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Transfer Pricing: The EC Arbitration Convention as a Dispute Resolution Mechanism*

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INTRODUCTION

On 23 July 1990 the then twelve Member States[1] of the European Communities (hereinafter "EC") signed in Brussels the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (hereinafter the "Arbitration Convention") [2]. Following lengthy ratification procedures in the Member States concerned, the Arbitration Convention entered into force on 1 January 1995, initially for a period of five years. On 21 December 1995 another convention concerning the accession of Austria, Finland and Sweden to the Arbitration Convention was signed in Brussels [3]. Since the Arbitration Convention expired at the end of its initial term of five years on 31 December 1999, a Protocol extending the Arbitration Convention of 23 July 1990 was signed in Brussels by all current fifteen Member States [4]. The Protocol provides for a

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[1] These Member States included Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Portugal, Spain, The Netherlands and the United Kingdom.

[2] Convention 90/463/EEC, Official Journal of the European Communities, N° L 225, 20 August 1990.

[3] Convention concerning the accession of the Republic of Austria, the Republic of Finland and the Kingdom of Sweden to the Convention on elimination of double taxation in connection with the adjustment of profits of associated enterprises, Official Journal of the European Communities, N° C 26, 31 January 1996.

[4] Protocol amending the Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, Official Journal of the European Communities, N° C 202, 16 July 1999.

tacit and automatic renewal of the Arbitration Convention for successive five-year periods. However, the Protocol has so far not entered into force failing completion of the ratification process in all fifteen EC Member States [5].

The aim of the Arbitration Convention is to eliminate international double taxation arising when the tax authorities of one or more Member States adjust the profits of associated enterprises established in their respective territories. Indeed, international double (or multiple) taxation occurs whenever the same taxable base (*e.g.*, income) is subject [6] to an identical or similar tax (*e.g.,* income tax) in at least two separate tax jurisdictions. For instance, with respect to transfer pricing applied by associated enterprises, such double taxation results when a Member State adjusts upward the profits (or taxable income) of an enterprise involved in transactions which are not "*at arm's length*" and when another Member State does not allow a corresponding downward adjustment of the profits (or taxable income) of the enterprise established in its own territory which is associated with the enterprise established in the Member State

[5] As of 1 August 2001, the Protocol has been ratified in Germany, Denmark, Spain, Luxembourg, The Netherlands and Finland.

[6] Double taxation does not require an effective tax levy.

making the upward adjustment and which benefited from the transactions that were not *“at arm’s length*” . The resulting international double taxation will be *“economic*” if the transfer pricing adjustment relates to cross-border business between enterprises that are separate legal entities, whereas it will be “*juridical*” if the adjustment relates to transactions between a permanent establishment (*e.g.,* a branch) in one Member State, and the permanent establishment or head office of the same legal entity in another Member State.

As explained in further detail below, the Arbitration Convention provides for relief where an upward adjustment of profits is believed to result in such international double taxation. First, the enterprise subject to the upward adjustment may submit a claim to the competent authority of the Member State of its tax residence. Subsequently, the other Member States involved (*i.e*., where the associated enterprise / enterprises participating in the transfer pricing arrangement is / are established) may be notified by this competent authority. If the authorities of the Member States concerned cannot agree on the elimination of international double taxation within two years, an advisory committee shall be set up to deliver an opinion not more than six months from the date on which the matter was referred to it. Within six months from the date of the opinion of the advisory committee, the competent authorities of the Member States concerned shall take a decision to eliminate double taxation. That decision may deviate from the opinion of the advisory committee, as this opinion becomes binding only should the competent authorities not reach an agreement on an alternative settlement within the fixed time frame.

By agreeing to the Arbitration Convention, the EC Member States have recognised the importance of eliminating international double taxation in connection with the adjustment of profits of associated enterprises [7]. This has been done in an effort to avoid possible distorting effects on the development of harmonious economic relations between the Member States, and to cope with the inadequacy of the remedies available under both their domestic and treaty laws. The territorial application of the Arbitration Convention being confined to the territories of the EC Member States (as defined), other international organisations having similar aims may inspire their Members to

[7] *See* Preamble to the Arbitration Convention, Official Journal of the European Communities, N° L 225, 20 August 1990, at 10.

adopt a multilateral arbitration convention of comparable or even broader scope exceeding the transfer pricing boundaries of the EC Arbitration Convention.

I. LEGAL STATUS OF THE ARBITRATION CONVENTION

As stated in the Preamble, the legal basis for concluding the Arbitration Convention should be found in Article 220 of the Treaty establishing the European Economic Community (Treaty of Rome) [8]. This Treaty Article specifies that, where necessary, the Member States shall enter into negotiations with each other with a view to securing, for the benefit of their nationals, the abolition of double taxation within the Community. Originally, the Commission of the European Communities had proposed a draft EC Council Directive [9], but the Member States preferred the legal form of a multilateral convention. An official of the European Commission reported that this choice was made on political grounds, namely the collective hesitation of the Member States to surrender a significant part of their fiscal sovereignty in matters of transfer pricing where there had not been any common rules [10]. Indeed, the proposed EC Council Directive was based on Article 100 of the Treaty of Rome [11] and had, as a result, become

[8] This Treaty was first concluded in Rome on 25 March 1957, but successively amended by the Treaties of Maastricht (7 February 1992) and Amsterdam (2 October 1997). Article 220 of the Treaty of Rome has been re-numbered as Article 293 of the Treaty of Amsterdam.

[9] Proposed EC Council Directive concerning the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises (arbitration procedure), submitted to the Council on 29 November 1976, Official Journal of the European Communities, N° C 301, 21 December 1976.

[10] SCHELPE, D., *The Arbitration Convention: its origin, its opportunities and its weaknesses*, EC Tax Review 1995/3, at 71.

full part of EC Community law. The legal form of the directive would not only have given a supranational character to the arbitration procedure established by it, but would also have given competence to the European Court of Justice (in Luxembourg) to monitor and interpret the terms of the arbitration procedure, and to the European Commission to commence infringement procedures before the European Court against any Member State which would not apply the arbitration procedure, nor comply with the arbitration decisions rendered thereunder. The political choice made by the Member States has given rise to some controversy with respect to the legal validity of the Arbitration Convention. Considering that the European Commission has no immediate intention to challenge the legal basis of the Arbitration Convention [12], this question seems academic.

Another controversy relates to the possible supranational character of the Arbitration Convention showing two schools of thought. The first group believes that the Arbitration Convention has no status in European Community law, has therefore no

[11] This article has been re-numbered as Article 94 of the Treaty of Maastricht. It empowers the EC Council to adopt, by unanimous vote, directives proposed by the European Commission.

[12] SCHELPE, D., *l.c.* However, the author, an official of the European Commission, does not exclude that the European Commission might still want to challenge the Arbitration Convention in the future, and propose a tax arbitration directive.

supranational character and is to be considered as an ordinary international tax convention. They reach their conclusion on the basis of the need for ratification of the Arbitration Convention (and the subsequent Protocol), the non-automatic accession of new EC Member States to the Arbitration Convention (requiring the ratification of a separate accession convention), the absence of jurisdiction of the European Court of Justice, the lack of monitoring powers of the European Commission, as well as certain provisions in the Arbitration Convention itself with regard to parallel obligations under other conventions or even domestic law of the Member States [13]. Yet, others claim that the Arbitration Convention has supranational legal status and has therefore superior legal value. They mainly justify their view by reference to Article 220 of the Treaty of Rome which is the legal source of the Arbitration Convention (*see* above) establishing a close connection with the European Community. The impact of such a higher legal status of the Arbitration Convention would still be fairly limited, and have little practical relevance. A possible higher ran

[13] *See* Article 15 of the Arbitration Convention.