Conference on "EU Corporate Tax Reform: Progress and New Challenges"

Session on "Tax Treaty Policies of Member States"

DISCUSSION DOCUMENT[1]

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The way forward on double taxation conventions of Member States

1. There are growing divergences between established principles of international tax law (on the basis of which existing double taxation conventions - "DTCs" - have been concluded) and the rules of EC tax law – these divergences are growing as the ECJ hands down decisions which differ from established principles of international tax law.
   Eg. St. Gobain[3] – established principles of international tax law would not have recognised a permanent establishment as enjoying the benefits of host-state DTCs.

2. The existing network of (largely) bilateral DTCs has grown over almost a century to remove barriers to cross-border trade and investment and has worked well in that context. Any changes to remove barriers to the Internal Market or to relieve perceived issues of double taxation need to be justified by clear evidence that the existing network is not sufficient.

3. Nevertheless, because of point 1, it is clear that MSs' existing DTCs need to be amended to conform with the developing rules of EC tax law as elaborated by the ECJ jurisprudence, by legislation and by soft-law in this area, specifically:

   a. The Parent-Subsidiary Directive
   b. The Mergers Directive – for which there are presently no equivalent provisions in DTCs
   c. The Arbitration Convention
   d. The Interest and Royalties Directive

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[1] This document has been prepared as a basis for discussion only. It is intended to raise issues rather than express a concluded view on its subject matter. The views expressed are entirely those of the author. It should not be quoted without reference to the author.

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[3] Case C-307/97.

e. The Savings Income Directive
f. The Mutual Administrative Assistance Directive
g. The Mutual Assistance in Recovery Directive
h. Soft law in the code of conduct
i. Soft law on cross-border workers

4. Looking ahead, it seems almost indisputable that there will be a difference in the approach taken to intra-MS DTCs ("horizontal harmonisation") and DTCs with third states ("vertical coordination"):

    a. Intra-MS DTCs are subject to the legislation and soft law in this area. Arguably, the (slowly) growing network of directives relating to direct taxation will ultimately replace intra-MS DTCs. Intra-MS DTCs may gradually wither away. (Is there any reason for MSs' DTCs to now have an Art. 26 MTC[4] (exchange of information) or a new Art. 27 (cross-border enforcement) when this would simply overlap with the existing Directives on this area? Arguably even Art. 24 is unnecessary since the EC is based up non-discrimination). Intra-MS DTCs may gradually grow shorter as they are displaced by legislative provisions, and ultimately disappear entirely.

    b. Third state DTCs are, however, subject to the impact of EC tax law in a different way. Most legislation and soft law does not apply to them. However, it would be wrong to assume that EC tax law will have no impact on these DTCs: it is probable that some DTCs negotiated with third states over the past 50 years have provisions incompatible with EC tax law as it is being developed by the ECJ. The classic example is the limitation of benefit article in many third state DTCs. There is a clear parallel here with the Open Skies cases.[5]

        There is no reason to assume, however, that DTCs with third states will disappear (or grow any shorter). They are likely to remain the major instrument for avoiding international double taxation with third states for the foreseeable future. The task here is to ensure that these third state DTCs are compatible with EC law.

5. The Commission Study on Company Taxation (Oct 2001) (pages 284-289) identified a number of issues not covered within the scope of existing DTCs. Primarily, these are issues for intra-MS DTCs. These issues include:
    a. Triangular situations;
    b. Deduction of pension contributions;
    c. Treatment of stock options;
    d. Relationship with anti-deferral and anti-abuse provisions;

[4] This refers to Article 26 of the OECD Model Tax Convention.
[5] See especially Case C-476/98

e. Cross-border loss compensation.

With the probable exception of the last issue, one wonders how far some of these issues could not be dealt with by a Directive, which would alleviate the need to attempt solutions to these issues in a multitude of bilateral DTCs.

To these issues one might add others, which have not yet been placed on the agenda. These may include:

f. Cross-border taxation of estates and inheritances. Given the small number of existing DTCs in this area, it would make more sense to try to work on a directive (or regulation) aimed at avoiding double taxation rather than waiting for the network of intra-MS DTCs to catch up. There is an OECD Model convention which offers a pattern for the basic principles, and existing conventions between MSs may indicate acceptable solutions.
g. Taxpayer protection within the EU – not a topic presently covered extensively by DTCs, but a worthy topic for inclusion on the agenda.
h. (More contentious) The attribution of profits to permanent establishments – working towards a directive/regulation based upon the OECD consensus (?) on this topic.

In principle, one might follow the order of Articles in the OECD Model to see how far each Model Article presents a solution which has proved acceptable to MSs in their DTCs and might prove acceptable to them in the form of a Directive. Thus, one might start with a Directive on resolving issues of dual residence (Art. 4 MTC), a Directive on a common definition of the concept of permanent establishment (Art. 5 MTC), a Directive on the taxation of shipping profits (Art. 6 MTC) and so on.

6. The Commission Study (pages 357-363) and the recent Communication (COM (2003) 726 (pages 10-11) discuss possible ways forward with respect to DTCs (though without distinguishing between intra-MS DTCs and third-state DTCs). These are:
   a. A multilateral tax treaty between all MSs;
   b. The development of an EU Model;
   c. Work on specific EU concepts within the OECD

   These are discussed below.

7. <u>A multilateral tax treaty between all MSs</u>. To the extent that this refers to a multilateral DTC between MSs (replacing intra-MS, bilateral DTCs), it seems unnecessary. These DTCs are being replaced by Directives. There is no reason to believe that a multilateral DTC would be any easier to negotiate than further Directives, (in fact the converse will probably be true), and may be harder to amend over time.

8. If the proposal refers to a multilateral DTC between all 25 EU MSs and individual third states, then the chances of achieving such a result seem almost negligible. In any event, one wonders if it would be desirable in any event. The very reason why international tax law opted for bilateral DTCs in the 1920s was because each

DTC has to be negotiated in the context of the tax system of the treaty partners. In the existing EU, where sovereignty over direct taxation remains clearly with MSs (subject to the rules of Community law), with highly divergent domestic tax systems of MSs, concluding a multilateral agreement with a single third state would involve immense complexity (even more so if a group of third states were involved).

9. On the issue of external competence, it is highly doubtful that competence to conclude DTCs has either shifted to the Community or is shared between MSs and the Community – Open Skies clearly has a bearing here, but one must not forget that the context of air transportation is not the same as the context of national direct tax systems. Art. 293 clearly contemplated MSs negotiating agreements for the relief of international double taxation. (That is not to suggest that there is no role for the Commission in this field – that point is considered below.)

10. If competence had been acquired by the Community as a result of internal legislation in the direct tax field (which is to be doubted, given that existing direct tax legislation is limited to the intra-Community sector), it would not be exclusive competence. Issues of subsidiarity would then arise. On grounds of subsidiarity, it is doubtful if Community action could be justified: MSs are competent and capable of resolving these issues themselves.

11. The development of an EU Model: Again, in the context of DTCs with third states, this has much to commend itself. The purpose of a Model DTC is to avoid the need for treaty negotiators to reinvent the wheel every time there is a new negotiation. It would be helpful for a model to be prepared which all MSs and the Commission agree is consistent with the requirements of EC tax law. One wonders how hard it would be to get agreement on this EU Model. At least an attempt to do so would disclose where disagreements exist (and might be identified by alternative texts).

12. One issue would be how far this EU Model would differ from the OECD Model. If the solutions are suitable for all EU MSs, might they also be suitable for all OECD MCs (including non-EU ones)? Alternatively, would an addendum to the Commentaries to the OECD Model, indicating where EC Law required EU MSs to adopt a different approach, suffice? Given the wide acceptance of the OECD Model, there is much to commend an approach which works within the accepted formulae as much as possible.

13. There remains a major problem here – and that comes from the ECJ. There is no guarantee that an EU Model (and specific DTCs based upon this model), even if all experts and the MSs and the Commission agreed it was consistent with EC law, would not later come under scrutiny by the ECJ which might hold that some of its provisions were inconsistent with EC law as it has developed further. To take a hypothetical example: suppose the EU Model contained an alternative of

relief by credit or relief by exemption; suppose the ECJ later concluded that relief by credit is incompatible with EC law. This could have an adverse impact on many new DTCs with third states. This is probably an unavoidable danger, though unanimous support from the MSs and the Commission for the Model might have a persuasive effect on the ECJ.

14. Work on specific EC concepts within the OECD: This is not incompatible with the development of an EU Model. Before developing an EU Model, work on EC concepts is inevitable. Whether the OECD is the right forum for this, however, is open for discussion. The OECD agenda is clearly not synonymous with the agenda of the EC MSs.

15. On the issue of a role for the Commission, there is much to be said for the Commission to take the lead with respect to:
    a. Preparing draft legislation to replace provisions of intra-MS DTCs; and
    b. Work on an EU Model or on specific EU concepts.

    Whether the Commission has a role to play in the conclusion of specific bilateral DTCs (either intra-MS or third state DTCs) is more open to debate. On the view expressed here (that competence with respect to DTCs remains with the MSs) no direct role would be envisaged.

16. One point which merits consideration is whether provisions contained in a DTC might ever contravene the State Aid provisions of the EC Treaty (Arts. 87-89) and require prior notification? In principle, a state aid might be contained in a treaty: the legal form of the measure is irrelevant.[6] Given that a DTC may well grant a relief from taxation (taxation which might otherwise be due); to certain recipients only (residents of the other contracting state; possibly ones engaged in a certain sector only – e.g. those engaged in the construction industry[7]); and may have an impact on trade and investment between MSs, there is at least a prima facie argument that this is the case. These measures would almost certainly be justifiable as intended to relieve double taxation: that does not, however, remove the obligation of notification. This suggests that the Commission may need to be informed under Art. 87 if provisions contained in a DTC present a potential state aid. The Commission might then helpfully develop guidance on DTC measures which do not constitute unjustified state aids.

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[6] The Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation, para. 13, refers to provisions to prevent double taxation as measures of a purely technical nature which should not constitute state aid. However, this may have been referring to general measures for the relief from double taxation – by a foreign tax credit, for example – rather than measures in a DTC.

[7] The definition of a permanent establishment in a DTC will usually include a specific provisions relating to construction sites: this may have the effect that enterprises of the other contracting state engaged in construction or installation have no exposure to taxation in the hose state when local enterprises would be so exposed.