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EU JOINT TRANSFER PRICING FORUM

SECRETARIAT DRAFT DISCUSSION PAPER ON PENALTIES

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Working document

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1. Introduction and context

1. Most EU Member States have rules which aim at enforcing taxpayers' compliance. These rules are regulated by national legislation and, therefore, can vary widely. In addition to penalties for non-compliance with transfer pricing documentation requirements, there exist penalties for uncooperative behaviour of a taxpayer. Also, more and more countries now have rules which apply if transfer pricing adjustments are made by tax administrations to bring a taxpayer's transfer pricing in line with the arm's length principle.
2. The issue of penalties was already discussed but not finalised during the Forum's first mandate from 2002 to 2004. The Forum agreed, therefore, to include the issue of penalties levied on transfer pricing adjustments in its work programme for 2005 and 2006 (see doc. JTPF/008/REV4/2004/EN). The work programme states that the Forum could identify the exact nature and extent of the problems of penalties related to transfer pricing (excluding criminal penalties) and examine the scope for solutions.
3. In 2002 and 2003 the Forum and the IBFD have undertaken surveys on transfer pricing rules in Member States that included penalties related to transfer pricing. In 2004 a Business Member of the Forum, Prof. Maisto, submitted to the Forum a comparative study on penalty regimes within the EU regarding transfer pricing documentation and adjustments. This "Transfer Pricing Penalties Report" was updated in 2005 to cover the 10 new Member States (see doc. JTPF/011/BACK/2005/EN).

2. Definition of penalties

4. Penalties are designed to provide disincentives for non-compliance in order to make tax underpayments and other types of non-compliance more costly than compliance. The compliance at issue may relate to procedural requirements such as timely filing of the tax return or providing necessary information, or to the substantive determination of tax liability.
5. In the area of transfer pricing penalties generally fall into one of the following categories:
 - a) Documentation related penalties, i.e. administrative (or civil) penalties imposed for failure to comply with the documentation requirements of a Member State at the time the documentation was due to be submitted to the tax administration;
 - b) Co-operation related penalties, i.e. administrative (or civil) penalties imposed for failure to comply in a timely manner with a specific request of a tax administration to submit additional information or documents going beyond the EU TPD or the domestic documentation requirements of a Member State; and
 - c) Adjustment related penalties, i.e. penalties imposed for failure to comply with 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.

6. As opposed to administrative (or civil) penalties, which are generally imposed by the tax administration, criminal penalties are imposed by a public prosecutor or court and are virtually always reserved for cases of very significant fraud.
7. Member States may use different names for penalties that accomplish the same purpose. Also, national compliance practices depend on the overall tax system and the judicial system in the Member State. Penalties can, therefore, take the form of monetary deterrents, e.g. a surcharge or additional tax imposed as a consequence of underpayments of tax in addition of the amount of underpayment, or, for example, a reversal of the burden of proof where a taxpayer has not acted in good faith.
8. Penalties related to transfer pricing adjustments must be distinguished from interest for late payment of tax. Some commentators consider commercial interest for late payment of tax as penalties where such interest is non deductible. Tax administrations, however, generally take the view that interest for late payment of tax at a commercial, i.e. market, interest rate does not constitute a penalty. Such interest can be considered as compensation for the "interest free loan" that the taxpayer has enjoyed due to his underpayment of tax.
9. By contrast, interest for late payment of tax at a higher than commercial rate could be considered a penalty just like separate, additional fines levied by tax administrations.

Question 1: Would the Forum consider that interest for late payment of tax could be regarded as a penalty only if it is above the commercial (i.e. market) rate?

3. Scope of this paper

10. This paper concentrates on adjustment related penalties, i.e. penalties imposed for failure to comply with 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.
11. As regards documentation related penalties, the JTPF in its activity report from 1st January 2004 to 31st May 2005 recommends in paragraph 38 of the conclusions on documentation rules:

"A Member State should not impose a documentation related penalty, where a taxpayer complies in good faith, in a reasonable manner, and within a reasonable time

- a) with standardized and consistent documentation as described in paragraphs 20 to 25 or with a Member State's domestic documentation requirements; and*
- b) properly applies his documentation to determine his arm's length transfer prices."*

12. The report continues in paragraph 39:

"A taxpayer avoids the imposition of a co-operation related penalty where he has agreed to adopt the EU TPD approach and provides, upon specific request or during a tax audit, in a

reasonable manner and within a reasonable time additional information and documents going beyond the EU TPD."

13. As the Forum agreed not to discuss criminal penalties and as documentation related and co-operation related penalties were already addressed in the JTPF activity report from 1st January 2004 to 31st May 2005, in particular in the conclusions on documentation rules, these issues are not discussed in this paper.
14. The EU Arbitration Convention offers business the certainty that they would not suffer from double taxation in the single market. The elimination of double taxation is, however, not secured if a serious penalty is imposed on a taxpayer (Art. 8 (1) of the Arbitration Convention). Member States have laid down their definitions of a serious penalty in the meaning of Art. 8 (1) of the Arbitration Convention in unilateral declarations to the Arbitration Convention.
15. The Commission Services have already pointed out in the past that some of the unilateral declarations appear to contain a rather broad definition of the term "serious penalty". This could, in certain circumstances, constitute an impediment to the effective access to the Arbitration Convention. This issue may, therefore, need to be addressed by the Forum.

4. Penalties and international laws

16. Penalties are governed by Member States' domestic laws. However, commentators state that the application of the Human Rights and Fundamental Freedoms ("ECHR") and the conformity of domestic penalty regimes with EU legislation and principles (discrimination, proportionality, compatibility with freedom of establishment, etc.) should also be taken into account as a more severe penalty regime for cross-border transactions as compared to domestic transactions might constitute an infringement of the fundamental freedoms as laid down in the EC Treaty.

5. Member States' rules on adjustment related penalties (main features)

17. According to the Transfer Pricing Penalties Report, in all Member States except Luxembourg administrative or civil penalties can be imposed in case of transfer pricing adjustments. A specific penalty regime in relation to transfer pricing adjustments, however, exists only in Greece (the Greek rule provides for a penalty equal to 10 % of the amount of the adjustment). In all other Member States, the general penalty regime applies.
18. In most Member States the penalty to be imposed is based on the behaviour of the taxpayer (wilful conduct, negligence, etc.). Only few Member States apply so-called monetary no-fault penalties. Such no-fault penalties would be imposed on the mere fact that a taxpayer's transfer pricing resulted in a lower tax assessment as determined by the tax administration, even in the absence of fraudulent intent or negligence. In Poland, in the Czech Republic and in the Slovak Republic penalties can be imposed regardless of the taxpayer's behaviour.

19. The rules for interpretation and specification of the amount of penalties are somewhat mixed; some countries regulate these issues in detail whereas other countries leave the application of general penalty principles to the discretion of the tax authorities. In most Member States the penalty consists of a percentage of the profit adjustment or the additional tax. The range is between 5 % and 30 % of the profit adjustment or between 10 % and 200 % of the additional tax. In most Member States the penalty can to some extent be waived under the administrative discretion of the tax administrations.

6. Effect of penalty regimes on transfer pricing policy

20. Paragraph 4.26 of the OECD Transfer Pricing Guidelines states "*...because cross-border transfer pricing issues implicate the tax base of two jurisdictions, an overly harsh penalty system in one jurisdiction may give taxpayers an incentive to overstate taxable income in that jurisdiction contrary to Article 9. If this happens, the penalty system fails in its primary objective to promote compliance and instead leads to non-compliance of a different sort: non-compliance with the arm's length principle and under-reporting in the other jurisdiction*". In other words, penalties in the context of transfer pricing can affect the trade between associated enterprises and substantial differences between Member States' penalty regimes can lead to undesirable distortions in the single market.

7. The taxpayer's conduct - definition and case scenarios

21. The imposition of penalties is generally influenced by the taxpayer's conduct. It is, therefore, important to have a common understanding of the terms used in this context. Broadly speaking, there are four types of conduct: (i) good faith, (ii) negligence, (iii) gross negligence, and (iv) fraudulent intent or wilful conduct. The use of these terms can best be explained with the following example and case scenarios:

Example

ManCo is a large joint stock company incorporated in Member State A and resident therein for tax purposes. ManCo is engaged in manufacturing consumer products through a factory located in Member State A and sells finished products to its subsidiary SubCo which is resident of Member State B.

Case I

ManCo undertook an economic study to confirm its compliance with the arm's length principle and commissioned a tax expert's opinion to confirm compliance with State A's transfer pricing regulations. Intercompany pricing is finally agreed by ManCo and SubCo on the basis of the economic study and tax expert's opinion. State A's tax administration makes a transfer pricing adjustment to ManCo based on the fact that a retail third party is not comparable to SubCo.

Case II

ManCo sells its items to SubCo at the same price charged to local independent retail outlets in State A. ManCo's CFO neither undertakes an economic study to establish/check

compliance with the arm's length principle nor requests a tax expert's opinion to confirm compliance with State A's transfer pricing regulations. State A's tax administration makes a transfer pricing adjustment to ManCo based on the fact that a retail third party is not comparable to SubCo.

Case III

ManCo sells its items to SubCo applying the cost plus method at a mark up of 1 per cent. ManCo's CFO neither undertakes an economic study to establish/check compliance with the arm's length principle nor requests a tax expert's opinion to confirm compliance with State A's transfer pricing regulations. State A's tax administration makes a transfer pricing adjustment to ManCo.

Case IV

ManCo sells its items to SubCo at cost plus 5 per cent, but makes arbitrary transfer pricing adjustments (properly documented and reflected in its accounting records) to reduce the group's taxable income (tax rate is higher in State A than in State B). State A's tax administration makes a transfer pricing adjustment to ManCo.

Question 2: *Tax Administration Members are invited to comment if a penalty would be imposed on a taxpayer according to their national laws or administrative practice in the above cases.*

Question 3: *In Member States' domestic laws, would the cases be considered as (a) good faith, (b) negligence, (c) gross negligence or (d) wilful conduct/fraudulent intent?*

Question 4: *Should the Forum deepen its comparative analysis with a view to trying to reach an agreement on the definitions of (a) good faith, (b) negligence, (c) gross negligence and (d) wilful conduct/fraudulent intent?*

8. Transfer pricing adjustments and penalties

22. As transfer pricing is not an exact science, there will usually be a range of possibilities in which the arm's length price will be found. This lack of precision means that transfer pricing by nature represents a potential for tax disputes, transfer pricing adjustments and possible double taxation. Business claims that it is often difficult for a taxpayer to prove its transfer pricing is arm's length, for example due to the lack of comparables.
23. A taxpayer's transfer pricing may, therefore, not be at arm's length without negligence or wilful conduct. It follows that failure to meet the arm's length standard should not per se give rise to the presumption of wilful conduct or negligence as the facts and circumstances need to show additional elements leading to the evidence of intent or negligence. The OECD Guidelines also stress in paragraph 4.33 that it would be unfair to impose sizable penalties on taxpayers that made a reasonable effort in good faith to set the terms of their transactions with related parties in a manner consistent with the arm's length principle.

Question 5: Do Forum Members agree that TP adjustments should not be automatically considered as negligence or a wilful conduct of the taxpayer?

Question 6: Do Forum Members agree that no adjustment related penalties should be imposed in the absence of wilful intent or gross negligence of the taxpayer?

Question 7: In the light of the particularities of transfer pricing, do Forum Members think that the issues raised in questions 5 and 6 above could be solved more easily if there were specific penalty rules for transfer pricing as opposed to general penalty regimes?

9. The "reasonable documentation test" - a business proposal

24. A Business Member has proposed that in case of an adjustment, no negligence should be alleged in the event that a so-called "reasonable documentation test" has been met. Such reasonable documentation test is met if (i) the taxpayer has collected the essential information regarding the disputed controlled transaction and (ii) such information is collected and available as from the date of filing the tax return for the relevant tax period. Such essential information should be limited to the intercompany agreement and a short description of the applied arm's length methodology. In the view of the Secretariat, alternatively, such essential information could be limited to the elements of the EU TPD.
25. In the view of this Business Member satisfaction of the essential "reasonable documentation test" would also limit the scope for the tax administrations to impose penalties on transfer pricing adjustments to situations in which the taxpayer's wilful conduct is proven. According to that view this would also prevent the tax administrations from imposing documentation related penalties unless the taxpayer either (i) does not provide the relevant information requested by the tax administration within a reasonable period of time after the receipt of the request or (ii) provides information that can reasonably not be considered adequate.

Question 8: What is the view of the Forum as regards the "reasonable documentation test"?

10. Cancellation or mitigation of penalties

26. Currently, in many Member States penalties are not reduced or waived in case a settlement between the taxpayer and the tax administration has been reached or following a downward transfer pricing adjustment resulting from a mutual agreement procedure (MAP) or arbitration. In Italy and Greece, however, it makes a difference for the penalty imposed

whether or not a transfer pricing adjustment is made on the basis of a settlement between the taxpayer and the tax administration. The discriminatory treatment of the taxpayer in those Member States with respect to the imposition of penalties in a dispute resolution procedure may discourage a taxpayer from invoking the MAP under the double tax treaty or the Arbitration Convention and raise the issue of compatibility with EU law.

27. Where penalties are not reduced or waived following a settlement between taxpayer and tax administration or a MAP or arbitration, they may become excessive or disproportionate to the final transfer pricing adjustment and constitute additional costs for the taxpayer. For that reason Member States should provide for a possibility to cancel or mitigate an imposed penalty where a transfer pricing adjustment is withdrawn or reduced in a settlement, MAP or arbitration.

Question 9: Does the Forum agree that penalties should be cancelled or mitigated in case of a withdrawal or reduction of a transfer pricing adjustment resulting from a dispute resolution procedure?