TAX TREATY LAW AND COMMUNITY LAW – SOME RECENT DEVELOPMENTS

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This article deals with general developments in tax treaty law and the impact that these developments have or might have on Community law. It is based on a paper presented at the Queen Mary annual tax conference in March 2007.[2]

The title of my presentation was 'Tax Treaties and Community Law: where are we now?'. When I first chose this theme, I thought my analysis would be limited to the recent case law of the ECJ; mainly, the *D case* and the *ACT Group Litigation* case. In fact, the actual time spent on these cases was minimal. After a brief examination of recent developments in tax treaty law, I realised that there were many more potential points of conflict or convergence with Community law that had little to do with the ECJ's tax treaty case law. In other words, the Community could have an impact on some mainstream tax treaty changes, regardless of its recent tax treaty case law.

The following topics were examined:

(1) The proposed changes to the commentary on Article 5 of the OECD Model to include the concept of a service Permanent Establishment (PE).

(2) The proposed changes to the commentary on Article 17 of the OECD Model to include the net basis of taxation of non-resident artistes and sportsmen.

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2 Some of these issues are address in my forthcoming book, "*Double Taxation, Tax Treaties, Treaty-Shopping and the European Community*," EUCOTAX Series, (The Hague; Netherlands: Kluwer Law International, 2007)

(3) The adoption of the 'functionally separate entity' approach for the calculation of profits of a PE pursuant to Article 7 of the OECD Model.

(4) The proposed changes to the Mutual Assistance Procedure of Article 25 of the OECD Model to supplement the current procedure with arbitration.

In a way, the following discussion is the reverse of what we have been accustomed to. It is not so much a case of how ECJ decisions could affect tax treaties but more like how changes in the OECD Model could fall foul of Community law or be in accordance with it.

(1) Service PEs

On December 8th 2006, the OECD's Working Party No. 1[3] issued a discussion document on proposed changes to the commentary on the PE article (article 5). The Working Party proposed the addition of a new section regarding services. The period for public comments has now expired.[4] The updated commentary to article 5 is likely to be released in 2008.

Under the current OECD Model, profits from services performed in the territory of a contracting state (say, State A) by an enterprise of the other contracting state (say, State B) are not taxable in State A unless they are attributable to a PE.

This continues to be the general rule. The justification for it is given in the suggested paragraphs to be inserted in the Commentary to Article 5. It is argued as being "supported by various policy and administrative considerations"[5] and as being "consistent with the principle of Article 7 that until an enterprise of one State sets up a permanent establishment in another State, it should not be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State [...]."[6]

It is also recognized that if an enterprise performing services in one Contracting State were taxed there without having a fixed place of business, this "would create difficulties concerning the determination of the profits to be taxed and the

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3 Working Party No. 1 on Tax Conventions and Related Questions and its Working Group on the treatment of services under tax treaty provisions.

4 Comments had to be sent before 16th February, 2007.

5 Paragraph 42.11.

6 *Ibid*.

collection of the relevant tax".[7] This is because in most cases, the enterprise would not have the accounting records and assets typically associated with a PE. Nor would there be a dependent agent which could comply with information and collection requirements.[8]

However, as the proposed Commentary states, the result was exclusive residence-based taxation of services not attributable to a domestic PE. Some States, typically countries in which the services were performed, disagreed with this result and advocated the preservation of source taxation rights in certain circumstances. These States considered that "from the exclusive angle of the pure policy question of where business profits originate, the state where services are performed should have a right to tax even when these services are not attributable to a permanent establishment."[9] Also, as noted by these States "some service businesses do not require a fixed place of business in their territory in order to carry on a substantial level of business activities therein and consider that these additional rights are therefore appropriate."[10] Administrative difficulties in assessing these profits did not suffice to preclude some source-based taxation.[11]

It seems that the Working Party No.1 has been convinced by these arguments and has now proposed the addition of a service 'deemed' PE in the Commentary to Article 5. The inclusion of such a clause in tax treaties would enable Contracting States to tax the services performed within their territory.

However, as clarified by the suggested Commentary "such taxation should not extend to services performed outside the territory of a State and should apply only to the profits from these services rather than to the payments for them. Also, there should be a minimum level of presence in a State before such taxation is allowed."[12]

7 Paragraph 42.

8 *Ibid.*.

9 Paragraph 42.15.

10 Paragraph 42.16.

11 Paragraph 42.17.

12 Paragraph 42.22.

Under the proposed changes, the Commentary would give the option[13] of the following wording for Article 5:

> "*Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State*
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> *a) through an individual who is present in that other State during a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross*
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> *revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or*
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> *b) during a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are performing such services in that other State or are present in that other State for the purpose of performing such services,*
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> *the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment that the enterprise has in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.*"

Therefore, under this provision, a PE would be deemed to exist for the purposes of taxing the services.

According to the suggested Commentary, the first subparagraph addresses the situation of an enterprise carried on by a single individual or through an individual. The second subparagraph deals primarily with the situation of an enterprise that performs services in a Contracting State in relation to a particular project (or for connected projects) and which performs these through one or more individuals over a substantial period. The periods referred to in the second subparagraph apply in relation to the enterprise and not to the individuals.

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13 In other words, the changes now proposed provide an alternative treaty text. A Contracting State may decide not to include a service PE clause.

There are a few points to note from the general wording of the suggested provision.

Firstly, this provision would only apply to services – other types of activities not constituting services would be excluded. Of course, whether or not a certain activity constitutes a service will be a question of interpretation.[14]

Secondly, the suggested provision would apply to services performed *by an enterprise*. Therefore, the services must be provided by the enterprise to third parties and not to the enterprise.[15] This could prove to be problematic, considering that the OECD has opted for the functionally separate entity approach, to be discussed below.

Thirdly, the provision only applies to services that are *performed* in a State by a foreign enterprise. It is therefore not sufficient that the relevant services be furnished to a resident of the State; these services must also be performed in that State.[16] Again, it would seem that whether or not services are performed in a State will be a question of interpretation.

The Working Party acknowledges the possibility of abuse and expressly permits legislative or judicial anti-avoidance rules.[17] Not only that, but the suggested commentaries include a specific optional anti-abuse wording in the following lines:

> "*For the purposes of paragraph [x], where an enterprise of a Contracting State that is performing services in the other Contracting State is, during a period of time, associated with another enterprise that performs substantially similar services in that other State for the same project or for connected projects through one or more individuals who, during that period, are performing such services in that State or are present in that State for the purpose of performing these similar services, the first-mentioned enterprise shall be deemed, during that period of time, to be performing services in the other State for that same project or for connected projects through these individuals. For the purpose of the*

14 An example of activity excluded from the ambit of the new clause is given in proposed paragraph 42.29: "the paragraph would not apply to a foreign enterprise that carries on fishing activities in the territorial waters of a State and derives revenues from selling its catches (in some treaties, however, activities such as fishing and oil extraction may be covered by specific provisions)."

15 Paragraph 42.30.

16 Paragraph 42.31.

17 Paragraph 42.42.

> *preceding sentence, an enterprise shall be associated with another enterprise if one is controlled directly or indirectly by the other, or both are controlled directly or indirectly by the same persons, regardless of whether or not these persons are residents of one of the Contracting States*."

As noted above, under this provision a PE is deemed to exist. This means that Article 7 of the OECD Model is activated and profits attributable to this PE may be taxed.[18] However, as this is a *deemed* PE, it may be even more difficult to determine what profits are to be allocated to it. The proposed Commentaries emphasize that

> "*it is important to ensure that only the profits derived from the activities carried on in performing the services are taxed; whilst there may be certain exceptions, it would be detrimental to the cross-border trade in services if payments received for these services were taxed regardless of the expenses incurred for the purpose of performing these services*".[19]

Attributing profits to such *deemed* service PEs may prove to be very problematic now that the OECD has opted for the functionally separate entity approach.[20] Will the hypothesizing step of that approach prove to be even more 'hypothetical' now that the PE is *deemed* to exist?[21] Would 'deemed' dealings also have to be recognized? In this regard, the service PE poses many uncertainties.

What this change effectively leads to is a form of a *lower* PE threshold that could be adopted by countries wishing to impose increased taxation at source on income from the performance of cross-border services. It is a significant departure from the long-standing PE threshold. Some multinationals have voiced their disatisfaction with this test.[22]

Could the lowering of the PE threshold have any Community repercussions? Arguably, recognising this service PE is a question going to jurisdiction to tax. Under established Community law, jurisdiction to tax falls within the powers of

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18 Paragraph 42.44.

19 Paragraph 42.44

20 See Part 3 below.

21 See analysis below.

22 See 45 Tax Notes Int'l 769 - Multinationals ask OECD to withdraw services proposal (Release Date: 15th February 2007) (Doc 2007-3959).

the Member States.[23] As recently reiterated by Advocate General Geelhoed in the *ACT Group Litigation* case, "the power to choose criteria of, and allocate, tax jurisdiction lies purely with Member States (as governed by international tax law)".[24]

However, what would be the actual status of this PE? To what extent would it be comparable to a resident entity? What kind of entitlements would they have in terms of allowances, expense deduction etc? The problem with service PEs or better 'deemed PEs' is that they are less than non-residents and, to an extent, less than PEs. Could they be comparable to residents?[25]

It would be interesting to see how the ECJ approaches such issues, if they are ever referred to it.

(2) Taxation of Artistes and Sportsmen

In the same report referred to above, the OECD Working Party 1 proposed changes to the Commentary on Article 17, and more specifically paragraph 10 of the Commentary.

The Working Party questioned whether Article 17 should continue to favour the taxation of non-resident artistes and sportsmen on the basis of gross income, as opposed to net profits. The Working Party agreed that the Commentary should be amended to include a provision enabling Contracting States to tax such non-residents on their net income as opposed to gross income. Under the proposed change, paragraph 10 of the Commentary to Article 17 would be amended as follows (in italics):

> "10. The Article says nothing about how the income in question is to be computed. It is for a Contracting State's domestic law to determine the

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23 See, for example, C-336/96 *Gilly*, paragraph 30; C-307/97 *Saint-Gobain*, paragraphs 56-57; C-385/00 *De Groot,* paragraph 94; and C-376/03 *D*, paragraph 53.

24 Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, paragraph 52.

25 If one applies the *Schumacker* test, a non-resident would be in a comparable situation with a resident when he receives "the major part of his income and almost all his family income in a Member State other than that of his residence". Case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker* [1995] ECR I-225, paragraph 38. It would seem that the service PE only exists in the source country and has income attributed to it in the source country. As there is no question of other income being derived elsewhere, isn't the *Schumacker* test satisfied and isn't the situation of the PE comparable to a resident?

> extent of any deductions for expenses. Domestic laws differ in this area, and some provide for taxation at source, at a low rate based on the gross amount paid to artistes and sportsmen. Such rules may also apply to income paid to groups or incorporated teams, troupes, etc. *Some States, however, may consider that the taxation of the gross amount may be inappropriate in some circumstances even if the applicable rate is low. These States may want to give the option to the taxpayer to be taxed on a net basis. This could be done through the inclusion of a paragraph drafted along the following lines:*
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>> *"Where a resident of a Contracting State derives income referred to in paragraph 1 or 2 and such income is taxable in the other Contracting State on a gross basis, that person may, within [period to be determined by the Contracting States] request the other State in writing that the income be taxable on a net basis in that other State. Such request shall be allowed by that other State. In determining the taxable income of such resident in the other State, there shall be allowed as deductions those expenses deductible under the domestic laws of the other State which are incurred for the purposes of the activities exercised in the other State and which are available to a resident of the other State exercising the same or similar activities under the same or similar conditions."*

This change *prima facie* aligns the OECD position with Community law. The ECJ requires consistent treatment of resident and non-resident persons to the extent they are in a comparable situation. The same goes as regards the taxation of non-resident artistes and more specifically the basis on which they are taxed (gross or net).

The seminal case in this area is *Gerritse*.[26] In this case, a Dutch musician performed in Germany. He was subject to a fixed withholding tax on gross earnings by contrast to German resident taxpayers who were subject to progressive taxation on their net income. Under German law, Mr Gerritse, being a non-resident, was not allowed to deduct business expenses unless business expenses exceeded 50% of the receipts.

On this point, the ECJ found that the inability of a non-resident to deduct business expenses was incompatible with freedom to provide services. The ECJ noted that in such circumstances, business expenses were "directly linked to the activity that generated the taxable income in Germany, so that residents and non-residents

[26] Case C-234/01, *Arnoud Gerritse v. Finanzamt Neukölln-Nord* [2003] ECR I-5933.

[were] placed in a comparable situation in that respect".[27]

The ECJ found that "a national provision which, in matters of taxation, refuses to allow non-residents to deduct business expenses, whereas residents are allowed to do so, risks operating mainly to the detriment of nationals of other Member States and therefore constitutes indirect discrimination on grounds of nationality"[28] and was contrary to freedom to provide services.

There was a second issue in this case: whether a fixed withholding tax for non-residents was permitted. The ECJ gave a qualified approval of such withholding tax. It held that as the fixed withholding tax was in fact no higher than the progressive tax and the tax-free allowance that would have been applicable to a resident person, then there was no breach of the Community freedoms. It was up to the referring court to verify this question.[29]

The *Gerritse* line of thought has recently been upheld in *Scorpio*.[30] Among the questions raised there were the following two: the deduction of expenses and the withholding tax.

Under the then applicable German law on Income Tax, non-residents were subject to a 15% withholding tax on a gross basis. The debtor was liable for the deduction. Even if a tax treaty provided for a lower or no German tax at all, all tax had to be withheld and was subsequently refunded, unless an exemption certificate was issued in advance by the tax authorities. There was no withholding tax and no liability for payments as regards resident creditors. Resident creditors were subject to tax on a net basis under the regular tax rate.

Scorpio was a German resident company which organised concerts. In 1993, it made a contract with a natural person trading under the name of Europop, who made a music group available to it. Europop was at that time established in the Netherlands and was not permanently or ordinarily resident in Germany. The national court stated that it did not know of Europop's nationality.

Scorpio made payments to Europop without withholding tax from the payments and without Europop having produced an exemption certificate. The tax

27 *Ibid*, paragraph 27.

28 *Ibid*, paragraph 28.

29 *Ibid*, paragraphs 53-54.

30 Case C-290/04 *FKP Scorpio Konzertproduktionen,* decided on 3rd October 2006.

authorities held Scorpio liable for the withholding tax, amounting to 15% of the remuneration.

The ECJ decided that, the obligation to withhold tax and liability for failure to do so could deter companies such as Scorpio from hiring non-resident providers of services.[31] This was therefore a restriction to the freedom to provide services.

However, the ECJ found this restriction to be justified. The procedure of retention at source and the liability rules supporting it constituted a legitimate and appropriate means of ensuring that the non-resident provider of services did not escape taxation.[32] Also, the use of retention at source and the fact of potential liability of the recipient of services who was required to make such retention, represented a proportionate means of ensuring the recovery of the tax debts of the non-resident.[33] Therefore, both the withholding and the liability for non-retention were compatible with Community law.[34]

Another point addressed was that of deductibility of expenses. The ECJ concluded that Scorpio's inability to deduct business expenses directly linked to its activity, when making a payment to a non-resident provider of services, when such expenses were deductible for resident providers of services, was incompatible with freedom to provide services.[35]

In the *Centro Equestria* case,[36] the facts were very similar to *Gerritse*. Here, a Portuguese company organized a tour of equestrian shows in various European countries including Germany. Under German law at the time, non-resident companies were subject to a fixed withholding tax. They could claim a refund of that tax for business expenses, when two conditions were satisfied. Firstly, the claimed operating expenses had a direct economic connection to the income

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31 *Ibid,* paragraph 33.

32 *Ibid,* paragraph 36.

33 *Ibid,* paragraph 37.

34 On the facts of the case, freedom to provide services was inapplicable. This was because freedom to provide services applied only when the service was provided within the Community *and* the service provider was an EU national established in a Member State. It did not apply where the service provider was a third country national, even if the provider was established within the Community and there was an intra-Community provision of services.

35 *Ibid,* paragraph 49.

36 Case C-345/04, *Centro Equestre da Lezíria Grande Lda v. Bundesamt für Finanzen,* nyr.

generated in Germany. Secondly, these expenses exceeded half of the amount of the overall income.

By contrast, German resident companies could deduct all of the expenses of their operations in Germany. The business expenses of the Portuguese company were less than half of the overall income. Therefore, the non-resident company was denied the refund request. The German *Bundesfinanzhof* referred a question to the ECJ as to whether the German rules were compatible with freedom to provide services.

The ECJ found that the second condition (that the amount of the expenses must exceed half of that income) was a prohibited and unjustified restriction of the freedom to provide services. It did not find the first condition (direct economic connection) to be objectionable. However, the way direct economic connection was phrased may suggest a broadening up of the concept.

As the ECJ noted:

> "Operating expenses directly connected to the income received in the Member State in which the activity is pursued must be understood as being expenses which have a direct economic connection to the provision of services which gave rise to taxation in that State and which are therefore inextricably linked to those services, such as travel and accommodation costs. In that context, the *place and time at which the costs were incurred are immaterial*."[37]

Arguably, if the place and time in which costs were incurred is immaterial, does this mean that expenses actually incurred in one Member State could still be considered as having a direct economic connection in another Member State? The ECJ does not address this point. Rather, it defers to the national court to consider whether on the facts of the case the claimed operating expenses were "directly connected to the provision of services which gave rise to taxation in that State and were therefore inextricably linked to those services".[38]

To sum up, it would seem that the new OECD tax treaty position on this point is aligned with Community case law. However, if the above dicta of the *Centro Equestria* case are interpreted broadly, then perhaps what effectively constitutes the net basis for Community purposes may not be the same as for OECD purposes.

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37 *Ibid,* paragraph 25. Emphasis added.

38 *Ibid,* paragraph 26

(3) Attribution of profits to PEs

Under Article 7 of the OECD Model, profits of an enterprise of one contracting state to a tax treaty cannot be taxed in the other contracting state unless the enterprise carries on business in that other state through a PE. Profits attributed to the PE are to be taxed in the contracting state where the PE is situated.

The method of calculating the profits to be attributed has been the subject of debate in OECD circles and was one of the topics discussed at the IFA conference in 2006.[39]

There are two competing approaches. Under the 'relevant business activity' approach, the PE is considered as forming part of a single enterprise. The profits of this single enterprise can be earned only from transactions with third parties and with associated enterprises – *not* between the PE and the enterprise.

Under the 'functionally separate entity' approach, the PE is treated as a separate entity. Here, profits can be earned from (deemed) transactions between the PE and the enterprise. Therefore, a profit could be seen to accrue and be attributed to the PE, even though no profit has been realized by the enterprise as a whole.[40]

The OECD, in its recent Report on the Attribution of Profits to Permanent Establishments published in December 2006,[41] has adopted the 'functionally separate entity' approach. This means that for the purposes of the OECD Model, in assessing the profits to be attributed under Article 7, PEs are to be considered as separate entities from the enterprise to which they are legally attached.

According to this report, the economic ownership of assets, the need for capital and the assumption of risk have to be apportioned between the PE and the rest of the enterprise. The OECD considers that the 'significant people functions' of the PE should be the lead indicator for such an allocation/apportionment. What this means is that, assets and risks will be attributed according to where the main decision-making over those assets and risks is located. This may vary from business sector to business sector and from enterprise to enterprise within sectors.[42] It is expressly claimed in the report that domestic anti-abuse legislation is

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39 IFA Report of the 60th Congress of the International Fiscal Association, Amsterdam 2006, The attribution of profits to permanent establishments in Cahiers de droit fiscal international (The Hague; London: Kluwer Law International, 2006)

40 *Ibid,* at sections 1.2.3.1. and 1.2.3.2.

41 www.oecd.org/dataoecd/55/14/37861293.pdf

42 See paragraph 19 of the OECD (2006) Report.

not prevented.[43] For non-financial enterprises the concept of the 'significant people functions' has replaced the previous concept of 'key entrepreneurial risk taker'.

The report envisages a two-step process of allocation/apportionment. The first step consists of hypothesizing the PE as a distinct and separate enterprise. This entails a functional and factual analysis.[44] Under the second step, the profitability of the PE would be determined, applying the transfer pricing guidelines by analogy.

On the 10th April, the OECD released the draft revised Commentary on Article 7 which effectively incorporates the conclusions of the report.[45]

Insofar as Community law is concerned, the above developments may have implications on the Community concept of a PE. Case law on the discrimination of PEs does not really point to a *de jure* or *de facto* categorisation of a PE vis-à-vis the whole enterprise.[46] Neither do any of the Community tax instruments in which the PE concept features suggest how this is in fact to be taxed.

In many cases where the issue was addressed the ECJ in fact assimilated the permanent establishment to a hypothetical subsidiary.[47] However, this was not done automatically. In all of these cases, the ECJ had first examined the comparability of the permanent establishment and a subsidiary, insofar as *that specific* source country's tax rules were concerned.

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43 See paragraph 12, where it is stated that the authorised OECD approach is not designed to prevent the application of any domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets or risks.

44 A functional and factual analysis is required because a legal analysis not possible. It would lead to (i) attribution to PE of the rights and obligations arising out of transactions between the enterprise and PE; (ii) identification of significant people functions relevant to the attribution of economic ownership of assets to PE and the attribution of risks to PE; (iii) identification of other functions of the PE; (iv) recognition of dealings between the PE and other parts of the same enterprise; (v) attribution of capital based on the assets and risks attributed to PE.

45 See http://www.oecd.org/dataoecd/0/2/38361711.pdf

46 Baker & Collier, the General Reporters to IFA (2006), also conclude that at present, the Community does not really have a developed position on the attribution of profits to permanent establishments. At 58-59. However, the position may become clearer in the future and there is a risk that the functionally separate approach "may have aspects which prove to be incompatible with Community law". *Ibid,* 59.

47 Case 270/83 *Avoir Fiscal,* paragraphs 19-20; C-311/97 *Royal Bank of Scotland,* paragraph 29; C-307/97 *Saint-Gobain*, paragraph 47; C-253/03 *CLT-UFA,* paragraphs 29-30.

In the now notorious *Avoir Fiscal* case, the ECJ concluded that, insofar as the extension of the avoir fiscal was concerned, French branches and agencies of insurance companies were in a comparable situation to French subsidiaries.[48] This was because French tax law did "not distinguish, for the purpose of determining the income liable to corporation tax, between companies having their registered office in France and branches and agencies situated in France of companies whose registered office is abroad".[49] Since the French tax rules did not distinguish between the two vehicles for the purposes of taxing their profits, those rules could not "without giving rise to discrimination, treat them differently in regard to the grant of an advantage related to taxation".[50]

Here, the emphasis was on the fact that these two vehicles were treated the same way by the French tax legislation. Therefore, the ECJ concluded that they were in a comparable situation. The same analysis was adopted in subsequent cases.[51]

Regardless of whether one agreed or disagreed with the ECJ's finding of comparability in this and in other cases, the important point to grasp is that nothing was assumed. It just happened that in these cases, the PE was in fact treated as if it was a functionally separate entity *akin to a subsidiary*. The focus was on assimilating the PE (a non-resident) to a hypothetical subsidiary vehicle (a resident), rather than to consider it separately from the whole enterprise. In other words, what the ECJ was concerned with was to show that the resident and non-resident entities were in a comparable situation for the purposes of the Community's non-discrimination rules.

By contrast, the OECD's chosen method of attribution of profits starts from a different point. It assumes that the PE and the subsidiary are in a comparable situation and demands that they be treated the same way for the purposes of attributing profits.

How is the new OECD method going to affect the Community concept of a PE? Assuming the ECJ understands the functionally separate entity approach, will it, from now, *always* assimilate a PE to a subsidiary or will the ECJ reserve the right to consider each case on its facts?

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48 Case 270/83 *Avoir Fiscal,* paragraphs 19-20.

49 *Ibid,* paragraph 19.

50 *Ibid,* paragraph 20.

51 See C-311/97 *Royal Bank of Scotland,* paragraph 29; C-307/97 *Saint-Gobain*, paragraph 47; C-253/03 *CLT-UFA,* paragraphs 29-30.

Even more at point, how can the functionally separate entity approach be accommodated within a CCCTB regime which is arguably based on more unitary premises?

Another very important issue is that of losses. How will losses of the PE or the enterprise/company be treated under the functionally separate approach and how will they be treated under Community law?

The ECJ has dealt with cross-border loss relief involving PEs in Case C-250/95 *Futura*[52] and Case C-141/99 *AMID*.[53] In *Futura*, the ECJ looked at the situation from the perspective of the source state (i.e. the host State of the PE). It found that the source state restriction of loss carry-forward to losses that had an economic link with income earned there, could be justified under the territoriality principle.

In *AMID,* the ECJ examined the situation from the perspective of the residence state (i.e. home State of the company). It found that a Belgian company with a Belgian branch was in a comparable situation to a Belgian company with a Luxembourg branch. There was a difference in treatment insofar as deduction of losses was concerned. Losses incurred in Belgium could be carried forward by companies established exclusively in Belgium. By contrast, if the loss-making Belgian company had a profit-making foreign branch, then these losses had to be offset as against the branch profits (here, Luxembourg branch) even though the profits were tax exempt under the applicable tax treaty between the two countries.

As the ECJ noted in paragraph 23,

> "by setting off domestic losses against profits exempted by treaty, the legislation of that Member State establishes a differentiated tax treatment as between companies incorporated under national law having establishments only on national territory and those having establishments in another Member State. [...] [W]here such companies have a permanent establishment in a Member State other than that of origin and a convention to prevent double taxation binds the two States, those companies are likely to suffer a tax disadvantage which they would not have to suffer if all their establishments were situated in the Member State of origin."

The difference in treatment was not justified.

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52 Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions* [1997] ECR I-2471.

53 Case C-141/99 *AMID* [2000] I-11621.

The Commission has recently published a Communication on the tax treatment of losses in cross-border situations. In this Communication, the Commission expressed the need for Member States to streamline their systems so that, *inter alia,* relief could be afforded to cross-border losses within one company (i.e. between the company and its foreign permanent establishment and vice versa).[54]

Will this Commission initiative be co-ordinated with the OECD project on PEs and the solutions (if any) offered under the functionally separate approach? Can it be so co-ordinated or are there inherent differences between the Commission's aspirations and the OECD project?

Regrettably, but somehow unsurprisingly, the revised Commentary does not address these questions. It is up to the Commission and the Working Parties involved in these initiatives to try and address the discords.

(4) Mutual Assistance Procedure

Another important change is the OECD's recent proposal to supplement the Mutual Assistance Procedure (MAP) of Article 25 with additional and compulsory dispute resolution techniques.[55]

What is proposed is for the following paragraph 5 to be added to Article 25. The Commentary is to be amended accordingly.

> "5. Where,
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> a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
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> b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the presentation of the case to the competent authority of the other Contracting State,

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54 See Communication published in 19th December 2006: Tax Treatment of Losses in Cross-Border situations, COM (2006) 824, p.11.

55 OECD 2007: "Improving the resolution of tax treaty disputes – Report adopted by the Committee of Fiscal Affairs on 30th January 2007", February 2007.

any unresolved issues arising from the case shall be submitted to arbitration if the person so requests. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.1

[Text of the footnote, which would appear on the same page:]

1. In some States, national law, policy or administrative considerations may not allow or justify the type of dispute resolution envisaged under this paragraph. In addition, some States may only wish to include this paragraph in treaties with certain States. For these reasons, the paragraph should only be included in the Convention where each State concludes that it would be appropriate to do so based on the factors described in paragraph 47 of the Commentary on the paragraph. As mentioned in paragraph 54 of that Commentary, however, other States may be able to agree to remove from the paragraph the condition that issues may not be submitted to arbitration if a decision on these issues has already been rendered by one of their courts or administrative tribunals."

This proposal does not come as a surprise. The current Article 25 has long been criticised by academics.[56] Recent OECD discussion documents have also alluded to the unsatisfactory nature of the MAP clause.[57] Under the current MAP clause, when a dispute is submitted to the relevant competent authorities, these competent

56 J. Avery Jones et al., The Legal Nature of the Mutual Agreement Procedure [1979] B.T.R. 333 et seq.; J. Avery Jones, The Relationship between the Mutual Agreement Procedure and Internal Law (1999) EC Tax Rev. 4; S. Lindecrona, How to Solve International Tax Disputes? (1990) Intertax 266

57 See OECD 2004 discussion document: "Improving the Process for Resolving International Tax Disputes", published on 27th July 2004 and OECD 2006 discussion draft: "Proposals for Improving Mechanisms for the Resolution of Tax Treaty Disputes", published in February 2006. Contrast with the findings of a report published by the OECD much earlier on, in which the Committee of Fiscal Affairs concluded that there was no need to recommend a more compulsory and binding procedure. See the OECD 1984 Report "Transfer Pricing and Multinational Enterprises: Three Taxation Issues".

authorities are required only to seek a solution and are not obliged to find one.[58] This is thought to remove the incentive to solve the disputes.

The limitations of the current MAP clause have even been acknowledged in the OECD Commentary to that Article. As stated in paragraph 45 of the OECD Commentary to Article 25:

> " […] The conclusion of a mutual agreement depends to a large extent on the powers of compromise which the domestic law allow the competent authorities. Thus, if a convention is interpreted or applied differently in two Contracting States, and if the competent authorities are unable to agree on a joint solution within the framework of a mutual agreement procedure, double taxation is still possible although contrary to the sense and purpose of a convention aimed at avoiding double taxation."

That same report recommended the mandatory submission of unresolved cases to arbitration. As the Committee of Fiscal Affairs noted therein,

> "[t]his obligation could possibly be viewed as arising from the general international law obligation to apply and interpret the treaty in good faith and gives more content to the requirement in the Model Convention to "endeavour … to resolve the case".[59]

What is noteworthy is that the 2004 OECD Report proposed only mandatory *submission* of disputes to arbitration rather than mandatory *resolution* of disputes. The latest 2007 OECD Report[60] followed up this point. Paragraphs 12-13 of the 2007 OECD Report are particularly illuminating.

> "12. The MAP can thus be improved *by supplementing it with additional dispute resolution techniques which can help to resolve issues which have prevented the countries from reaching*

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58 See Article 25(2): "The competent authority *shall endeavour*, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State […]". Also see Article 25(3): "The competent authorities of the Contracting States *shall endeavour* to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. […]". Emphasis added.

59 OECD 2004 discussion document: "Improving the Process for Resolving International Tax Disputes", paragraph 132

60 OECD 2007: "Improving the resolution of tax treaty disputes – Report adopted by the Committee of Fiscal Affairs on 30th January 2007", February 2007.

agreement in a MAP. In this way, international tax disputes will to the greatest extent possible be resolved in a final, principled, fair and objective manner for both the countries and the taxpayers concerned. Reducing the number of unresolved cross-border tax disputes in this way is clearly an important goal. *Recourse to these techniques, however, must be an integral part of the mutual agreement procedure and should not constitute an alternative route to solving tax treaty disputes between States, which would risk undermining the effectiveness of the mutual agreement procedure. The techniques are aimed at ensuring that the competent authorities are able to offer to the taxpayer an agreed solution to the case which he has presented.* On the other hand, where the competent authorities are able to resolve their differences as to the application of the treaty without recourse to supplementary techniques, there is no further need for applying such techniques in that case.

13. These additional techniques can *make the MAP itself more effective even in cases where resort to the techniques is not necessary. The very existence of these techniques can encourage greater use of the MAP since both governments and taxpayers will know at the outset that the time and effort put into the MAP will be likely to produce a satisfactory result.* Further, governments will have an *incentive to ensure that the MAP is conducted efficiently in order to avoid the necessity of subsequent supplemental procedures.* In addition, the introduction of supplementary dispute resolution techniques *will reduce the likelihood of costly, time-consuming and possibly conflicting domestic judicial proceedings."*[61]

The 2007 OECD Report emphasises that arbitration is not an alternative or additional recourse. Rather, "the resolution of the case continues to be reached through the mutual agreement procedure, whilst the resolution of a particular issue which is preventing agreement in the case is handled through an arbitration process."[62]

Furthermore, the 2007 OECD Report recognises that arbitration may not be possible under domestic law. Therefore, "the paragraph should only be included in

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61 *Ibid.* Emphasis added.

62 *Ibid*, paragraph 46.

the Convention where each State concludes that the process is capable of effective implementation".[63]

There is a Sample Mutual Agreement on Arbitration (the Sample) in the Annex to this 2007 OECD Report. This Sample contains guidelines, *inter alia,* on the terms of reference, the timing for submission, the procedure for the selection of arbitrators and some procedural and evidentiary rules. However, the Sample is mere guidance; it does not purport to be an exhaustive nor a binding document.

There are a few interesting points insofar as the suggested provision is concerned.

Firstly, the binding effect of the arbitration decision. Under the suggested provision, only a person directly affected by the case can refuse the mutual agreement that implements the arbitration decision. If that person accepts it, then the decision shall be binding on both States.[64] In other words, the States cannot raise objections to the arbitration decision.

Secondly, the arbitration decision is only binding with respect to the specific issues submitted to arbitration.[65] There is no question of the arbitration decision having precedential value. Each decision will be limited to the facts of the case. In my view, this does not preclude the establishment of a precedent relating to procedural issues; e.g. the appointment of the arbitrators, the mode of operation of the arbitration commission etc.

Thirdly, supplementary dispute resolution mechanisms other than arbitration can be implemented on an *ad hoc* basis as part of the mutual agreement procedure.[66] This enables the new regime to be even more flexible.

Fourthly, Member States are urged to co-ordinate the scope of the new paragraph with their obligations under the Arbitration Convention.[67]

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63 *Ibid*, paragraph 47.

64 *Ibid,* paragraphs 63-64.

65 *Ibid,* paragraph 65.

66 *Ibid,* paragraph 68.

67 See paragraph 49 which reads as follows: "49. *States which are members of the European Union must co-ordinate the scope of paragraph 5 with their obligations under the European Arbitration Convention*."

What does this mean in practice? In order to answer this question, one must examine the nature of the Arbitration Convention.

It should be pointed out that the Arbitration Convention is a mere treaty between countries that happen to be the EU Member States. It is *not* a Directive; i.e. it is not an EC instrument, and deliberately so.[68] The practical effect of this distinction is important. It means that the powers to police and enforce the provisions of this instrument are limited. The ECJ has no jurisdiction over the Arbitration Convention. No references can be made to it and it has no right to interpret its provisions. Also, the Commission cannot initiate infringement proceedings in case of a violation of the Convention, even non-adoption of it, as it does not form part of EU law.[69] In fact, Member States may, at any time, withdraw from the Arbitration Convention without there being any Community repercussions.[70]

The fact that the Arbitration Convention is a mere international treaty means that it may not have direct effect. The application of the Arbitration Convention in the domestic law of the Member States would depend on how international treaties are actually given effect in those jurisdictions. In other words, it would depend on whether an international instrument is binding in domestic law without further action by the Member States or whether a separate act of incorporation of the international instrument is required for the instrument to be effective in domestic law.

From the above, it would seem that in applying the amended MAP clause, a Member State may not be so constrained by the Arbitration Convention in the way that it would be constrained by Directives or general Community law. Nevertheless, the fact that the OECD urges Member States to co-ordinate the scope of the amended provisions with their obligations under the Arbitration Convention suggests that some deference is to be paid to the Arbitration Convention when there is divergence.

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68 The Member States could not agree to a Directive and therefore this instrument took the form of a Convention rather than a Directive. Article 293 EC was used as a legislative base rather than Article 94 EC. The Commission did not challenge this legal basis.

69 This partly explains the delays in ratifying the protocol to the Arbitration Convention, from 1999 until 2004. The implementation deadline could not have been guaranteed and enforced by the ECJ or the Commission. All hinged on the political will (or lack of) of the Member States. See Olivier Rousselle, *The EC Arbitration Convention – An Overview of the Current Position* [2005] European Taxation 14; Pietro Adonnino, *Some Thought on the EC Arbitration Convention* [2003] European Taxation 304.

70 There could be repercussions under international treaty law, depending on whether the treaty contained a right to withdraw and if so, how that right had been exercised. See HJI Panayi, Christiana, *Exploring the Open Skies: EC-incompatible treaties between Member States and Third Countries* [2007] Yearbook of European Law 350.

Before one looks at possible points of divergence between the two provisions, one ought to look at the points of convergence. Actually, there seem to be many similarities between the structure envisaged under the amended MAP (in conjunction with its suggested Sample) and the Arbitration Convention.

For example, both are initiated by taxpayers.[71] Both encompass a three stage procedure[72] and both have a similar fee structure.[73] The Advisory Commission is set up in a similar way.[74] There are time limits for the implementation of the arbitration award.[75]

Also, both the Arbitration Convention and the Sample are rather vague when it comes to the information that the Advisory Commission may demand for submission.[76] There seems to be more guidance on the question of voluntary submission of information by taxpayers. In fact, the Arbitration Convention

71 See Article 6 of the Arbitration Convention.

72 Namely, (a) Obligation to notify the intention to make a tax adjustment; (b) Mutual Agreement Procedure and (c) Advisory Commission procedure.

73 Under Article 11(3) of the Arbitration Convention, the costs of the advisory commission procedure, other than those incurred by the associated enterprises, shall be shared equally by the Contracting States concerned. The fee structure is established under the Code of Conduct for the Effective Implementation of the Arbitration Convention (90/436/EEC of July 1990). Under the new MAP, each competent authority and the person requesting arbitration bear their own costs. In other words, the competent authorities bear the costs for their appointed arbitrators. Other costs, for example the costs of any additional arbitrators, are borne jointly by the competent authorities. See paragraph 13 of the Sample.

74 See Article 9 of the Arbitration Convention and the Sample, paragraphs 5 and 7.

75 Under Article 12 of the Arbitration Convention, it is 6 months from the day the advisory commission delivers its decision. The Sample also suggests 6 months, but this may be extended. See paragraph 16 of the Sample.

76 Under Article 10(1) of the Arbitration Convention, the Advisory Commission may require taxpayers to provide certain information. "The enterprises and the competent authorities of the Contracting States concerned shall give effect to any request made by the advisory commission to provide information, evidence or documents." *Ibid.* However, there is carve-out in that competent authorities are under no obligation to carry out administrative measures at variance with domestic law, or supply information not obtainable under domestic law or supply information which would disclose trade or business secrets. See Article 10(1)(a), (b) and (c) of the Arbitration Convention.

Under the Sample (paragraph 10), the arbitrators shall adopt the procedural and evidentiary rules that they deem necessary to answer the questions posed to them.

appears to be more permissive than the Sample on this point.[77]

In both instruments, there is a duty of confidentiality. The arbitrators are considered as the authorised representatives of the competent authorities who appointed them and are bound by duties of confidentiality.[78]

Although there are many similarities, there are junctures where the Arbitration Convention diverges from the amended MAP clause and its suggested Sample.

Firstly, the Arbitration Convention only covers transfer pricing disputes. By contrast, the ambit of the MAP clause has always been much wider.

Secondly, the Arbitration Convention is silent as to arbitration process and the actual decision making. Can the Advisory Commission deliver its own decision without following the submissions of the competent authorities (the 'independent opinion' approach)[79] or is it obliged to follow the position of one of the two competent authorities (the 'last best offer' or 'final offer' approach)?[80] The Sample recognises both approaches. Although it takes as its starting point the former, it contains alternative wording in case the relevant parties opt for the latter.[81]

Thirdly, the two instruments diverge insofar as the binding effect of the Advisory Commission is concerned. Under the Arbitration Convention, the competent authorities are not bound to follow the Advisory Commission's opinion if they agree.[82] In other words, they can agree to disagree. In such circumstances, the affected taxpayer cannot do anything to ensure the application of the Advisory

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77 Under Article 10(1) of the Arbitration Convention, "the associated enterprises concerned may provide any information, evidence or documents which seem to them likely to be of use to the advisory commission in reaching a decision". By contrast, under the Sample (paragraph 11) the person who made the request for arbitration may, either directly or through his representatives, present his position to the arbitrators in writing *to the same extent that he can do so during the mutual agreement procedure*. With the permission of the arbitrators, the person may present his position orally during the arbitration proceedings.

78 See Article 9(6) of the Arbitration Convention and paragraph 8 of the Sample.

79 See 2007 OECD Report, p.17.

80 See 2007 OECD Report, p.17. In the Sample, this is described as the streamlined arbitration process. See paragraph 6 of the Sample. In the US, this method is often called 'baseball arbitration'.

81 See paragraph 6 of the Sample.

82 This is perhaps why this is called an 'opinion' rather than 'decision'. Contrast with the Sample, where the term 'arbitration decision' is used rather than 'opinion'.

Commission's opinion. It is only when the competent authorities fail to reach an agreement, that they are obliged to act in accordance with that opinion.[83]

By contrast, under the suggested MAP, if a person directly affected does not accept the Advisory Commission's decision, then this decision is not binding.[84] If the person accepts it, then the competent authorities are bound by it and must follow it. However, the proposed Commentary to the new paragraph contains alternative wording[85] to ensure that States wishing to do so may allow the competent authorities to depart from the arbitration decision, provided that they can agree on a different solution. The provisions of the Arbitration Convention are specifically referred to in the proposed Commentary when explaining this alternative wording.[86]

Overall, it would seem that the new MAP clause and its accompanying Commentary and Sample are striving for alignment with the Arbitration Convention. To an extent, this seems to be the general overtone of recent changes or proposed changes to the OECD Model, even though the reason behind these changes is certainly not Community law. Although the correlation between Community law and these OECD Model changes is openly reflected upon in some of these reports, the reports tend to be silent (or offer no answers) in the areas where there is divergence of approach, whether minimal or significant.

Quite understandbly so. In proposing changes to the OECD Model, the Committee of Fiscal Affairs and all its Working Groups serve the goals and policies of the OECD member countries, not the EU. It is up to the EU to develop its own EU Model or perhaps lobby for its own working party in the OECD.

One thing seems to be clear from the above exposition of recent tax treaty developments: further alignment is desirable. If there is to be some differentiation,

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83 See Article 12 of the Arbitration Convention.

84 See wording of proposed paragraph 5 to Article 25 OECD: "Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, the competent authorities hereby agree to consider themselves bound by the arbitration decision and to resolve the case pursuant to paragraph 2 of Article 25 on the basis of that decision."

85 This is found in the proposed paragraph 66 of the Commentary. "[...] Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision or the competent authorities and the persons directly affected by the case agree on a different solution within six months after the decision has been communicated to them, the arbitration decision shall be binding on both States and shall be implemented notwithstanding any time limits in the domestic laws of these States."

86 See proposed paragraph 66 of the Commentary.

this should be done as transparently as possible in order to enable the Member States to act accordingly. Split loyalties are not conducive to better integration of the European and the international tax community – if this is indeed what we are seeking to achieve.