In many instances, the interplay between Directives will effectively rule out the possibility of member states levying interest payments from a qualifying subsidiary to its EU parent company. But even if transfer pricing and thin capitalization rules were in compliance with EC tax law, there would still be broad areas that give rise to cross-border problems that affect the functioning of the internal market and that create additional costs for both business and national tax administrations.

GEORG W. KOFLER

TRENTV AND EC TAX LAW

P ART 2

THE RELATIONSHIP BETWEEN THE ARM’S-LENGTH PRINCIPLE IN THE OECD MODEL TREATY AND EC TAX LAW
of this article began with the premise that the arm’s-length principle is globally accepted when determining the price charged for goods and services between affiliated companies conducting cross-border business, though the principle is not without criticism due to the practical problems of its application. The article covered ground on the internal market and transfer pricing in the EU, the arm’s-length principle in Article 9 of the OECD Model Income Tax Convention (‘OECD Model’), and Article 4 of the EC Arbitration Convention, and began a discussion of the Lankhorst-Hohorst case and the incompatibility of the German thin capitalization rules with EC law and the relevance of Article 9 OECD Model in the case.

Part 2 below, the final installment, picks up with conclusions from Lankhorst-Hohorst regarding arm’s-length adjustments; analyses the potential application of the EU Parent-Subsidiary Directive to the facts of the case; and wraps up with some remarks on the interplay between the Parent-Subsidiary Directive and the Interest and Royalties Directive.

Relevance of Lankhorst-Hohorst for Arm’s-Length Adjustments

The implications of the arguments put forward by the AG in Lankhorst-Hohorst—and their acceptance by the European Court of Justice (ECJ)—seem clear. Article 9 OECD Model, and thus the arm’s-length principle, may neither immunize national tax provisions from the verdict of discrimination nor justify purported discrimination. Thus, any thin capitalization rates that apply only to cross-border situations must be reconsidered, even if they are based on the arm’s-length principle, since the German thin capitalization rule that the ECJ rejected allowed such an arm’s-length test in section 8a(1)(2) Körperschaftsteuergesetz (KStG) (‘Corporate Income Tax Act’) as a defense to the thin capitalization rules in section 8a KStG. Although the arm’s-length principle was not applied as a positive criterion, but only negatively as a standardized safe harbor with the burden of proof on the corporation, it was nevertheless an integral part of section 8a(1)(2) KStG.

Lankhorst-Hohorst therefore highlights, probably more than any previous case, that EC law prevails over OECD rules, such as Article 9 OECD Model, which, in principle, allows for application of national thin capitalization rules. The AG could not have made this clearer. The German government’s position in Lankhorst-Hohorst did not address the classical arm’s-length adjustment of interest rates under Article 9 OECD Model, since section 8a KStG led to a complete redetermination of all interest payments into hidden profit distributions. However, the loan from the Dutch parent to the German subsidiary was cheaper than the bank loan it replaced and thus seemingly not intended to extract excess interest from the subsidiary. Thus, if the arm’s-length principle under Article 9 OECD Model were applied to the interest rate charged by the Dutch parent, Germany (step 1) would have had to tax the subsidiary on the difference between an arm’s-length interest rate and the cheaper intercompany rate, and (step 2) grant the subsidiary a deduction for the deemed-paid full arm’s-length interest rate.

It can easily be derived from Lankhorst-Hohorst that all unfavorable transfer pricing adjustments that apply only to transactions with nonresident related persons constitute a restriction on the freedom of establishment or the freedom of capital movement, as relevant. However, it seems that the ECJ did not care much for dealing with the more general transfer pricing issues or with recharacterizing interest payments beyond the specific issues raised by the German thin capitalization rules in Lankhorst-Hohorst. This may explain why the court did not consider the impact and breadth of the EC issue on Article 9 OECD Model. The following discussion therefore aims to reconcile the holding in regard to Article 9 OECD Model in Lankhorst-Hohorst with Gilly in which the ECJ basically found that the allocation of tax rights in a tax treaty is neutral and thus not discriminatory. Further, the relationship between primary and secondary law. Thus, even though Article 9 OECD Model permits arm’s-length adjustments, the ECJ’s case law clearly forbids such adjustments if they are applied only in cross-border settings and therefore lead to disadvantageous treatment of cross-border transactions, as opposed to domestic transactions.

Article 9 OECD Model: Tension Between Lankhorst-Hohorst and Gilly?

The arm’s-length principle under Article 9 OECD Model is an international method accepted method for countries to stake their tax claims. Thus, the issue arises whether Article 9(2) of the OECD Model may be considered in the case and the incompatibility of the thin capitalization rules under the OECD Model with respect to thin capitalization rules may lead to economic double taxation in Germany and the country of the interest recipient if that country does not recognize the German thin capitalization rules as a defense to the thin capitalization rules. The ECJ’s case law clearly forbids such adjustments if they are applied only in cross-border settings and therefore lead to disadvantageous treatment of cross-border transactions, as opposed to domestic transactions.

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rendered nondiscriminatory if the par-

ten's country of residence makes cor-

responding adjustments to avoid economic double taxation. It can be

argued that, if this were true, such adjustments do not lead to disadvan-

tageous treatment of cross-border financ-

ing as opposed to domestic financing.

The prevailing opinion in legal

scholarship holds that the treatment in the parent's country of residence is not

relevant to a justification of a discrimi-

natory tax provision in the subsidiary's

country of residence. Nevertheless, the

issue should be considered in a broad-

er framework, raising the general ques-

tion: when must the case be cut, or shall

the matter be dealt with? The latter view

seems preferable. First, ECJ case law

seems to proceed in this direction.

Second, if discrimination must be eva-

luated from the perspective of one

country, it would be asymmetri
cal to consider taxation in another state
to potentially justify this discrimination.

Third, if the tax situation in the other

country is taken into account without reservation, conformity with EC law
would depend on legislation and administra-
tive acts in the other country, which

would not be compatible with the sovereign status of national

law taxation still existing in the EU.

This said, the issue nevertheless seems
different when a member state, for instance,
takes a restricting measure, but makes

sure, in a bilateral or multilateral agree-

ment, that the discrimination is cured in

another member state. It is possible that

this possibility was introduced by De Groot,

which involved whether the state of residence must take into account its

residents' personal and family cir-

cumstances in the full amount, as opposed
to an amount proportional to the per-

centage of income earned in the other

country.

The method considered in De Groot

is that member states would agree on a

bilateral agreement and in deviation from

the ECJ's case law to allocate per-

sonal deductions in the same propor-

tion as the taxpayer's earnings in the

state of residence and the state of

employment. Thus, for instance, 30%

income in the state of residence and 70%
in the state of employment would

lead to the same ratio of personal
deductions. In principle, the ECJ

rejects a pro rata allocation under EC law,

but it does allow member states to agree
to such an allocation by way of a

bilateral or multilateral treaty.

If this idea was transferred to the

issue of corresponding adjustments, it

would mean that a discriminatory

measure of one member state might be

accepted as, for example, as member state

is interested, in the event, does make an appropriate corre-

sponding adjustment. It seems that

member states have a strong argument in favor of applying arm's-

length principle to the Contracting States. The State of residence can therefore be released by way of an

international agreement from its

obligation to take into account in
d
full the personal and family situa-
tion of taxpayers residing in its ter-

ritorial who work partially abroad.

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itorial who work partially abroad.
Although such procedures provide for a result, they are not penalized compared with cooperation between companies of different member states, as long as the measures are twofold. First, the residence country of a parent company that receives a cross-border distribution from its subsidiary must either exempt the distributions from corporate tax or grant an indirect deduction. Second, to ensure fiscal neutrality, the profits that a subsidiary distributes to its parent company are exempt from withholding tax in the subsidiary’s country of residence.29

Withholding tax exemption. The latter rule, as laid down in Article 5 of the Directive, is as simple as it can be: “Profits which a subsidiary distributes to its parent company shall be exempt from withholding tax.” Article 7(1), however, raises a complication by providing that “withholding tax shall not cover an advance payment or prepay- ment (prospective) of corporation tax to the Member States of the subsidiary which is made in connection with a distribution of profits to its parent company.”

ECJ case law. The ECJ’s case law has given some guidance on how to understand “distribution of profits” and “withholding tax” as set forth in Article 5 of the Directive. In Epson, the ECJ clearly stated that the “term withholding tax contained in it is not limited to certain specific types of national tax- ation.”30 Further, the nature of a tax, duty, or charge must be determined with regard to its objective characteristics, irrespective of its classification under national law. The Epson and Athinaiki Zythopoiia cases clarified that any tax on income received in the state in which dividends are distributed is a withholding tax on distributed profits for purposes of Article 5 of the Directive where the charge- able event for the tax is the payment of dividend income from shares, the taxable amount is the income from those shares, and the taxable person is the holder of the shares. These considerations can be con- sidered settled case law.

German imputation system. Since the promulgation of the German Ausschüttungsbelastung (“distribution burden”), which qualifies as a corporate tax under German domestic tax law, it is worthwhile to take a brief look at the German imputation system as it is in force during the relevant years in Lankhorst-Hohorst.31 Under that system, undistributed income of a corporation generally was subject to a tax of 45% (section 23(1) KStG) or a lower or zero rate under special provisions or exemptions (Tarif- belastung), but the corporate tax was only decreased or increased to 30% when profits were distributed (section 27(1) KStG (“Ausschüttungsbelastung”)).

Thus, the Ausschüttungsbelastung had two forms. If corporate income was subject to full corporate taxation, the 45% corporate tax burden was distributed to the shareholder; in other words, only a 30% corporate tax was levied on distrib- uted income. On the other hand, if the corporate income was taxed at a low or a zero rate (for example, because of tax exemptions), the corporate tax was increased to 30% through the Ausschüttungsbelastung, which equal- ized the German tax burden on every domestic profit distribution to neutralize the imputation credit.32 Also, a 25% withholding tax was imposed on the distribution. These considerations can be con- sidered settled case law.

Application in Lankhorst-Hohorst. In Lankhorst-Hohorst, the German tax authorities classified the interest payments as hidden profit distributions under Section 8a of KStG, increased the income tax on dividends by 30% (§ 36(2)(3) EStG), and thus could be considered a further obsta-cle to the application of the Parent-Subsidiary Directives (ESG) (“Tarifbelastung” (for example, 45% corporate tax)). Also, that classification of withholding tax were also present in the application of the Parent-Subsidiary Directives (ESG) (“Tarifbelastung”), which qualifies as a corporate tax under German domestic tax law, it is worthwhile to take a brief look at the German imputation system as it is in force during the relevant years in Lankhorst-Hohorst. Under that system, undistributed income of a corporation generally was subject to a tax of 45% (section 23(1) KStG) or a lower or zero rate under special provisions or exemptions (Tarif- belastung), but the corporate tax was only decreased or increased to 30% when profits were distributed (section 27(1) KStG (“Ausschüttungsbelastung”)).

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excluded from “withholding tax” by means of Article 7(1) of the Directive.

As to the first issue, it seems clear that the source state, which reclassifies interest payments as hidden distributions, must grant the benefits provided by the Parent-Subsidiary Directive.37 This conclusion implicitly underlies the reasoning of the AG in Lankhorst-Hohorst. Indeed, it would be cynical if a member state was allowed not only to treat interest payments as profit distributions, but to argue that the interest is not the kind of profit distribution covered by the Directive, since that position would lead to the double taxation that the Directive aims to eliminate.

As to the second issue, the AG’s finding is somewhat surprising. The German government had argued that the Ausschüttungsbelastung “is not a withholding tax but normal taxation of the profits of the subsidiary, in the form of corporation tax.”38 This statement has merit. If the AG’s argument in the event of a reclassification of domestic thin capitalization rules were correct, it would equally apply when a corporation simply makes profits and immediately distributes them to its EU shareholders. However, the 30% Ausschüttungsbelastung is usually achieved by a reduction of the 45% Tarifbelastung.

Before the French tax reform of 2004 took effect39 and assuming, as in Athinaiki Zythopia,40 that the “term ‘withholding tax’ as used in this Directive shall not cover an advance payment or prepayment (précompte) of corporation tax to the Member State of the subsidiary which is made in connection with a distribution of profits to its parent company”41 the AG’s argument could be questioned with regard to Article 7(1) of the Directive, which the AG did not even mention. This provision states that the “term ‘withholding tax’ as used in this Directive shall not cover an advance payment or prepayment (précompte) of corporation tax to the Member State of the subsidiary which is made in connection with a distribution of profits to its parent company.”42

The FINANCIAL CENTRAL BOARD OF TAXATION recently published an avoir fiscal tax credit for shareholders. However, the purpose of the avoir fiscal tax credit, aimed at avoiding double taxation of residual gain on corporation simply makes profits and immediately distributes them to its EU shareholders. However, the 30% Ausschüttungsbelastung is achieved by a reduction of the 45% Tarifbelastung.


42 See Hintsanen and Pettersson, note 38, supra.

43 For example, Italy repealed the Finish compensatory tax.

44 The Finnish Central Board of Taxation recently published an avoir fiscal tax credit for shareholders. However, the purpose of the avoir fiscal tax credit, aimed at avoiding double taxation of residual gain on

45 This reasoning raises the question of the relationship between Article 7(1) and equalization taxes in imputation-system countries, as implied by the Court of Justice in Lankhorst-Hohorst clearly reflects the language of the Directive and is in line with the ECJ’s decision in Athinaiki Zythopia, it still could be questioned why Article 7(1) of the Directive explicitly uses the term “précompte.” It was intended to extend the exception to the French précompte in general and thus beyond an “advance payment or prepayment,” there are good reasons why the German Ausschüttungsbelastung should have been covered by Article 7(1) as well.

46 The reasoning of the ECJ in Athinaiki Zythopia seems to overrule the prevailing opinion toward the meaning of Article 7(1) of the Directive. The court stated that the “taxation relates exclusively to a benefit which is taxed only in the event of a dis-
Economic Substance
(Continued from page 56) above, the DGT considers the following:
• To evaluate the existence of valid eco-
nomic motives, all circumstances of the
transaction, the legal and factual context,
including the practical result obtained. If a negative result is pro-
duced, i.e., a failed business pro-
posal, the transaction is only sufficiently explained, it has the burden of proving the
non-existence of a valid motive.
• If a case falls within the rule that disposit-
is applicable of the special system when the transaction is not carried out for valid economic motives but rather for the pur-
pose of obtaining a tax benefit, the tax
administration need not prove the exis-
tence of tax avoidance. Therefore, the system will not apply
when (1) the primary purpose of the transaction is tax avoidance;
and (2) valid economic motives do not exist and the sole purpose of
the transaction is to obtain tax sav-
ings. In conclusion, it is not suffi-
cient for there to be any type of
restructuring or rationalization—
only those carried out for valid eco-
nomic motives are eligible for deferred tax treatment—and then there
is no tax savings. This is where
we find the contradiction, however.
A transaction may have no eco-
nomic motive and still not have tax
avoidance as its primary purpose,
yet the tax administration refus-
es eligibility for the special system.
• Not only the main transaction but also preparatory transactions and
those carried out subsequently may be analyzed, as they may constitute
proof of a valid business restruc-
turing or that a tax advantage is pri-
marily sought.
Finally, and for the purpose of eval-
uating whether the objective of the transaction is to obtain a tax advan-
tage, the taxation of the parties before and after the transaction must be analyzed to evaluate the tax sav-
ings, if any.
Consequently, to evaluate the main economic reason for the transaction, it appears that the tax burden of the companies involved, both before and after the transaction, must be com-
pared to determine whether this tax burden has decreased significantly as
a result of the transaction. Subse-
quent, the economic advantages (e.g.,
volume of activity and resources) that
are transferred or premises that are identified and it must be determined whether these advantages are propor-
tions to the tax benefits. If the economic motive is more rel-
ent than the tax savings obtained, the tax administration should not dispute eligibility for the special system.

Interplay Between Parent-
subsidiary and the interest and Royalties Directives
The proposal for a Council Directive in Lankhorst-
Hohorst also raise the question of whether the Parent-Subsidiary Direc-
tive and the recently issued Interest and Royalties Directive supplement each other with regard to thin capitalization:
reclassifications and transfer pricing adjustments of interest rates. Article 1 of the Interest and Royalties Directive requires member states, under certain pre-
quises, to exempt interest and royalties from the withholding tax under sections 43 and 43a EStG, which formally refer to the
non-existence of a valid motive. Article 2(a) of the Directive reflects Article 11(3) OECD Model,
defining interest as “income from debt-
claims of every kind, whether or not
secured by mortgage and whether
may not levy a withholding tax on the
distribution. Thus, Article 5 of the Direc-
tive may play an important role in
transfer pricing cases and may thereby
have an influence on whether the parent’s country of resi-
dence must grant a tax credit for with-
holding taxes levied on the “interest on transactions” by the source country.

Implications for Reclassified Interest Payments Under Thin Cap Rules and “Secondary Adjustments”

Arm’s Length Principle
(Continued from page 43) Finance Bill for 2004 will repeal the imputation sys-
tem and the prerequisite of January 1, 2005; and Finland intends to abolish its imputation system and the compen-
satory tax by January 1, 2005.54

54 See Hirt and Petersen, supra note 39, page 198, of “Railways “Working Group Rec-
ommends Tax Cuts, Revocation of Dividend

55 This approach seems broadly consistent with the treatment of reclassified interest payments under sections 43 and 43a EStG in the German OECD Model, which provides for a reduction of withholding tax on interest and royalties charged where the source state taxes the income of the payer at higher rates. See OECD, Commentaries to the Model Tax Convention on Income and Capital 2003 (2003); Article 10B. In issue in International Taxation No. 27 Thin Capitalization (Paris, 1987), the OECD Council on Fiscal Affairs con-
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58 The possibilities include the 25% withholding tax rate under German domestic law (section 43, 43a EStG) and the reduced treaty rate of 5% (determined under the German-Dutch income tax treaty).

59 The question boils down to whether the reclas-
cification is barred by the prohibition on the
administration of thin capitalization „reclassifica-
tions” paragraph now clearly
should be assessed, where the beneficial own-
der the provisions of this Directive shall
apply only to the latter amount, if any.”

60 Reforms and their possible effect on interest withholding is evidenced by a clearly expressed article in this Arti-
cule 4 (now Article 4(1)) by stating that

61 According to Article 1(1) of the Directive, the expection applies only if the payer and payee are associated companies. Companies are asso-
ciated when one has a direct minimum holding of 25% in the equity of another company where a third party company has a direct minimum holding of 25% in the equity of one of these companies.

62 Proposal for a Council Directive on a common system of taxation applicable to interest androyalties payments made by the payer andbeneficial owner in the absence of such relationship, the provisions of the Directive shall only be applied to such transactions. Although this proposed version made explicit reference to thin capitalization as a means to prevent such “tax avoidance relationships” paragraph now clearly refers only to situations where the inter-

63 Article 4(1)(a) and (2) of the Directive also covers thin capitalization rules based on reclassification of a loan as an equity irrespective of an arm’s-length inquiry. However, Article 4(2) clearly is not concerned with the interest rates and renders the Directive inapplicable to the amount that exceeds the amount of interest.

64 Articles 4(1)(a) and (2) of the Interest and Royalties Directive thus raise the question of whether the Par-

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Further, the Parent-Subsidiary and Interest and Royalties Directives may play a major role with regard to thin capitalization rules and secondary adjustments in transfer pricing cases. The AG’s reasoning in Lankhorst-Hohorst and existing case law make it clear that member states must not levy withholding taxes on deemed profit distributions in a qualifying subsidiary-parent relationship when those distributions result either from a reclassification of interest payments under thin capitalization rules or secondary adjustments in the form of dividends under transfer pricing rules. Application of the arm’s-length principle may also lead to situations where payments are split between an accepted amount of interest and a deemed profit distribution in the amount exceeding the arm’s-length interest rate. If the respective prerequisites are met, the Parent-Subsidiary Directive takes over where the Interest and Royalties Directive stops. Although the latter arguably does not apply to the reclassified interest payments according to Articles 4(1)(a) and 4(2), the former will. Thus, in many instances the interplay between these Directives will effectively rule out the possibility of member states levying withholding taxes on (purported) interest payments from a qualifying subsidiary to its EU parent company.

But even if transfer pricing and thin capitalization rules were in compliance with EC tax law, there would still be broad areas that give rise to cross-border disputes detrimental to the smooth functioning of the internal market and that create additional costs both for business and national tax administrations. Thus, the harmonization attempts by the Commission and the establishment of an “EU Joint Transfer Pricing Forum” with member states and business representatives raise hopes for a taxpayer friendly solution of many issues revolving around transfer pricing, such as documentation requirements and possible preventative measures to avoid double taxation (e.g., advance pricing agreements). The accession of the new member states to the EU on May 1, 2004, should also put additional focus on the future of the EC Arbitration Convention.