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Intermediation and arbitration: the Arbitration Convention of the European Union for the resolution of transfer pricing disputes*

Summary

On 23 July 1990, member States of the European Communities (EC) signed the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, an international agreement and legal instrument relevant to the Communities based on article 293 of the Treaty establishing the European Community. According to this provision, "Member States shall, so far as is necessary, 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".

It is known as the Arbitration Convention and refers to transfer pricing issues. According to internationally agreed principles, transactions within a given multinational group of companies must be evaluated according to their market value. This arm's length principle aims at a fair allocation of taxing rights among tax jurisdictions. The Convention is intended to resolve the problem of double taxation that arises when tax authorities apply differing transfer pricing values for the same transactions between related companies in different member States.

Tax treaties based on the Organisation for Economic Cooperation and Development (OECD) model provide for procedures whereby the tax authorities concerned try to reach an agreement to resolve the problem; but there is in practice no guarantee that an agreement eliminating the double taxation will be reached. The aim of the Convention is to improve this situation by imposing time limits on the procedures and ultimately requiring binding arbitration.

* The present paper was prepared by Mr. Juan Lopez Rodriguez. The views and opinions expressed are those of the author and do not necessarily represent those of the United Nations.

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This Convention refers to enterprises of the contracting States and covers affiliated companies and permanent establishments. It embraces enterprises run by self-employed individuals or by companies or other entities. Associated enterprises are those where one enterprise participates directly or indirectly in the management, control or capital of the other or where the same persons participate in the management, control or capital of both. Profit adjustments between a head office and its permanent establishment fall within the scope of the Convention.

Article 6 of the Arbitration Convention refers to the main goal of eliminating double taxation. For this purpose, it provides for a mutual agreement procedure. If an agreement is not possible within two years, article 7 provides for an arbitration procedure to settle the dispute in such a way as to eliminate double taxation.

The mutual agreement procedure is initiated following the initiative of the enterprise. It is expressly mentioned that the case may be presented for a mutual agreement procedure, irrespective of the remedies provided by the domestic law of the contracting States concerned.

The arbitration phase takes place only when the respective competent authorities have failed to reach an agreement to eliminate double taxation after two years. The aim of the arbitration phase is to set up an advisory commission. This advisory commission will deliver an opinion on the case. Its opinion must be based on the principles of the Convention.

The advisory commission is composed of representatives of each competent authority concerned and of independent persons of good standing. The independent persons must be nationals of a contracting State and resident within the territory to which this Convention applies. They must be competent and independent.

The advisory commission must deliver its opinion. Afterwards, the competent authorities must adopt a decision. They may deviate from the opinion of the advisory commission but in the case where they fail to agree on an alternative solution, they must act in accordance with the opinion.

It is increasingly difficult to apply the arm’s length principle for a number of reasons. An alternative to this system of profit allocation could be a formula apportionment system. Unitary taxation would do away with many of these problems. Under a system of unitary taxation, transfer prices are irrelevant for tax purposes, and physical presence in a jurisdiction is not decisive.

In October 2001, the Commission of the European Communities presented a communication to the other institutions of EC stating its policy for corporate tax. This communication was the result of a study on company taxation. The study has found that allocation of profits on an arm’s length basis gives rise to numerous problems on the fiscal treatment of intra-group transfer pricing.

To resolve these issues, the Commission proposed a two-track strategy directed towards immediate action on targeted measures and, at the same time, the launch of a wider debate on a general comprehensive approach. One of the targeted measures in the area of transfer pricing is the improvement of the dispute settlement procedures of the Arbitration Convention. For this purpose, a European Union Joint Forum on Transfer Pricing involving member States and business representatives has been set up in order to examine those issues that can be addressed without legislative initiatives.

However, this approach would not address the underlying problem of dealing with the different tax systems of the member States. Only an approach providing multinational companies with a consolidated corporate tax base for their EU-wide activities would really, through a single framework of company taxation, systematically tackle the majority of the tax obstacles to cross-border economic activity in the internal market. Companies with cross-border and international activities within EU should, in future, be allowed to compute all the taxable income of the entire group using only one set of rules and establish consolidated accounts for tax purposes.

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I. The European Union and its legal instruments

Objectives of the European Communities

1. According to article 2 of the Treaty establishing the European Community, the Community has as its task, by establishing a common market and an economic and monetary union and by implementing common policies or activities referred to thereby, to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among member States.

Institutional system

2. The European Union (EU) carries out its activities through a unique institutional system established to achieve the aforementioned goals. The member States delegate sovereignty for certain matters to independent institutions that represent the interests of the Union as a whole, its member countries and its citizens. The Commission traditionally upholds the interests of the Community as a whole, while each national Government is represented within the Council, and citizens directly elect the European Parliament. Democracy and the rule of law are therefore the cornerstones of the structure.

3. This “institutional triangle” of Commission, Council and Parliament is flanked by two more institutions — the Court of Justice and the Court of Auditors — and five other European bodies. In addition, 13 specialized agencies have been set up to handle certain essentially technical, scientific or management tasks.

Nature of Community law

4. From the formal point of view, Community law belongs to international law. It is partly embodied in and partly based on treaties concluded between sovereign States. However, Community law exhibits a number of properties that are foreign to traditional international law.

5. From the viewpoint of its content, Community law is a common international law within the member States rather than a law between these States. Indeed, the core of Community law is formed by the rules for the establishment and maintenance of a common market, this common market being an internal market common to the member States. The conclusion is that the law regulating the relations within the internal market is domestic law common to all the member States.

Sources of law

6. The Community has the competence to make law. Its organs exercise sovereign rights and may carry on autonomous legislative and administrative activities within the limits set by the treaties of foundation. The policy-making is not exclusively in the hands of a body composed of representatives of the member States taking decisions by a unanimous vote. The Council of Ministers may take its decisions in a growing number of cases acting by a qualified majority. The Commission, consisting of persons independent of the member States, has the power of initiative and enforces legislation already in force. The European Parliament shares this function as well. Its role varies according to the subject matter. The Economic and Social Committee issues opinions during this process.

7. In order to carry out their task and in accordance with article 249 of the Treaty, the European institutions make regulations and issue directives, take decisions, make recommendations or deliver opinions. Recommendations and opinions do not have binding effects.

8. Three characteristic elements of a regulation are: its general application, its binding character in all respects, and its direct applicability in each member State. The general application of a regulation concerns the impersonal, non-individualized character of the situation to which it applies as well as the legal effects it entails for the legal subject to whom it is addressed.

9. A directive has binding force in relation to the result to be achieved for each member State to which it is addressed but it leaves the member States free to choose the form and methods for implementing it. It is binding as to the result to be achieved, which may be defined as a legal or factual situation. The result to be achieved by virtue of a directive will in practice always necessitate amendment of national law unless it already conforms to the directive. Member States must implement the directive within the period prescribed therein.

10. Decisions are binding in all respects on their addressees. They can be addressed to member States as well as to private parties and are the means by which the Community adopts individual administrative acts. In other words, they are the means by which Community law is applied in specific cases.

11. Other legal instruments relevant to the Communities are the treaties concluded between member States concerning questions connected with the subject matter of the Community treaties. They may be very important for the attainment of the objectives of the Communities and may be concluded with a view to these very objectives. Article 293 of the Treaty states that “Member States shall, so far as is necessary, 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”.

Community competence in tax matters

12. The provisions of the Treaty that are directly concerned with taxation are restricted in their scope. Taxation remains a competence of the member States. The Treaty provides for the harmonization of legislation concerning indirect taxation to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market. Concerning direct taxes, no specific provisions

are included in the Treaty. Harmonization in this area is possible only regarding approximation of such laws, regulations or administrative provisions of the member States as directly affect the establishment or functioning of the internal market. In the absence of unifying or harmonizing measures in the Community, direct taxation falls essentially within the competence of member States and the conventions concluded between them in order to avoid double taxation. Nevertheless, when exercising this competence, member States must respect the basic principles laid down in the Treaty. In particular, there must be no direct or indirect discrimination on the basis of nationality.

II. The Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (Arbitration Convention)

Background and history

13. The Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (Arbitration Convention) started life as a proposal for a directive which the Commission submitted to the Council on 29 November 1976. The draft was associated with the proposal for a directive on mutual assistance in matters of direct taxation. At the time, the Commission believed that an increase in the exchange of information between tax administrations would lead to an increase in the number of profit adjustments and that a mechanism was needed to eliminate any double taxation that could arise in connection with such adjustments.

14. The Mutual Assistance Directive was adopted (in 1977) whereas the proposed directive concerning the elimination of double taxation was not. However, member States did eventually agree on a multilateral convention, much of whose wording is taken directly from the Organisation for Economic Cooperation and Development (OECD) Model Double Taxation Convention on Income and on Capital. On 23 July 1990, member States signed the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, more commonly known as the Arbitration Convention. The Arbitration Convention is based on article 293 of the Treaty establishing the European Community.

15. The Arbitration Convention was concluded for a period of five years, and came into force on 1 January 1995. On 25 May 1999, member States signed a Protocol amending the Convention in order to extend it for further periods of five years at a time. In other words, henceforth the Convention will be automatically renewed for another five years unless a contracting State objects at least six months before the expiry of any five-year period. The Protocol takes effect as from 1 January 2000, but shall enter into force only once all member States have deposited their instruments of ratification, acceptance or approval. At present, the Protocol is not yet in force.

16. When member States signed the Arbitration Convention in 1990, no provision was made in the Convention for the accession to the Community of new member States. The accession of Austria, Finland and Sweden to the Community therefore required the negotiation of an Accession Convention.

17. The Arbitration Convention has received its fair share of criticism over the years. Part of this criticism relates to the type of instrument chosen. The Commission's 1976 proposal was for a directive, on the grounds that the problem of transfer price adjustments affected "the establishment or functioning of the common market". The choice of a convention rather than a directive has a number of drawbacks from the point of view of taxpayers. Unlike a directive, a convention does not form part of the corpus of Community law which is enforced by the Commission and whose uniform interpretation is ensured by the European Court of Justice. Moreover, a directive would have come into force automatically after a specific period and would not have been dependent on ratification by all member States. It would have applied immediately to new member States without requiring further negotiation. Nor would it have required a ratification process. Insofar as its provisions were sufficiently clear and precise, it could have had direct effect, enabling taxpayers to enforce its principles directly in the national courts; the latter would have been able to refer questions of interpretation to the European Court of Justice for a preliminary ruling.

Aims of the Convention

18. The Arbitration Convention refers to transfer pricing issues. According to internationally agreed principles, transactions within a given multinational group of companies must be evaluated according to their market value. This arm's length rule aims at a fair allocation of taxing rights among tax jurisdictions.

19. The Convention is intended to resolve the problem of double taxation which may arise when tax authorities apply differing transfer pricing values for the same transactions between related companies in different member States.

20. Related companies can determine their own commercial relationships including the price and other conditions of transactions between them without having regard to market conditions. This raises the question how each tax authority can assure that it receives an appropriate proportion of the tax base. The generally accepted international approach is to tax each enterprise on an arm's length basis, that is to say, on the basis of transfer prices that would have been set between independent enterprises in the open market. OECD has developed methodologies for determining the arm's length transfer price. Nevertheless the detailed application of the methods by countries may vary and, for certain transactions, establishing the arm's length price is notoriously difficult. Even where a company attempts to price on an arm's length basis, there is no guarantee that the tax authority will concur.

21. Failure to price on an arm's length basis can lead to profit adjustments by a tax authority. Unless such an adjustment is matched by a corresponding adjustment in the other State(s) concerned, the result will be international double taxation. Tax treaties based on the OECD model provide for procedures whereby the tax authority concerned tries to reach mutual agreement with respect to resolving the problem. In short, there is in practice no guarantee that an agreement eliminating the double taxation will be reached. Moreover, such procedures can be rather lengthy and, as in most cases there is no suspension of the additional tax payment available, the companies concerned will often have to bear the cost of the double taxation during this period.

22. The aim of the Convention is to improve this situation by imposing time limits on the procedures and by ultimately requiring binding arbitration.

Interpretation and application

23. The Arbitration Convention lacks provisions defining the terms applied by the Convention. The only term defined in the Convention is “competent authority”.

24. Article 3(2) states that any term not defined in the Convention shall, unless the context otherwise requires, have the meaning that it has under the double taxation convention between the States concerned. Moreover, the convention itself may contain few definitions and will instead refer to the national legislation of the State applying the convention. Thus, the Arbitration Convention as it stands does not guarantee relief from double taxation where member States have differing definitions or apply different interpretations to them.

25. Finally, the European Court of Justice has no jurisdiction in these matters. Consequently, the national judiciaries are the final interpreters of the Convention, and 15 different interpretations are therefore possible.

26. In any case, the Vienna Convention on the Law of Treaties[1] provides for interpretation rules that are available. According to its article 31(1), international agreement provisions should be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the agreement in their context and in the light of the object and purpose of the agreement. This will allow reference to international agreed principles in the area, including the OECD Model Double Taxation Convention and its commentaries and the OECD Transfer Pricing Guidelines.

Scope of the Convention

27. The Convention covers any situation in which, for tax purposes, the profits of an enterprise of a contracting State that are included in its taxable income in that State, are also included in the taxable income of an enterprise of another contracting State on the grounds that the principles set out in article 4 have not been observed. It is made clear that the Convention also applies in cases where the enterprises concerned have made losses rather than profits.

28. The Convention applies to taxes on the income of individuals and corporations, in particular those taxes listed in article 2(2) and any identical or similar taxes introduced subsequently. It also states that competent authorities of the contracting States shall inform each other of any changes made in the respective domestic laws.

Personal scope

29. Concerning personal scope, the Convention refers to enterprises of the contracting States and covers, in particular, affiliated companies and permanent establishments.

30. The term “enterprise of a contracting State” is not defined in the Convention. Since it applies to individual income taxes and to corporate income taxes, this

concept embraces enterprises run by self-employed individuals or by companies or entities subject to such taxes. It probably covers any permanent, independent commercial activity carried on with a view to making a profit (a business). Incorporation is not required.

31. Under article 4, enterprises are associated in cases where one enterprise participates directly or indirectly in the management, control or capital of the other or where the same persons participate in the management, control or capital of both. This definition literally follows article 9 of the OECD Model and covers both vertical and horizontal affiliation. No specific minimum threshold is required.

32. Article 1(2) expressly deems a permanent establishment in a contracting State of an enterprise of another contracting State to be an enterprise of the State in which it is situated. No definition of permanent establishment is given. According to article 3(2) the question of undefined terms should be addressed by referring to the relevant double taxation treaty.

33. Profit adjustments between a head office and its permanent establishment in another member State therefore fall within the scope of the Convention. In addition, the treaty covers transfer pricing adjustments for transactions between a permanent establishment and an affiliated company.

34. A joint declaration annexed to the Convention makes it clear that the Convention applies also to transactions between an enterprise and a permanent establishment of an associated enterprise in a third State. Under article 4(2), the profits of a foreign permanent establishment are to be taxed as if it were a separate business dealing independently with the enterprise to which it belongs. Article 4 restates articles 9(1) and 7(2) of the OECD Model Convention almost word for word.

35. Judging by the phrase appearing in the French text of this joint declaration attached to the Final Act of the Arbitration Convention, namely, *dans un troisième État contractant*, it is clear that this third country must be a third EC member State. The Convention does not, on the other hand, cover permanent establishments of enterprises resident in a non-member State.

The arm's length principle

36. As mentioned before, the general principles governing the adjustment of profits are the arm's length principle and separate accounting. The Convention provides, in the case of associated enterprises, for the inclusion of profits in the profits of the enterprise to which they would normally have accrued had the enterprises been independent. Concerning permanent establishments, it follows the OECD Model Convention concerning taxation of business income attributed to permanent establishments.

37. The Convention does not specify which methods may be used to determine the arm's length price. It is essentially procedural and comes into play only when the arm's length principle is not observed, so that a contracting State makes a profit adjustment that results or is likely to result in double taxation. In principle, this may mean that any method is valid as long as it is based on the hypothesis of independence of the associated enterprises involved.

38. Article 4(1) refers to the case where the conditions made or imposed between the two associated enterprises differ from those that would be made between independent enterprises. In such a case, any profits that would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

39. In order to avoid double taxation, the adjustment of an international transfer price in one State should be followed by a corresponding adjustment in the other State.

40. This is the main goal pursued by the Convention. It confers on the enterprises affected by a reallocation of profits the right to file a complaint with the competent authority. It provides for a mutual agreement procedure between the States involved and, if they cannot reach such agreement, for an arbitration procedure to settle the profit allocation dispute in such a way as to eliminate double taxation. Its procedures look for an agreement between the contracting States on the terms of the adjustments to be made under the arm's length principle.

41. Furthermore, article 14 is very precise in describing the circumstances under which, for the purposes of the Convention, the double taxation of profits shall be regarded as eliminated, namely, when the profits are included in the computation of taxable profits in one State only; or when the tax chargeable on those profits in one State is reduced by a corresponding amount in the other. It necessarily implies a corresponding adjustment under the arm's length principle.

42. It is important to mention that the Arbitration Convention strictly follows the arm's length principle. In consequence, the procedures established therein are not meant to solve other international tax conflicts. Problems linked to tax competition or those fiscal State aids that are illegal under the EC treaty are outside its scope.

Application of the arm's length principle

43. The Arbitration Convention refers to the application of the arm's length principle. The contracting States may adjust transfer prices of an enterprise according to the fair market value of the transactions between related or associated parties.

44. According to the treaty, when the tax authorities of a contracting State intend to adjust the results of an enterprise in accordance with the arm's length principle, they shall first of all notify the enterprise. This notification is an initial step allowing the enterprise to inform the enterprise in the other contracting State, which can in turn inform its own tax authorities. It is important to note, however, that the authorities are not prevented from immediately proceeding to make the adjustment.

45. Where both enterprises and the tax authorities of the other contracting State agree to the adjustment, the matter goes no further: the mutual agreement procedure is not initiated. This will normally entail a corresponding adjustment in the second contracting State, although that is not explicitly mentioned in the Convention.

Mutual agreement procedure

46. The mutual agreement procedure is initiated following the initiative of the enterprise. Its claim must be based on circumstances where taxation is not in accordance with the arm's length principle. This may be the case where, for example, the initial and unilateral adjustment of the tax authorities does not correspond to such a principle or where such an adjustment is not followed by the corresponding adjustment in the other contracting State.

47. The procedure starts with the presentation of the case to the competent authority of the contracting State of the enterprise or that in which the relevant permanent establishment is situated. It is expressly mentioned that the case may be presented for a mutual agreement procedure, irrespective of the remedies provided by the domestic law of the contracting States concerned. Thus, simultaneous proceedings concerning the same transfer pricing issues are possible. The absence of recourse to a domestic legal remedy does not prevent recourse to the Arbitration Convention procedures. The complaint must be submitted within three years of the first notification of the action resulting in double taxation.

48. The enterprise shall at the same time inform the competent authority if other contracting States may be concerned, and the competent authority shall inform the competent authorities of those other States.

49. The tax authority may consider that the complaint is well-founded. In this case, it can adopt unilateral measures for double taxation relief. Up to this point, the procedure does not surpass the domestic level.

50. On the other hand, if the competent authority of the State of the relevant enterprise is not able or not willing to provide a unilateral solution, it must attempt to reach an agreement eliminating double taxation, on the basis of the arm's length principle, with the competent authority of any other State concerned (article 6(2)). The Convention seems to confer a discretionary power on the competent authority by stating that only "if the complaint appears to it to be well-founded" is the competent authority obliged to initiate proceedings. This statement is also found in article 25(1) of the OECD Model Convention. Although the quoted phrase appears to imply a preliminary assessment by the tax authority, some say that this provision should be used only to dismiss manifestly unfounded applications.

51. No further rules are found concerning the steps to be followed in the mutual agreement procedure. In any case, it seems clearly modelled on article 25 of the OECD Model Convention. The proceedings will be at the intergovernmental level and the enterprises involved are not party to the procedure between the States. The obligation on the contracting States during this phase is still to negotiate, not necessarily to reach a final agreement. They may require the enterprises to provide further information.

52. If an agreement is reached, it shall be implemented irrespective of any time limits laid down in domestic law. In any other case and after the time limit set in the Convention, the contracting States are required to enter into the arbitration procedure. This latter provision is an addition to the usual bilateral treaty provisions. The goal is to guarantee a final agreement between the contracting States so that double taxation is eliminated.

Arbitration procedure

53. The condition required for entry into the arbitration phase is the failure of the competent authorities concerned to reach an agreement that eliminates the double taxation within two years from the date on which the case was first submitted to one of the competent authorities.

54. The aim of the arbitration phase is to set up an advisory commission. In fact, it is for the competent authorities concerned to appoint the members of the advisory commission, which will deliver an opinion on the issue. Its opinion must be based on the principles of the Convention and it must eliminate the double taxation in question.

55. The two-year limit is suspended when one of the enterprises has also submitted the case to a national court or tribunal under the appeals provisions of national law. In such a case, the two-year period will be computed from the date on which the final judgement by the national jurisdiction is rendered. Recourse to domestic legal remedy is a certain way of deferring arbitration into the distant future.

56. Another important provision is article 7(3) which stipulates that where the domestic law of a contracting State does not permit the competent authorities of that State to derogate from the decision of their judicial bodies, it is possible to proceed to the arbitration phase only if the associated enterprise of that State has allowed the time for appeal to expire or has withdrawn any such appeal.

57. The competent authorities are also relieved of any obligation to appoint an advisory commission if one of the enterprises involved is liable to a “serious penalty” because of actions giving rise to the profit adjustment and they may stay an arbitration procedure already initiated for as long as such penalty proceedings are pending. Article 8(2) provides that the competent authorities may suspend an arbitration procedure already initiated for as long as such penalty proceedings have not resulted in a final decision.

58. The contracting States’ national definitions of “serious penalty” are set out in unilateral declarations annexed to the Convention and vary considerably. The definitions provided by those member States that joined the European Communities after the adoption of the Convention are included in unilateral declarations annexed to the Treaty of Accession to the Arbitration Convention. These national definitions have little in common. In some States, a simple administrative fine for not filing a return may exclude access to the Convention procedures. Most States refer to domestic legislation. Greece and Portugal state minimum fraud sums. Luxembourg has a rather interesting concept of a serious penalty in tax matters: it considers serious whatever the other contracting States consider serious for this same purpose. It should be noted that it is unclear whether double taxation may be left unresolved if fraud or irregularities are suspected. Not eliminating the double taxation may result in two penalties for the same offence: one through criminal prosecution or administrative sanction, and the other through the deliberate maintaining of double taxation.

59. No case has yet been reported as having been rejected under article 8 (serious penalty clause). This is surprising, since the article has been the subject of criticism inasmuch as the “seriousness” of the penalty varies considerably according to the interpretations of member States.

60. In practice, the first phase lasts much longer than two years. For many reasons, member States are not moving to the panel phase. The average length of the mutual agreement procedure is 18 months within EU. However, this average has been reduced by the data provided by the authorities of one of the contracting States, which accounts for 50 per cent of all reported cases and resolves them on average within 13 months.

61. Businesses complain about the considerable difference of opinion about the starting date for the two-year period. This has been borne out by a survey. Some member States refer to the moment when the tax authorities receive a request from the taxpayer. Some other contracting States follow this same criterion but require, in addition, that the request not be made until adjustment is made. Another State considers it possible to start only when all the relevant information has been submitted to the competent authorities. Finally, another contracting State starts to compute this term only when the corresponding adjustment is formally refused.

62. Another complaint by businesses is that there are no rules on the suspension of the collection of tax. Associated enterprises may have to finance the same tax burden twice.

Advisory commission

63. The advisory commission is composed of two representatives of each competent authority concerned (or one, if the authorities so agree) and an even number of independent persons of standing chosen from a permanent list composed of five nominees of each contracting State.

64. The members of the commission then choose a chairman from the same list of independent persons; the chairman must possess the qualifications required for appointment to the highest judicial offices in his country or be a jurisconsult of recognized competence. It should be noted that these are the same qualifications required for appointment to the European Court of Justice. The competent authorities have the right to object to the appointment of a person as chairman under one of the following circumstances: where that person belongs to or is working on behalf of one of the tax administrations concerned; where that person has, or has had, a large holding in or is or has been an employee of or adviser to one or each of the associated enterprises; or where that person does not offer a sufficient guarantee of objectivity for the settlement of the case or cases to be decided.

65. Concerning the appointment of the independent persons, an alternate has to be appointed for each of them according to the rules for the appointment of the independent persons, in case the independent persons are prevented from carrying out their duties.

66. Where lots are drawn, each of the competent authorities may object to the appointment of any particular independent person of standing in any circumstance agreed in advance between the competent authorities concerned or in one of the following situations: where that person belongs to or is working on behalf of one of the tax administrations concerned; where that person has, or has had, a large holding in or is or has been an employee of or adviser to one or each of the associated enterprises; or where that person does not offer a sufficient guarantee of objectivity for the settlement of the case or cases to be decided.

67. The list of independent persons of standing shall consist of all the independent persons nominated by the contracting States. For this purpose, each contracting State will nominate five persons and will inform the Secretary-General of the Council of the European Communities thereof. Such persons must be nationals of a contracting State and resident within the territory to which this Convention applies. They must be competent and independent.

68. The contracting States may make alterations to the list of independent persons and inform the Secretary-General of the Council of the European Communities as soon as possible.

69. The members of the commission are bound by secrecy on the matters that they become party to as a result of the proceedings. The Convention refers to the contracting States to adopt appropriate provisions to penalize any breach of secrecy obligations. They must inform the Commission of the European Communities of the measures taken. The Commission of the European Communities will inform the other contracting States.

70. The Convention also refers to the contracting States to take all necessary steps to ensure that the advisory commission meets without delay once cases are referred to it.

71. Whatever the exact composition of the advisory commission, the independent persons' votes will usually be decisive. Therefore, the commission may be regarded as an independent body.

The proceedings, the opinion of the advisory commission and the final decision

72. The enterprises concerned are not parties to the proceedings. They can participate in the procedure and may submit to the commission any documents or other evidence that they consider useful. They may also request to be heard or to be represented before the commission. The enterprises and the tax authorities concerned must comply with any request for information, documents or evidence made by the commission. It could be also the case that the advisory commission requests each of the associated enterprises to be represented before it.

73. There are, however, certain safeguards: the authorities are not required to carry out administrative measures contrary to their national law or usual administrative practice; provide information that is not obtainable under their national law or administrative practice; or reveal trade, business, industrial or professional secrets or provide information whose disclosure is contrary to the public interest. Insofar as the second exception simply means that the tax authorities are not obliged by the Convention to obtain information that they cannot obtain under their national law, it is a necessary proviso, but it should not be interpreted as permitting them to withhold information that is in fact in their possession. Moreover, a blanket exception in relation to business secrets and other sensitive information does not seem necessary, since the members of the commission are bound by an obligation of secrecy.

74. The advisory commission must deliver its opinion within a period of six months from the date on which the matter was referred to it. The decision is to be taken by a simple majority of its members. The Convention permits the competent

authorities of the member States to agree on additional rules of procedure. The costs of the advisory commission procedure, other than those incurred by the associated enterprises, will be borne equally by the contracting States concerned in a particular case.

75. The opinion of the advisory commission is simply an opinion: it is not automatically binding on the tax authorities. It is the authorities themselves who, acting by common consent within six months of the delivery of the opinion, must take a decision eliminating the double taxation. In their decision they may deviate from the opinion, although the decision must in any event comply with the arm's length principle laid down in article 4 and their agreement must eliminate double taxation; however, if they fail to agree on an alternative solution, they must act in accordance with the opinion. All parties consenting, the competent authorities may agree to publish the decision. No provision is made for publication of the opinion of the advisory commission, nor does the Convention require the competent authorities to state the grounds for their decision.

76. Article 14 provides that double taxation is deemed to be eliminated if either the profits are included in the taxable profits of one enterprise in one State only or the tax chargeable on those profits in one State is reduced by an amount equal to the tax chargeable on them in the other.

77. The Convention does not address the question whether interest should be paid on tax refunds or payments resulting from the arbitration procedure. Therefore, the national law of the member States in which payment or the refund is due will be decisive.

Final provisions

78. The Arbitration Convention provides a minimum standard. It does not affect national and bilateral rules that provide for more far-reaching elimination of double taxation. However, the fact that, in practice, such wider rules rarely exist was the very reason for adopting the Arbitration Convention in the first place.

Problems and shortcomings

79. The Convention represents an advance over classical double taxation treaties. Its great merit lies in the fact that, unlike domestic appeals procedures or bilateral negotiations between tax authorities, the arbitration procedure directly involves all the parties affected — that is to say, not only the tax authorities but also the enterprises that are called upon to pay the tax — and provides for mandatory elimination of the double taxation. The introduction of a time limit is also important for taxpayers.

80. A number of member State seems to be unsure about how to set up an advisory commission. Some would like to see some guidelines thereon.

81. Apparently, the Arbitration Convention has led to only one arbitration so far. However, the Convention's preventative effect may be significant. It is an incentive for the contracting States to arrive at a solution without arbitration. They can be certain that they may eventually have to give in anyway while incurring costs.

82. An important question remains. It is increasingly difficult to apply the arm's length principle. In the first place, companies and markets become increasingly integrated and intertwined. This will be enhanced by the Single European Market and by globalization in general. It will therefore become increasingly difficult to find comparable independent transactions.

83. In the second place, products and services keep attaining further levels of specialization. Even if comparable independent parties are available, they may not trade sufficiently comparable goods and services. The product or process traded may be patented and not provided by any other party.

84. In the third place, a very significant part of cross-border intra-group trade is in intangibles (brand names, copyrights, know-how etc.) which are notoriously difficult to price.

85. Furthermore, some costs do not even exist outside groups of associated enterprises. It is difficult to tell which part of the head office overhead must be charged to which group company.

86. Finally, e-commerce makes profit allocation on the basis of physical presence in a jurisdiction (branch, subsidiary) inadequate: an e-commerce company may realize a very significant turnover in a foreign jurisdiction without physical presence in that jurisdiction, and thus without nexus for profit allocation to that jurisdiction. In particular, the permanent establishment concept as the basis of international profit allocation within one multinational enterprise becomes inadequate in the light of the possibilities that the Internet and other information and telecommunication technologies offer for data transmission, telephone services, computer shopping, mail-order sales, insurance and banking services, and down-loading of software, digitally recorded movies and music.

III. The corporate tax policy of the Commission of the European Communities

87. In October 2001, the Commission of the European Communities presented a communication to the other institutions of the European Community stating its policy on corporate tax. This communication was the result of a study on company taxation, which examined whether the current application of company taxation hampers the goal of creating an internal market in the European Communities. It considered in depth the question whether national tax systems are creating inefficiencies and preventing operators from receiving its full benefits.

88. From an economic point of view, it is considered that company taxation in this internal market must contribute to the international competitiveness of EU businesses; it must ensure that tax considerations distort as little as possible economic decisions by operators; it must avoid unnecessary or unduly high compliance costs and tax obstacles to cross-border economic activity; and it must not hinder the possibility of general tax competition while tackling all harmful or economically undesirable forms of tax competition.

89. The study identified a number of fields in which company tax systems present or lead to obstacles to cross-border economic activities in the internal market. The additional tax or compliance burdens associated with doing business in more than

one member State resulting from these obstacles undermine the international competitiveness of European companies and waste resources. Among the obstacles cited are the risk of double taxation linked to withholding taxes on intra-group payments of dividends, interests and royalties; the major limits on cross-border loss relief; and capital gains taxation deriving from business restructuring.

90. In particular, it is mentioned that profits have to be allocated on an arm's length basis by separate accounting, that is to say, on a transaction-by-transaction basis. This gives rise to numerous problems on the fiscal treatment of intra-group transfer pricing, notably in the form of high compliance costs and potential double taxation.

91. To resolve these issues, the Commission proposed a two-track strategy directed towards immediate action on targeted measures and, at the same time, the launch of a wider debate on a general comprehensive approach.

92. The targeted measures in the area of transfer pricing entail the improvement of the Arbitration Convention. The shortcomings of the Convention must be addressed and its provisions should be made subject to interpretation by the Court, preferably by turning it into an instrument of Community law. Moreover, subject to safeguards to prevent aggressive tax planning, a framework should be established for prior agreement between the tax administrations involved or at least a consultation procedure before tax administrations enforce transfer pricing adjustments. For this purpose, a European Union Joint Forum on Transfer Pricing involving member States and business representatives has been set up in order to examine the issues that can be addressed without legislative initiatives, for example, development and exchange of best practice on advance pricing agreements and documentation requirements; and to examine necessary improvements to the Arbitration Convention with a view to presenting a formal proposal for a directive, and thus turning it into an instrument of Community legislation. The Commission stated that it would determine the nature of further initiatives in the light of the discussions in the Forum.

93. The above targeted solutions would go some way towards remedying the tax obstacles. However, even if all of them were implemented, they would not address the underlying problem of dealing with up to 15 different tax systems. Only an approach providing multinational companies with a consolidated corporate tax base for their EU-wide activities would really, through a single framework of company taxation, systematically tackle the majority of the tax obstacles to cross-border economic activity in the internal market. Companies with cross-border and international activities within EU should in future be allowed to compute the income of the entire group according to one set of rules, and establish consolidated accounts for tax purposes. This approach aims at eliminating the potential tax effects of purely internal transactions within the group. It will be necessary to develop an appropriate apportioning mechanism, with member States continuing to determine the applicable national corporate tax rates.

Notes

[1] United Nations, *Treaty Series*, vol. 1155, No. 18232.