



## CFE Forum Reports on European Taxation – 4

**Sharing information across borders in indirect and direct tax – 2010**  
**The permanent establishment in international tax law – 2011**

### **Contributors**

Servaas van Thiel  
Jacques Gombeer  
Alain Steichen  
Pascal Hinny  
Alexander Wiedow  
Tigran Mkrtchyan  
Georg Kofler  
Michael Tumpel  
Gustav Wurm  
Tracy A. Kaye

Stephen W. Mazza  
Adolfo Jimenez  
Gottfried Schellmann  
Marie Lamensch  
Niamh Keogh  
Piergiorgio Valente  
Georg Geberth  
Hans Pijl  
Jan Koerner





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### Dear Reader,

The Confédération Fiscale Européenne (CFE) is the European association of the tax profession, representing 180,000 tax advisers throughout Europe. It was founded in 1959 and today has 33 member organisations from 24 European states. The CFE holds an annual Forum in Brussels on current international tax issues which bring together professional tax advisers, senior officials from the European Commission and from member states, leading academics and other experts in the fields of politics, business and public administration.

This book reports on the main topics of the CFE Fora 2010 and 2011.

The CFE Forum 2010 took place on 15 April and dealt with sharing of information between tax authorities across borders in both direct and indirect tax, in the light of the recent EU and OECD initiatives to increase administrative cooperation.

In the following year, the CFE Forum took place on 7 April, dealing with the issue of permanent establishment in international tax law, again both in indirect and direct tax, taking into account the amendments of the OECD Model Tax Convention and Commentary in 2010 and the EU VAT Implementing Regulation in 2011 as well as the recent EU proposal for a Common Consolidated Corporate Tax Base.

The contributions contained in this booklet are based on the speeches rendered at the CFE Forum or related to the issues discussed.

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**Stephen Coleclough**  
President of the CFE, June 2011

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## 16. The “Authorized OECD Approach” and European Tax Law

by Georg Kofler and Servaas van Thiel<sup>690</sup>

### 16.1. Introduction

The “Authorized OECD Approach” (AOA) aims at aligning the tax treaty rules for business profits under Article 7 OECD MC with the transfer pricing rules laid down in Article 9 OECD MC and the OECD Transfer Pricing Guidelines.<sup>691</sup> It does so by allocating profits between different parts of the enterprise under the fiction that permanent establishments are distinct and separate entities to which the arm’s-length-standard applies (“functionally separate entity approach”). The core ideas of the AOA were set out by the OECD in several reports, which were consolidated in 2008.<sup>692</sup> The main conclusions were subsequently implemented in the 2008 Update of the OECD Commentary insofar as they were in compliance with the wording of (old) Article 7 at that time.<sup>693</sup> To fully conform the OECD MC with the conclusions of the AOA, the 2010 Update of the OECD MC implemented a new wording of Article 7, a revised Commentary to this provision and a revised version of the report on the attribution of profits to permanent establishments.<sup>694</sup>

Broadly speaking, the attribution of profits between different parts is based on the fiction that (1) the permanent establishment is a separate enterprise and that (2) such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person, i.e., that the profits of the hypothesized distinct and separate

<sup>690</sup> Prof. DDr. Georg Kofler, LL.M. (NYU), is Professor of Tax Law at the Johannes Kepler University in Linz, Austria. Prof. Dr. Servaas van Thiel works for the European Union, is Professor of International and European tax law at the Free University Brussels and part time Judge in the Regional Court of Appeal in Den Bosch (Netherlands). This contribution is based on a presentation of the topic at the 2011 CFE Forum held in Brussels on 7 April 2011.

<sup>691</sup> The latest version of which was published as OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2010).

<sup>692</sup> OECD Report on the Attribution of Profits to Permanent Establishments (Parts I to IV) (July 2008).

<sup>693</sup> Hence, for example, concepts of the AOA with regard to the allocation of economic ownership of certain assets (e.g. intangibles) and to the explicit recognition of internal dealings did not form part of 2008 Update.

<sup>694</sup> 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).

enterprise have to be determined under the arm’s length principle set out in Article 9 for the purpose of adjusting the profits of associated enterprises. This means that profits attributable to a permanent establishment under Art. 7(2) OECD MC are

“the profits that the permanent establishment might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprise. In addition, the paragraph clarifies that this rule applies with respect to the dealings between the permanent establishment and the other parts of the enterprise”.<sup>695</sup>

The new wording of Art. 7 OECD MC is, of course, not (yet) implemented in bilateral tax treaties. However, the parts of the AOA that were included in the 2008 Update to the OECD Commentary are supposed to apply retroactively to “old” treaties as well.<sup>696</sup> Finally, some States obviously consider a unilateral, potentially treaty overriding implementation of the complete AOA in their domestic legislation.<sup>697</sup>

The new wording will also raise a number of issues under European tax law,<sup>698</sup> some of which will be dealt with in the following chapters. First, we will examine the impact of the allocation of assets under the AOA on the permanent establishment clauses in the EU direct tax directives (section 16.2). Second, the cross-border transfer of assets and other “internal dealings” between the head office and a permanent establishment or between permanent establishments raises not only questions under the AOA and implementing domestic law, but also under the fundamental freedoms. This is because an immediate realization of hidden reserves or profits on such transfer might be viewed as a discriminatory exit charge if no taxation is triggered on purely domestic transfers of assets (section 16.3). Third, the AOA only applies for purposes of Art. 7 and 23 of the OECD MC, which means that notional payments for internal dealings between the head office and a permanent establishment or between permanent establishments will

<sup>695</sup> Art 7 Para 15 OECD Model Commentary 2010.

<sup>696</sup> Art 7 Para 7 OECD Model Commentary 2008.

<sup>697</sup> For example, Germany is currently discussing a revision of § 1 Außensteuergesetz (AStG) to unilaterally implement the AOA.

<sup>698</sup> For a first analysis see Baker and Collier, “General Report”, in IFA (Ed.), *The attribution of profits to permanent establishments*, CDFI Vol. 91b (2006), 21 (58-59), and Cussons and FitzGerald, “EU Report”, in IFA (Ed.), *The attribution of profits to permanent establishments*, CDFI Vol. 91b (2006), 69 (87-88).

in principle not trigger withholding taxes. However, States are of course free to fully deem permanent establishments as separate taxpayers in their domestic law and bilateral treaties also for purposes of, e.g., the dividends, interest and royalty articles. This raises the question whether withholding taxes triggered by such extensive implementation of the AOA may be barred by the EU direct tax directives or the fundamental freedoms (section 16.4). Finally, we will take a brief look at whether the Arbitration Convention can provide a mechanism to solve disputes under the AOA through binding arbitration (section 16.5).

### 16.2. Allocation of Assets to Permanent Establishments

The Merger Directive, the Parent-Subsidiary-Directive and the Interest-Royalties-Directive all take into account permanent establishments and implicitly defer to domestic tax law and tax treaty law.<sup>699</sup> This also implies that the AOA will have significant impact on the EU direct tax directives, as it requires an attribution of assets according to the performance of significant people functions regarding the creation or purchase of the asset, which means that place of booking is, in principle, irrelevant.<sup>700</sup> The 2010 OECD Commentary includes a number of clauses that highlight the requirement of such an “effective connection” of holdings, liabilities, intangible assets and capital assets with a permanent establishment.<sup>701</sup> Conversely, only if such an effective connection exists will the respective assets be considered part of the business assets of the permanent establishment; and only if they form part of the business assets of a permanent establishment will they be covered by the permanent establishment provisions of the EU direct tax directives.

<sup>699</sup> Art. 4(2)(b) of the Merger Directive states as a requirement for tax neutrality of certain cross-border reorganizations that “assets and liabilities of the transferring company” “are effectively connected with a permanent establishment of the receiving company in the Member State of the transferring company and play a part in generating the profits or losses taken into account for tax purposes.” This generic definition implicitly takes into account double taxation conventions: Only assets generating “profits or losses taken into account for tax purposes” are considered to form part of the permanent establishment for purposes of Art. 4(2)(b) of the Merger Directive. For this determination it is, however, decisive whether the taxing right of the State of the permanent establishment is effectively restricted by a double taxation treaty. Likewise, Art 2(2) of the Parent-Subsidiary-Directive requires a fixed place of business and furthermore notes that profits must be “subject to tax”, hereby also implicitly referring to the question whether a double taxation convention leaves the taxing right to the State of the permanent establishment. Finally, Art 3(c) of the Interest-Royalties-Directive defines a permanent establishment as a fixed place of business but furthermore required that payments represent a tax-deductible expense for a permanent establishment to be considered the payor of interest or royalties (Art 1(3)) and that payments are effectively connected and subject to tax for a permanent establishment to be considered the beneficial owner of interest or royalties (Art 1(5)).

<sup>700</sup> See, e.g., Art 10 Paras 32 OECD Model Commentary 2010.

<sup>701</sup> See Art 10 Paras 32.1 and 32.2 OECD Model Commentary 2010 (dividends), Art 11 Paras 25.1 and 25.2 OECD Model

This impact may briefly be demonstrated with regard to the “sandwich structures” under the Parent-Subsidiary-Directive. This Directive also applies to profit distributions to a permanent establishment in one Member State where parent and subsidiary company are both resident in the same other Member State. This is technically achieved by including holdings via a permanent establishment into the definition of the parent company (Art 3(1)(a)), hence creating a fictitious cross-border element at the level of the companies involved,<sup>702</sup> and by covering such profit distributions in Art. 1(1) third and fourth intend. In such a situation, no withholding tax is triggered on the profit distribution to the permanent establishment (Art 5)<sup>703</sup> and relief by exempting the dividend or providing an indirect credit has to be granted both at the level of the permanent establishment<sup>704</sup> and the parent company<sup>705</sup> (Art 4). This said, the main prerequisite for these provisions to apply is that a “permanent establishment” exists. In this respect, Art. 2(2) contains the following definition:

“For the purposes of this Directive the term ‘permanent establishment’ means a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on in so far as the profits of that place of business are subject to tax in the Member State in which it is situated by virtue of the relevant bilateral tax treaty or, in the absence of such a treaty, by virtue of national law.”

Commentary 2010 (interest), Art 12 Paras 21.1 and 21.2 OECD Model Commentary 2010 (royalties), Art 13 Paras 27.1 and 27.2 OECD Model Commentary 2010 (capital gains), and Art 21 Paras 5.1 and 5.2 OECD Model Commentary 2010 (other income).

<sup>702</sup> See also Maisto, “The 2003 amendments to the EC Parent-Subsidiary Directive: what’s next?”, 13 EC Tax Rev. (2004), 164 (170).

<sup>703</sup> Maisto, “The 2003 amendments to the EC Parent-Subsidiary Directive: what’s next?”, 13 EC Tax Rev. (2004), 164 (169); Bullinger, “Änderungen der Mutter-Tochter-Richtlinie ab 2005: Erweiterung des Anwendungsbereiches und verbleibende Probleme”, 13 *Internationales Steuerrecht* (2004), 406 (408); Zanotti, “Taxation of Inter-Company Dividends in the Presence of a PE: The Impact of the EC Fundamental Freedoms”, 44 *European Taxation* (2004), 493 (503); Englisch and Schütze, “The Implementation of the EC Parent-Subsidiary Directive in Germany – Recent Developments and Unresolved Issues”, 45 *European Taxation* (2005), 488 (490); Thömmes and Nakhai in Thömmes and Fuks (Eds.), *EC Corporate Tax Law – Parent-Subsidiary Directive* (2007) Art 1 Para 33; Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Para 53.

<sup>704</sup> Maisto, “The 2003 amendments to the EC Parent-Subsidiary Directive: what’s next?”, 13 EC Tax Rev. (2004), 164 (167); Bullinger, “Änderungen der Mutter-Tochter-Richtlinie ab 2005: Erweiterung des Anwendungsbereiches und verbleibende Probleme”, 13 *Internationales Steuerrecht* (2004), 406 (408); Tenore, “The Parent-Subsidiary Directive”, in Lang, Pistone, Schuch and Staringer (Eds.), *Introduction to European Tax Law on Direct Taxation* (2nd edition, 2010), 111 (124 et seq.); Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Para 53.

<sup>705</sup> See also Maisto, “The 2003 amendments to the EC Parent-Subsidiary Directive: what’s next?”, 13 EC Tax Rev. (2004), 164 (170); Bullinger, “Änderungen der Mutter-Tochter-Richtlinie ab 2005: Erweiterung des Anwendungsbereiches und verbleibende Probleme”, 13 *Internationales Steuerrecht* (2004), 406 (408); Tenore, “The Parent-Subsidiary Directive”, in Lang, Pistone, Schuch and Staringer (Eds.), *Introduction to European Tax Law on Direct Taxation* (2nd edition, 2010), 111 (124 et seq.); Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Para 53.

The first part of this definition resembles Art. 5(1) OECD MC und Art. 3(c) of the Interest-Royalties-Directive,<sup>706</sup> while the second part contains a rather ambiguous “subject-to-tax” clause that raises several issues of interpretation: It states that profits must be subject to tax in the State of the fixed place of business “by virtue of the relevant bilateral tax treaty”. This is quite misleading as tax treaties only restrict domestic taxing rights and do not create them.<sup>707</sup> What this clause seems to imply is that the treaty in place between the State of the head office and the State of the permanent establishment must not restrict the latter’s domestic taxing rights (“by virtue of national law”).<sup>708</sup> This prerequisite is generally fulfilled if the treaty clause is based on Art. 7 OECD MC. In addition, Art. 2(2) of the Parent-Subsidiary-Directive requires that profits are “subject to tax”. This clause is obviously aimed against the abusive interposition of permanent establishments in “sandwich structures” to avoid the application of domestic law.<sup>709</sup> However, there is broad consensus that such a “subject to tax” clause does not require effective taxation of the profits allocated to the permanent establishment.<sup>710</sup> Also, such a prerequisite could clearly not be justified in the context of the Parent-Subsidiary-Directive.<sup>711</sup> If “subject to tax” were to refer to all income of the permanent establishment, the application of the Directive would largely depend on the mix of – positive or negative – income in the permanent establishment, which would seem to be a quite arbitrary criterion to answer the question whether relief from economic double taxation

<sup>706</sup> Ebenso Bendlinger, “Änderung der Mutter-Tochter-Richtlinie der EU”, 14 *Steuer und Wirtschaft International* (2004), 277 (280); Zanotti, “Taxation of Inter-Company Dividends in the Presence of a PE: The Impact of the EC Fundamental Freedoms”, 44 *European Taxation* (2004), 493 (495); Englisch and Schütze, “The Implementation of the EC Parent-Subsidiary Directive in Germany – Recent Developments and Unresolved Issues”, 45 *European Taxation* (2005), 488 (491); Kofler and Kofler, “Betriebsstätten in der Mutter-Tochter-Richtlinie”, in Quantschnigg, Wiesner and Mayr (Eds.), *Steuern im Gemeinschaftsrecht, Festschrift für Wolfgang Nolz* (2008) 53 (62); see also Maisto, “The 2003 amendments to the EC Parent-Subsidiary Directive: what’s next?”, 13 *EC Tax Rev.* (2004), 164 (169-170).

<sup>707</sup> Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Para 39.

<sup>708</sup> See also Englisch and Schütze, “The Implementation of the EC Parent-Subsidiary Directive in Germany – Recent Developments and Unresolved Issues”, 45 *European Taxation* (2005), 488 (491).

<sup>709</sup> Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Paras 52 et seq.

<sup>710</sup> See Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 2 Paras 32 et seq. and specifically for permanent establishment situations Maisto, “The 2003 amendments to the EC Parent-Subsidiary Directive: what’s next?”, 13 *EC Tax Rev.* (2004), 164 (170); Tissot, GeS 2004, 244 (244 f); Bullinger, “Änderungen der Mutter-Tochter-Richtlinie ab 2005: Erweiterung des Anwendungsbereiches und verbleibende Probleme”, 13 *Internationales Steuerrecht* (2004), 406 (408); Englisch and Schütze, “The Implementation of the EC Parent-Subsidiary Directive in Germany – Recent Developments and Unresolved Issues”, 45 *European Taxation* (2005), 488 (491); Kofler and Kofler, “Betriebsstätten in der Mutter-Tochter-Richtlinie”, in Quantschnigg, Wiesner and Mayr (Eds.), *Steuern im Gemeinschaftsrecht, Festschrift für Wolfgang Nolz* (2008) 53 (63-64).

<sup>711</sup> See Kofler and Kofler, “Betriebsstätten in der Mutter-Tochter-Richtlinie”, in Quantschnigg, Wiesner and Mayr (Eds.), *Steuern im Gemeinschaftsrecht, Festschrift für Wolfgang Nolz* (2008) 53 (63-64); Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Para 40.

should be granted to cross-border profit distributions.<sup>712</sup> If, however, “subject to tax” were to refer solely to dividend income, the clause itself would be contradictory: Such a reading would lead to the consequence that the Directive would require relief under Art. 4 if a permanent establishment exists under Art. 2(2); however, if relief would be granted through the exemption method, those distributions would not be “subject to tax”, which would mean that the permanent establishment definition under Art. 2(2) is flunked; hence, the distributions could be taxed and again Art. 2(2) would apply, implying the necessity to grant relief under Art. 4 etc. Clearly, such an endless circle cannot be the right interpretative result.<sup>713</sup>

In our view, therefore, the “subject to tax” clause in Art. 2(2) can only mean that the taxing right of the State of the permanent establishment is not restricted by a tax treaty and that such state allocates dividend income to the permanent establishment.<sup>714</sup> This implies that the holding must form part of the business assets of the permanent establishment under domestic law as well as under a double tax treaty.<sup>715</sup> For this determination, therefore, the AOA gains vital importance, as “attributing economic ownership of financial assets [...] attributes the income and expenses associated with holding those assets or lending them or selling them to third parties”.<sup>716</sup> The 2010 OECD Commentary notes in that respect that a shareholding must be genuinely connected to that business which requires more than merely recording the shareholding in the books of the permanent establishment for accounting purposes.<sup>717</sup> It goes on to state:

“A holding in respect of which dividends are paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the ‘economic’ ownership of the holding is allocated to that permanent establishment under the principles developed in the Committee’s report entitled Attribution of

<sup>712</sup> Englisch and Schütze, “The Implementation of the EC Parent-Subsidiary Directive in Germany – Recent Developments and Unresolved Issues”, 45 *European Taxation* (2005), 488 (491).

<sup>713</sup> Kofler and Kofler, “Betriebsstätten in der Mutter-Tochter-Richtlinie”, in Quantschnigg, Wiesner and Mayr (Eds.), *Steuern im Gemeinschaftsrecht, Festschrift für Wolfgang Nolz* (2008) 53 (64); Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 2 Para 40.

<sup>714</sup> Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Para 40.

<sup>715</sup> Maisto, “The 2003 amendments to the EC Parent-Subsidiary Directive: what’s next?”, 13 *EC Tax Rev.* (2004), 164 (170); Englisch and Schütze, “The Implementation of the EC Parent-Subsidiary Directive in Germany – Recent Developments and Unresolved Issues”, 45 *European Taxation* (2005), 488 (491); Kofler and Kofler, “Betriebsstätten in der Mutter-Tochter-Richtlinie”, in Quantschnigg, Wiesner and Mayr (Eds.), *Steuern im Gemeinschaftsrecht, Festschrift für Wolfgang Nolz* (2008) 53 (63); Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Para 41.

<sup>716</sup> See, e.g., Para 73 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).

<sup>717</sup> Art 10 Para 32 OECD Model Commentary 2010.



Profits to Permanent Establishments (see in particular paragraphs 72-97 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the ‘economic’ ownership of a holding means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the dividends attributable to the ownership of the holding and the potential exposure to gains or losses from the appreciation or depreciation of the holding).<sup>718</sup>

Given the vagueness of the concept of “economic” ownership, one can expect to experience quite some problems when it comes to the allocation of shareholdings to permanent establishments – for tax treaty purposes as well as for purposes of the Parent-Subsidiary-Directive. It only seems clear that the mere booking of a shareholding in the accounts of a permanent establishment is not sufficient to create an effective connection.<sup>719</sup> For more tricky issues such as the allocation of shareholdings to a “passive” permanent establishment no clear guidance is provided either in the OECD Commentary or in the 2010 Report on the Attribution of Profits to Permanent Establishments.<sup>720</sup> Since there is no abstract solution for a conflict between two States concerning the allocation of assets, quite some pressure will be put on the procedures for the solution of conflicts provided in Art. 7(3) OECD MC 2010, which will also impact on the Directive.

### 16.3. Transfer of Assets

Art. 7(2) OECD MC requires the attribution of profits a permanent establishment “might be expected to make, in particular in its dealings with other parts of the enterprise”. Such an internal dealing may also occur if economic ownership of an asset (e.g. a machine, inventory) is transferred to the head office or another permanent establishment.<sup>721</sup> In essence, this approach does not restrict domestic law that foresees an immediate realization of hidden reserves upon the cross-border transfer of assets within

<sup>718</sup> Art 10 Para 32.1 OECD Model Commentary 2010.

<sup>719</sup> Austria, for example, has given up this position following the publication of the AOA and now requires that holdings serve the activity of the permanent establishment; see, e.g., EAS 2910 (12 November 2007).

<sup>720</sup> See Paras 72-97 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).

<sup>721</sup> See for the transfer of tangible assets Paras 194-196 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).

one enterprise. Likewise, it does not restrict realization of arm’s-length-profits on other cross-border internal “dealings” (e.g., internal services)<sup>722</sup> where no real transaction and no corresponding cash flow takes place. While this may be seen as discriminatory if no similar charge is levied upon the purely domestic transfer of assets or other internal dealings,<sup>723</sup> the updated Commentary to Art. 24(3) OECD MC clearly rejects such understanding of the non-discrimination clause concerning permanent establishments:

“It appears necessary first to make it clear that the wording of the first sentence of paragraph 3 must be interpreted in the sense that it does not constitute discrimination to tax non-resident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied. For example, paragraph 3 does not prevent the application of specific mechanisms that apply only for the purposes of determining the profits that are attributable to a permanent establishment. The paragraph must be read in the context of the Convention and, in particular, of paragraph 2 of Article 7 which provides that the profits attributable to the permanent establishment are those that a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions would have been expected to make. Clearly, rules or administrative practices that seek to determine the profits that are attributable to a permanent establishment on the basis required by paragraph 2 of Article 7 cannot be considered to violate paragraph 3, which is based on the same principle since it requires that the taxation on the permanent establishment be not less favourable than that levied on a domestic enterprise carrying on similar activities.”<sup>724</sup>

There is, however, a broad and ongoing discussion whether a different treatment of domestic and cross-border transfers of assets is in compliance with the fundamental freedoms.<sup>725</sup> Such a different treatment can basically result from a difference in timing of realization and from a difference in valuation. Both aspects and hence the discrimi-

<sup>722</sup> See Paras 216-219 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).

<sup>723</sup> See Baker and Collier, “General Report”, in IFA (Ed.), *The attribution of profits to permanent establishments*, CDFI Vol. 91b (2006), 21 (57-58).

<sup>724</sup> Art 24 Para 34 OECD Model Commentary 2010.

<sup>725</sup> See specifically with regard to the AOA Baker and Collier, “General Report”, in IFA (Ed.), *The attribution of profits to permanent establishments*, CDFI Vol. 91b (2006), 21 (58-59), and Cussons and FitzGerald, “EU Report”, in IFA (Ed.), *The attribution of profits to permanent establishments*, CDFI Vol. 91b (2006), 69 (87-88).

nation analysis, however, largely depend on the domestic law treatment of comparable situations. If, however, no taxation would occur on a domestic transfer of assets, one has to note that the ECJ in *du Saillant*<sup>726</sup> and *N*<sup>727</sup> has accepted that under the fundamental freedoms the exit State may only tax an appreciation in value that occurred while the taxpayer was a resident if and insofar such taxation is deferred until the eventual alienation of such assets.<sup>728</sup> Whereas these cases only concerned shareholdings

<sup>726</sup> ECJ, 11 March 2004, C-9/02, *de Lasteyrie du Saillant* [2004] ECR I-2409 (exit tax on substantial shareholdings of an individual).

<sup>727</sup> ECJ, 7 September 2006, C-470/04, *N* [2006] ECR I-7409 (exit tax on substantial shareholdings of an individual).

<sup>728</sup> For general analyses of problems concerning the EU compatibility of exit taxation regimes, see, e.g. Malmer, “Emigration Taxes and EC Law”, in IFA (Ed.), *The tax treatment of transfer of residence by individuals*, CDFI 87b (2002), 79; Van Arendonk, “Hughes de Lasteyrie du Saillant: crossing borders?” in Van Arendonk, Engelen and Jansen (Eds.), *A Tax Globalist, Essays in honour of Maarten J. Ellis* (IBFD, 2005), 181; De Broe, “Hard times for emigration taxes in the EC”, in Van Arendonk, Engelen and Jansen (Eds.), *A Tax Globalist, Essays in honour of Maarten J. Ellis* (IBFD, 2005), 210; Van den Hurk and Korving, “The ECJ’s Judgment in the *N* Case against the Netherlands and its Consequences for Exit Taxes in the European Union”, 61 *Bulletin for International Taxation* (2007), 150; Führich, “Exit Taxation and ECJ Case Law”, 48 *European Taxation* (2008), 10; Terra and Wattel, *European Tax Law* (Kluwer, 5th edition 2008), 780-790.

<sup>729</sup> See for analyses in the area of corporate reorganizations, e.g. Schön, “Besteuerung im Binnenmarkt – die Rechtsprechung des EuGH zu den direkten Steuern”, 13 *Internationales Steuerrecht* (2004), 289, 297; Schön, “Tax Issues and Constraints on Reorganizations and Reincorporations in the European Union”, 34 *Tax Notes International* 197, 202 (April 12, 2004); Rödder, “Deutsche Unternehmensbesteuerung im Visier des EuGH”, 42 *Deutsches Steuerrecht* (2004), 1629, 1633; Schön and Schindler, “Zur Besteuerung der grenzüberschreitenden Sitzverlegung einer Europäischen Aktiengesellschaft”, 13 *Internationales Steuerrecht* (2004), 571, 575-576; Schindler, “Steuerrechtliche Folgen der Sitzverlegung einer Europäischen Aktiengesellschaft”, 15 *ecollex* (2004), 770, 771; Schindler, “Steuerrecht”, in Kalss and Hügel (Eds.), *SE-Kommentar* (Linde, 2004), Part III, paras. 27-28; Hügel, “Grenzüberschreitende Umgründungen, Sitzverlegung und Wegzug im Lichte der Änderung der Fusionsrichtlinie und der neueren EuGH-Judikatur”, in König and Schwarzingler (Eds.), *Körperschaften im Steuerrecht, Festschrift für Werner Wiesner* (Linde, 2004), 177, 196-197; Rödder, “Gründung und Sitzverlegung der Europäischen Aktiengesellschaft (SE) – Ertragsteuerlicher Status quo und erforderliche Gesetzesänderungen”, 43 *Deutsches Steuerrecht* (2005), 893, 895-896; Kinzl, “Grenzüberschreitende Verschmelzung: Soviel Steuerneutralität wie nötig oder nur soviel wie fiskalisch möglich?”, 50 *Die Aktiengesellschaft* (2005), 842, 844-845; Klingberg and van Lishaut, “Die Internationalisierung des Umwandlungssteuerrechts”, 3 *Der Konzern* 2005, 698, 705-707, 714; Kofler and Schindler, “Grenzüberschreitende Umgründungen: Änderungen der steuerlichen Fusionsrichtlinie und Anpassungsbedarf in Österreich”, 1 *taxlex* (2005), 496, 501, and 1 *taxlex* (2005), 559, 563-564; Achatz and Kofler, “Internationale Verschmelzungen”, in Achatz, Aigner, Kofler and Tumpel (Eds.), *Internationale Umgründungen* (Linde, 2005), 23, 41-42; Schindler, “EU Report”, in IFA (Ed.), *Tax Treatment of International Acquisitions of Businesses*, CDFI 90b (2005), 49, 66-67; Körner, “Europarecht und Umwandlungssteuerrecht”, 15 *Internationales Steuerrecht* (2006), 109, 110-111; Schön, “Grenzüberschreitende Sitzverlegung und Verschmelzung im Steuerrecht”, *Jahrbuch der Fachanwälte für Steuerrecht* (2006/2007), 90-92; Schön and Schindler, *Die SE im Steuerrecht* (O. Schmidt, 2008), paras. 25-34, 157 (transfer of seat of a SE) and 240 (merger); Terra and Wattel, *European Tax Law* (Kluwer, 5th edition 2008), 540; Hofstätter and Hohenwarter, “The Merger Directive”, in Lang, Pistone, Schuch and Staringer (Eds.), *Introduction to European Tax Law on Direct Taxation* (Linde, 2008), 111, 121-122. In this direction also Louven, Dettmeier, Pöschke and Weng, “Optionen grenzüberschreitender Verschmelzungen innerhalb der EU – gesellschafts- und steuerrechtliche Grundlagen”, *Betriebs-Berater Special No 3* (2006), 1, 6-7; Gammie, “EU Taxation of the Societas Europaea – Harmless Creature or Trojan Horse?”, 44 *European Taxation* (2004), 35, 42; Fischer, “Europarecht und Körperschaftsteuerrecht”, 44 *Deutsches Steuerrecht* (2006), 2281, 2285-2286; Russo and Offermanns, “The 2005 Amendments to the EC Merger Directive”, 46 *European Taxation* (2006), 250, 253-254 and 257; Hahn, “Kritische Erläuterungen und Überlegungen zum Entwurf des SEStEG”, 15 *Internationales Steuerrecht* (2006), 797, 802-804. Possibly contra Thömmes, “EC Law Aspects of the Transfer of Seat of an SE”, 44 *European Taxation* (2004), 22, 27; for a critical position, see Förster and Lange, “Grenzüberschreitende Sitzverlegung der Europäischen Aktiengesellschaft aus ertragsteuerlicher Sicht”, 48 *Recht der Internationalen Wirtschaft* (2002), 585, 587; Schwenke, “Europarechtliche Vorgaben und deren Umsetzung durch das SEStEG”,

by individuals, prevailing opinion<sup>729</sup> – including the Commission<sup>730</sup> and the Council<sup>731</sup> – considers, in principle, that these decisions are also applicable for the cross-border transfer of business assets. However, Member States may nevertheless find valid justifications in this area, especially in respect of the obstacles to a deferred taxation of hidden reserves in intangible assets and short-term assets.<sup>732</sup> Indeed, the practical difficulties of deferred exit taxation might have lead the Commission to accept Swedish legislation that does not grant deferred taxation but rather spreads the exit tax on realized hidden reserves in tangible assets over 5 years and those on intangible assets over 10 years.<sup>733</sup> Given these uncertainties, it remains to be seen how the ECJ will rule in the pending cases on exit taxation in the corporate area.<sup>734</sup>

## 16.4. Notional Payments by Permanent Establishments

Art. 7(2) OECD MC specifically mentions “dealings” of the permanent establishment “with other parts of the enterprise”.<sup>735</sup> For the purposes of attributing profits under Art. 7 and the corresponding relief under Art. 23, the AOA hence may create arm’s-length notional “royalties” as a reward for intangible property<sup>736</sup> or notional “rents”<sup>737</sup>

<sup>94</sup> *Deutsche Steuerzeitung* (2007), 235, 246-247. For a different approach, see Englisch, *Aufteilung der Besteuerungsbefugnisse – Ein Rechtfertigungsgrund für die Einschränkung von EG-Grundfreiheiten* (IFSt, 2008), 89-92, who suggests to not scrutinize the domestic implementation but rather the directive itself, and concludes that an immediate taxation may be justified for most assets in light of the difficulties of obtaining pertinent information.

<sup>730</sup> See the Commission’s Communication on “Exit taxation and the need for co-ordination of Member States’ tax policies”, COM(2006) 825 final

<sup>731</sup> See Council Resolution on coordinating exit taxation, 2911th Economic and Financial Affairs (2 December 2008).

<sup>732</sup> See, e.g. Thiel, “Europäisierung des Umwandlungssteuerrechts: Grundprobleme der Verschmelzung”, 57 *Der Betrieb* (2005), 2316, 2318; Schwenke, “Europarechtliche Vorgaben und deren Umsetzung durch das SEStEG”, 94 *Deutsche Steuerzeitung* (2007), 235, 246-247; see also Englisch, *Aufteilung der Besteuerungsbefugnisse – Ein Rechtfertigungsgrund für die Einschränkung von EG-Grundfreiheiten* (IFSt, 2008), 89-92.

<sup>733</sup> Kemmeren, “European Commission requests Belgium, Denmark and the Netherlands to change restrictive exit tax provisions for companies and closes a similar case against Sweden”, 3 *Highlights & Insights on European Taxation* No 6 (2010), 66 (69).

<sup>734</sup> These cases are pending as Case C-38/10, *Commission v. Portugal*, and Case C-64/11, *Commission v. Spain*; for a review of ongoing infringement proceedings see Kemmeren, “European Commission requests Belgium, Denmark and the Netherlands to change restrictive exit tax provisions for companies and closes a similar case against Sweden”, 3 *Highlights & Insights on European Taxation* No 6 (2010), 66 (69).

<sup>735</sup> See also Art 7 Para 24 OECD Model Commentary 2010.

<sup>736</sup> Paras 203.204 and Para 206 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).

<sup>737</sup> Para 199 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).



as a reward for the use of tangible assets; however, and for obvious reasons relating to anti-avoidance, internal interest dealings are recognized only for the purpose of rewarding treasury functions.<sup>738</sup> Likewise, the AOA does not create “notional” dividends as a return on “free” capital, which might be described as the deemed equity portion as determined under the OECD’s approach of hypothetically establishing a capital structure of a permanent establishment.<sup>739</sup> The OECD Commentary<sup>740</sup> and the Report<sup>741</sup> also clearly note that such notional payments are only relevant for the attribution of profits and “should not be understood to carry wider implications as regards withholding taxes”,<sup>742</sup> which is also set clear by the introductory wording of Art. 7(2) (“[f]or the purposes of this Article and Article [23 A] [23B]”).

Nevertheless, States may wish to align the – domestic and tax treaty – treatment of notional compensations for internal dealings made by permanent establishments to a foreign head offices with (real) payments made by subsidiaries to foreign parent companies. In that respect, the 2010 OECD Commentary notes:

“Some States consider that, as a matter of policy, the separate and independent enterprise fiction that is mandated by paragraph 2 should not be restricted to the application of Articles 7, 23 A and 23 B but should also extend to the interpretation and application of other Articles of the Convention, so as to ensure that permanent establishments are, as far as possible, treated in the same way as subsidiaries. These States may therefore consider that notional charges for dealings which, pursuant to paragraph 2, are deducted in computing the profits of a permanent establishment should be treated, for the purposes of other Articles of the Convention, in the same way as payments that would be made by a subsidiary to its parent company. These States may therefore wish to include in their tax treaties provisions according to which charges for internal dealings should be recognised for the purposes of Articles 6 and 11 (it should be noted, however, that tax will be levied in accordance with such provisions only to the extent provided for under domestic law). Alternatively, these States may wish to provide that no internal dealings will be recognised in circum-

<sup>738</sup> Paras 157-158 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).

<sup>739</sup> Paras 115 et seq. of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).

<sup>740</sup> Art 7 Para 28 OECD Model Commentary 2010.

<sup>741</sup> See, e.g., Para 203 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).

<sup>742</sup> Para 203 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments (July 2010).

stances where an equivalent transaction between two separate enterprises would give rise to income covered by Article 6 or 11 (in that case, however, it will be important to ensure that an appropriate share of the expenses related to what would otherwise have been recognised as a dealing be attributed to the relevant part of the enterprise). States considering these alternatives should, however, take account of the fact that, due to special considerations applicable to internal interest charges between different parts of a financial enterprise (e.g. a bank), dealings resulting in such charges have long been recognised, even before the adoption of the present version of the Article.”<sup>743</sup>

While the OECD Commentary discusses only Art. 6 and 11, one should keep in mind that – unlike the OECD MC – most actual bilateral tax treaties also foresee withholding taxation of royalties under Art. 12. It hence seems possible or even likely that some States will want to structure their tax treaties to be able to subject such “notional” rents, interest and royalties to their domestic (withholding) tax regimes, given that these are generally treated as deductions in establishing the attributable profit under the AOA. Likewise, States could consider to treat deemed returns on “free capital” as dividends and tax those “notional returns on equity”, just like some countries levy a branch profits tax.

Such a situation would raise the question whether such taxation would be in line with the Interest-Royalty-Directive with respect to notional royalties and interest and the Parent-Subsidiary-Directive with regard to the taxation of notional returns on free capital. While both directives could arguably also apply to “notional” or “fictitious” payments,<sup>744</sup> both directives require the existence of (at least) two companies.<sup>745</sup> Moreover, and under the assumption that two companies were involved, neither directive would cover payments of dividends, interest or royalties by a permanent establishment to its own head office.<sup>746</sup> This means that – even though permanent establishments are deemed to be distinct and separate enterprises under the AOA – a straightforward cross-border “notional” payment from a permanent establishment to a head office could not qualify under the directives.

<sup>743</sup> Art 7 Para 29 OECD Commentary 2010.

<sup>744</sup> For an analysis of the Parent-Subsidiary-Directive see Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Paras 25-27.

<sup>745</sup> I.e., parent and subsidiary companies under Art. 3 of the Parent-Subsidiary-Directive or parent and subsidiary companies or sister companies of a common parent under Art 3(b) of the Interest-Royalty-Directive.

<sup>746</sup> For a discussion concerning “branch profits taxes” within the scope of the Parent-Subsidiary-Directive see Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Para 47.



This result is unsatisfactory. However, the fundamental freedoms may provide relief. This is especially true if there is no (withholding) taxation on purely domestic flows of dividends, royalties, interest, rents etc.<sup>747</sup> The Court's decisions in *Denkavit Internationaal*,<sup>748</sup> *Amurta*,<sup>749</sup> *Aberdeen Property Fininvest Alpha*,<sup>750</sup> *Commission v. Netherlands*,<sup>751</sup> *Commission v. Italy*<sup>752</sup> and *Commission v. Spain*<sup>753</sup> have already clarified that principle for the area of dividend taxation, and a case on discriminatory taxation of interest payments is currently pending before the ECJ.<sup>754</sup> Moreover, and independent from the domestic comparator, in CLT-UFA<sup>755</sup>, the ECJ seems to have established a specific (though debatable) "horizontal" non-discrimination principle. When it had to rule on a special tax rate applying only to permanent establishments of foreign corporate taxpayers under German tax law, the Court summed up its previous case-law and found that, under the freedom of establishment, it:

"is necessary to apply a tax rate to the profits made by a branch which is equivalent to the overall tax rate which would have been applicable in the same circumstances to the distribution of the profits of a subsidiary to its parent company".<sup>756</sup>

Consequently, under the freedoms, one would have to (horizontally) compare the tax levied on a domestic subsidiary, including the source country tax levied on its non-resident parent company upon profit distribution, with the tax levied on a non-resident taxpayer with a permanent establishment. Under the assumption that the profits of the permanent establishment of a non-resident EU company are taxed in the same way as profits of a local subsidiary, this implies, of course, that a tax on cross-border "notional returns on equity" in the State of the permanent establishment with respect to its corporate EU head office would generally violate the freedom of establishment, since in

<sup>747</sup> See, e.g., Cussons and FitzGerald, "EU Report", in IFA (Ed.), *The attribution of profits to permanent establishments*, CDFI Vol. 91b (2006), 69 (88).

<sup>748</sup> ECJ, 14 December 2006, C-170/05, *Denkavit Internationaal BV* [2006] ECR I-11949.

<sup>749</sup> ECJ, 8 November 2007, C-379/05, *Amurta* [2007] ECR I-9569.

<sup>750</sup> ECJ, 18 June 2009, C-303/07, *Aberdeen Property Fininvest Alpha* [2009] ECR I-5145.

<sup>751</sup> ECJ, 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-4873.

<sup>752</sup> ECJ, 19 November 2009, C-540/07, *Commission v. Italy* [2009] ECR I-10983.

<sup>753</sup> ECJ, 3 June 2010, C-487/08, *Commission v. Spain* (n/r).

<sup>754</sup> See Case C-600/10, *Commission v. Germany*.

<sup>755</sup> Case C-253/03, CLT-UFA S.A., [2006] ECR I-1831, paras. 31 et seq. For a discussion of this case see Schnitger, "The CLT-UFA Case and the 'Principle of Neutrality of Legal Form'", 44 *European Taxation* (2004), 522 et seq.

<sup>756</sup> ECJ, 23 February 2006, C-253/03, CLT-UFA [2006] ECR I-1831, Para. 33.

the hypothetical comparison Art. 5 of the Parent-Subsidiary-Directive would usually prohibit the levying of withholding taxes on a distribution by a wholly-owned domestic subsidiary to its EU parent company.<sup>757</sup> If one accepts this reasoning, the *CLT-UFA* decision could provide a strong argument that a withholding tax on notional interest or royalties would likewise infringe on the freedom of establishment, since under Art. 1(1) of the Interest-Royalty-Directive such payments between associated enterprises "shall be exempt from any taxes imposed on those payments" in the State of source, "whether by deduction at source or by assessment".

### 16.5. Profit Allocation and the Arbitration Convention

Art. 7(3) OECD MC – like Art. 9(2) OECD MC<sup>758</sup> – contains a rather complex procedural link between the State of the permanent establishment and the State which has to grant relief under Art. 23 OECD MC that aims at resolving differences based on different interpretations of Art. 7(2) OECD MC by giving deference to the adjusting State's preferred position as to the arm's length price or method. However, if the States involved do not agree that an adjustment is warranted by Art. 7(2) OECD MC, there will be need for a mutual agreement procedure under Art. 25(1) OECD MC, including, if necessary, the arbitration provision of Art. 25(5) OECD MC.

This procedure may possibly be supplemented by the Arbitration Convention,<sup>759</sup> which provides for a binding elimination of double taxation in transfer pricing cases (also in relation to permanent establishments) by agreement between the contracting states including, if necessary, by reference to the opinion of an independent advisory body, within a given time frame. Since 2010, this Convention is applicable in all 351 bilateral relationships between EU Member States, and its interpretation and application has been supplemented by a Code of Conduct<sup>760</sup>. The Arbitration Convention seems to primarily have a "chilling effect" on Member States to work on a possibly swift resolution of transfer pricing disputes and to avoid arbitration.

<sup>757</sup> See for this discussion, e.g., Zanotti, "Taxation of Inter-Company Dividends in the Presence of a PE: The Impact of the EC Fundamental Freedoms", 44 *European Taxation* (2004), 493 (495); Kofler, *Mutter-Tochter-Richtlinie* (2011) Art 1 Para 47.

<sup>758</sup> See Art 7 Paras 58-59 OECD Model Commentary 2010.

<sup>759</sup> Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, [1990] OJ L 225, 10, as amended.

<sup>760</sup> See the Revised Code of Conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, [2009] OJ (C 322), 1 (the proposal was published as COM(2009) 472 final)

The wording of the Arbitration Convention also suggests that it can serve as a legal instrument to resolve conflicts arising from different approaches to the arm's length price of cross-border "internal dealings" between head offices and permanent establishments in the EU. This is because the Arbitration Convention can be read to already include the AOA: Its Art. 4(1) resembles the old wording of Art. 7(2) OECD MC but does not reiterate the language of Art. 7(3) OECD MC. Moreover, Art. 1(2) of the Arbitration Convention states that "[f]or the purposes of this Convention, the permanent establishment of an enterprise of a Contracting State situated in another Contracting State shall be deemed to be an enterprise of the State in which it is situated." This language is certainly broad enough to deem permanent establishments as completely distinct and separate enterprises and to make the Convention apply to disputes over the pricing of "internal dealings".<sup>761</sup> It should be noted, however, that the Arbitration Convention has a different approach to the solution of transfer pricing disputes: Rather than avoiding double taxation through a corresponding adjustment of the tax base, Art. 14 of the Convention uses an alternative method by considering double taxation as eliminated if either exemption or a tax credit is granted for the additional tax charged to the associated enterprise by the adjusting State as a consequence of the revised transfer price.<sup>762</sup>

### 16.6. Conclusions

This contribution found that the "Authorised OECD approach" and the new wording of Art. 7 OECD MC raises a number of issues under European tax law. First, the AOA requires that assets be allocated to a permanent establishment on the basis of an "effective connection" which again depends on performance of significant people functions rather than on the place of booking. This is relevant for the permanent establishment provisions of the EU direct tax Directives because these only cover assets that form part of the business assets of the permanent establishment. For instance, when we assume that the "subject to tax" clause in Art. 2(2) of the PS Directive means that the taxing right of the State of the permanent establishment is not restricted by a tax treaty and that that state allocates dividend income to the permanent establishment, which means that the holding must form part of the business assets of the permanent establishment under domestic law as well as under a double tax treaty, the AOA gains vital

<sup>761</sup> See also Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (1994), 314.

<sup>762</sup> This alternative method is also mentioned in Para 4.34 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2010).

importance, as it requires the shareholding to be genuinely connected to that business thus requiring "economic ownership" rather than a mere recording of the shareholding in the books of the permanent establishment for accounting purposes.

Second, the cross border transfer of the economic ownership of an asset triggers taxation on accrued capital gains, and while this is perfectly acceptable under the OECD Commentary, it may cause EU incompatible discrimination in cases in which similar domestic asset transfers are treated differently for instance as regards the timing of the realisation of the gains and/or as regards the valuation of the gains.

Third, whereas notional investment income flows from the permanent establishment to the foreign head office (notional returns on free capital/equity or notional dividends, notional interests, and notional royalties) may give rise to source state withholding taxes under the OECD approach (and perhaps even under the EU Directives), such withholding taxes do raise questions under directly applicable EU law on the fundamental freedoms, in particular if there are not withholding taxes on similar domestic flows, or if cross border flows are subject to a heavier tax burden than similar domestic flows.

Finally, the mutual agreement procedure foreseen by Article 25 of the OECD MC, may possibly be supplemented by the Arbitration Convention, which, however, rather than providing for corresponding adjustments, solves transfer pricing disputes by considering double taxation as being eliminated if either the exemption or credit method is applied to the additional tax charged to the associated enterprise as a result of a revised transfer price.