illecito-penale-scritto-con-il-prof-ivo-caraccioli/>; <http://piergiorgiovalente.postilla.it/2010/11/10/transfer-pricing-puzzle-still-unsolved-how-to-balance-administrative-penalties-and-criminal-offence/>.

penalty exist does not sit easily with the idea of a single market. Therefore the JTPF will in the future look at what precisely a serious penalty should be for the purposes of the Arbitration Convention. The idea behind this work would be to clarify what a serious penalty is in terms of transfer pricing and to prevent taxpayers from being disadvantaged from different definitions within the EU. The JTPF will seek to define in which cases a penalty should be considered as serious.[10]

The Communication dated 14 September 2009 contains the proposal for a *Revised Draft* of the Code of Conduct on the effective implementation of the Convention.[11] The new Code of Conduct, approved by the EU Council on 22 December 2009, regulates the most significant applicative and procedural aspects of the Convention. Among these, the most salient are:

- the application scope of the Arbitration Convention, with special reference to thin capitalization and triangular cases;
- the elapsing of the established three-year period, ex Article 6 paragraph 1 of the Convention;
- the elapsing of the established two-year period, ex Article 7 paragraph 1 of the Convention;
- questions linked to the mutual agreement and arbitration procedures;
- the collection of tax and interest due, during the settlement procedure of controversies.

In the subject matter of *serious penalties*, the Code reiterates the opportunity to reinterpret the term in a restrictive sense:

As Article 8(1) provides for flexibility in refusing to give access to the Arbitration Convention due to the imposition of a serious penalty, and considering the practical experience acquired since 1995, Member States are recommended to clarify or revise their unilateral declarations in the Annex to the Arbitration Convention in order to better reflect that a serious penalty should only be applied in exceptional cases like fraud.

4 Transfer Pricing Adjustments and Penalties

In the Summary Report on Penalties, the Commission also outlines, on the basis of the activity carried out by the Forum, certain conclusions on the topic of:

- penalties and transfer pricing adjustments;
- penalties, transfer pricing adjustments, and subsequent MAP.

With reference to the first issue, it should be noted that the determination of the arm's-length value is *fact-dependent*, and quite often, identifying the arm's-length price turns out to be rather difficult. For such reasons, the tax authorities should not apply penalties *merely due to the existence of what turns out to be incorrect transfer pricing* without considering the actual circumstances of the concrete case.

In relation to the second issue, it should be observed that, often, a transfer pricing adjustment is subject to a *reduction* in the course of a MAP. In such case, where a penalty has been applied, such penalty has to be *proportionally reduced*. Such latter principle, however, should not be applied when *criminal penalties or penalties considered as serious under the Arbitration Convention* are involved.

Notes

[10] Similar conclusions may be found in the Final Report of the EU Joint Transfer Pricing Forum on the Interpretation of Some Provisions of the Arbitration Convention (SEC(2009)1168) of 14 Sep. 2009, whereby the Forum presents the following conclusions and recommendations:

JTPF conclusion:

The JTPF cannot change specific provisions of the Arbitration Convention but considers that the aim of the Arbitration Convention is the elimination of the double taxation and that Article 8.1 provides for the application of judgment by the Competent Authorities and as such, it was agreed that the Forum would recommend a liberal interpretation of the provision as follows.

JTPF recommendation:

As Article 8.1 provides for flexibility as regards the refusal to give access to the Arbitration Convention due to the existence of a serious penalty and considering the practical experience acquired since 1995 the JTPF invites MS to clarify or revise their unilateral statements in Annex of the Arbitration Convention in order to better reflect that a serious penalty should only be applied in exceptional cases like fraud.

[11] In April 2004, the European Commission, adopting the Forum's recommendations on the matter, submitted a Code of Conduct Draft, for approval by the EU Council, for the elimination of double taxation in cross-border inter-company transactions. The Code, which was approved in late November 2004, finds application in those cases where there is an increase of taxable income engendered by cross-border transactions as a consequence of transfer pricing adjustments and introduces measures for the settlement of disputes among states in proceedings concerning the elimination of double taxation. The objective is a more effective and standardized application of both the Arbitration Convention as well as the mutual agreement procedures (MAPs) foreseen by double tax treaties.

As a significant step forward in the strategy of the European Commission towards the removal of tax obstacles to cross-border activities of EU enterprises, the Code of Conduct establishes procedural common rules relating to

–the determination of the *dies a quo* of the three-year period, meaning the term within which the company, subject to double taxation by effect of a transfer pricing adjustment, is required to submit its case to the competent authority;

–the determination of the *dies a quo* for the three-year period during which the tax authorities of the Member States are required to spend their best efforts to reach a mutual agreement on the elimination of the double taxation;

–the rules to be followed during the MAP, the general provisions, the transparency, the exchange of documents, and the taxpayer's participation;

–the rules to be followed in the case where the arbitration phase is to commence as a result of failure to reach an agreement within the two-year term;

–the suspension of the tax collection in case of pending procedures set forth by the Convention.

The Code has the weight of a political commitment and does not encroach upon the rights or obligations of Member States, nor does it impinge upon the respective spheres of competence of Member States or of the EU.

For further details, cf. Valente, 2009, *supra* n. 1, 123 et seq.; *ibid*., 2010, *supra* n. 1.