MADRID
Castellana, 216
28046 Madrid
Tel.: (34) 91 582 91 00

BARCELONA
Diagonal, 640 bis
08017 Barcelona
Tel.: (34) 93 415 74 00

BILBAO
Alameda Recalde, 36
48009 Bilbao
Tel.: (34) 94 415 70 15

MÁLAGA
Marqués de Larios, 3
29015 Málaga
Tel.: (34) 952 12 00 51

VALENCIA
Gran Vía Marqués
del Turia, 49
46005 Valencia
Tel.: (34) 96 351 38 35

VIGO
Colón, 36
36201 Vigo
Tel.: (34) 986 44 33 80

BRUSELAS
Avenue Louise, 267
1050 Bruselas
Tel.: (322) 231 12 20

LONDRES
Five Kings House
1 Queen Street Place
EC 4R 1QS Londres
Tel.: +44 (0) 20 7329 5407

LISBOA
Avenida da Liberdade, 131
1250-140 Lisboa
Tel.: (351) 213 408 600

SPANISH SUPREME COURT RAISES DOUBTS ON THE CONSTITUTIONALITY OF THE TRANSFER PRICING LAW

José Manuel Calderón Carrero
Professor of Tax Law, University of La Coruña
Member of the Academic Council of Gómez-Acebo & Pombo Law Firm, Madrid

Mariana Díaz-Moro Paraja
Tax Lawyer of Gómez-Acebo & Pombo Law Firm, Madrid

The Spanish Supreme Court has released a ruling dated February, 8th 2011 whereby a constitutional issue is raised on paragraphs 2 and 10 of article 16 of the Corporate Income Tax Lax (RD.Leg.4/2004, hereinafter, CITL) for possible infringement of article 25.1 of the Spanish Constitution[1] (hereinafter, CE).

Basically the Supreme Court questions the breach of the principle of legality laid down in article 25.1 CE related to criminal and administrative penalties. This constitutional provision includes the principles of *lex certa* and *typicity* in the sense that it must be a Law the instrument to be used to establish which act or omission constitutes an offense and what its punishment is, and that the Law must be clear and ascertainable in order to determine the offense and the penalty.

The Supreme Court said that article 16.10 CITL, contains the definition of the offence and penalty for violating the transfer pricing rules establishing that such offence results from the failure to maintain, or maintaining in an incomplete or inaccurate manner or with false data the transfer pricing documentation so established in paragraph 2 of the same article. Such paragraph of Article 16 CITL does not contain a real o material regulation of the transfer pricing documentation. In fact, the content and extent of the transfer pricing documentation was established by the Royal Decree 1793/2008, of 3 of November. In this sense, the CITL leaves completely open the content of the transfer pricing documentation that the taxpayers must prepare in order to properly document their transactions with related parties. Due to the above, the Spanish Supreme Court considers that there could be an infringement of the principle of legality so established in article 25.1 CE, which provides that a Law must completely define the offence´s unlawful conduct. The Supreme Court held that such constitutional rule excludes the cases where a Law do a 'blank' referral to a regulation, which is what is happening with article 16.2 CITL, as it does not even minimally define the content of the documentation the taxpayers must have so that the CIT regulations set it freely and not subject to any legal limitation.

If the Constitutional Court share or follow the position of the Supreme Court any penalty imposed according to the Spanish domestic transfer pricing laws would result null and illegal. In that sense the taxpayers should be aware of the issues posed by the current transfer pricing regulations, and should take the procedural steps to take advantage of this Supreme Court ruling and any possible ruling on unconstitutionality by the Constitutional Court.

[1] Section 25.1 of the Spanish Constitution states that *no one may be convicted or sentenced for actions or omissions which when committed did not constitute a criminal offence, misdemeanor or administrative offence under the law then in force.*

Notwithstanding, the Supreme Court considered that other transfer pricing rules contained in the CIT regulations are not unconstitutional but could be illegal inasmuch as their legal basis is unclear.

We found particularly interesting some remarks made by the Supreme Court on the "Secondary adjustment" regulations. In this regard, the Supreme Court excluded from the unconstitutional question the legal and regulatory rules related to the so called "secondary adjustment" established in article 16.8 CITL. The Court held that although article 16.8.2 CITL may contain an *iuris et de iure* presumption that has nothing to do with the real transactions carried out and therefore involves a tax charge over a fictitious economic capacity that could be contrary to the economic capacity principle laid down in article 31.1 CE[2], article 21.bis paragraph 2 of the CIT Regulations establishes a kind of "safe harbor" that leaves a door open for the non-application of such presumption when a cause, other than those referred in paragraph 2, can be demonstrated by the taxpayer.

In our humble opinion, it is arguable whether or not article 21.bis of the CIT Regulations (safe harbor clause contained in paragraph 2) will in practice mitigate the *iuris et de iure* presumption, as in most cases such evidence would be impossible or difficult to provide (*probatio diabolica*). It is also remarkable that the Supreme Court acknowledges that article 21.bis.2 of the CIT Regulation is of doubtful legality, stating that it could be declared invalid in a new ruling that could be issued in that respect, something which could be contradictory and inconsistent with what is stated above in relation to the constitutionality of the secondary adjustment legal regulation. Indeed, to maintain the constitutionality of the secondary adjustment regulation on the basis of a regulation that can be declared illegal due to lack of legal basis raises its doubts. All in all, in our view, the Supreme court could be proposing an interpretation of the law regulating the secondary adjustments in the light of the constitutional principle of economic capacity in the sense interpreted by the Spanish Constitutional Court in its ruling 194/2000, which excludes the application of presumptions (*iuris et de iure*) of tax fraud that do not allow the taxpayers to demonstrate the non-existence of such fraud. This interpretation of the secondary adjustments laws in line with the Constitutional Court ruling referred to above, could be invoked by the taxpayers to exclude the application of such secondary adjustments by the tax authorities when, for instance, they could demonstrate that the difference between the transfer pricing used by the taxpayers and the arm´s length (adjusted) pricing determined or assessed by the tax authorities it is not motivated by an artificial fiscal scheme inasmuch as such taxpayers undertook a bona fide and reasonable application of the methods so established to set the arm´s length price. In our view, it would be inconsistent to levy a secondary adjustment in a case where the primary adjustment reflects a mere technical difference in the determination of the arm´s length price of a genuine business transaction where the taxpayer carried out a bona fide and reasonable efforts to observe the arm´s length principle, inasmuch as there is no other "secondary transaction" hidden or undertaken by the related parties.

A quick reaction from the Ministry of Economy and Finance is expected in order to address the obvious problems of both constitutionality and legality that were already pointed out by Supreme Court and the commentators.

[2] Section 31.1 of the Spanish Constitution states that *everyone shall contribute to sustain public expenditure according to their economic capacity, through a fair tax system based on the principles of equality and progressive taxation, which in no case shall be of a confiscatory scope*.

The most desirable would certainly be that the Ministry of Finance would carry out a proactive reading of the Supreme Court rule in the sense of carrying out a complete revision of the Spanish transfer pricing rules resizing its scope and softening the law.

In sum, the Supreme Court ruling poses doubts on the constitutionality of the law on transfer pricing penalties. It also contains interesting remarks on the secondary adjustment provisions that can exert some influence limiting their application. The taxpayers should be aware of these developments bearing in mind that they have to observe the tough Spanish transfer pricing law, that is, fulfill the arm´s length principle and comply with transfer pricing documentation obligations. A consistent transfer pricing documentation could be useful not only to prevent the imposition of tax penalties but also to exclude the application of primary as well as secondary adjustments.