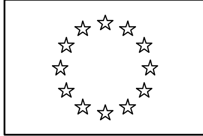

EUROPEAN COMMISSION
DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
Direct taxation, Tax Coordination, Economic Analysis and Evaluation
Company Taxation Initiatives

Brussels,
Taxud/D1/
January 2011

DOC: JTPF/006/BACK/2011/EN

EU JOINT TRANSFER PRICING FORUM

BELGIAN CONTRIBUTION ON THE INTERACTION BETWEEN ARTICLE 4(2) OF THE ARBITRATION CONVENTION AND ARTICLE 7 OF DTAS CONCLUDED BETWEEN EU MEMBER STATES

Meeting of 10 February 2010

Centre de Conférences Albert Borschette
Rue Froissart 36 - 1040 Brussels

Interaction between Article 4(2) of the EU Arbitration Convention and Article 7 of the Double Tax Agreements concluded between EU Member States

The EU Arbitration Convention establishes rules to resolve disputes where double taxation occurs between associated enterprises of different EU Contracting States as a result of an adjustment of the profits of one of those enterprises. The EU Arbitration Convention is a multilateral treaty concluded between the EU member states (Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises). For the purposes of the Convention, Article 1(2) deems a permanent establishment of an enterprise of a Contracting State situated in another Contracting State to be an enterprise of the State in which it is situated.

1. Article 4(2) of the EU Arbitration Convention

Article 4 of the Convention states the principles that must be observed in the application of the Arbitration Convention. According to Article 4(2):

> *"Where an enterprise of a Contracting State carries on business in another Contracting State through a permanent establishment situated therein, there shall be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

On the basis of the Arbitration Convention:

- A Contracting State may adjust the profits attributable to a permanent establishment according to the principles of Article 4(2).
- Under Article 6 an enterprise may present a case to the competent authority of the Contracting State in which its permanent establishment is situated where it considers that those principles are not observed by a Contracting State having adjusted the profits attributable to that permanent establishment.
- Article 6 commits the concerned competent authorities to endeavour to resolve the case by mutual agreement on the basis of the same principles.
- According to Article 11, the advisory commission must base its opinion on Article 4(2).
- Finally, the concerned competent authorities must, on the basis of the principles of Article 4(2), take a decision which will eliminate the double taxation.

The principles set out in Article 4(2) condition the application of the Convention at each level as of the taxation by a Contracting State until the final decision eliminating double taxation.

2. Principles applicable under bilateral tax treaties containing an Article 7 similar to Article 7 of the OECD Model Tax Convention as it reads before 22 July 2010

The text of Article 4(2) reproduces almost wholly the text of Article 7(2) of the OECD Model Tax Convention as it reads before 22 July 2010 (such text is included in most of the bilateral tax treaties concluded between the EU member States):

> *"2. <u>Subject to the provisions of paragraph 3</u>, where an enterprise of a Contracting State carries on business in <u>the</u> other Contracting State through a permanent establishment situated therein, there shall <u>in each Contracting State</u> be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the*

same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

Article 4 does not contain the text of Article 7(3) of the OECD Model.

> *"3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere."*

OECD has fundamentally changed the principle governing the attribution of profits to a permanent establishment in the Report entitled *"Attribution of Profits to Permanent establishments"*, which was approved by the OECD Committee on Fiscal Affairs in 2008. The Report represents the outcome of the work on how the "separate arm's length enterprise" provision of Article 7 should be applied.

The conclusions of the Report were implemented in the OECD Model Tax Convention in two stages.

The first stage was the revision of the Commentary on Article 7 as Article 7 reads before 22 July 2010. This stage was completed in the 2008 Update of the OECD Model. It was aimed at implementing the conclusions of the Report that do not conflict with the interpretation previously provided in the Commentary on Article 7.

Under the OECD Commentary on Article 7(2) updated in 2008, Sections D2 and D3 of Part I of the Report *"Attribution of Profits to Permanent establishments"* is applicable in order to determine the profits attributable to a permanent establishment, including the profits attributable to dealings with other parts of the enterprise (see especially paragraph 17 of this Commentary).

The OECD Commentary on Article 7(3) updated in 2008 has clarified the general directive in relation to the expenses of a permanent establishment laid down in paragraph 2. It has endorsed the previous OECD Commentary with respect to intangible rights, services and interest charges departing from the authorised OECD approach provided for in the Report *"Attribution of Profits to Permanent establishments"* (e.g. presumption that services which are related to the general management activity of the enterprise should normally be allocated at cost, no internal interest dealings in non-financial enterprises, no internal royalty dealings). To the extent that the Report contains some departures from what was previously said in the Commentary on Article 7(3), there was indeed a risk that Courts express doubts about the validity to interpret Article 7 on the basis of the whole Report, including those departures[1].

The second stage was the finalization of a completely new article 7 with related Commentary changes in the 2010 Update of the OECD Model.

3. Principles applicable under bilateral tax treaties containing an Article 7 similar to Article 7 of the 2010 Update of the OECD Model Tax Convention

---

[1] The Vienna Convention on the Law of Treaties recognizes that practices that have been previously followed by tax administrations and that show that countries have agreed on a certain interpretation are relevant for the interpretation of a treaty provision (under Article 31(3), the context in which a treaty must be interpreted includes "(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation."

The text of Article 7(2) of the OECD Model Tax Convention as changed on 22 July 2010 reads as follows:

> *"For the purposes of this Article and Article [23 A] and [23 B], the profits that are attributable in each Contracting State to that permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, 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 by the enterprise through the permanent establishment and through the other parts of the enterprise."*

The text of previous Article 7(3) is considered useless and is deleted.

The Report *"Attribution of Profits to Permanent establishments"* is wholly applicable under the new Article 7. The new Article goes further than before in treating the permanent establishment as a separate and independent enterprise and in recognizing the dealings between the permanent establishment and the other parts of the enterprise. It provides a greater level of consistency between the taxation of branches and the taxation of subsidiaries under tax treaties. For instance, under this new approach, dealings in the nature of a license provided by a head office (the economic owner of the intellectual property) to a permanent establishment that is using the intellectual property will be recognized. The notional license will give rise to a notional royalty from the permanent establishment to the head office and will reduce the profits of the permanent establishment by the amount of that notional royalty.

The separate and independent enterprise fiction (including the recognition of notional dealings and notional payments) is confined to determining the attribution of profits to a permanent establishment under Article 7 and Article 23 (Elimination of double taxation).

4. The arm's length principle applicable under Article 4(2) of the EU Arbitration Convention

The drafters of the Arbitration Convention have worded the arm's length principle similarly as it was generally worded, at that time, in the bilateral tax treaties but without referring to those treaties. This seems due to the lack of tax treaties between some EU member states and to the inconsistent wording of Articles 7(2) (and 9) in tax treaties.

The aim of the arm's length principle of Article 4(2) is to solve double taxation resulting from conflicting approaches within the European Union between tax administrations and between tax administrations and enterprises with respect to the attribution of profits to permanent establishments. In order to fully achieve that aim, the Contracting States, their competent authorities and the advisory commission should rely on a common interpretation of the arm's length principle on the basis of which the profits should be attributed.

The EU Arbitration Convention itself does not contain any substantive rules as to how the general "arm's length principle" it endorses should be understood. Consequently, it must be considered whether the Contracting States, the competent authorities and the advisory commission may freely decide the rules to be followed under the Arbitration Convention or whether they are bound to international rules when applying the Convention. If they are bound to international rules, those rules should be specified.

The assessment and the allocation of income between an enterprise of a Contracting State and its permanent establishment have to be based on the domestic laws of the Contracting States and also on the provisions of Article 7 of the tax treaty entered into by the concerned Contracting States and of Article 4(2) of the Arbitration Convention which are directly applicable. It is normally on that basis that an enterprise determines the dealings between

the different parts of the enterprise and that tax administrations control those dealings. In this respect, the provisions of Article 7 of the concerned treaty and their interpretation are especially relevant in order to apply the Arbitration Convention[2].

The relevance of the tax treaty in force between the concerned countries in order to define the concept "at arms' length" is confirmed by Article 3(2) of the Arbitration Convention, which refers for any term not defined in the Arbitration Convention (and unless the context otherwise requires) to the meaning that the undefined term has under the tax treaty between the concerned countries.

Due to the divergences in the application of the profits attribution rules between states, enterprises face uncertainty as to whether the rules accepted in one state will subsequently be accepted in another state. In this respect, the OECD Commentary on Article 7 is of great assistance in the application and interpretation of that Article. Tax administrations and taxpayers give great weight to the guidance contained in that Commentary. Observations have sometimes been inserted at the request of some OECD Member countries that do not endorse an interpretation given in the Commentary. Those observations usefully indicate the way in which those countries will apply Article 7 of their tax treaties. The OECD Commentary has been approved by the representatives of the OECD Member countries (apart from some observations), and consequently is part of the international legal order that the EU member states should follow in order to comply with the legal basis of Article 4(2).

In this respect, the Revised Code of Conduct for the effective implementation of the Arbitration Convention provides that *"The arm's length principle will be applied, as advocated by the OECD, without regard to the immediate tax consequences for any particular Member State."* but does not specify if the arm's length principle advocated by the OECD should apply as revised from time to time (evolutionary interpretation) or not.

Different approaches can be followed in order to determine which rules shall apply to attribute profits to a permanent establishment.

<u>Option I</u>

The EU member states could agree that the principle "at arm's length" of Article 4(2) shall have the same meaning than the principle "at arm's length" of the Article on business profits included in the bilateral tax treaty concluded between the concerned states. Consequently, the tax administrations, the competent authorities and the Advisory Commission should take into consideration the interpretation given by the OECD Commentary on the provisions of Article 7 (including the observations of some states) corresponding to the provisions included in the concerned tax treaty.

The reference to the meaning of the concept "at arms' length" under a bilateral tax treaty shall imply that such meaning is taken into consideration even where the wording of Article 7 of the treaty differs from the wording of Article 4(2).

<u>Examples</u>:
Where the concerned treaty contains the provisions of Article 7(2) and (3) of the OECD Model as it reads before 22 July 2010, the principles of Article 4(2) will be interpreted on the basis of the OECD Commentary on Article 7 contained in the 2008 Update. This will be the case, even if such Commentary restricts the application of the Report "Attribution of Profits to Permanent establishments" by reason of the provisions of Article 7(3) which are not included

[2] The Vienna Convention on the Law of Treaties recognizes that any relevant rules of international law applicable in the relations between the parties should be taken into consideration in interpreting a treaty provision (Article 31(3)(c)).

in Article 4(2) and even if, therefore, it could be argued that the Report should be entirely applicable in the context of Article 4(2).

Where the concerned treaty contains the provisions of Article 7(2) of the OECD Model as it reads in the 2010 Update, the principles of Article 4(2) will be interpreted on the basis of the OECD Commentary on Article 7 contained as of the 2010 Update. This will be the case, even if the wording of that provision is different from the wording of Article 4(2) and if, therefore, it could be argued that such Commentary should not apply.

Where the concerned treaty contains the provisions of Article 7(2) and (3) of the UN Model Double Taxation Convention, the principles of Article 4(2) will be interpreted on the basis of the UN Commentary on Article 7 that will be contained in the 2011 Update of that Model.

Where no treaty exists between the EU member states concerned by the application of the Arbitration Convention, the EU member states should expressly agree that the principle "at arm's length" of Article 4(2) has the same meaning than the principle "at arm's length" interpreted in the OECD Commentary as of the 2010 Update. As Article 4(2) does not contain the provisions of Article 7(3), the wording of Article 4(2) is large enough to cover all the rules provided for in the Report *"Attribution of Profits to Permanent establishments"*.

Those agreements could be included in the Code of Conduct for the effective implementation of the Arbitration Convention.

Advantages: Option I reconciles the rules governing the attribution of profits under bilateral tax treaties in force between the different EU member states and under the Arbitration Convention. It can be based on Article 3(2) of the Arbitration Convention.

Disadvantages: Option I endorses the application of two different sets of rules in order to attribute profits to a permanent establishment. Where several parts of an enterprise are situated in several states between which different treaty provisions are applicable, this option renders the attribution of profits to a permanent establishment more complicated and gives rise to mismatches.

Example: An enterprise situated in State A has a PE in State B and a PE in State C. The tax treaty between State A and State B contains the new OECD Article 7 while the treaty between State A and State C contains the old OECD Article 7. A piece of software developed by the PE situated in State B is used by the PE situated in State C.
In order to determine the benefits attributable in States A and B to the PE situated in State B, the economic ownership of the software shall be attributed to the PE in State B and a notional royalty for the use of the software by the PE situated in State C shall be added to the benefits attributable to the PE situated in State B.
In order to determine the benefits attributable in States A and C to the PE situated in State C, a part of the actual costs of the development of the software shall be allocated to the PE situated in State C by reason of the use of the software by that PE and shall be deducted from the benefits attributable to that PE.

Option II

In order to achieve a uniform application of the principle "at arms' length" among all the EU member states, the member states could agree that the principle "at arm's length" of Article 4(2) has the same meaning than the principle "at arm's length" interpreted in the OECD Commentary as of the 2010 Update. As Article 1(2) deems a permanent establishment to be an enterprise of the State in which it is situated, the wording of Article 4(2) seems large enough to cover all the rules provided for in the Report *"Attribution of Profits to Permanent*

establishments" based on the fiction that the permanent establishment is a separate and independent enterprise.

In order to achieve that goal, pre-eminence should be given to the Arbitration Convention in relation to the bilateral tax treaties that contain the old Article 7(2) and (3) of the OECD Model. In this respect, it can be argued that:

- Article 3(2) of the Arbitration Convention is not applicable to the meaning of the principle "at arm's length" of Article 4(2) because such application would go beyond the reference to the meaning of a term not defined in the Convention.
- Articles 3(2) and 15 of the Arbitration Convention imply that, except where the Arbitration Convention expressly provides otherwise, that Convention prevails over any treaty to which the Contracting States are or will become parties.
- It corresponds to the intent of the States having concluded the Arbitration Convention: they have included in Article 4 an autonomous definition of the principles "at arm's length" without referring to the corresponding principles included in Articles 7 and 9 of the bilateral treaties concluded between most of the EU member states; they have deemed a permanent establishment to be an enterprise of the State in which it is situated.

Advantages: Option II achieves a uniform application of the principle "at arms' length" among all the EU member states. It endorses the approach that most of the OECD member states have agreed to follow in the future.

Disadvantages: Some taxpayers could contest that interpretation where the applicable bilateral tax treaty contains Article 7(2) and (3) of the OECD Model as it reads before 22 July 2010.

Option III

In order to achieve a uniform application of the principle "at arms' length" among all the EU member states, the Arbitration Convention could be revised in order:

- to replace the text of Article 4(2) by the text of Article 7(2) of the 2010 OECD Update;
- to stipulate that the OECD Commentary on Article 7(2), as amended from time to time, shall be used in order to interpret such provision;
- to stipulate expressly that the provisions of the Arbitration Convention shall prevail over the provisions of a bilateral tax treaty.

Advantages: Option III provides more certainty with respect to the rules governing the attribution of profits under the Arbitration Convention and the pre-eminence of those rules over the rules provided for in bilateral tax treaties.

Disadvantages: Option III needs a lengthy procedure in order to be in force and applicable. The implementation of Option III is outside the mandate of the EU Transfer Pricing Forum.