

The “Authorized OECD Approach” and EU Tax Law

This article examines certain European law issues that arise from the Authorized OECD Approach (AOA) and the new Art. 7 of the 2010 OECD Model, including the applicability of the EU direct tax directives (AOA requirement that assets be effectively connected with the PE), the EU compatibility of exit taxation (on outbound asset transfers by the PE) and possible withholding taxes (on outbound “notional payments” by the PE), as well as possible use of the Arbitration Convention to resolve any disputes under the AOA.¹

1. Introduction

The “Authorized OECD Approach” (AOA) aims to align the tax treaty rules for business profits under Art. 7 of the OECD Model Tax Convention (OECD Model) with the transfer pricing rules laid down in Art. 9 of the OECD Model and the OECD Transfer Pricing Guidelines.² It does so by allocating profits between different parts of the enterprise under the fiction that permanent establishments (PEs) are distinct and separate entities to which the arm’s length standard applies (“functionally separate entity approach”). The core principles of the AOA were set out by the OECD in several reports, which were consolidated in 2008.³ The main conclusions were subsequently implemented in the 2008 Update of the OECD Commentary insofar as they were in compliance with the wording of the (former) Art. 7 at that time.⁴ To make the OECD Model fully conform to the conclusions of the AOA, the 2010 Update of the OECD Model led to new wording in Art. 7, a revised Commentary on this provision and a revised version of the OECD Report on the Attribution of Profits to Permanent Establishments.⁵

Broadly speaking, under the AOA, the attribution of profits to different parts of an enterprise is based on the fiction that: (1) the PE is a separate enterprise and (2) such an enterprise is independent from the rest of the enterprise of which it forms a part, as well as from any other person. Consequently, the profits of the fictional distinct and separate enterprise have to be determined under the arm’s length principle set out in Art. 9 for the purpose of adjusting the profits of associated enterprises. This means that profits attributable to a PE under Art. 7(2) of the OECD Model 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.⁶

The new wording of Art. 7 of the OECD Model has, of course, not yet been implemented in tax treaties. However, the parts of the AOA that were included in the 2008 Update to the OECD Commentary supposedly apply retroactively to “old” treaties.⁷ Finally, some states may consider unilaterally implementing the complete AOA in their domestic legislation (treaty override).⁸

The new wording will also raise a number of issues under EU tax law,⁹ some of which will be dealt with in this article. First, the article examines the impact of the allocation of assets under the AOA on the PE clauses in EU direct tax directives (section 2.). Second, cross-border transfers of assets and other “internal dealings” between a head office and a PE or between PEs raise questions not only under the AOA and the domestic implementing law, but also under the EU fundamental freedoms. This is because an immediate realization of hidden reserves or profits upon such a transfer might be viewed as a discriminatory exit charge if no taxation is triggered on purely domestic transfers of assets (section 3.). Third, the AOA only applies for purposes of Arts. 7 and 23 of the OECD Model, which means that notional payments for internal dealings between the head office and a PE or between PEs will, in principle, not trigger withholding taxes. However, states are, of course, free to fully deem PEs as separate taxpayers

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1. This contribution is based on a presentation on the topic made at the 2011 CFE Forum held in Brussels on 7 April 2011.
2. The latest version of which was published as the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, 2010).
3. OECD Report on the Attribution of Profits to Permanent Establishments (Parts I to IV) (Paris: OECD, 2008).
4. Some AOA concepts, with regard to the allocation of economic ownership of certain assets (for example, intangibles) and the explicit recognition of internal dealings, did not, for instance, form part of the 2008 Update.
5. OECD, 2010 Report on the Attribution of Profits to Permanent Establishments (Paris: OECD, 2010).
6. Para. 15 of the Commentary on Art. 7 of the 2010 OECD Model.
7. Para. 7 of the Commentary on Art. 7 of the 2008 OECD Model.
8. For example, Germany is currently discussing a revision of Sec. 1 of the Foreign Tax Act (*Außensteuergesetz*, AStG) to unilaterally implement the AOA.
9. For an initial analysis see P. Baker and R. Collier, “General Report”, in IFA (ed.), *The attribution of profits to permanent establishments*, *Cahiers de droit fiscal international*, Vol. 91b (Amersfoort: Sdu fiscale en financiële uitgevers, 2006), p. 21 at pp. 58-59 and P. Cussons and E. FitzGerald, “EU Report”, in id., p. 69 at pp. 87-88.

in their domestic law and tax treaties also for purposes of, for example, the dividends, interest and royalties articles. This raises the question of whether or not withholding taxes triggered by such extensive implementation of the AOA may be barred by the EU direct tax directives or the fundamental freedoms (section 4.). Finally, the authors briefly look at whether or not the Arbitration Convention can provide a mechanism to resolve disputes under the AOA through binding arbitration (section 5.).

2. Allocation of Assets to PEs

The EU Merger Directive, the EU Parent-Subsidiary Directive and the EU Interest and Royalties Directive all take PEs into account. However, all directives implicitly rely on domestic tax law and tax treaty law.¹⁰ This also implies that the AOA will have a significant impact on the EU direct tax directives, as it requires that assets be attributed 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.¹¹ The 2010 OECD Commentary includes a number of clauses that highlight the requirement that there be an “effective connection” between the PE and the holdings, liabilities, intangible assets and capital assets.¹² The respective assets will only be considered part of the business assets of the PE if such an effective connection exists. This again impacts on the scope of application of the EU direct tax directives because the assets will only be covered by the PE provisions of those EU direct tax directives if they form part of the business assets of a PE.

The impact of the above may briefly be demonstrated with regard to “sandwich structures” under the EU Parent-Subsidiary Directive. This Directive can apply to profit distributions to a PE in one Member State where the parent and subsidiary company are both resident in the same other Member State. This is technically achieved by first including holdings via a PE into the definition of a parent company (Art. 3(1)(a)), i.e., creating a fictitious cross-border element at the level of the companies involved,¹³ and second by covering such profit distributions in Art. 1(1) third and fourth indent. In such a situation, no withholding tax is triggered on the profit distribution to the PE (Art. 5)¹⁴ and relief, by exempting the dividend or providing an indirect credit, has to be granted both at the level of the PE¹⁵ and the parent company¹⁶ (Art. 4). This said, it is a prerequisite that a PE exist for these provisions to apply. 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.

The first part of this definition resembles Art. 5(1) of the OECD Model and Art. 3(c) of the Interest and Royalties Directive,¹⁷ 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.¹⁸ What this clause seems to imply is that the tax treaty between the head office state and the PE state must not restrict the latter’s domestic taxing rights (“by virtue of national law”).¹⁹ This prerequisite is generally fulfilled if the tax treaty clause is based on Art. 7 of the OECD Model. In addition, Art. 2(2) of the EU Parent-Subsidiary Directive requires that profits be “subject to tax”. This clause is obviously aimed at preventing an abusive interposition of PEs in “sandwich structures” to avoid the application of domestic law.²⁰ However, there is broad consensus that such a “subject to tax” clause does not require effective taxation of the profits allocated to the

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10. Art. 4(2)(b) of the EU Merger Directive (2009/133/EC) states that it is a requirement for tax neutrality of certain cross-border reorganizations that the “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 tax treaties: only assets generating “profits or losses taken into account for tax purposes” are considered to form part of the PE for purposes of Art. 4(2)(b) of the EU Merger Directive. For this determination it is, however, decisive whether the taxing right of the PE state is effectively restricted by a tax treaty. Likewise, Art. 2(2) of the EU Parent-Subsidiary Directive (90/435/EEC) requires a fixed place of business and, furthermore, notes that profits must be “subject to tax”, hereby also implicitly referring to the question of whether or not a tax treaty gives the taxing right to the PE state. Finally, Art. 3(c) of the EU Interest and Royalties Directive (2003/49/EC) defines a PE as a fixed place of business but requires that the payments constitute a tax-deductible expense for a PE to be considered the payor of interest or royalties (Art. 1(3)) and that the payments be effectively connected and subject to tax for a PE to be considered the beneficial owner of the interest or royalties (Art. 1(5)).
 11. See, for example, Para. 32 of the 2010 Commentary on Art. 10 of the OECD Model.
 12. See Paras. 32.1 and 32.2 of the Commentary on Art. 10 (dividends), Paras. 25.1 and 25.2 of the Commentary on Art. 11 (interest), Paras. 21.1 and 21.2 of the Commentary on Art. 12 (royalties), Paras. 27.1 and 27.2 of the Commentary on Art. 13 (capital gains) and Paras. 5.1 and 5.2 of the Commentary on Art. 21 (other income) of the OECD Model.
 13. See also G. Maisto, “The 2003 amendments to the EC Parent-Subsidiary Directive: what’s next?”, *EC Tax Review* 13 (2004), p. 164 at p. 170.
 14. Maisto, note 13, p. 169; P. Bullinger, “Änderungen der Mutter-Tochter-Richtlinie ab 2005: Erweiterung des Anwendungsbereiches und verbleibende Probleme”, 13 *Internationales Steuerrecht* 12 (2004), p. 406 at p. 408; E. Zanotti, “Taxation of Inter-Company Dividends in the Presence of a PE: The Impact of the EC Fundamental Freedoms – Part 1”, 44 *European Taxation* 11 (2004), p. 493 at p. 503; J. Englisch and A. Schütze, “The Implementation of the EC Parent-Subsidiary Directive in Germany – Recent Developments and Unresolved Issues”, 45 *European Taxation* 11 (2005), p. 488 at p. 490; O. Thömmes and K. Nakhai in O. Thömmes and E. Fuks (eds.), *EC Corporate Tax Law* (Amsterdam: IBFD, 2007), Art. 1, Para. 33; G. Kofler, *Kommentar zur Mutter-Tochter-Richtlinie* (Vienna: LexisNexis, 2011), Art. 1, Para. 53.
 15. Maisto, note 13, p. 167; Bullinger, note 14, p. 408; M. Tenore, “The Parent-Subsidiary Directive”, in M. Lang, P. Pistone, J. Schuch and C. Staringer (eds.), *Introduction to European Tax Law on Direct Taxation*, 2nd ed. (Vienna: Linde, 2010), p. 111 at p. 124 et seq.; Kofler, note 14, Art. 1, Para. 53.
 16. See also Maisto, note 13, p. 170; Bullinger, note 14, p. 408; Tenore, note 15, p. 124 et seq.; Kofler, note 14, Art. 1, Para. 53.
 17. E. Bendlinger, “Änderung der Mutter-Tochter-Richtlinie der EU”, 14 *Steuer und Wirtschaft International* 6 (2004), p. 277 at p. 280; Zanotti, note 14, p. 495; Englisch and Schütze, note 14, p. 491; H. Kofler and G. Kofler, “Betriebsstätten in der Mutter-Tochter-Richtlinie”, in P. Quantschnigg, W. Wiesner and G. Mayr (eds.), *Steuern im Gemeinschaftsrecht, Festschrift für Wolfgang Nolz* (Vienna: LexisNexis, 2008), p. 53 at p. 62; see also Maisto, note 13, pp. 169-170.
 18. Kofler, note 14, Art. 1, Para. 39.
 19. See also Englisch and Schütze, note 14, p. 491.
 20. Kofler, note 14, Art. 1, Para. 52 et seq.

PE.²¹ Also, a requirement of effective taxation is clearly not justified in the context of the EU Parent-Subsidiary Directive.²²

- If the phrase “subject to tax” refers to all income of the PE, the application of the Directive would largely depend on the mix of – positive or negative – income in the PE. The use of such a criterion in determining whether or not relief from economic double taxation should be granted in regard to cross-border profit distributions would be quite arbitrary.²³
- If, however, the phrase “subject to tax” refers solely to dividend income, the clause, itself, would be contradictory: such a reading would lead to the consequence that relief under Art. 4 of the Directive would be available if a PE exists under Art. 2(2); however, if relief were to be granted through the exemption method, those distributions would not be “subject to tax”, which would mean that the PE definition under Art. 2(2) would not be met; 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 a circular result cannot be correct from an interpretative perspective.²⁴

In the authors’ view, therefore, the “subject to tax” clause in Art. 2(2) can only mean that the taxing right of the PE state must not be restricted by a tax treaty and that such state allocates dividend income to the PE.²⁵ This implies that the holding must form part of the business assets of the PE under domestic law, as well as under a tax treaty.²⁶ In making this determination, therefore, the AOA is of 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”.²⁷

The 2010 OECD Commentary notes, in this respect, that a shareholding must be genuinely connected to that business, which requires more than merely recording the shareholding in the books of the PE for accounting purposes.²⁸ 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 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).²⁹

Given the vagueness of the concept of “economic” ownership, the allocation of shareholdings to PEs is problematic – for tax treaty purposes, as well as for purposes of the EU Parent-Subsidiary Directive. It is evident, however, that the mere booking of a shareholding in the accounts of a PE is not sufficient to create an effective connection.³⁰ For more tricky issues, such as the allocation of share-

holdings to a “passive” PE, no clear guidance is provided either in the 2010 OECD Commentary or in the 2010 Report on the Attribution of Profits to PEs.³¹ Since there is no abstract solution for a conflict between two states concerning the allocation of assets, pressure is put on the procedures for the resolution of conflicts provided for in Art. 7(3) of the 2010 OECD Model, which will also impact the Parent-Subsidiary Directive.

3. Transfers of Assets

Art. 7(2) of the 2010 OECD Model requires the attribution of the profits a PE “might be expected to make, in particular in its dealings with other parts of the enterprise”. Such an internal dealing may also occur where economic ownership of an asset (for example, a machine or inventory) is transferred to the head office or another PE.³² In essence, this approach does not restrict a domestic law provision regarding an immediate realization of hidden reserves upon a cross-border transfer of assets within an enterprise. Likewise, it does not restrict the realization of arm’s length profits on other cross-border internal “dealings” (for example, internal services)³³ where no real transaction takes place and there is no corresponding cash flow. While this may be seen as discriminatory if no similar charge is levied upon a purely domestic transfer of assets or other internal dealings,³⁴ the 2010 Commentary on Art. 24(3) of the OECD Model clearly rejects such an understanding of the non-discrimination clause concerning PEs:

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

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21. See Kofler, note 14, Art. 2, Para. 32 et seq. and, specifically in regard to PE situations, Maisto, note 13, p. 170; M. Tissot, “Änderungen der Mutter-Tochter-RL – Welcher Änderungsbedarf ergibt sich daraus für den österreichischen Steuergesetzgeber”, 3 *Zeitschrift für Gesellschafts- und Steuerrecht* (GeS) 6 (2004), p. 244 et seq.; Bullinger, note 14, p. 408; Englisch and Schütze, note 14, p. 491; Kofler and Kofler, note 17, pp. 63-64.
 22. See Kofler and Kofler, note 17, pp. 63-64; Kofler, note 14, Art. 1, Para. 40.
 23. Englisch and Schütze, note 14, p. 491.
 24. Kofler and Kofler, note 17, p. 64; Kofler, note 14, Art. 2, Para. 40.
 25. Kofler, note 14, Art. 1, Para. 40.
 26. Maisto, note 13, p. 170; Englisch and Schütze, note 14, p. 491; Kofler and Kofler, note 17, p. 63; and Kofler, note 14, Art. 1, Para. 41.
 27. See, for example, Para. 73 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments, note 5.
 28. Para. 32 of the 2010 Commentary on Art. 10 of the OECD Model.
 29. Para 32.1 of the Commentary on Art. 10 of the OECD Model.
 30. Austria, for example, gave up this position following the publication of the AOA and now requires that holdings serve the activity of the PE; see, for example, Austrian Ministry of Finance of 12 November 2007 EAS 2910, published in 17 *Steuer und Wirtschaft International* 12 (2007), p. 573.
 31. See Paras. 72-97 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments, note 5.
 32. See, in regard to a transfer of tangible assets, Paras. 194-196 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments, note 5.
 33. Id., Paras. 216-219.
 34. See Baker and Collier, note 9, pp. 57-58.

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.³⁵

There is, however, an extensive on-going discussion regarding the question of whether or not a difference in treatment of domestic and cross-border transfers of assets is in compliance with the fundamental freedoms.³⁶ Such a difference in treatment can basically result from a timing difference in regard to realization or from a difference in valuation. Both aspects and, hence, the discrimination analysis, largely depend on the domestic law treatment of comparable situations. If no taxation would occur in regard to a domestic transfer of assets, it should be noted that the ECJ in *de Lasteyrie*³⁷ and *N*³⁸ accepted that, under the fundamental freedoms, the exit state may only tax value increases that occurred while the taxpayer was a resident and provided such taxation is deferred until the eventual alienation of such assets.³⁹ Although these cases only concerned shareholdings of individuals, the prevailing opinion⁴⁰ – including the opinion of the Commission⁴¹ and the Council⁴² – is that, in principle, these decisions are also applicable to cross-border transfers of business assets. However, Member States may, nevertheless, find valid justifications in this area, especially in respect of the obstacles to deferred taxation of hidden reserves in regard to intangible assets and short-term assets.⁴³ Indeed, the practical difficulties of deferred exit taxation might have led the Commission to accept Swedish legislation that, instead of granting deferred taxation, spreads the exit tax on realized hidden reserves over a period of years, namely five years for tangible assets and ten years for intangible assets.⁴⁴ Given these uncertainties,

den direkten Steuern", 13 *Internationales Steuerrecht* 9 (2004), p. 289 at p. 297; W. Schön, "Tax Issues and Constraints on Reorganizations and Reincorporations in the European Union", 34 *Tax Notes International*, p. 197 at p. 202 (12 April 2004); T. Rödder, "Deutsche Unternehmensbesteuerung im Visier des EuGH", 42 *Deutsches Steuerrecht* 39 (2004), p. 1629 at p. 1633; W. Schön and C. Schindler, "Zur Besteuerung der grenzüberschreitenden Sitzverlegung einer Europäischen Aktiengesellschaft", 13 *Internationales Steuerrecht* 16 (2004), p. 571 at pp. 575-576; C. Schindler, "Steuerrechtliche Folgen der Sitzverlegung einer Europäischen Aktiengesellschaft", 15 *ecolex* 10 (2004), p. 770 at p. 771; C. Schindler, "Steuerrecht", in S. Kalss and H. Hügel (eds.), *Europäische Aktiengesellschaft SE-Kommentar* (Vienna: Linde, 2004), Part III, Paras. 27-28; H. Hügel, "Grenzüberschreitende Umgründungen, Sitzverlegung und Wegzug im Lichte der Änderung der Fusionsrichtlinie und der neueren EuGH-Judikatur", in E. König and W. Schwarzwinger (eds.), *Körperschaften im Steuerrecht, Festschrift für Werner Wiesner* (Vienna: Linde, 2004), p. 177 at pp. 196-197; T. Rödder, "Gründung und Sitzverlegung der Europäischen Aktiengesellschaft (SE) – Ertragsteuerlicher Status quo und erforderliche Gesetzesänderungen", 43 *Deutsches Steuerrecht* 21/22 (2005), p. 893 at pp. 895-896; U.-P. Kinzl, "Grenzüberschreitende Verschmelzung: Soviel Steuerneutralität wie nötig oder nur soviel wie fiskalisch möglich?", 50 *Die Aktiengesellschaft* (2005), p. 842 at pp. 844-845; D. Klingberg and I. van Lishaut, "Die Internationalisierung des Umwandlungssteuerrechts", 3 *Der Konzern* (2005), p. 698 at pp. 705-707 and 714; G. Kofler and C. Schindler, "Grenzüberschreitende Umgründungen: Änderungen der steuerlichen Fusionsrichtlinie und Anpassungsbedarf in Österreich", *taxlex* 9 (2005), p. 496 at p. 501 and 1 *taxlex* 9 (2005), p. 559 at pp. 563-564; M. Achatz and G. Kofler, "Internationale Verschmelzungen", in M. Achatz, D. Aigner, G. Kofler and M. Tumpel (eds.), *Internationale Umgründungen* (Vienna: Linde, 2005), p. 23 at pp. 41-42; C. Schindler, "EU Report", in IFA (ed.), *Tax Treatment of International Acquisitions of Businesses. Cahiers de droit fiscal international*, Vol. 90b (Amersfoort: Sdu fiscale en financiële uitgevers, 2005), p. 49 at pp. 66-67; A. Körner, "Europarecht und Umwandlungssteuerrecht", 15 *Internationales Steuerrecht* 4 (2006), p. 109 at pp. 110-111; W. Schön, "Grenzüberschreitende Sitzverlegung und Verschmelzung im Steuerrecht", *Jahrbuch der Fachanwälte für Steuerrecht* (2006/2007), pp. 90-92; W. Schön and C. Schindler, *Die SE im Steuerrecht* (Cologne: O. Schmidt, 2008), Paras. 25-34, 157 (transfer of seat of an SE) and 240 (merger); Terra and Wattel, note 39, p. 540; M. Hofstätter and D. Hohenwarter, "The Merger Directive", in M. Lang, P. Pistone, J. Schuch and C. Staringer (eds.), *Introduction to European Tax Law on Direct Taxation* (Vienna: Linde, 2008), p. 111 at pp. 121-122. In this direction see also C. Louven, M. Dettmeier, M. Pöschke and A. Weng, "Optionen grenzüberschreitender Verschmelzungen innerhalb der EU – gesellschafts- und steuerrechtliche Grundlagen", *Betriebs-Berater Special No. 3* (2006), p. 1 at pp. 6-7; M. Gammie, "EU Taxation of the Societas Europaea – Harmless Creature or Trojan Horse?", 44 *European Taxation* 1 (2004), p. 35 at p. 42; M. Fischer, "Europarecht und Körperschaftsteuerrecht", 44 *Deutsches Steuerrecht* 51/52 (2006), p. 2281 at pp. 2285-2286; R. Russo and R. Offermanns, "The 2005 Amendments to the EC Merger Directive", *European Taxation* 6 (2006), p. 250 at pp. 253-254 and 257; H. Hahn, "Kritische Erläuterungen und Überlegungen zum Entwurf des SEStEG", *Internationales Steuerrecht* 15 (2006), p. 797 at pp. 802-804. For a possibly contrary view see O. Thömmes, "EC Law Aspects of the Transfer of Seat of an SE", 44 *European Taxation* 1 (2004), p. 22 at p. 27; for a critical position, see G. Förster and C. Lange, "Grenzüberschreitende Sitzverlegung der Europäischen Aktiengesellschaft aus ertragsteuerlicher Sicht", 48 *Recht der Internationalen Wirtschaft* 8 (2002), p. 585 at p. 587; M. Schwenke, "Europarechtliche Vorgaben und deren Umsetzung durch das SEStEG", 94 *Deutsche Steuerzeitung* (2007), p. 235 at pp. 246-247. For a different approach, see D. Englisch, *Aufteilung der Besteuerungsbefugnisse – Ein Rechtfertigungsgrund für die Einschränkung von EG-Grundfreiheiten* (Bonn: IFSt, 2008), pp. 89-92, who suggests that the domestic implementation should not be scrutinized but rather the Merger Directive itself, and concludes that immediate taxation may be justified for most assets in light of the difficulties of obtaining pertinent information.

41. See Commission of the European Communities, Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: exit taxation and the need for co-ordination of Member States' tax policies, COM(2006) 825 final, 19 December 2006.

42. See Council Resolution on coordinating exit taxation, 2911th Economic and Financial Affairs (2 December 2008).

43. See, for example, J. Thiel, "Europäisierung des Umwandlungssteuerrechts: Grundprobleme der Verschmelzung", 57 *Der Betrieb* 43 (2005), p. 2316 at p. 2318; Schwenke, note 40, pp. 246-247; see also Englisch, note 40, pp. 89-92.

44. E. 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* 6 (2010), p. 66 at p. 69.

35. Para. 34 of the 2010 Commentary on Art. 24 of the OECD Model.

36. See, specifically with regard to the AOA, Baker and Collier, note 9, pp. 58-59 and Cussons and FitzGerald, note 9, pp. 87-88.

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

38. ECJ, 7 September 2006, Case C-470/04, *N v. Inspecteur van de Belastingdienst Oost/kantoor Almelo* [2006] ECR I-7409 (exit tax on substantial shareholdings of an individual).

39. For general analyses of problems concerning the EU compatibility of exit taxation regimes, see, for example, K. Malmer, "Emigration Taxes and EC Law", in IFA (ed.), *The tax treatment of transfer of residence by individuals, Cahiers de droit fiscal international*, Vol. 87b (The Hague: Kluwer, 2002), p. 79; H. van Arendonk, "Hughes de Lasteyrie du Saillant: crossing borders?" in H. van Arendonk, F. Engelen and S. Jansen (eds.), *A Tax Globalist: Essays in honour of Maarten J. Ellis* (Amsterdam: IBFD, 2005), p. 181; L. De Broe, "Hard times for emigration taxes in the EC", in the same publication, p. 210; H. van den Hurk and J. Korving, "The ECJ's Judgment in the *N* Case against the Netherlands and its Consequences for Exit Taxes in the European Union", 64 *Bulletin for International Taxation* 4 (2007), p. 150; G. Führich, "Exit Taxation and ECJ Case Law", 48 *European Taxation* 1 (2008), p. 10; B. Terra and P. Wattel, *European Tax Law*, 5th ed. (Deventer: Kluwer, 2008), pp. 780-790.

40. See, for analyses in the area of corporate reorganizations, for example, W. Schön, "Besteuerung im Binnenmarkt – die Rechtsprechung des EuGH zu

it remains to be seen how the ECJ will rule in the pending cases on exit taxation in the corporate area.⁴⁵

4. “Notional Payments” by PEs

Art. 7(2) of the OECD Model specifically mentions “dealings” of the PE “with other parts of the enterprise”.⁴⁶ For the purpose of attributing profits under Art. 7 and the corresponding relief under Art. 23, the AOA may consequently deem there to be arm’s length notional “royalties” in consideration for intangible property⁴⁷ or notional “rents”⁴⁸ in consideration 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 compensating treasury functions.⁴⁹ Likewise, the AOA does not deem there to be a “notional” dividend in regard to 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 PE.⁵⁰ The 2010 OECD Commentary⁵¹ and the Report⁵² 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,”⁵³ which is also clearly set out in the introductory wording of Art. 7(2), which states that it applies, “[f]or the purposes of this Article and Article [23A] [23B]”.

Nevertheless, states may wish to align the – domestic and tax treaty – treatment of notional compensation by PEs to a foreign head office in regard to internal dealings with (real) payments made by subsidiaries to foreign parent companies. In this respect, the 2010 OECD Commentary notes that:

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 circumstances 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.⁵⁴

While the 2010 OECD Commentary discusses only Arts. 6 and 11, one should keep in mind that – unlike the

OECD Model – most tax treaties also provide for withholding taxation of royalties under Art. 12. It, therefore, 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 treating deemed returns on “free capital” as dividends and tax such “notional returns on equity”, in the same manner as some countries levy a branch profits tax.

Such a situation would raise the question of whether or not such taxation would be in line with the EU Interest and Royalties Directive with respect to notional royalties and interest and the EU 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,⁵⁵ both directives require the existence of (at least) two companies.⁵⁶ Moreover, and under the assumption that two companies are involved, neither directive would cover payments of dividends, interest or royalties by a PE to its own head office.⁵⁷ This means that – even though PEs are deemed to be distinct and separate enterprises under the AOA – a straightforward cross-border “notional” payment from a PE to a head office would not qualify under the directives.

This result is unsatisfactory. However, the fundamental freedoms may provide relief. This is especially true if there is no (withholding) taxation imposed on purely domestic flows of dividends, royalties, interest, rents, etc.⁵⁸ The ECJ’s decisions in *Denkavit Internationaal*,⁵⁹ *Amurta*,⁶⁰ *Aberdeen Property Fininvest Alpha*,⁶¹ *Commission v. Netherlands*,⁶² *Commission v. Italy*⁶³ and *Commission*

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45. ECJ, Pending Case C-38/10, *European Commission v. Portuguese Republic*, and Pending Case C-64/11, *European Commission v. Kingdom of Spain*; for a review of ongoing infringement proceedings, see Kemmeren, note 44, p. 69.
 46. See also Para. 24 of the 2010 Commentary on Art. 7 of the OECD Model.
 47. Id., Paras. 203, 204 and 206.
 48. Id., Para. 199.
 49. Id., Paras. 157-158.
 50. Id., Para. 115 et seq.
 51. Para. 28 of the 2010 Commentary on Art. 7 of the OECD Model.
 52. See, for example, Para. 203 of Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments, note 5.
 53. Id., Para. 203.
 54. Para. 29 of the 2010 Commentary on Art. 7 of the OECD Model.
 55. For an analysis of the EU Parent-Subsidiary Directive see Kofler, note 14, Art. 1, Paras. 25-27.
 56. I.e., parent and subsidiary companies under Art. 3 of the EU Parent-Subsidiary Directive or parent and subsidiary companies or sister companies of a common parent under Art. 3(b) of the EU Interest and Royalties Directive.
 57. For a discussion concerning “branch profits taxes” within the scope of the EU Parent-Subsidiary Directive, see Kofler, note 14, Art. 1, Para. 47.
 58. See, for example, Cussons and FitzGerald, note 9, p. 88.
 59. ECJ, 14 December 2006, Case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l’Économie, des Finances et de l’Industrie* [2006] ECR I-11949.
 60. ECJ, 8 November 2007, Case C-379/05, *Amurta SGPS v. Inspecteur van de Belastingdienst* [2007] ECR I-9569.
 61. ECJ, 18 June 2009, Case C-303/07, *Aberdeen Property Fininvest Alpha Oy v. Uudenmaan verovirasto and Helsingin kaupunki* [2009] ECR I-5145.
 62. ECJ, 11 June 2009, Case C-521/07, *Commission of the European Communities v. Kingdom of the Netherlands* [2009] ECR I-4873.
 63. ECJ, 19 November 2009, Case C-540/07, *Commission of the European Communities v. Italian Republic* [2009] ECR I-10983.

*v. Spain*⁶⁴ have already clarified this principle in the area of dividend taxation. Further, a case on discriminatory taxation of interest payments is currently pending before the ECJ.⁶⁵ Moreover, and independent from the domestic comparator, in *CLT-UFA*,⁶⁶ the ECJ appeared to have established a specific (though debatable) “horizontal” non-discrimination principle. In ruling on a special tax rate applicable only to PEs 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.⁶⁷

Consequently, under the fundamental 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 a profit distribution, with the tax levied on a non-resident taxpayer’s PE profits. Assuming that the profits of the PE of a non-resident EU company are taxed in the same way as profits of a local subsidiary, this would imply, of course, that a tax on cross-border “notional returns on equity” in the PE state with respect to its corporate EU head office would generally violate the freedom of establishment, since, in the hypothetical comparison, Art. 5 of the EU 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.⁶⁸ If this reasoning is correct, the *CLT-UFA* decision could provide a strong basis for arguing that a withholding tax on notional interest or royalties would likewise infringe the freedom of establishment, since, under Art. 1(1) of the EU Interest and Royalties Directive, such payments between associated enterprises, “shall be exempt from any taxes imposed on those payments” in the source state, “whether by deduction at source or by assessment”.

5. Profit Allocation and the Arbitration Convention

Art. 7(3) of the OECD Model – similar to Art. 9(2) of the OECD Model⁶⁹ – contains a rather complex procedural link between the PE state and the state that has to grant relief under Art. 23 of the OECD Model that aims to resolve differences based on differing interpretations of Art. 7(2) of the OECD Model by giving deference to the adjusting state’s preferred position on the arm’s length price or method. However, if the states involved do not agree that an adjustment is warranted pursuant to Art. 7(2) of the OECD Model, a mutual agreement procedure under Art. 25(1) of the OECD Model will be needed, including, if necessary, arbitration pursuant to Art. 25(5) of the OECD Model.

This procedure may, possibly, be supplemented by the Arbitration Convention,⁷⁰ which provides for binding elimination of double taxation in transfer pricing cases (also in relation to PEs) 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 has also applied in all 351 bilateral relationships between EU Member States, and its interpretation and application has been supplemented by a Code of Conduct.⁷¹ The Arbitration Convention seems to have had a “chilling effect” on Member States, encouraging them to work on a swift resolution of transfer pricing disputes and to avoid arbitration.

The wording of the Arbitration Convention also suggests that it can serve as a legal instrument to resolve conflicts arising due to different approaches to the arm’s length price of cross-border “internal dealings” between head offices and PEs within the European Union. This is because the Arbitration Convention can be read as already incorporating the AOA. Its Art. 4(1) resembles the former wording of Art. 7(2) of the OECD Model but does not reiterate the language of Art. 7(3) of the OECD Model. 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 PEs as completely distinct and separate enterprises and to make the Convention apply to disputes over the pricing of “internal dealings”.⁷² It should be noted, however, that the Arbitration Convention takes a different approach to resolving 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 that considers double taxation as having been eliminated if either an 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.⁷³

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64. ECJ, 3 June 2010, Case C-487/08, *Commission of the European Communities v. Kingdom of Spain* (not yet reported).
 65. See ECJ, 3 June 2010, Case C-600/10, *European Commission v. Federal Republic of Germany* (not yet reported).
 66. ECJ, 23 February 2006, Case C-253/03, *CLT-UFA SA v. Finanzamt Köln-West* [2006] ECR I-1831, Para. 31 et seq. For a discussion of this case see A. Schnitger, “The *CLT-UFA* Case and the ‘Principle of Neutrality of Legal Form’”, *European Taxation* 12 (2004), p. 522 et seq.
 67. *CLT-UFA*, note 66, Para. 33.
 68. See, for this discussion, for example, Zanotti, note 14, p. 493 at p. 495 and Kofler, note 14, Art. 1, Para. 47.
 69. See Paras. 58-59 of the 2010 Commentary on Art. 7 of the OECD Model.
 70. 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.
 71. 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).
 72. See also M. Tumpel, *Harmonisierung der direkten Unternehmensbesteuerung in der EU* (Vienna: Verlag Österreich, 1994), p. 314.
 73. This alternative method is also mentioned in Para 4.34 of the OECD Transfer Pricing Guidelines, note 2.

6. Conclusions

Based on the analysis in this article, it is evident that the AOA and the wording of the (new) Art. 7 of the 2010 OECD Model raise a number of issues regarding EU law. First, the AOA requires that assets be allocated to a PE on the basis of an "effective connection" that, again, depends on performance of significant people functions rather than on the place of booking. This is relevant for the PE provisions of the EU direct tax directives because these directives only cover assets that form part of the business assets of the PE. For instance, assuming that the "subject to tax" clause in Art. 2(2) of the EU Parent-Subsidiary Directive means that the taxing right of the PE state is not restricted by a tax treaty and that that state allocates dividend income to the PE, which means that the holding must form part of the business assets of the PE under domestic law, as well as under a tax treaty, the AOA gains vital importance, as it requires that the shareholding be genuinely connected to that business. Thus, "economic ownership" is required rather than a mere recording of the shareholding in the books of the PE for accounting purposes.

Second, a cross-border transfer of economic ownership of an asset may trigger taxation of accrued capital gains and, while this is perfectly

acceptable under the OECD Commentary, it may cause EU incompatible discrimination in circumstances where similar domestic asset transfers are treated differently, for instance, as regards the timing of the realization of the gains and/or the valuation of the gains.

Third, whereas notional investment income flows from the PE to the foreign head office, notional interest and notional royalties, in particular, may give rise to source state withholding taxes. Although not prohibited by either the OECD approach or the EU directives, such withholding taxes do raise questions under directly applicable EU law on the fundamental freedoms, in particular if there are no 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 provided for by Art. 25 of the OECD Model may possibly be supplemented by the Arbitration Convention, which, rather than providing for corresponding adjustments, resolves transfer pricing disputes by considering that double taxation has been 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.

BOOK

Transfer Pricing and Dispute Resolution

Aligning Strategy and Execution

Transfer Pricing and Dispute Resolution addresses the complexity, valuation and administrative nuances, and cultural impacts of resolving this significant cross-border issue when tax disputes arise.

Contents

- Foreword
- Introduction
- Dispute Channels
- International Developments
- Country chapters
- Case Study



IBFD, Your Portal to Cross-Border Tax Expertise

Editors: Anuschka Bakker and Marc M. Levey
Date of publication: July 2011
ISBN: 978-90-8722-100-3
Type of publication: Book
Number of pages: ± 750
Terms: Price includes delivery
Price: € 145 | \$ 195 (VAT excl.)

To view detailed contents or to order, visit www.ibfd.org. Alternatively, contact our Customer Service Department via info@ibfd.org or +31-20-554 0176.

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