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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL,
THE EUROPEAN PARLIAMENT AND THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE**

on the work of the EU Joint Transfer Pricing Forum in the period March 2007 to March 2009
and a related proposal for a revised Code of conduct for the effective implementation of the
Arbitration convention (90/436/EEC of 23 July 1990)

EU Joint Transfer Pricing Forum – Summary Report on Penalties

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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 undertook 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.

3. SCOPE OF THIS SUMMARY REPORT

9. 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.
10. 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."*

11. 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."

12. 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.

13. The EU Arbitration Convention at Article 12 offers business the certainty/comfort that they would not suffer from unresolved transfer pricing related 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.
14. 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 EU LAWS

15. Penalties are governed by Member States' domestic laws. However, it might be the case that the application of the Convention for the Protection of 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 seen 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. MAIN FEATURES OF THE TRANSFER PRICING REPORT COMPILED BY JTPF BUSINESS MEMBERS

16. According to the Transfer Pricing Penalties Report, nearly all Member States administrative or civil penalties can be imposed in case of transfer pricing adjustments and no specific penalty regime in relation to transfer pricing adjustments exists.
17. 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. THE TAXPAYER'S CONDUCT - CASE SCENARIOS

18. 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. To enable Tax administrations' members to present their thoughts, they were asked to

comment on four purely illustrative case scenarios. These scenarios and an analysis of the answers received are set out in the annex.

19. This annex therefore is to be considered as a useful insight into tax administration's reasoning processes in the field of penalties related to transfer pricing adjustments.
20. However the Forum did not consider it useful to 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. Most tax administration members felt that it would be difficult to reach meaningful definitions, and to do so would in any case not be especially helpful to taxpayers since each transfer pricing case is very dependent on the facts of the case. Some tax administrations merely commented that these definitions were a matter of domestic law and therefore not appropriate to be considered in the Forum.

7. TRANSFER PRICING ADJUSTMENTS AND PENALTIES

21. 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.
22. A taxpayer's transfer pricing may, therefore, be non 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.
23. In the light of these features of transfer pricing, the Members examined whether specific penalty rules for transfer pricing as opposed to general penalty regimes would meet tax administrations and taxpayers concerns. Tax administration members concluded that penalty regimes are a matter for domestic law and most tax administration members seemed to feel that the inter-action of transfer pricing and penalties could be accommodated in existing penalty regimes.
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 would be 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. However the forum did not consider that this approach should be deepened because transactions are not acceptable on the basis of the documentation provided but well on the basis of evidence that the transaction is arm's length.

8. CANCELLATION OR MITIGATION OF PENALTIES IN CASE OF MUTUAL AGREEMENT PROCEDURE

25. Even if currently penalties are generally 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, the JTPF considered as appropriate to include some considerations on this issue in its conclusions

9. CONCLUSIONS

This section represents the Forum's conclusions in the area of penalties in transfer pricing. The JTPF excluded criminal and documentation penalties from its deliberations.

1. Penalties for transfer pricing adjustments

The JTPF considers that transfer pricing holds unique difficulties for both taxpayers and tax administrations. Transfer pricing, famously, is not a science – see the OECD guidelines 1.45 and 4.8. The determination of the arm's length price is very fact dependent. It is often difficult to determine the arm's length price. Under these circumstances, it is inappropriate for tax administrations to automatically, without having regard to the facts of the case, impose a penalty merely due to the existence of what turns out to be incorrect transfer pricing. The Forum also explicitly agrees with the considerations in paragraph 4.28 of the OECD guidelines.

2. Penalties for transfer pricing adjustments and subsequent MAPs.

It is often the case that a transfer pricing adjustment is subsequently reduced during a Mutual Agreement Procedure. The JTPF considers that where such an adjustment initially attracted a tax geared penalty and such a penalty was applied it is appropriate that the penalty is reduced commensurately. This would put the penalty in line with the final, agreed transfer pricing. This, however, would not necessarily be the case for criminal penalties or penalties considered as serious under the Arbitration Convention.

Such a reduction would not have to take place, however, if the taxpayer would gain a better result than would be available under a domestic procedure.

3. Penalties and the Arbitration Convention

The Arbitration Convention currently excludes taxpayers who have incurred a serious penalty. The situation at the moment under the Arbitration Convention where 27 different definitions of a serious 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.

ANNEX

Penalty scenarios for illustrative purpose only.

Case scenarios

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.

Case II

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 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.

Possible interpretations of the Case scenarios

1. Case I – probably good faith behaviour evidenced by taking expert advice and providing sufficient supporting information or documentation.

2. Case II- it is likely that the taxpayer has been at least negligent if no evidence of arm's length pricing was produced, either to put in place the transfer pricing policy or to justify it during the audit. However, the lack of a tax advisor's opinion or economic study is not conclusive when assessing culpability; a taxpayer who accumulated documentation based on internal comparables could be acting in good faith even if those comparables turned out to be incorrect.
3. Case III – there is nothing in this scenario to indicate that the taxpayer has been more or less culpable than in Case II but here a methodology has been selected with no reference to internal comparables nor any economic study or tax advisor's opinion. Therefore it is likely that the culpability of the taxpayer is worse than in the previous cases; the precise size of the mark up chosen is not conclusive when considering the culpability once the transfer pricing is shown to be wrong.
4. Case IV – here the situation is the same as in Case III (especially if one views the size of the mark up as not conclusive when assessing culpability) until the arbitrary adjustments are made. As the adjustments were arbitrary they were not made to change the transfer pricing in place at the time the transactions took place to arm's length pricing for the tax return. The adjustments were made for some other purpose – one can assume that it is possible, perhaps likely, that they were made to push profits into a lower taxing country and not in accordance with the arm's length principle. This would affect the culpability of the taxpayer. Equally, the adjustments may have taken place so that a sales manager could enjoy a greater salary bonus. The facts would have to be examined. If the adjustments had not been made arbitrarily but to adjust the profits in line with a documented transfer pricing policy, then the taxpayer would have grounds for arguing a much reduced degree of culpability (perhaps even good faith), even if the transfer pricing policy was later discredited during an audit. The mere fact that an adjustment is made to a transacted price should not merit a penalty: the reason for the adjustment needs to be examined.

Analysis of tax administration comments

5. The comments from tax administrations recognised that real life cases are often more complex than can be encompassed in any illustrative example. Nevertheless, the relevant facts that need to be considered for any particular purpose are often fewer in number than the total facts of a case and most tax administrations have been ready to comment on the Case scenarios to further the discussion. Tax administrations have different interpretations of what good faith, negligence, gross negligence and wilful misconduct consist of, and in real life cases categorising actions will be very dependent on the facts. Despite this, there is a large degree of consistency in the comments received. In particular, tax administrations frequently had the same reasoning and viewed the same facts as most important. Looking at the answers provided, one can extract these points as the ones that were most relevant to the tax administrations:
6. There is a question over whether the company is negligent or worse in not using the right comparable. There is also a question of whether a company discharges part of its responsibilities by paying a tax advisor for an opinion of its transfer pricing; the taxpayer of course remains responsible for his tax return but some taxpayers might genuinely believe a tax professional's opinion, not knowing that the opinion would be unacceptable to tax administrations.

7. The main difference between Cases I and II seems to be that in Case I the taxpayer genuinely tried to put in place an arm's length transfer pricing policy and obtained evidence that it had done so from professional advisors, even if the evidence was later found to be incorrect. In Case II, the taxpayer may have assumed that the transfer pricing policy was arm's length but did not check. Alternatively, the taxpayer may have been (mistakenly) confident that the internal comparable was a good one. A third alternative is that the taxpayer may have known that the transfer pricing policy was not arm's length. The truth would depend on the facts of the case.
8. Tax administrations who can exercise discretion in the application of penalties tended to assume that the taxpayer in Case I was less culpable than the taxpayer in Case II. However, tax administrations do not hold the view that a taxpayer, through the mere act of consulting with a tax advisor or commissioning an economic study (or a functional analysis), can automatically avoid a penalty. It is not compelling proof of "good faith" behaviour where a tax advisor's opinion and economic evidence have been produced but most tax administration seemed to believe that in the majority of cases it was at least indicative of "good faith" behaviour. On the other hand, to follow a transfer pricing policy that was manifestly not arm's length is unlikely to be viewed as "good faith" behaviour whatever the economic evidence and opinions that had been paid for. If the taxpayer had known, or should have known, that the independent retail company was not a comparable then the taxpayer's culpability is worse.
9. There is a difference between having abundant documentation which only reveals non arm's length transfer pricing and producing documentation as evidence which proves transfer pricing is arm's length. In Cases I and II the transfer pricing was equally incorrect. In Case II, less documentation was available than in Case I – but this did not result in most tax administrations automatically assuming a greater degree of culpability in Case II although some did so. All recognised that the degree of culpability would depend on all the facts in a real case.
10. In Case III no comparable is used at all. There is nothing at all to substantiate the 1% mark up. Most tax administrations concluded that this behaviour was more likely to attract a penalty and that the level of culpability was beyond negligence, probably gross negligence.
11. In Case IV, nearly all tax administrations concluded that the taxpayer's behaviour would attract a penalty. The level of culpability had probably gone beyond gross negligence and bordered on wilful misconduct and intent. The key fact in this conclusion was seen as the taxpayer's arbitrary behaviour, whatever the motive. The motive for that arbitrary behaviour might also be a factor when assessing the degree of culpability involved: if the facts revealed that the taxpayer's behaviour was motivated by a desire to minimise tax payable, this might result in a greater level of culpability. But even without considering motivation, for most tax administrations the taxpayer's behaviour would have attracted a penalty. Intent is not the most important factor for some tax administrations which chose to focus on the action of the taxpayer. Motive of course remains difficult to assess objectively, behaviour is easier to categorise.