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examine an important tax development or issue of interest to an international readership of tax
professionals, lawyers and scholars. The contribution should be of a practical nature and provide
background, perspective and analysis as well as a description of the tax development or issue.

Manuscripts should range from 5,000 to 12,000 words. Manuscripts accepted for publication in
the Bulletin will be subject to editorial review and revision. Additional information may be
obtained from the managing editor.

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Editorial

A New Style Special Issue – But It’s Still Special

The Publisher and the Managing Editor would like to update readers on an important development regarding the Bulletin for International Taxation.

Based on the input from readers in the recent survey and discussions between the Editorial Board and the International Fiscal Association (IFA), for 2011, a new format Bulletin Special Issue has been devised. Previously, the Special Issue coincided with the annual IFA Congress. It is now felt that it would be more interesting for readers if the Special Issue were published in advance of the IFA Congress so as to highlight the Congress themes. Accordingly, from this year onwards, the Special Issue is published in April/May.

Specifically, in the April/May Special Issue, half of the Special Issue concerns the two Subjects of the Paris IFA Congress (“Cross-border business restructuring” and “Key practical issues to eliminate double taxation of business income”) from a French perspective, together with four articles dealing with topical tax developments in the host country, France (French tax treaty policy, the interaction between tax treaties and French domestic law, the new non-cooperative jurisdiction tax reform in France, and beneficial ownership and tax treaties from the French point of view). All of the contributions have been written by noted French tax experts and professionals. The intention is to provide readers with a foretaste of the Paris IFA Congress, with a view to wetting their appetite.

With regard to the 2011 Special Issue, the Managing Editor would like to express his thanks to Bruno Gouthière of CMS Bureau Francis Lefebvre for all of his assistance in compiling the Paris IFA Congress section of the Special Issue.

The remainder of the Special Issue is devoted to the Bulletin as usual, i.e. the Tax Treaty Monitor, the Tax Treaty Case Law Monitor and the general Articles section.

A normal issue of the Bulletin will be published at the time of the Paris IFA Congress in September. This will give those readers who are not already familiar with the Bulletin an idea of its regular contents.

Both the Publisher and the Managing Editor welcome any feedback from readers on the new format Special Issue, and any other aspects of the Bulletin on which they have an opinion.

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Sophie Witteveen* and Fraser Dickinson**

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In this foreword to the 2011 Special Issue, Manuel Tron, the President of the International Fiscal Association (IFA), introduces the Paris 65th IFA Congress. In so doing, he outlines the scientific and other aspects of the Congress, as well as providing some thoughts on the future of IFA.

1. An Invitation!

It is, indeed, a pleasure to introduce our 65th International Fiscal Association (IFA) Congress to be held in Paris from 11 to 16 September this year. Today, 73 years after IFA’s foundation, IFA has 62 branches around the world with more than 12,000 members and, for the first time, a Regional Committee.

IFA is more alive than ever before. It sponsors local, bi-national and now regional activities in a regular programme, all of which, combined with its annual world Congresses, allow its members to interact, exchange knowledge and views, and learn from each other, whilst, at the same time, creating a unique network of tax specialists representing all of the sectors in the field of international taxation.

2. Scientific Programme: Subjects and Seminars

2.1. What to expect

In Paris, as is traditional, we will discuss the main two subjects of the Congress as well as attending many interesting seminars, together with truly unique cultural and social functions. This year, our two main subjects are as described below.

2.2. Subjects

2.2.1. Subject 1: Cross-border business restructuring

This is undoubtedly a current matter of interest for companies, practitioners, tax authorities and international organizations. The tax authorities of a number of different...
countries have been reviewing the reorganizations carried out by multinational enterprises by which they redeploy assets, functions and risks around different countries in the search for greater efficiency and global competitiveness. This has generated a number of questions addressing issues ranging from the true motivation for the reorganizations to the substance of the implemented changes.

General Co-reporters, Mr Heinz-Claus Kroppen (Germany) and Mr Jose Carlos Silva (Mexico), have compiled the branch reports into a comprehensive general report, which is not only technically accurate, but interesting to read as well.

The Chair of the discussion, Mr Bruno Gibert (France), has developed a comprehensive agenda and a case study, which will make for an outstanding presentation on issues, such as the allocation of profits, the mechanisms available to audit reorganizations and the use of the mutual agreement procedure.

2.2.2. Subject 2: Key practical issues to eliminate double taxation of business income

For this subject, the General Co-reporters, Mr Gauthier Blanluet and Mr Philippe Durand (France), have formulated a precise set of directives that has allowed our branch reporters to prepare their reports and to address the main issues concerning this topic. The report combines the theoretical foundations of the methods to eliminate double taxation, with a precise practical view of the problems that businesses have to deal with and resolve.

The Chair of the discussion is Mr Philip West (United States), a well-known expert, who will lead the panel in addressing, inter alia, issues such as the inconsistencies on how and when to recognize taxable income, and the deduction of foreign losses.

2.3. Seminars

2.3.1. Overview

Again following our long-standing tradition, the Paris Congress offers interesting seminars, all of which will be discussed under the expert guidance of the selected chairs, who are not only well-known experts in the relevant fields of analysis, but are also active leaders of discussion, thereby ensuring both a high quality and a lively discussion of each topic. The seminars and the chairs for this year are summarized below.

2.3.2. Seminar A: VAT aspects of business restructuring

Mr Marcus Achatz (Austria) will lead the discussion on this topic, which, following the essential elements of the case study used in Subject 1 (see 2.2.1.), will present the VAT aspects of cross-border business restructurings and demonstrate the interest and relevance of VAT in relation to such restructurings.

2.3.3. Seminar B: The corporate tax base – alternative basis for corporate taxation and its international consequences

Mr Antonio Carlos de Abreu e Silva (Brazil) has assembled a group of experts and relevant materials to analyse the alternatives considered and used by different countries to create taxable bases quite different from the generally understood concept of income and their relation to tax treaties.

2.3.4. Seminar C: Credit vs exemption

Always a subject matter worth discussing, Mr Yoshihiro Masui (Japan) will lead a group of selected panellists to re-evaluate once again the merits, advantages and/or disadvantages of one method of eliminating double taxation compared to the other. This is a companion seminar to Subject 2 (see 2.2.2.).

2.3.5. Seminar D: IFA/EU – Double taxation and EU law

A well-known and respected international tax expert, Mr Peter Wattle (the Netherlands), will have the opportunity to lead a group of EU experts in dissecting the application of the EU Directives and the avoidance of double taxation.

2.3.6. Seminar E: Recent developments in international tax

Always unexpected and always new in content, this seminar presents the current issues generating interest amongst IFAs constituency. Mr Phillip Baker (United Kingdom), who needs no introduction, is in charge of identifying the specific topics of discussion as well as the discussants.

2.3.7. Seminar F: Uncertain tax positions

Some believe this is the future and the way it should be, whilst others consider this to be a clear example of excess of reporting. Mr Phillipe Derouin (France) will conduct the discussion, which we anticipate will be intense and passionate.

2.3.8. Seminar G: Collective investment vehicles

In a globalized economy in which diversification appears to be the name of the game, Mr Nigel Johnston (Canada) will chair the seminar analysing the issues surrounding the treatment of collective investment vehicles and access to treaty relief.

2.3.9. Seminar H: IFA/OECD “Liable to no tax”

In an always much-anticipated topic, Mr Richard Vann (Australia) will coordinate and lead the discussion involving OECD representatives together with other tax experts in examining the requirement of being “liable to tax” to be treated as a resident of a contracting state.

2.3.10. Seminar I: Immovable properties and treaties

This subject concerns the most “fixed” of assets that can be envisaged and the rapidly evolving international busi-
ness dealings around these assets. Mr. Ekkehart Reimer (Germany) will lead the discussion on this always relevant topic.

2.3.11. Seminar J: Tax rulings in an international framework

Can a ruling granted in one jurisdiction become an element of unfair advantage for a taxpayer in another? Mr. Marcus Desax (Switzerland), a former President of IFA and an experienced chair, will lead a panel to explore in depth this and other aspects of the rulings issued by tax authorities around the world.

2.3.12. Wrap-up

As in the past, each seminar will have its peculiarities imprinted by its chairs, but be certain that at Central IFA great attention has been paid to both the selection and preparation of the panel members, and to the structure and procedures to be observed during the discussion to make them more interesting and dynamic.

3. Other Scientific, Cultural and Social Events

The subjects and seminars represent the core of our Congress this year, but, within it, there are other events worth noting:

- the Young IFA Network (YIN) Seminar, which is already a tradition, is a refreshing view of our common interests and the way our best part (our younger members) address these from the scientific and technical points of view. The YIN Meet and Greet Reception is where to enjoy social interaction amongst not only the young members, but also those members attending an IFA Congress for the first time;
- we have retained the Government Luncheon, at which the representatives of the different branches of the governments of the countries represented at the Congress will be invited by the Organizing Committee to interact, and, as usual, to listen to a carefully chosen speaker; and
- for the second time at an IFA Congress, we will have the Corporate Tax Officers Luncheon, at which invited members of this sector of IFA will meet to enjoy a presentation and again to interact.

As in other years, issues papers and other documentation for the main subjects and the seminars will be made available shortly before the Congress on IFA’s web site (www.ifa.nl); please consult these materials. As is our way, if you have questions or suggestions on issues that you would like to be addressed, you may get in touch with the Chairs of the various sessions via the IFA General Secretariat (e-mail address: t.gensecr@ifa.nl).

The different committees of Central IFA will meet and work during the Congress. At these sessions (always occurring backstage, so to speak), we will consider current projects (including, inter alia, future Congresses).

We are convinced that, as you have also indicated, to keep the different sectors within IFA motivated and integrated worldwide, we need not only better but also more enjoyable Congresses, and, believe me, this one will be memorable. We will also have a series of social and cultural events in Paris that can only take place in this city. Please join us and the rest of the attendants to the Congress to enjoy them. For more information, visit IFA’s web site!

4. Our Path to the Future

At the Rome Congress last year, a number of discussions took place emphasizing the uniqueness of IFA, for ours (and allow me to repeat it) is certainly a unique organization, which should and will remain neutral, but without remaining passive.

Looking forward, IFA will continue to discuss the ideas and concerns of taxpayers, academics, corporate tax officers and independent tax practitioners, all of whom have a voice and the right and need to use it in the face of the new ‘enhanced relationship’. We will continue the work of the sectorial groups that started last year in Rome, and we intend to develop this further and eventually to produce conclusions that will allow all of us in IFA to be better at what each of us do.

Once we have defined what it is that the members of IFA want and what it is that they believe in, we will be able to include more advanced groups in the discussion, particularly the OECD, which is clearly leading the way in this respect and with which we need to continue this work if we want to complete it.

Looking to ourselves, last year in Rome, we made a number of important decisions and the first regional committee was formed within IFA. Specifically, 11 branches from the Latin American region (Argentina, Brazil, Bolivia, Chile, Colombia, Costa Rica, the Dominican Republic, Mexico, Peru, Uruguay and Venezuela) decided to formalize a working agreement through which they bring IFA closer to its members. There have already been two regional meetings (in Argentina and Chile), and further ones are planned and in the making (this year, in Colombia). At Central IFA we believe that the regionalization of the work of IFA will bring great benefits to its members, will allow most of them to attend to international gatherings closer to home, and will enable them to discuss international matters more relevant to their particular situation. The Latin American Regional Committee will meet during the Paris Congress to advance its work in respect of international tax law in the region.

This year we expect to have other regions following the same route. In fact, the members of several Central and Eastern European countries are currently working towards the definition of a possible Regional Committee in that part of the world. We hope to see this established and we certainly expect them to gather whilst in Paris for the Congress to further advance their organization.

IFA is an organization that belongs to its members, to all of them, to all of us; let’s make the best out of it, let’s bring it closer to us in each corner of the world, and let’s enjoy the benefits of being part of it, for it is undoubtedly a great organization. See you in Paris!
French Tax Aspects of Cross-Border Restructurings

International restructurings have increased exponentially in the current globalized business world. Consequently, the authors consider various key aspects of such restructurings with regard to France, including OECD guidance on the issue, the recharacterization of transactions, challenges to pre- and post-restructuring transactions, and relevant financing matters.

1. Introduction

In recent years, the rapid development of communication and transport has resulted in a fundamental change to international business relationships. The globalization of exchanges has generated opportunities through the opening-up of new markets, whilst, at the same time, the arrival of new competitors has contributed to an increase in the level of clients’ demands and expectations and has forced enterprises to tighten margins and monitor costs more closely.

Accordingly, multinational enterprises (MNEs) have grown used to frequent restructurings to adapt to this ever-changing environment, by ensuring a local presence in new markets and controlling or reducing costs to maintain a sufficient level of operational margin, whilst simultaneously charging competitive prices. Typically, such restructurings take the form of changes in the supply chain organization – for example, through the creation of local distribution entities or through the closure of certain entities or the modification of such entities into structures assuming less functions and risks. Following this trend, a number of groups have decided to turn their local buyer-reseller entities into commissionaire structures, reallocate manufacturing operations to countries with lower cost structures or transfer other functions from one country to another.

Restructurings may also take place when an acquisition results in the coexistence of two entities – one in the purchasing group and another in the purchased group – that have similar functions. In such circumstances, the need to rationalize the group could result in the reallocation of functions, the termination of certain positions, the closure of premises or even the closure of one of the two entities.

Restructurings are generally accompanied by significant exceptional costs and expenses. Such costs and expenses, in addition to the transfers of functions and profit potential, have an effect on the taxable income realized in the relevant countries.

It is for these reasons that business restructurings have become a recurring topic in international taxation. This is also why this topic is considered by tax authorities in the context of tax audits involving MNEs. Consequently, the absence of clear guidance on this subject has become a growing concern for MNEs.

International organizations such as the OECD have established dedicated working groups to provide guidance on the subject and reduce the level of legal insecurity (see 2.). However, such guidance has not succeeded in resolving all of the outstanding issues.

In this regard, the first level of analysis should consider the possibility that the tax authorities may refuse to recognize the reality of the operation and, therefore, disregard or recharacterize such transactions (see 3.). The tax authorities may also challenge as abnormal the compensation paid in respect of the transactions corresponding to the restructurings (see 4.) or intercompany transactions post-restructuring (see 5.). Finally, the financing of the restructurings may give rise to further issues (see 6.).

2. OECD Guidance on Restructurings

In 2005, the OECD established a working group to investigate the transfer pricing aspects of business restructurings. This resulted in a discussion draft that was released for public comment in September 2008. Based on the comments received from practitioners and private organizations, a new Chap. IX was added to the latest version of the “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” (the “Transfer Pricing Guidelines”) published in July 2010.

The Transfer Pricing Guidelines address the transfer pricing issues that can arise in respect of the cross-border reallocation of functions, risks and assets. The OECD notes a development from vertically integrated business models, in which local entities can be considered to be acting as real entrepreneurs, to more centrally integrated business models. As an example, this results in a change from local fully fledged manufacturing or distributing entities to more limited-risk types of structures, such as risk-stripped distributors, commissionaires or toll man-
manufacturers, with a consequent transfer of profits to the country in which the central entity is established (often in a jurisdiction where it enjoys a lower tax burden than that imposed in the countries of the local entities).

The OECD makes a number of recommendations to ensure the correct application of the arm’s length principle to such restructuring transactions. In this regard, the OECD deals with the transfer of risks, the remuneration, and the recognition of the restructuring itself and of post-restructuring transactions, taking into consideration the fact that the restructuring may entail transfers of valuable intangibles or a transfer of profit potential.

The Transfer Pricing Guidelines refer to the rather subjective concept of “commercially rational behaviour” that is supposed to reflect what an independent enterprise would have done in a similar situation. This involves an analysis of all options available to a taxpayer to identify the most favourable approach (“the best alternative to a negotiated agreement”).

France generally recognizes and applies the OECD principles insofar as they are consistent with the French concepts and rules in respect of an “abnormal management decision” and transfer pricing, even if the principles are not per se transcribed into French law. Accordingly, the French tax authorities (FTA) may refer to the principles set out by the OECD in the new Transfer Pricing Guidelines regarding business restructurings as published in July 2010.4

3. Risk of Non-Recognition of Intercompany Transactions

When a business restructuring could result in the reduction in the taxable income in a given country, the first reaction of the local tax authorities is often to dispute the realization of the operation itself or its effects. This possible “non-recognition” of transactions was addressed by the OECD in Part IV of Chap. IX of the Transfer Pricing Guidelines. If transactions are not recognized, the consequence is either that no transaction is deemed to have occurred or that the transaction is recharacterized as a different transaction for transfer pricing purposes, regardless of the original qualification given by the parties to the operation.

The OECD has reconfirmed and emphasized that, generally, enterprises should be free to organize their business operations as they see fit and that tax authorities should not be allowed to interfere in the management decisions of an MNE, or in the way the enterprise designs or structures the locations of its business operations. Accordingly, such non-recognition of the actual transaction or arrangement should be limited to exceptional cases. However, the Transfer Pricing Guidelines allow for the non-recognition or recharacterization of intercompany transactions in the following two situations: (1) where the economic substance of a transaction differs from its form; and (2) when the arrangements made in relation to the transactions, viewed in their totality, differ from those that would have been adopted by independent enterprises behaving in a commercially rational manner.5

The reference to the concept of a “commercially rational transaction” means that, in other terms, the tax authorities would be entitled to assess whether or not the transactions and related risk allocations “make commercial sense”. Where this is not the case, the tax authorities could recharacterize the relevant transactions.

Many practitioners consider that the terminology adopted by the OECD is not entirely satisfactory, as it seems to permit a subjective approach, whereby the tax authorities could clearly interfere with the freedom of management of enterprises.6 It has also been noted that taxpayers cannot reasonably be expected to justify each and every decision after having envisaged and documented all of the other options available.

Under French law, the FTA are not bound by the characterization given by the parties to a transaction if this does not correspond to the real nature of such a transaction. In such circumstances, the FTA are entitled to disregard the characterization and to draw the tax consequences of the correct characterization.

As an example, the Transfer Pricing Guidelines refer to the transfer of a valuable trademark to a shell company with no real capacity at a local level to develop a marketing strategy or assume the risks associated with the management of the brand name.7 It is, therefore, important to ascertain an appropriate allocation of capital and human resources that is consistent with the business model adopted. Another example is a licence agreement for the use of an intangible asset that, in fact, results in the definitive transfer of such asset (taking into account the useful life of this asset, the exclusivity of the licence, the payment terms and other factual and contractual elements). In these circumstances, the FTA may recharacterize the license as an assignment and consider the payments made under the agreement to be the purchase price instead of licence fees for tax purposes.

The FTA can also seek the non-recognition or recharacterization of a transaction on the basis of the concept of “abuse of law” or “fraud in respect of the law”, as set out in Art. L. 64 of the French Tax Procedures Code (Livre des Procedures Fiscales, LPF). The definition in Art. L. 64 of the LPF has been extensively redrafted following a series of court cases8 and now provides that the FTA may refuse the application of certain favourable tax regimes where

6. OECD, “Public comments on the Transfer Pricing Aspects of Business Re-structurings”, available at www.oecd.org/document/25/0,3746,en_2649_37989760_42155737_1_1_1_1,00.html.
7. OECD, “Public comments on the Transfer Pricing Aspects of Business Re-structurings”, available at www.oecd.org/document/25/0,3746,en_2649_37989760_42155737_1_1_1_1,00.html.
it appears that an arrangement or structure has been set up for the sole purpose of avoiding or reducing taxation and is based on a wrongful application of a tax rule, which is counter to the initial will of the lawmaker, or if the arrangement or structure is artificial.

Generally, as previously noted, international business restructurings, even though they may result in a reduction in or the transfer of the taxable base, cannot be deemed to have been decided solely for such tax optimization purposes. Rather, restructurings are normally driven by the need to reduce costs or to rationalize a business structure, with tax aspects being only a side effect of the restructuring. As an example, the FTA could hardly oppose a decision to relocate a production centre outside France to a country where the cost of the workforce is lower by arguing that the decision was solely tax driven.9

4. Assessment of the Arm’s Length Nature of Restructurings

4.1. Introductory remarks

When undertaking a business restructuring, MNEs should take into account the potential exit costs that this restructuring may involve. A first question to ask is whether an indemnity must be paid, either as a result of the termination of an existing contractual relationship (see 4.2.), in exchange for the transfer of an intangible asset (see 4.3.) and/or as a result of a loss of profit potential (see 4.4.). Even in the absence of the transfer of clientele, the transfer of an activity (or successor’s agreement) could have transfer tax implications (see 4.5.). It should also be analysed as to whether the restructuring costs are deductible at the level of the local entities or whether they should be recharged (see 4.6.). Finally, the question arises as to whether the restructuring results in a change of activity significant enough to be regarded as a cessation of activity (see 4.7.).

4.2. Indemnification for termination of contracts

Where the restructuring of business operations in an international group results in the termination of existing intercompany contracts, the question must be asked as to whether or not such a termination should involve an indemnification in respect of the “terminated” party. The answer should be derived from an analysis of what independent companies would have done in a similar situation.

For example, it may result from the terms of the intercompany agreement that the terminating party should indemnify the other contracting party for the termination of the contractual relationship. If the terminated party renounced such an indemnity without any commercially rational reason, i.e. for no other consideration, the FTA could consider that this was an abnormal management decision, resulting in a deemed undisclosed transfer of profits.

In the absence of specific contractual terms, a termination indemnity may also be due for legal reasons. Certain contractual relationships, such as commercial agency agree-

ments, are covered by specific legal provisions that can give rise to an obligation to pay an indemnity, regardless of any contrary terms in the agreement. For instance, a commercial agent is legally entitled to a termination indemnity when the commercial relationship is terminated by the principal.10

Even in the absence of a specific legal regime, the French Commercial Code (Code de Commerce, CC) provides that, as a general principle, the termination of contractual relationships should be made with sufficient and reasonable prior notice.11 A number of court cases have been heard regarding this matter. Abusive termination may also give rise to an obligation to pay indemnities under civil law.12

In an intercompany context, it can arise that, for the sake of simplicity, the parties do not respect such a prior-notice obligation or otherwise provide in the agreement that it can be terminated without any cause, indemnity or prior notice. In such circumstances, the FTA may try to determine whether or not an independent party in similar circumstances would also have renounced a right to indemnity on termination.13

In all cases, the circumstances of the termination must be considered in light of previous contractual arrangements. This would include, for example, the existence of significant investments, or the level of profits arising from a pre-existing transfer pricing policy.

4.3. Transfer of a going concern, trade asset or workforce

When preparing for a restructuring, another critical issue is whether or not the transaction can be deemed to result in the transfer of a valuable asset. This is frequently ignored by enterprises, notably because the most valuable assets are not always booked as such in the balance sheets of the companies involved in the restructurings. Such a situation may apply to trade intangibles created by the enterprise, such as patents or brands, and obviously for going concerns or goodwill. It is not usual under French law to consider the value of a workforce, but where employees are to be transferred, it may be contemplated whether or not the transferor is entitled to compensation corresponding to the estimated cost of replacing the workforce.

As noted in 3., the FTA are not bound by the characterization given by the parties to a transaction where it does not correspond to the real substance of the operation. Accordingly, even in the absence of a written transaction or recognition by the taxpayer, the FTA may, nevertheless, consider that a taxable transaction has occurred. The question of a termination indemnity is, however, different from that of the transfer of assets. For example, a termi-

10. Arts L 134-12 and L 134-13 CC.
11. Art. L 442-6-1, 5 CC.
nation may take place without a transfer of assets; conversely, a transfer of assets may take place without a termination.

Transactions resulting in a transfer of an asset out of the balance sheet of a company should be treated as a sale giving rise to a capital gain or loss. Such gains or losses are taxable at the normal rate of corporate income tax (33⅓%, plus 3.3% on the portion of corporate income tax exceeding EUR 763,000, although certain specific assets can benefit from lower taxation on disposal).

In the case of a transfer of goodwill and/or clientele, transfer tax would also apply. According to Art. 719 of the French Tax Code (Code Général des Impôts, CGI), the sale of a French ongoing business concern or clientele is subject to French registration duties if: (1) the deed is concluded in France; or (2) the clientele is based in France. Transfer tax applies to the portion of the price paid (or fair market value if higher) of the tangible and intangible fixed assets other than real estate properties and is levied at the following rates:

- 0% up to EUR 23,000;
- 3% on the portion of the purchase price between EUR 23,000 and EUR 200,000; and
- 5% on the portion of the purchase price over EUR 200,000.

According to the FTA’s guidelines, 14 when a deed is not signed in France, only the transfers of French clientele are subject to registration duties in France. In this regard, clientele is considered to have a physical base in France when it is “located or exploited in France”. Consequently, on the basis of this definition:

- a foreign enterprise not established in France can argue that it had no French-based clientele, even if it had customers in France, where sales were negotiated and concluded outside France; and
- an enterprise established in France and carrying out its activities from France can be considered to have French clientele, even if the customers were located outside France.

A transfer of an exploited trademark or patent should have similar consequences as the sale of a going concern, as clientele is generally deemed to be attached to such an asset. However, specificities must be taken into account:

- With regard to corporate income tax (and capital gains tax), Art. 39 terdecies 1° of the CGI provides for a favourable tax regime for long-term capital gains generated by a licence or assignment of patents, patentable inventions or industrial manufacturing processes under specific conditions. This favourable regime allows for the taxation of such income at a reduced corporate income tax rate of 15%. It is, however, not available for intercompany sales of patents between related entities within the meaning of Art. 39, 12° of the CGI, i.e. when one of the companies controls the other (a holding of, directly or indirectly, 50% or more of the share capital or the de facto decision-making power) or where the two companies are controlled by another (third) party.

- For transfer tax purposes, a sale of an exploited patent may benefit from a favourable transfer tax regime. In this regard, Art. 731 of the CGI states that sales of patents are subject to a fixed registration duty of EUR 125.

It should also be noted that, where the transfer is organized as a transfer of company shares, such a transfer could be subject to different tax treatments, depending on the legal form of the company and on the nature of the assets (real estate) held by the company whose shares are being transferred.

Finally, Art. 720 of the CGI provides for the assessment of transfer duties on the transfer of functions for consideration (convention de successeur). For more on this, see 4.5.

It has to be determined whether or not the restructuring results in a change in the legal or economic ownership of a going concern or valuable trade asset. As an example, when changing from a fully fledged distributor to a low-risk type of distribution structure, such as a commissionaire, a frequent topic of discussion with the FTA is whether or not this gives rise to the transfer of a going concern. This would be the case if the fully fledged distributor was arguably the owner of its clients, whilst the commissionaire, acting as a mere intermediary, would not have any title over its clientele.

This issue cannot be resolved by the mere application of tax principles. In this respect, the case law of the Conseil d’Etat (Supreme Administrative Court) acknowledges that the decision to tax must be based on the application of tax principles to a legally classified situation. 15

Recently, the development of litigation regarding the use of commissioner agreements in retail activities has resulted in the Cour de Cassation (Supreme Civil and Commercial Court) considering these structures in depth. In particular, certain independent commissionaires have requested that an agreement be recharacterized as a mere commercial-agent agreement, as this would allow them to claim termination indemnities from the principal. In the recent case of Chattawak, 16 the Cour de Cassation emphasized that the primary difference between a commercial agent and a commissionaire is that a commercial agent cannot be deemed to have its own clientele. A contrario, this would appear to confirm that a commissionaire should be considered to own its clientele.

From a tax perspective, the analysis of the Conseil d’Etat is that the concept of a ‘going concern’ corresponds to an activity exercised autonomously at the risk of the enterprise and through the use of its own means. 17 This...
analysis may be relevant for a commissioner structure where the commissioner has direct relationships with customers, but it may result in the recognition of the existence of a going concern in a number of situations where customer relationships are not maintained directly with the local entity.

Another example of questionable situation may be found on the restructuring of a research and development (R&D) activity involving a transfer of the ownership of intellectual property (IP). If a group has several companies performing R&D functions on their own account, these entities, therefore, have a title to the R&D rights they create, with possibly a cross-licensing system allowing several entities to use the IP thereby created by other members of the group. A change of structure whereby one enterprise takes on the role of the central IP owner, with all the other R&D entities acting as contract R&D service providers on behalf of the centralized entity, should be carefully implemented, as it may involve transfers of IP. Consequently, "buy-in" arrangements could be necessary not only for the transfer of existing IP to the new central IP owner, but also for the transfer to the R&D service providers of the IP necessary for their activities. Other arrangements, such as cost-sharing ones, should also be organized carefully, insofar as they involve buy-in payments.

4.4. Loss of profit potential
In certain cases, a restructuring may result in a reduction in profit potential for a given entity. This may even be the case if no identified going concern or asset is transferred.

The Transfer Pricing Guidelines provide useful guidance on this by indicating that an independent enterprise need not necessarily receive compensation when a change in its business arrangements results in a reduction in its profit potential or expected future profits. The Guidelines give an example of the conversion of a fully fledged manufacturer into a contract manufacturer. Such an operation would probably result in a reduction in the profit potential expected to be realized by the new contract manufacturer, as compared to the profits realized under its former status as a fully fledged manufacturer acting for its own account. However, it could be argued that this change in the profit potential is fully compensated for by the reduction in the level of functions and risks assumed. In this case, no indemnity would be necessary to the extent that no identifiable asset was transferred.

The OECD considers that whether an indemnity is justified depends on the circumstances of the restructuring. It is, however, acknowledged that the indemnity would be more justified if the entity renouncing its fully fledged status realized recurrent significant profits in the past and operates in an industry with optimistic profit forecasts.

If the remuneration of the entity before and after the change can be considered to be at arm's length, taking into account the functions and risks assumed, and if no identified business asset has been transferred, there is no obvious need for an indemnity. However, this conclusion may be affected by market trends. In an economic downturn, where fully fledged structures are more exposed to losses than limited-risk entities, probably no need for an indemnity can be established. Conversely, if a limited-risk distributor is transformed back into a fully fledged distributor in the context of an economic downturn, the conversion may be found to be inappropriate.

4.5. Transfer of activity without clientele or goodwill (convention de successeur)
Even in the absence of the transfer of clientele or significant intangible asset, a restructuring may qualify as a successor's agreement subject to transfer tax in France. Under the provisions of Art. 720 of the CGI, a successor's agreement gives rise to a liability to transfer tax on all of the amounts paid or borne by the successor as a result of the agreement (at the same rates as for sales of going concerns; see 4.3.). A successor's agreement may so qualify if it is concluded in exchange for consideration that the purchaser is allowed to perform the activity formerly carried out by the seller.

A key condition is that the activity of the transferee must be identical to that formerly carried out by the transferor. In this respect, the case law of the French tax courts indicates that, when an activity initially carried out internally by an enterprise for its own benefit is subsequently transferred to another entity that acts as a service provider for third parties, the activities, before and after the transfer, cannot be considered to be identical. In particular, in-house services cannot be considered to be of a professional nature, whilst services provided to third parties are of a professional nature.

4.6. Deductibility or reinvoicing of restructuring expenses
In the context of international groups, a decision to restructure is often taken at group level and not at the level of each local entity. The question, therefore, arises as to whether or not the local entities should bear the costs of the actions that have been decided on elsewhere.

In the absence of recognition of the concept of "group interest", the arms-length nature of a restructuring must be assessed from the perspectives of each of the restructured entities. The fact that the restructuring may be motivated...
by sound commercial reasons at the level of the group is not relevant in this analysis.

For example, a decision may be taken at group level to downsize the group presence in certain jurisdictions or to relocate certain production or R&D functions in others. These decisions may result in the local entity bearing significant costs in relation with the downsizing, such as redundancy indemnities or the disposal or scrapping of assets.

These costs are by nature exceptional as they are incurred only once. Consequently, a first reaction could be to exclude such exceptional operations from the transfer pricing discussion. The arm’s length principle is based on comparison with independent companies, which obviously do not incur similar exceptional expenses. This is why the transfer pricing methodologies, such as the transactional net margin methods, are applied at the level of operational margins. Exceptional costs are disregarded in such circumstances, as they are considered to be “below the line.”

However, such costs may significantly affect the profitability of the local company or even result, in certain cases, in threatening its financial viability. The local tax authorities may, therefore, examine in detail these costs and challenge the fact that the costs were borne by the local entity, either by refusing a tax deduction for such costs or through a transfer pricing approach, which could result in an argument that all or part of the costs should be recharged to other entities in the group.21

If the costs incurred are the result of the termination of an activity that would not have been so terminated by an independent third party without compensation, the FTA may have a ground for refusing the deductibility of such costs. In contrast, if it can be demonstrated that the costs result in a more efficient management of the French entity concerned in the restructuring and increased profitability at the level of this entity, the costs should arguably remain at the level of the French entity.

In this regard, it should, however, be noted that, as a general principle, in the situation in which a specific operation would primarily benefit the local entity and to a less extent other entities of the group, this would not result in an obligation for the local entity to recharge these costs. Consequently, in order to decide on the treatment of the costs, it must be determined which entity primarily benefits from the restructuring.

These issues are often not anticipated by MNEs when preparing transfer pricing documentation, as it is always easier to document a recognized intercompany transaction than to justify the absence of the recharge of costs. This is why such matters are frequently treated only within the context of a tax audit, after a decision by the FTA to reassess the taxable basis of the company bearing the costs without recharge. However, restructurings should be considered as falling within the scope of the transfer pricing documentation requirements provided for by Art. L. 13 AA and AB of the LPF with regard to large MNEs exceeding certain thresholds.22 In this context, any “missing” transaction could be regarded by the FTA as a lack of documentation.

4.7. Change or cessation of activity

Changes of activity are by law assimilated to a cessation of activity, provided that the change is sufficiently material. The consequences involve, in particular, the immediate taxation of untaxed capital gains and income, and the loss of any non-offset losses.

In the context of a group restructuring, it is necessary to determine whether or not the change in the functions and risks assumed by each company is a material change. This issue can arise where a restructuring results in a reduction in the functions performed locally – for example, in a change from a fully fledged distributor to a commissionaire.

French case law indicates that a change in the activity is considered to be material if it entails that the enterprise changes its clientele, or undergoes significant changes in the functions performed and the personnel or assets used.23 Recently, the Conseil d’Etat clarified certain issues regarding the concept of a “material change of activity” where a company performing several activities ceased one of these or where, in contrast, it added a new activity to its existing activities. In practice the characterization as a fundamental and material change of activity depends on various criteria (for example, the relative size of the former and the new activities in terms of turnover).24

Clearly, a change from a distributor to a commissionaire should involve limited changes in the turnover, operational structure and headcount, and would correspond more to a change in the level of risks incurred. This does not appear to correspond to the definition of a material change as set out in case law. A similar conclusion can also be reached in respect of a change from a fully fledged manufacturer to a contract manufacturer.

In a case concerning a conversion of a buyer-reseller into a commissionaire, a French administrative court held that such a conversion does not represent a significant change of business when the business remains the same, in the same industry, and with the same employees and the same clients. The court indicated that the conditions of the supply of goods and the modalities of the compensation of the commissionaire, in principle, do not affect how the change of the business is qualified.25 However, this decision was issued by a first-level administrative court and

25. Administrative Tribunal (Tribunal administratif) of Versailles, 10 July 2002, Société Nellcor Puritan Bennett France.
has not been confirmed either by the Conseil d’Etat or by the FTA. Following this rationale, the conversion of a fully fledged distributor or manufacturer into a transparent agent or toll manufacturer would probably be treated as a material change of activity that also results in a transfer of goodwill.

5. Post-Restructuring Aspects

5.1. Introductory remarks

Not only the restructuring itself, but also the post-restructuring aspects should be reviewed from a tax perspective. Notably, the FTA may try to establish the existence of a taxable permanent establishment (PE) in France of a foreign entity of the group (see 5.2.) or challenge the substance of the group entities abroad (see 5.3.). The FTA may also challenge the transfer pricing policy applied after the restructuring (see 5.4.).

5.2. Permanent establishments

The application of territoriality rules and, in particular, of the concept of a “permanent establishment” is often a matter of concern for MNEs. In the context of international business restructurings, it is necessary to ensure that the contemplated change does not result in the characterization as a PE. This issue is particularly important where the restructuring consists of a change to a more centralized type of structure, with a reduction of the functions assumed by the local entities.

The FTA challenged a number of commissionaire structures by relying on the decision of the Paris Administrative Court of Appeal in Zimmer. In this regard, the FTA argued that commissionaires should be considered to be independent agents empowered to engage their foreign principal in contractual relationships with customers in France within the meaning of Art. 5(5) of the OECD Model Tax Convention (the “OECD Model”).

The Zimmer decision was grounded on an economic analysis of the contractual relationships, whereby the Court tried to demonstrate that the principal was bound by the commissioner with regard to third parties. This approach was based on an extensive interpretation of the first sentence of Para. 32.1 of the Commentary on Art. 5(5) of the OECD Model, which states that:

the phrase 'authority to conclude contracts in the name of the enterprise' does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.

Zimmer raised concerns regarding all commissionaire structures in France because the terms of the agreement and the functions of the commissionaire in the case, as reported by the Court, corresponded to common practice.

The FTA made extensive use of such PE reassessments, in particular in situations where they had initially unsuccessfully attempted to challenge the transfer pricing policy of an international group and specifically where the French commissionaire entity had incurred losses. Such PE reassessments were also indirectly caused by the case law regarding transfer pricing audits, which increased the burden of proof for the FTA.

Further reasons for PE reassessments were that, as compared to transfer pricing disputes, the penalties incurred are much higher and that the statute of limitations may be extended. Specifically, in respect of undisclosed activities in France (such as an undisclosed French PE of a foreign enterprise), the statute of limitations is extended to ten years. An exceptional penalty of 80% of the reassessments may apply in addition to the late-interest penalty, even though it is generally not applied in practice. In principle, if the activity of a PE is not disclosed, the FTA can also use the unilateral taxation procedure of Art. 1, 66 of the LPF, which transfers the burden of proof to the taxpayer and denies the taxpayer certain administrative appeals procedures. In addition, the FTA have developed the use of “tax raids” in this context. As a result, restructurings involving a change from a distributor to a commissionaire in France were put at risk and alternative solutions were envisaged by practitioners – notably the use of stripped (“limited risk”) distributors, which limit the PE exposure, whilst allowing a similar level of remuneration as a commissionaire.

However, the Conseil d’Etat held that, as a matter of principle, a commissionaire acting as such cannot give rise to a PE. The Court’s decision followed the conclusions of Judge Reporter Julie Burguburu, who made it clear that the Paris Administrative Court of Appeal had erred in interpreting the Commentaries on the OECD Model, due to a misunderstanding of the historic background leading to the publication of the Commentaries.

The Conseil d’Etat adopted the position of the Judge Reporter and clearly held that the concept of a “factual binding power” does not correspond to Art. 5 of the OECD Model. The Court expressly noted that this confirmed that, if the legal relationships correspond to a genuine commissionaire agreement, the activity of the commissionaire cannot give rise to a PE in respect of its principal.

30. Art. 1728, 1 CGI.
31. Following a 30-day prior notice to provide the account records of the deemed PE.
32. Art. L 16 B LPF.
33. Conseil d’Etat, 31 March 2010, Case Nos. 304715 and 308525, 10e and 9e s.-s., Sté Zimmer Ltd.
34. Bulletin des conclusions fiscales (06/2010), No. 64.
This decision limited the situations in which a commissionaire agreement may be recharacterized as another type of agreement. Although practitioners consider such cases to be exceptional, the FTA still tend to challenge commissionaire structures.

5.3. Lack of substance and economic activity

Another way of challenging an international business restructuring would be for the FTA to evoke a lack of substance and economic activity of a group entity established abroad, in order to recapture the taxable income realized by such an entity in France. The rationale for such a reassessment can be connected with the issue of non-recognition or recharacterization considered in 5.2.

A recent decision of the *Conseil d'Etat* provides an example of the application of the PE concept based on a lack of substance of a foreign company. In this case, a Luxembourg company carried out the wholesale and export of perfumes, as well as cosmetic and fashion products, whilst the French subsidiary of the Luxembourg entity was held to provide marketing services.

The FTA considered that all of the substantive activity was in fact performed from France. In particular, they noted that the Luxembourg company had only one part-time employee in Luxembourg during the audited period. Subsequently, the premises of the French subsidiary were searched and the FTA seized various documents produced on the letterhead of the Luxembourg company, i.e. invoices, business mails, customer account extracts, goods delivery and pick-up orders, and bank statements for accounts in France. The French company had also pretended that it was acting as a service provider on account of the Luxembourg company. However, no such agreement had been concluded and no corresponding compensation had been paid or booked.

The FTA concluded that the Luxembourg company had a PE on the premises of the French subsidiary. This was confirmed by the Versailles Administrative Court of Appeal and by the *Conseil d’Etat*, which confirmed the existence of a fixed place of business under Art. 4 of the France–Luxembourg tax treaty and noted that the Luxembourg company had the premises of its subsidiary freely at its disposal for the entire audited period to conduct its business.

This case is a good example of the current FTA trend in respect of tax audits to make use of all the opportunities available. These, in particular, include the right of communication, which allows obtaining information from French customers or suppliers regarding their relationships with the audited entity. The FTA also make use of administrative assistance procedures in coordination with the tax authorities of other countries, as well as “tax raids” under the procedure of Art. L 16 B of the LPF.

In a post-restructuring context, such a reassessment may be made if the description of the functions carried out by each of the parties does not correspond to reality. This is why it is necessary to ensure that the contractual arrangements following a restructuring always reflect the business model and relationships and responsibilities of each entity, and that these relationships are supported by written agreements that are correctly applied.

5.4. Transfer pricing policy following restructurings

The OECD publications dealing with business restructurings analyse the treatment of post-restructuring situations and the requirement for MNEs to adapt their transfer pricing policies. The primary question, as addressed by the OECD, is whether or not, and to what extent, transactions occurring following a restructuring should be treated differently from those that would have been performed by MNEs maintaining the same structure from the beginning, even though the facts and the business environment may have changed.

In general, the OECD guidelines envisage that arms length principles should not be applied differently to post-restructuring transactions as compared to pre-restructuring transactions. However, the question could arise as to how a transfer pricing policy should take into account market penetration or learning curve periods. For example, where an internal manufacturing activity is externalized and relocated to a new entity established in another jurisdiction under a contract manufacturing agreement with a cost-plus remuneration, it is to be expected that, during a start-up period, the basis of the costs invoiced will be high due to organizational problems, the loss of materials or inefficiencies that may be resolved over time. In such a situation, it has to be decided whether a fair transfer pricing approach would be to cap the compensation of the new contract manufacturer, either by not reinvoicing all of the costs or by reducing the markup applied, or whether the principal should bear the additional costs for a certain period.

It is generally accepted that, during a start-up period, the prices of intercompany transactions can differ from the prices of comparable enterprises that have greater experience in the relevant activity, thereby resulting in the principal bearing higher costs than would have been assumed had the principal concluded an agreement with a third party. The duration of such learning period obviously varies depending on circumstances, and the functions and industries, even though a three-year period has often been considered to be reasonable.

Another example, given by the OECD, is the existence of long-term relationships within a group. In this regard, the Transfer Pricing Guidelines discuss a conversion from a fully fledged distributor to a limited-risk distributor, where the new limited-risk distributor may not have a trial period, whilst an agreement with a third party would typically have included such an arrangement.

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37. Under the authority of Art. L 16 B of the LPF.
When an analysis of the pre- and post-operation situations reveals that either an asset or profit potential has been transferred, it may also be examined whether or not a transfer pricing policy deviating from a strict application of the arm’s length principle should be implemented in place of an upfront indemnity. In practice, this may result in start-up situations, where an entity can freely benefit from a service or from the use of an asset for a limited time. It is always difficult to assess precisely what is reasonably acceptable in this respect, so it is, in any case, advisable to prepare in advance a clear and documented rationale supporting the option adopted, whilst, as the same time, properly considering the corporate and registration tax aspects of those options.

6. Financing Aspects of Restructurings

Restructurings and the difficulty in obtaining financing from banks or financial institutions have contributed to the growth of intercompany financing. Apart from thin capitalization considerations, such intercompany financing could raise transfer pricing issues that should be reviewed. The granting of a loan without interest or, in contrast, with excessive interest could be deemed to be a transfer of benefits abroad. It is, therefore, necessary to ensure that the remuneration of intercompany loans is at arm’s length. A guarantee should also be fairly compensated.39 The recent case law of the French administrative courts has cast light on the comparability issues raised by intercompany financing.

In this respect, it has been confirmed that enterprises should be free to decide the modalities of their financing. A parent company should, therefore, be able to finance an operation of a subsidiary by a loan rather than capital without any possibility for the FTA refusing the deduction of interest in principle.40

In an international context, the legal qualification of the operations in the foreign country should be taken into consideration. In this regard, the case law of the Conseil d’Etat has confirmed that, in the case of the financing of a Portuguese subsidiary by a French parent company that qualified as free capital under Portuguese rules, the FTA could not argue that interest should be paid, even though the operation had provided as a loan had it been carried out in France.41 However, it was also confirmed that the loan should be formalized; otherwise, reimbursement in respect of the loan could be considered to correspond to a distribution.42

With regard to the rate of interest on an intercompany loan, the Conseil d’Etat has confirmed that it is necessary to consider all of the specificities of the loan in determining what would have been the rate that could have been obtained from a financing institution. In the relevant cases, the FTA held that the rate of interest could be compared to the interest obtained or that could have been obtained by the lending company in respect of other comparable investments. The Conseil d’Etat, however, noted that the FTA bear the burden of proving that the loans have the same characteristics.43 In practice, it is necessary to take into account all of the characteristics of a loan (the amount, duration, subordination level, etc.) and the profile of the borrower (indebtedness, credit worthiness, etc.).

The use of currency exchange rates that differ from official rates could also be considered as implying a transfer of profits outside France.44

7. Conclusions

Although the viability of a group may depend on its ability to adapt to evolving technical and economic conditions, the tax authorities, which are themselves confronted with budget deficits, tend to react strongly to the erosion of the taxable base. Whilst base erosion is only a consequence of the required adaptation, the tax authorities frequently consider it to reflect the transfer of assets outside the jurisdiction, which should be subject to tax. An attempt to tax any change could, however, have very negative results for the enterprises and could be detrimental to the attractiveness for foreign investments.

The authors, therefore, favour a more legalistic approach to these issues. This would presume that any changes in legal situations (the termination of contracts and the transfer of assets) should be taken into account and that a tax analysis should always be substantiated by a legal analysis.

39. Administrative Court of Appeal of Douai, 24 June 2010, Case No. 08DA01124, Sofitec.
42. Administrative Court of Appeal of Nantes, 14 June 2010, SARL Slobic.
Key Practical Issues in Eliminating the Double Taxation of Business Income

The author, in this article, considers the key practical issues that enterprises encounter in relation to the allocation of business income between the residence and source states, and in resolving the conflicts that regularly arise between those two states – notably, but not exclusively, with regard to transfer pricing.

1. Introduction
Double taxation arises if business income is taxable in more than one state, generally in the state in which the income arises and in the state of residence of the enterprise. For instance, enterprises may be subject to double taxation when they exercise their activity in more than one state or when they have relations with enterprises situated in another state. In the first scenario, the enterprise is taxable in the source state, in the residence state, or in both, in which case a mechanism for the avoidance of double taxation is normally applied. The second scenario raises the more general issue of transfer pricing. In both cases, tax treaties remedy the double taxation by setting out rules for allocating business income and for the avoidance of double taxation. In order to resolve conflicts between jurisdictions, rules apply to assist the competent authorities in arriving at a solution to avoid double taxation through the mutual agreement procedure (MAP) and, more recently, arbitration.

In essence, the key practical issues that arise in eliminating double taxation of business income stem from difficulties in allocating the income between the two states and in resolving the disputes that this allocation may trigger – notably, but not exclusively, in respect of transfer pricing.

2. Allocating Business Income between Two States

2.1. Introductory remarks
In order to avoid double taxation of business income, tax treaties include rules to allocate the income between the two states. These rules are generally similar to those in Arts. 5 and 7 of the OECD Model Tax Convention (the "OECD Model"). The application of these rules raises, as a practical matter, several issues.

2.2. Determining the existence of a permanent establishment

2.2.1. Initial comments
Whether or not an enterprise of one state has a permanent establishment (PE) in another state is the key criterion in determining if it is taxable or not in the source state. Double taxation only arises if it is taxable in the source state, as well as the residence state; however, if it is not taxable in the residence state by virtue of a territoriality principle, there will be no double taxation. Accordingly, the elimination of double taxation requires that the two states agree on the concept and on the methods. In France, practical issues often arise.

2.2.2. Principles
In general, France follows the OECD Model, pursuant to which the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.1 As a matter of principle, this concept does not raise any practical difficulties, as it is close to the French concept of "enterprise carried out in France". Indeed, the French system of taxation of businesses is governed by the territoriality principle, under which only income realized by enterprises carried out in France is taxable.2 In contrast, profits realized by enterprises carried out outside France are not taxable in France.

French law contains this general principle, but no guidelines are provided as to what an "enterprise" carried on in France means. Taking into account the case law of the Conseil d’État (Supreme Administrative Court), the French tax authorities (FTA) have developed the interpretation that carrying on an enterprise in France refers to the habitual exercise of an activity in France that can be conducted by a separate establishment or, in the absence of any establishment, through representatives with no independent professional status, or even within the framework of operations forming a "complete operation cycle" in France.3 Accordingly, except for the latter concept, i.e. that of a "complete operation cycle", French law is broadly in line with the OECD principles.

In most cases, the existence of a PE is obvious – for example, where the enterprise has premises, people and equipment to carry on its business activity. Experience

1. Art. 5(1) OECD Model.
2. Art. 209,1 CGI.
3. Regulations 411412 3.
4. The idea behind this concept is that, if a foreign company is engaged in France in various commercial operations that are related to and consistent with each other so that they form a whole, the profits resulting from those operations are taxable in France. The classic example in this respect is that of the purchase of goods in France followed by their resale in France. Under case law, however, there is a tendency to tax those operations in France only if they can be deemed to be separate from the general activity of the company.

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reveals, however, that practical issues may arise in the circumstances outlined in 2.2.3 to 2.2.6., which may potentially give rise to double taxation.

### 2.2.3. Building sites

Under the OECD Model, a building site or construction or installation project constitutes a PE only if it lasts more than 12 months. One issue that, inter alia, has arisen in France, particularly regarding the treatment of business income earned in foreign countries, is whether or not the mere supervision by a French enterprise of a building site situated abroad gives rise to a PE. Generally, the response should be negative, but the OECD Commentaries may create some confusion in this respect.

Indeed, since the 2003 OECD Commentary, the term “installation project” has not been restricted to an installation related to a construction project; on-site planning and supervision of the erection of a building are included. However, if the applicable tax treaty does not contain precise provisions to that effect, a mere supervisory activity in respect of a building site should not be considered to constitute a PE. Such a view was taken in a case involving a French taxpayer supervising the construction of a hotel and a place of extraction of natural resources in Togo and Benin. The Conseil d’État held that the activity was taxable in France, as it was not attributable to a foreign PE. It should be noted that, in his findings, the commissaire du gouvernement referred to the OECD Commentaries prior to the 2003 release to uphold the position that there was no PE. (This illustrates, in passing, the uncertainty created by the OECD Committee on Fiscal Affairs when it amended the Commentaries without also amending the text of the OECD Model itself.)

Another practical difficulty that often arises is that of the correct computation of the 12-month period, as a building site is a PE only if it lasts more than 12 months. In this respect, the OECD Commentary indicates that a site exists from the date on which the contractor begins his work, including any preparatory work, and that it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. These dates are sometimes not easy to determine, although, to the author’s knowledge, there is no case law in France in this respect. Practical double taxation issues may, therefore, arise where the two states do not agree on the commencement and termination dates of a site.

### 2.2.4. Dependent agents

In principle, tax treaties concluded by France should contain a provision, according to which, in essence, a person acting in a state on behalf of an enterprise of the other state (other than an agent of independent status) is deemed to be a PE in the first-mentioned state if he has, and habitually exercises in that state, an authority to conclude contracts in the name of the enterprise. One difficulty is that the concept of dependence is somewhat uncertain, as it is questionable whether it refers only to legal dependence or also to “de facto” dependence. As recommended by the OECD, it has been held in France that dependence may be de jure or de facto. Double taxation may, therefore, arise if the other state adheres to a pure legal approach.

Next, the concept of “having the authority to bind” is unclear and the resulting uncertainty may give rise to double taxation. In France, it has been held that only a legal authority to bind is relevant. In this case, which involved the French commissionaire of a UK company, the Conseil d’État held that, regardless of the degree of dependency of the commissionaire with regard to the principal, no PE existed in France for the reason that, from a legal standpoint, a commissionaire does not have the power to legally bind a principal.

It should, however, be noted that a PE may exist if it is apparent, either from the provisions of the commissionaire agreement or from the facts and circumstances, that, despite the characterization of the agreement as a commissionaire agreement, the principal is personally bound by the contracts concluded by the commissionaire with the clients. In such a case, double taxation may occur, not only between France and the other state, but also within France. Indeed, where a subsidiary is treated as a PE, two taxpayers exist (the subsidiary and the PE) and both are separately taxable. The profits may, therefore, be taxed twice – first, in the hands of the subsidiary, as would be the situation with regard to any French enterprise, and second, in the hands of the French PE of the foreign company. A proper way to avoid this would be to decide that the commission paid to the subsidiary by the foreign parent is deductible for the purposes of determining the taxable income of the PE. In such a circumstance, additional profits should be recognized in France only if there is a difference between the arm’s length remuneration that the subsidiary should have received as agent and the profits attributable to the PE – for example, if an additional margin should be attributable to the PE, taking into account its functions, the assets and/or the capital used, and the risks assumed.

### 2.2.5. Liaison offices

A practical issue often arises with regard to foreign enterprises that exercise an activity in France in “liaison offices”, i.e. installations that are considered as having an

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5. Art. 5(3) OECD Model
6. Para. 7.3 of the Commentary on Art. 5 of the OECD Model
8. The commissaire du gouvernement is similar to the Advocate-General before the European Court of Justice. See the findings of Stéphane Austry in Chupin, supra note 7, BDCF No. 3/03 31.
9. The OECD, by adding that states wishing to modify the text of the paragraph to provide expressly for that result are ‘free to do so’ in their tax treaties, appears to be implicitly acknowledging the difficulty that it has created.
10. Para. 19 of the Commentary on Art. 5 of the OECD Model.
11. Art. 5(5) OECD Model.
ancillary activity and that are, therefore, not regarded as PEs. In this respect, it should be noted that the OECD Model states that a fixed place of business used solely for the purpose of carrying on, for the enterprise, any activity of a preparatory or auxiliary character, is deemed not to be a PE. The OECD Commentary adds that it is recognized that such a place of business may contribute to the productivity of the enterprise, but that the services it performs are so remote from the realization of profits that it is difficult to allocate any profit to the fixed place of business in question.

In France, it was held that the French branch of a Netherlands company that was in charge of monitoring and coordinating advertisement expenses of European subsidiaries was not a PE, although it was a headquarters, as it had no involvement with third parties and took no decisions that would bind the head office. However, the FTA have indicated that they disagree and that, in principle, headquarters are taxable entities. Accordingly, the matter is far from clear. For instance, as a practical matter, a French enterprise that has set up a branch abroad with the premises of its French subsidiary. In this case, it was found that a Luxembourg company had a PE in France, on the basis that, inter alia, a number of invoices sent to foreign clients were found in the offices of the subsidiary to develop its commercial activity in France, on the basis that, inter alia, a number of invoices sent to foreign clients were found in the offices of the subsidiary to develop its commercial activity in France. This does not mean that a subsidiary may never be treated as a PE (see 2.2.4. regarding commissionaire agreements) or that a PE may never exist ‘within’ the subsidiary. For instance, in a France–Luxembourg case, it was found that a Luxembourg company had a PE in the premises of its French subsidiary. In this case, it was held that the Luxembourg company was, in effect, using the premises of the subsidiary to develop its commercial activity in France, on the basis that, inter alia, a number of invoices sent to foreign clients were found in the offices of the subsidiary, papers were signed in the name of the Luxembourg company by a salaried employee of the French company, and the employee received letters on account of the Luxembourg company and centralized the delivery of the products. Such situations may give rise to double taxation issues if the income has already been taxed in the foreign jurisdiction or if the subsidiary has already received appropriate compensation for its activity.

2.2.7. Possibility to obtain an advance ruling

As briefly indicated in 2.2.3. to 2.2.6., the determination of whether or not a PE exists is often not easy and conflicts may arise between both states. In order to resolve such practical difficulties at an early stage and to avoid double taxation, the FTA introduced an advance ruling procedure in 2004. This procedure applies to foreign enterprises that wish to ensure that they do not have a PE in France. The procedure applies if: (1) the enterprise acts in good faith; (2) it is a resident of a state with which France has signed a tax treaty; and (3) it has submitted a written request to the FTA providing a full description of the facts and circumstances.

In contrast to what generally applies, the FTA, in these circumstances, are deemed to have agreed with the taxpayer if they fail to respond within three months (normally, the absence of a reply is equivalent to a tacit refusal). If the FTA do not respond or respond that they agree, the taxpayer is granted a guarantee that is legally binding, provided that the facts have been fully disclosed. If the FTA disagree and find that a PE exists, the taxpayer can ask for a second review of its ruling request. If the answer is still negative, the enterprise may act as if no PE exists, but could obviously be subject to a tax reassessment if there is an audit.

This procedure is interesting insofar as it reduces the exposure to double taxation. It is not, however, frequently used by foreign taxpayers. Indeed, only two requests were made in 2008 and 13 in 2009.

2.3. Allocating business income to a permanent establishment

2.3.1. Initial comments

Eliminating double taxation of business income is only possible if there is no conflict as to whether or not the enterprise carries on its activity through a PE. Further, if there is a PE, double taxation will only be avoided if there are no conflicting views between the two states as to the amount of income and expenses that are attributable to the PE.

2.3.2. Principles

As a matter of principle, France follows the OECD Model, pursuant to which the profits of an enterprise of a state should be taxable only in that state, unless the enterprise carries on business in the other state through a PE situated therein. In such a case, the profits of the enterprise may be taxed in the other state, but only to the extent that they are attributable to that PE. (There is no force-of-attraction principle under French law and tax treaties.)

Most tax treaties also state that the profits of a PE are those that it might be expected to realize if it were a distinct and separate enterprise. Eliminating double taxation assumes that this principle is applied consistently in both states. Experience reveals, however, that practical issues arise.

15. Para. 23 of the Commentary on Art. 5 of the OECD Model.
17. Regulations of 3 September 1999 (BOI 4 H 7-99) and 6 September 1999 (BOI 13 G 1-99), BF 10/99 No. 1043.
2.3.3. Relations between the head office and the permanent establishment

In France, all consequences are generally due to the fact that a PE, in contrast to a subsidiary, does not have a legal personality distinct from that of the head office. This means that there cannot be any licensing of intangibles between the two and no payment of deductible and/or taxable royalties. There also cannot be any payment of interest between the two, except for banks. For instance, it was held that interest paid by a French branch to its UK head office on advances made by the head office to help the branch commence its activity was not tax deductible in France.

With regard to banks, the regulations provide an exception, as the purpose of a bank is to deal with money. As far as banks are concerned, the sums that the head office puts at the disposal of the branch should be divided into the following two categories: (1) the equivalent of “share capital”, which may not be remunerated; and (2) funds regarded as equivalent to a loan that may give rise to tax-deductible interest.

Given that, to date, this is the sole exception, it remains to be seen what the practical consequences of the new Commentaries will be in light of the updated 2010 OECD Model. The OECD now recommends that the profits of a PE should be the profits that it would be expected to realize, 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, the assets used and the risks assumed by the enterprise through the PE and the other parts of the enterprise. This principle assumes, as the OECD clearly states, that, inter alia, capital should be attributed to the PE based on the assets and the risks attributed to the PE.

It is evident that, pursuant to the Commentaries, this principle applies not only for the purposes of determining the profits that may be taxed by the state in which the PE is situated, but also for the purpose of applying Arts. 23A and 23B of the OECD Model by the other state with regard to the avoidance of double taxation. It is also true that the OECD Model states that, where a state adjusts the profits that are attributable to a PE of an enterprise of one of the states and accordingly taxes profits of the enterprise that have been charged to tax in the other state, the other state should, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. (In determining such adjustment, the competent authorities of the states should, if necessary, consult each other.) However, there is a concern that this principle will not be respected and that practical double taxation cases may result from the application of this new principle to business income.

2.3.4. Management fees

Double taxation can only be eliminated to the extent that there is no conflict regarding the allocation of expenses in general. In principle, all expenses incurred for the benefit of a PE should be deductible, whether incurred domestically or abroad. Accordingly, normally, all expenses incurred abroad by the head office in respect of managing a PE should be deductible for the purpose of computing the taxable income of the PE. As a practical matter, however, businesses frequently encounter difficulties in allocating such expenses, as these cannot easily be allocated between the PE and the head office or between the various PEs that the enterprise may have in various jurisdictions.

In France, methods that rely on estimates are permitted to allocate expenses that cannot easily be apportioned – for example, by using a formula based on each entity’s respective turnover. For instance, it has been held that a French company with a PE in Belgium could, in the absence of specific circumstances that would justify another method, use the ratio of the turnover of the PE to the total turnover of the enterprise. Such methods, in practice, however, are not always accepted by all jurisdictions and double taxation may occur.

For example, where a French company has a PE abroad, the expenses that are attributable to that PE are not allowed as deductible expenses in France. For instance, a French company may not deduct in France an interest expense that it has incurred to finance the business of foreign PEs or the portion of the general head office expenses that is related to a foreign PE. It has been held, for example, that the fact that the Algerian tax authorities did not allow a deduction for the portion of the head office expenses that related to an Algerian PE, although regrettable, had no consequences for the determination of the French taxable income. The same approach was adopted in a case where the tax legislation of Cameroon capped the amount of deductible head office expenses at 10% of the turnover of the PE. It is for this reason that double taxation issues frequently arise in this area.

2.4. Eliminating double taxation in France as the residence state

2.4.1. Initial comments

Eliminating double taxation is also a concern for the state of residence. In this respect, France has a relatively unique position, as it applies, under domestic law, a territoriality principle that, in many cases, obviates most double taxation issues.

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2.4.2. Principles

Under the OECD Model, two methods may generally be used to eliminate double taxation. These are: (1) the exemption method and (2) the credit method.

Under the exemption method, as provided for in Art. 23A of the OECD Model, where a resident of a state derives income that, in accordance with the provisions of a tax treaty, may be taxed in the other state, the first-mentioned state should exempt such income from tax (except for dividends and interest). This method is generally subject to the proviso that the income can be taken into account for the purpose of applying progressive income tax rates.

Under the credit method, as provided for in Art. 23B of the OECD Model, where a resident of a state derives income that may be taxed in the other state, the first-mentioned state should allow as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other state. The deduction should not, however, exceed that part of the income tax, as computed before the deduction is given, that is attributable, as the case may be, to the income that may be taxed in that other state.

As far as French businesses are concerned, the situation under domestic law is rather peculiar. As noted in 2.2.2., the French system for the taxation of companies or enterprises is governed by the territoriality principle, under which only income realized by enterprises carried on in France is taxable. Conversely, profits realized by enterprises carried on outside France are not taxable in France, regardless of the nationality or the location of the head office. This basic principle, pursuant to which corporate income tax depends on where the income is deemed to be realized, applies in respect of profits and losses. It follows that, if profits are not taxable, losses are not deductible. As a matter of principle, this method generally eliminates double taxation of business income and, therefore, few practical issues arise.

2.4.3. Method used in France to avoid double taxation under tax treaties

The French territoriality principle, which has existed for many years under French law, has been incorporated into many French tax treaties. Tax treaties generally give France the right to tax the income of a foreign company with a PE in France and, conversely, deny France the right to tax a French company that has foreign PEs insofar as the income of the foreign PEs is concerned.

Traditionally, tax treaties eliminated double taxation through a classical exemption system. However, for some 20 years, French tax treaties have employed a rather unusual method that consists of giving French enterprises (or taxpayers, in general, except with regard to passive income) a tax credit equal to the French tax on the foreign income. This method, which results in a de facto exemption, was adopted as it appeared to be more readily understandable by taxpayers – particularly individuals who do not really understand exemption with progression (i.e. they tend to be confused when they are informed that their foreign income is tax exempt, but, at the same time, has to be recorded in their tax returns). The taxpayers suspect that, as the income must be reported, it is not exempt, as otherwise there would be no need for them to declare it. Accordingly, it appeared at the time that it would be easier to inform taxpayers that their income was taxable, but that double taxation would be eliminated through a credit system. Now, as the credit is equal to the French tax on the income, it is equivalent to exemption with progression. There is, however, one difference. Although the foreign tax is deductible in computing the tax for progressivity purposes, it is not deductible when a credit equal to French tax is given.

With regard to enterprises, the issue is not the same. This is because progressivity has no meaning to the extent that corporate income tax is levied at a fixed rate – currently, 33.33% (in effect, 34.43% including the surtax).

Indeed, the FTA have indicated that, where the income is tax exempt under domestic law, as is the case with regard to business income, double taxation is eliminated by reference to domestic law and not the tax treaty. The FTA add that, as corporate income tax is not computed in accordance with progressive rates, this method for the avoidance of double taxation is equivalent to an exemption, as long as the credit is equal to the French tax. The FTA have, therefore, confirmed that business income earned by a French enterprise that is taxable in the foreign country should not be taken into account for the purpose of determining French taxable income.29

There are, however, some exceptions regarding tax treaties that include an anti-abuse provision – for example, the Chile–France tax treaty. This provides that the credit is equal to French tax only if the income (generally business income) has been subject to Chilean tax, to avoid double exemption.

Finally, in principle, tax treaties provide for a credit equal to French tax only if the foreign income is not taxable in France under domestic law. If the income is normally taxable under the territoriality principle, the credit is generally equal to the foreign tax. This is intended, in particular, to preserve France’s right to tax where the foreign income is taxable under Art. 209 B of the French Tax Code (Code Général des Impôts, CGI) as far as PEs are concerned (see 2.4.4.). As tax treaties are generally consistent with domestic law and domestic law exempts foreign business income, generally no practical issues arise.

2.4.4. Elimination of double taxation under the controlled foreign company rules

The French controlled foreign company (CFC) legislation is contained in Art. 209 B of the CGI, which provides, in essence, that, where an entity subject to French corporate income tax has an enterprise outside France or holds, directly or indirectly, more than 50% of the shares, interest

29 Regulations 14 B-3-03 of 22 May 2003 with regard to the Algeria–France tax treaty. These regulations expressly apply to tax treaties drafted in the same manner.
shares, financial rights or voting rights in a company or an entity established outside France, and the enterprise, company or entity benefits from a privileged tax regime within the meaning of Art. 238 A. The profits of the enterprise, company or entity are taxable in France in proportion to the shares, interest shares or financial rights that that entity directly or indirectly holds in the foreign entity. Where Art. 209 B of the CGI applies, the French enterprise is subject to corporate income tax on the profits of the foreign entity or PE. Since a 2005 amendment, Art. 209 B of the CGI provides that, where realized by a legal entity, such profits are deemed to constitute income distributed to the French parent. The tax is imposed on all of the foreign profits in respect of a PE or a 100% subsidiary, but only in proportion to the shares, interest shares or financial rights that the French enterprise, directly or indirectly, holds in its foreign affiliate.

French tax rules apply with regard to the taxation in France of the foreign profits. Accordingly, the French company must prepare a balance sheet and a profit and loss statement for each of its subsidiaries or PEs in the same way as any other French company.

Obviously, such a provision may give rise to double taxation of the business income. There are, however, several mechanisms designed to avoid double taxation.

First, profits that correspond to participations indirectly held by other companies that are, themselves, subject to tax under Art. 209 B of the CGI on the same income are not taxed twice. For instance, if a French parent owns shares in a French subsidiary that holds itself shares in a 'tax haven' company, the profits of the tax haven company are subject to tax in the hands of the subsidiary and not in the hands of the parent company.

Second, the law provides for a credit against French tax for foreign taxes that are of the same or a similar nature as French corporate income tax.

Third, foreign withholding taxes may be credited, if provided for by a tax treaty. This is the situation, for example, where the foreign income has been distributed and a withholding tax has been levied abroad on the distribution.

Fourth, if the income earned by the foreign enterprise or legal entity includes dividends, interest or royalties that arise from another country (including France) and such income has been subject to withholding tax in the source state, the withholding tax constitutes a tax credit against the tax to be paid in France under the CFC legislation, provided that the source state is France or the source state has signed a tax treaty with France in respect of transparency and the exchange of information for tax purposes. The tax credit is limited, as the case may be, to 0%, 5% or 15% (the France–United States tax treaty rates, depending on the percentage of shareholding). A law of 30 December 2009, however, provides that the tax credit for foreign withholding taxes on dividends, interest and royalties assumes that the income is not derived from a non-cooperative state or territory (NCST).

Finally, income in the form of dividends distributed to a parent company is not taxed if the parent company is subject to tax on the income of the subsidiary under Art. 209 B of the CGI. This is designed to prevent double taxation of the same income, first, when deemed to be income of the French parent and, second, when distributed to the parent.

With regard to the application of the CFC legislation, where a tax treaty applies, France may still apply these rules if the foreign entity is a subsidiary. This is because the French income is deemed to be distributed income earned by the French parent, except in rare cases where undistributed income that is not legally a dividend is taxable only in the source state.

If the foreign entity is a PE and if a tax treaty applies, either the income of the PE is taxable only in the state of the PE, in which case Art. 209 B of the CGI does not apply, or the income is taxable in both states and Art. 209 B applies. (Some tax treaties, however, specifically reserve France's right to apply the provisions in any event.)

3. Resolving Conflicts between States

3.1. Introductory remarks

The rules set out in the OECD Model are generally considered by most states to be fair and acceptable. This does not mean, however, that there is no conflict and that, in practice, tax treaties always reach their objective of avoiding double taxation. On the contrary, experience reveals that many conflicts arise where, for example, two states interpret the facts and circumstances of a case differently or with regard to transfer pricing.

In general, conflicts that give rise to double taxation of business income may be resolved using the following procedures. The key practical issues, as far as France is concerned, may be summarized as follows.

30. Under this article, a foreign entity benefits from a privileged tax regime where it is subject to a tax on its profits or income that is less than 50% of the tax on profits or income that it would have had to pay under the standard rules if it were domiciled or established in France.

31. The definition of NCST contained in Art. 238-0 A of the CGI is not based on the tax regime of the foreign jurisdiction, but, rather, on its attitude with regard to the OECD standard on exchange of information for tax purposes. The jurisdictions covered are defined as states or territories (the conditions are cumulative):

- that do not belong to the European Union;
- that have been examined by the OECD with regard to their situation in respect of transparency and the exchange of information for tax purposes;
- that have not concluded with France an administrative assistance agreement allowing for the exchange of information necessary for the application of the tax legislation of the parties; and
- that have not signed an administrative assistance agreement with at least 12 states or territories, allowing for the exchange of information necessary for the application of the tax legislation of the parties.

A list of states and territories meeting this criteria is published annually.

32. Such is the case, for example, under the France–Lebanon tax treaty.

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3.2. Elimination of double taxation through a mutual agreement procedure

3.2.1. Initial comments

France generally follows Art. 25 of the OECD Model, pursuant to which, when a taxpayer anticipates that the action of one or both states will result in taxation not in accordance with the provisions of the tax treaty, it may, irrespective of the remedies provided by the respective domestic laws of those states, present its case to the competent authority of the state of which it is a resident.33 This may sometimes be difficult to determine in cases of economic double taxation, which frequently occur with regard to transfer pricing adjustments.

In principle, it is generally believed that, where a group of companies suffers economic double taxation, the company that wishes to claim the corresponding adjustment should open the procedure. For instance, if a tax adjustment was imposed in France on a French company as a result of a transfer of profits to a US affiliate, in principle, the US affiliate should request a corresponding adjustment and present its case to the US authorities. If the French company were to present its case to the French competent authority, the latter would likely contend that the procedure is not in accordance with the tax treaty and would declare itself not competent to hear the case. Simply put, in cases of economic double taxation, the FTA, a MAP should be opened by the company that has not been subject to the tax adjustment.

As it is not always easy to determine the competent authority that may hear the case, it is generally recommended that the case be submitted to both competent authorities. In this respect, see also 3.2.5. with regard to a stay of collection.

3.2.2. Determination of the relevant taxpayer

The French practice is to require the taxpayer to present its case to the competent authority of the state of which it is a resident.33 This may sometimes be difficult to determine in cases of economic double taxation, which frequently occur with regard to transfer pricing adjustments.

In principle, it is generally believed that, where a group of companies suffers economic double taxation, the company that wishes to claim the corresponding adjustment should open the procedure. For instance, if a tax adjustment was imposed in France on a French company as a result of a transfer of profits to a US affiliate, in principle, the US affiliate should request a corresponding adjustment and present its case to the US authorities. If the French company were to present its case to the French competent authority, the latter would likely contend that the procedure is not in accordance with the tax treaty and would declare itself not competent to hear the case. Simply put, in cases of economic double taxation, the FTA, a MAP should be opened by the company that has not been subject to the tax adjustment.

As it is not always easy to determine the competent authority that may hear the case, it is generally recommended that the case be submitted to both competent authorities. In this respect, see also 3.2.5. with regard to a stay of collection.

3.2.3. Time limits

French tax treaties frequently set a time limit for presenting a case. The clock starts on the date of the first notification of action leading to taxation not in accordance with the provisions of the tax treaty. The time limit may vary depending on the tax treaty – for example, it is two years under the Canada–France tax treaty and six months under the Belgium–France tax treaty. A three-year limit is provided for under the France–United States tax treaty. In general, however, the limit is three years, as recommended in the OECD Model. Consequently, businesses may suffer double taxation if they miss the deadline, as, in this event, the competent authorities may refuse to discuss the case. (They may also agree to discuss it, although they do not have to.)

3.2.4. Proof of double taxation

The MAP exists to avoid double taxation. Accordingly, it may be opened only if there is double taxation. This principle was recently reaffirmed in a case where a Luxembourg company was treated as having a PE in France in the premises of its French subsidiary (see 2.2.6.).34 In this case, the taxpayer requested the opening of the procedure, but the French competent authority refused on the ground that the company could not provide evidence that the income that France wanted to tax had already been subject to Luxembourg tax. With regard to this case, it should also be noted that the Luxembourg competent authority refused to open the procedure on the ground that the procedure is not to be used in ‘abusive situations’. In this respect, the Conseil d’Etat held that the opening of a procedure might be refused by either state if it considers that the request is not well founded.

3.2.5. Collection of tax claimed

A practical issue that frequently arises where there is double taxation is that the tax authorities want to collect the taxes without waiting for the result of a MAP. This situation can be very costly for the enterprise.

In France, in order to avoid this cost, the statute provides for a stay of collection when a MAP is opened. Where, following a tax deficiency notice, a MAP is opened based on a tax treaty or the EU Arbitration Convention,35 the time limit for collecting the tax is extended to the end of the third month following the date on which the taxpayer is notified of the result of the procedure.37 Accordingly, the FTA do not collect the taxes reassessed under a transfer pricing adjustment and, at the same time, do not risk being statute barred. Although this advantage appears, based on a strict reading of the law, to be at the discretion of the FTA, it has been held that the statute requires the FTA to grant a stay of collection, unless they can provide evidence of specific difficulties that would justify immediate collection of the taxes.37

If a taxpayer wishes to benefit from a stay of collection, this must be requested in a letter to the French competent authority requesting the opening of a MAP. It should, however, be noted that the procedure does not apply to a penalty for non-production of the transfer pricing documentation that large enterprises are required to retain. The requirement to provide documentation upon request at the beginning of an audit applies for the first time, with regard to 2010 income.38 Accordingly, a large enter-

33. Regulations of 23 February 2006 (BOI 14 F-1-06).
35. Convention 90/436/EEC.
36. Art. L 189 A LPF.
38. “Large enterprises” are required, since the entry into force of a law of December 2009, to maintain transfer pricing documentation and to deliver
prise that has not produced the documentation upon request (or has produced documentation that is blatantly insufficient) may not benefit from a stay of collection of the resulting 5% penalty, although it could benefit from a stay of collection with regard to the tax reassessed.39

With regard to MAPs opened as of 1 January 2011, the stay of collection does not apply if the income or profits adjusted have benefited from a privileged tax regime in the other state or territory within the meaning of Art. 238 A of the CGI.40 This measure could, for example, apply to a transfer of profits to Switzerland if the Swiss entity is regarded as benefiting from a privileged tax regime to the extent that it pays tax that is less than 50% of the tax that would be due in France on the same income.

3.2.6. Absence of obligation to resolve cases

The French competent authority considers it a duty to endeavour to resolve a case by mutual agreement with the competent authority of the other state to avoid double taxation. It, however, takes the position that it is under no obligation to succeed.

For instance, it was held that a taxpayer could not demand that a procedure be opened.41 The Conseil d'Etat takes the position that the taxpayer's rights are limited to a requirement that the request be examined; there is no requirement to allow the request. This principle was emphasized in a case in which the FTA did not answer the letter from the taxpayer and did not open the procedure. It was held that this implicit refusal had not deprived the taxpayer of a resolution, as the states could not be compelled to resolve the case. It, therefore, appears that the FTA have a true discretionary power to determine whether or not a request should be examined. For instance, the usual practice in France is that the procedure will not be opened in cases where there is no evidence of double taxation (as explained in 3.2.4) or where the tax adjustment has given rise to the definitive application of 'serious penalties', such as criminal penalties or bad-faith penalties. The same may apply where the taxpayer has spontaneously made a correlative adjustment, i.e. where an adjustment has been made by the taxpayer without the support of an administrative decision to that effect.

In practice, however, it is rare for a MAP not to be opened when it is requested, except in abusive situations. In most situations a MAP is only refused where, for example, the taxpayer does not apply to the correct state or the time limits have expired.

3.2.7. Legal value of the agreement reached

Where the competent authorities reach an agreement, the French practice is to ask the enterprise if it agrees with such an agreement. The enterprise, therefore, receives a letter that sets out the terms of the agreement and proposes a solution. The enterprise has one month to decide if it agrees. If the enterprise rejects the agreement, the compromise reached by the two states is of no effect and the situation is settled by each state in accordance with its own interpretation.

If the taxpayer disagrees, the agreement reached by the two states has no binding effect. An agreement reached under a MAP by two states does not have the legal value of an international agreement, but simply that of an administrative agreement; an administrative agreement does not have any legal value in resolving a case. For instance, in one case, it was held that an agreement concluded between France and the United States on the determination of the place of residence of a taxpayer was not in accordance with the tax treaty and, therefore, was subject to the approval of the courts.42 This is not to say that courts have the power to void such an agreement, but only that they must decide the case as if the agreement did not exist, which means, in essence, that when dealing with a case, the courts ignore the agreement.

If the taxpayer agrees with the result of a MAP and is prepared to accept the solution, the agreement applies. Consequently, no particular issues arise, subject to the obvious condition that the taxpayer discontinue any contentious procedure it may have initiated.

3.2.8. Statute of limitations

In France, there are generally no practical issues regarding a statute of limitations, as the regulations43 indicate that any agreement reached should generally be implemented without regard to the time limits set out under domestic law, as recommended in the OECD Model.44 The taxpayer, however, is not entitled to interest on any tax refund resulting from the agreement.

3.2.9. Length of the procedure

The FTA have indicated in the regulations45 that a case should be resolved within a maximum of 24 months. It appears that, in practice, this limit is rarely respected, particularly in relatively complex cases. For instance, the competent authorities have themselves stated that, in practice, the average time for negotiating a MAP is three years and seven months. The length of the procedure is, however, mitigated by the fact that a stay of collection is normally granted, as explained in 3.2.5.

3.3. Elimination of double taxation through arbitration

Under a MAP, the competent authorities are not under an obligation to arrive at a solution that eliminates double taxation. This is obviously not satisfactory and, for this reason, France has agreed to use arbitration procedures

Footnotes:
39. If the documentation is not produced, or is not complete, a penalty of EUR 10,000 applies for each year in question. The penalty may be 5% of the profits transferred abroad (subject to a minimum penalty of EUR 10,000).
41. Conseil d'Etat, 2 June 1986, Case No. 44571, RJF 8-9/86 No. 818.
42. Conseil d'Etat, 13 May 1983, Case No. 28831, RJF 7/83 No. 848.
43. Regulations of 23 February 2006 (BOI 14 F-1-06).
44. Art. 25(2) OECD Model.
45. Regulations of 23 February 2006 (BOI 14 F-1-06).
as recommended by the OECD since the release of the 2008 OECD Model, which introduced a new Art. 25(5) in this regard.

Arbitration provisions had been included in the past (for example, in the France–Germany tax treaty), but had never been applied. The situation in the France–United States context has been different since the entry into force of the protocol of 13 January 2009 to the France–United States tax treaty. This protocol provides, in a new Art. 26(5) and (6), which deal with the MAP that where, under a MAP, the competent authorities have endeavoured but have been unable to reach a complete agreement during a two-year period, the case should be resolved through arbitration, provided that:

- tax returns have been filed with at least one of the states with regard to the tax years at issue in the case;
- the case is not a case that both competent authorities have agreed, before the date on which arbitration proceedings would otherwise have begun, is unsuitable for determination by arbitration;
- all of the persons involved agree not to disclose to any other person any information received in the course of the arbitration proceeding from either state or the arbitration panel, other than the determination of the panel; and
- no decision in respect of the case has already been given by a court or administrative tribunal of either state.

The arbitration procedure constitutes "baseball arbitration". This means that each competent authority is required to submit proposals and the arbitration panel must select one of those offered and has no discretion to reach a different compromise or to use a "split the pie" approach. Unless a person involved (basically, the taxpayer) does not accept the determination of the arbitration panel, the determination constitutes a resolution by mutual agreement and is binding on both states with regard to the case (the determination of the arbitration panel must be made within six months). This represents a positive move towards the elimination of double taxation – particularly, but not exclusively, with regard to business income.

3.4. Elimination of double taxation resulting from transfer pricing disputes

3.4.1. Initial comments

Transfer pricing disputes can give rise to serious double taxation issues for businesses. The elimination of such double taxation raises the following practical issues, depending on the procedure used.

3.4.2. Advance pricing agreements

A good method for eliminating double taxation issues is to obtain an advance pricing agreement (APA). In France, since September 1999, enterprises can obtain certainty with regard to their transfer prices by way of an APA between France and another state. 46 The APA procedure, initially governed only by administrative regulations, was later incorporated into the statute. 47

An APA is defined as an agreement concluded between competent authorities that provides certainty to an enterprise, through the determination of an agreed transfer pricing methodology, thereby ensuring that the FTA will not make a transfer pricing adjustment. Under an APA, a methodology is chosen that applies for a certain period of time, based on a number of criteria considered to be appropriate by the competent authorities and the enterprise itself. The APA allows the enterprise to safely determine the prices for transactions between related entities. Consequently, it is an appropriate means to avoid the double taxation that would otherwise occur.

Some elements of uncertainty, however, remain. First, the scope of the APA may be extended or reduced by the FTA, taking into account the information given by the enterprise and its consequences on the taxable income in another state. The FTA has wide discretion in this respect. There is also no certainty that an APA will, if requested, be granted. Accordingly, the taxpayer may be in a difficult position if, after having disclosed all the facts and circumstances, the APA is not granted (the tax audit service may have all the required information to subsequently adjust the profits of the enterprise). In order to mitigate this risk, however, a preliminary meeting, prior to the submission of the official request, may be arranged with the FTA to discuss the APA on a no-names basis (for example, through an attorney).

Finally, some uncertainty may be associated with the basic hypotheses and critical assumptions, i.e. thresholds and parameters, which, according to the enterprise, may result in a modification of the method or its revision or suspension. Such basic hypotheses must be carefully considered and discussed with the FTA, as the latter must give their approval. In practice, however, these critical assumptions are often simply limited to a statement that the facts and circumstances must not materially differ in the future from what has been disclosed in the request.

3.4.3. Practical issues regarding the elimination of double taxation with regard to transfer pricing

3.4.3.1. Opening remarks

Under the OECD Model, where a state taxes the profits of an enterprise of that state and an enterprise of another state has been taxed on those profits in that other state and the profits are profits that would have accrued to the enterprise of the first-mentioned state had the transactions between the two enterprises been undertaken on the same basis as similar transactions between independent enterprises, that other state must make an appropriate adjustment of the amount of the tax charged on those

47. Art. L 80 B 7 LPE
48. Since 1 January 2005, enterprises may also obtain a unilateral APA, i.e. an agreement concluded only with the FTA. This procedure is discussed in the Regulations of 24 June 2005 (BOI 4 A-11-05). Unilateral APAs are an exception and may only be requested where no APA procedure exists in the other state, the operations at stake concern a large number of countries, the operations relate to specific subjects or simple but frequent issues, or the taxpayer is a small or medium-sized enterprise.
Key Practical Issues in Eliminating the Double Taxation of Business Income

...This provision is, however, generally not included in tax treaties concluded by France, as, for many years, it was considered too restrictive (France did not want to be bound in this respect). The French policy has, however, changed and the former reservation included in the Commentary on Art. 9 of the OECD Model has been withdrawn. In general, it may be said that, currently, the French competent authority clearly recognizes that double taxation cases should be eliminated to the greatest possible extent.

Once the French competent authorities agree, the next issue is how to characterize the invalidated transaction. In this respect, two situations may arise (see 3.4.3.2. and 3.4.3.3.).

3.4.3.2. No distributed income

Where the competent authorities of both states decide that there was a mistake in the determination of prices, but do not go so far as to contend that this mistake was deliberate or that there was an intention to transfer profits artificially, the response will be to deem that no income has been distributed. For instance, if excess royalties were paid by a foreign subsidiary to a French parent, the FTA and the foreign tax authorities would agree that the prices were incorrect and that the amount of the royalties should have been lower. The excess part would not be considered to be a deemed distribution from the foreign subsidiary to its French parent. In such circumstances, each state would adjust its taxpayer’s positions as follows.

In the source state of the income, an adjustment of profits would be made to the extent of the agreement reached between the competent authorities. As the two states would agree that there has been no distribution of profits, this would mean that the excess royalties would constitute a deemed loan extended by the foreign subsidiary to its French parent. The repayment of that loan by the French parent would resolve the situation and the adjustment in the foreign country would take the form of disallowing the excess part of the royalties as a deductible expense.

The French competent authorities would take a reciprocal approach. If a loan were granted by the foreign subsidiary to its French parent, the French parent would owe a corresponding debt to the subsidiary. The excess part of royalties that were, in the first place, treated as taxable income in the hands of the French parent would, under the adjustment, be treated as a debt of the French parent to the subsidiary. The French parent, therefore, would benefit from a corresponding adjustment of the amount of the excess part of the royalties, provided, however, that it effectively repays its debt to the subsidiary. The FTA, therefore, would require that there be a flow of money from the French parent to the subsidiary in an amount equal to the ‘loan’ deemed to be initially granted by the foreign subsidiary to the French parent.

This solution, which presupposes an agreement between the two competent authorities, raises certain practical issues, including the following:

- Financial years concerned: the adjustment, which is retroactive, concerns former years, particularly considering that a MAP takes a significant amount of time to complete (sometimes ten or more years after the tax years at issue). Once the competent authority procedure is concluded, the issue is whether the adjustments should be made to the tax years at issue or to the taxable income of the tax year in which the adjustment was approved by the competent authorities and the taxpayer.
- Exchange rate fluctuation problems: an adjustment is made in each country in its national currency. The exchange rates, however, have usually changed since the tax years at issue. Accordingly, the company that has benefited from the transfer of profits (the French company in the example) has to reimburse the deemed loan using the exchange rate that prevails at the time of reimbursement, which might be very different from the rate in the tax years at issue. The issue, therefore, is what exchange rate should be applied. This can, for tax purposes, be either the historical exchange rate or the actual exchange rate. There is no general principle that applies. Instead, the issue is up to the competent authorities to decide.
- Interest rate problems: if the company that was subject to the adjustment is regarded as having extended a loan to the foreign related company, the issue is whether or not interest should be applicable to the loan, which is generally the case for tax purposes in the presence of normal loan agreements.

As expressed in the regulations, the French policy in this respect is, as a matter of principle, to reach an agreement regarding corresponding adjustments that places the enterprise in the same position as if there had been no transfer of profits. Accordingly, the corresponding adjustment should be made in respect of the tax years concerned (irrespective of any domestic statute of limitations) and the exchange rate should be that of the relevant years (for the sake of simplicity, the exchange rate as of the date of closing of those tax years may be used if the French and the foreign companies close their accounts on the same dates). The corresponding adjustment assumes that the company that benefited repays to the other company the profits unduly transferred either through recognition of a debt or through actual repayment within 90 days from the date on which the taxpayer agreed with the result of the MAP. Such a transfer must be made based on the exchange rate on the day of the transfer.

If the adjustments relate to goods or services, the repayment must be made in the currency that was used in the initial contract between the related entities, in the absence of which it should be in the currency of the vendor. With regard to a transfer of profits relating to the licensing of intangibles, the currency should be that used in the licence agreement or, if the agreement does not specify the cur-

49. Art. 9(2) OECD Model.
50. Regulations of 23 February 2006 (BOI 14 F-1-06).
Bruno Gouthière

rency or if no royalties were paid in the first place, in the currency of the licensee.

As far as exchange gains and losses are concerned, the regulations take the view that exchange gains should be taxable if the corresponding loss is deductible in the other state and that exchange losses should be deductible only if they are taxable in the other state. Finally, the repayment should not give rise to interest payable by one entity to the other and no withholding tax should be applied in such circumstances.

3.4.3.3. Distributed income

The second situation is where both states find that there was a “voluntary” transfer of profits. In contrast to the first scenario, the states do not recognize the existence of an implicit loan from one company to the other.

Consequently, the transfer of profits is treated as a deemed distribution and not as a loan. This generally means that the company that has transferred the profits must impose withholding tax on the distribution.

In such circumstances, the result of a MAP concerns only the amount of the primary adjustment, i.e. the adjustment in terms of profits and corresponding deductions. In the state of residence of the company that transferred the profits, the taxpayer-transferor is subject to the following:

– an adjustment that adds the income transferred abroad back into its accounts, as is always the case with regard to transfer pricing adjustments; and
– a withholding tax, levied on deemed distributions, as is provided for generally by French law, subject to any applicable tax treaty.

In the state of residence of the company that has benefited from the transfer of profits, the consequence is more complex, as there are primary and secondary adjustments:

– Primary adjustment: the income is added back to the taxable income of the company that has transferred the profits and is treated as a deductible expense in the accounts of the company that has benefited from the transfer.
– Secondary adjustment: the income received (and not repaid in this case) as a deemed distribution is taxed. Under French case law and administrative doctrine, such income is fully taxable in the hands of the parent company and may not benefit from the parent-subsidiary regime, as this mechanism applies only to regular distributions.\(^{31}\) In such a case, the only remedy to double taxation is allowing a tax credit in France equal to the withholding tax levied on the deemed distribution in the source state, subject to tax treaties.

Finally, where France is the source state, i.e. where a French company has transferred profits abroad, the issue of whether or not withholding tax may be levied depends on the wording of the tax treaty (a withholding tax applies under domestic law, generally at the rate of \(\%\)). It has been held that no withholding tax may be levied where the tax treaty follows the OECD language.\(^{52}\) The consequence is different where the definition of dividends includes “income treated as a distribution by the taxation laws of the state of which the company making the distribution is a resident”, as in the France–United States tax treaty, or where the ‘other income’ article of the tax treaty gives the right to tax to the source state, in contrast to the OECD Model. Where a tax treaty treats all distributed income as ‘dividends’, withholding tax may be levied in France, provided that it does not exceed the treaty rate.

4. Conclusions

A proper allocation of business income between the states and the establishment of rules to settle disputes are key elements in eliminating double taxation of business income. If the states agree on the rules and if the relevant concepts are clear, by definition, no double taxation may arise. However, this result is difficult to achieve, as it is impossible to deal in advance with all possible circumstances and business strategies may also have an impact. Clearly, enterprises seek to obtain the most favourable result in allocating income and expenses amongst the states and this may not always be accepted by the tax authorities. Double taxation cases will, therefore, not disappear.

This is why the resolution of disputes is key. From this perspective, the development of APAs and the recent move towards arbitration are positive. It remains, however, to be seen if all new tax treaties will include an arbitration provision and how the arbitration procedure will be implemented in practice.

\(^{51}\) Conseil d’État, 6 June 1984, Case Nos. 35415 and 36733, RIF 8-9/84 No. 940.

\(^{52}\) See, for example, with regard to the France–Netherlands tax treaty, Conseil d’État, 13 October 1999, Case No. 190083, Banque française de l’Orient, RIF 12/99 No. 1587.
French Treaty Policy

In addition to their traditional function of eliminating tax frictions to promote France as a place to do business and the capacity of French firms to develop abroad, France’s tax treaties now represent a set of administrative cooperation tools that assist in countering international tax fraud and evasion.

1. Overview

1.1. Background

French domestic law does not include double taxation relief provisions, 1 in contrast to most of France’s partner countries. This does not give rise to difficulties as far as business profits are concerned, insofar as France taxes such profits on a territorial basis. However, the same does not apply to income from employment and passive income, which are taxed on a worldwide basis. This provides a strong incentive to expand France’s network of tax treaties that are intended to remove tax frictions. 2 In contrast to a unilateral mechanism, a tax treaty has the additional advantage of resolving all conflicts of qualification (the residence of a person, the situs of an asset, the type of income, etc.).

1.2. An extensive treaty network

As at 1 January 2010, France had signed tax treaties with 116 countries or territories, of which 89 are designed to eliminate the double taxation of income (and, in some cases, of wealth) and 27 are intended to cover not only income tax (and, where applicable, wealth tax), but also inheritance tax (and, again where applicable, gift tax). This has both increased the competitiveness of French companies and enhanced the attractiveness of France as an investment destination. By preventing double taxation and keeping the tax environment as stable as possible, it encourages French investment abroad and foreign investment in France.

1.3. Difficulties identified

It is difficult to update such an extensive treaty network. France’s longest-standing tax treaties are now half a century old. Such updating is necessary to adapt France’s treaty network to economic developments—for example, as new investment patterns emerge—and changes in the legal environment resulting from amendments to French law or in that of France’s partners, and as a result of the modernization of international standards—for instance, the OECD Model Tax Convention (the “OECD Model”)—or the growing importance of EU law. 3

What is more, in addition to protracted (re)negotiation procedures, as is traditional amongst treaty negotiators, France used to take significantly longer than most of its partner countries to ratify tax treaties. The French practice of placing treaty law above domestic laws, even those enacted subsequently, and of applying tax treaties exclusively in accordance with interpretation prevalent at the time of signature, 4 further aggravates the effects of this rigidity in France’s treaty network.

2. The Primary Objectives of Current Policy

2.1. A selective approach

The French approach to tax treaties is guided by:

– economic considerations: these include both macroeconomic issues connected with financing the national economy and winning new markets, and sectoral or microeconomic concerns; and
– budgetary and fiscal considerations: costs incurred in reducing tax withheld at source, for example, must be set against gains arising from stricter measures to counter tax fraud and evasion.

France’s priority is, therefore, to modernize the tax treaties with its significant partners. New partners are brought into its network dependent on the existence of significant economic flows and the possibility of obtaining most-favoured-nation treatment.

Accordingly, France has overhauled the tax treaties with its main partners (in particular, those with Belgium, Germany, Japan, Switzerland, the United Kingdom and the United States) over the past five years. However, this has not prevented the extension of the French treaty network to some Asian and Latin American countries.

2.2. Consistency

2.2.1. Treatment of entities

France seeks to achieve a fair degree of homogeneity in the treatment of various entities that now play a growing role in the workings of the international economy.

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1. Except in respect of gift and inheritance tax.
2. By using the exemption method with regard to income from employment and the credit method for passive income.
3. Within the European Union, EU law requires the Member States to apply equivalent treatment to domestic income, inbound flows of income and outbound flows of income (in the latter case and where applicable, with due regard to the amount of tax withheld at source that is allowed as a deduction by the state of residence). The principle of the free movement of capital also gives rise to certain effects with regard to third countries.
4. Other countries are more flexible, particularly in the interpretation of tax treaties in the light of the most recent OECD Commentaries.
Christian Comolet-Tirman

Bearing in mind the specifically French concept of "tax translucency", which applies to French partnerships, a clause is generally included in tax treaties to recognize the status of these partnerships as residents. Conversely, and with partner countries for which this is warranted, France takes care to insert a clause into its tax treaties making income streams routed by way of fiscally transparent partnerships eligible for the benefits of the tax treaty, subject to certain conditions. Previously, French policy was to deny these benefits to both the foreign partner, which could not be deemed resident within the meaning of a tax treaty because it was not liable to tax, and to its partners, as "the flow-through" nature of the entity was not recognized by France.

Traditionally, France recognized the status of resident only in respect of legal persons liable to tax without being exempted from tax. France had, however, already agreed to extend the benefits of tax treaties to certain collective investment vehicles. The same issue has become increasingly acute with regard to pension funds. Various considerations must be borne in mind where these are concerned. Specifically, the cost to the budget, which is asymmetric in the absence of French pension funds, must be balanced against the ambition to develop France as a financial centre. Consideration should also be given to obligations arising under EU law, which may require that certain pension funds are accorded the same treatment as French retirement funds. Consistent with the French treatment of investment companies and funds, France now extends the benefits of tax treaties to passive income received by pension funds, when the funds are based in a partner country that so requests and most of the beneficiaries reside in one or the other of the contracting states.

2.2.2. Taxing rights

With regard to the allocation of taxing rights, the first issue to note is that France has taken care to preserve the special regimes from which several tens of thousands of cross-border workers benefit (with taxation of income from employment in France, the state of their residence, rather than in the neighbouring state where they work). France also seeks to strike a balance with regard to taxation at source by moderating the demands of relatively high-tax emerging countries and withholding taxes on flows to low-tax jurisdictions.

With regard to the rules for taxation at source of business profits, France tries to set the minimum period required to establish the existence of a permanent establishment (PE) at 12 months, whereas a number of France's partners that are not OECD Member countries favour a period of six months. Similarly, France prefers not to insert into its tax treaties any specific definition of a PE in respect of services performed by an enterprise. There is, however, growing pressure for this.

With regard to interest, France favours exclusive taxation in the state of residence, but can countenance taxation in the state of source of up to 10% if accompanied by substantial exemptions. As far as royalties are concerned, France generally seeks residence-based taxation in keeping with the OECD Model, but can countenance a 5% withholding tax. Finally, with regard to dividends, in excess of the common rate of 15%, France proposes an exemption in respect of significant shareholdings, except when the characteristics of the partner country’s tax system are conducive to a withholding tax.

Changes have also occurred in the treatment of income from immovable property. Traditionally, and to preserve a tax base that was not yet very mobile, France has tried to insert into its tax treaties a clause covering the situation in which the rights in an entity give an entitlement to enjoy the immovable property held by that entity. According to this clause, income derived from the use of that right of enjoyment may be taxed in the state where the immovable property is situated. However, the development of real estate investment funds that convert income from immovable property into dividends has recently altered this context. As these entities’ are not incorporated or are tax exempt, they cannot generally be treated as residents under a tax treaty in accordance with the French conception of residence. Only a clause that refers to such entities specifically can allow them to claim the benefits of the tax treaty. However, it must also be borne in mind that the income that these entities distribute is not taxed when it is earned. In order to avoid complete exemption in the source state of the income earned from immovable property and allow for the fact that such income is not always taxed in the hands of non-resident beneficiaries, France inserts a clause into its tax treaties providing for a 15% rate withholding tax for equity interests below 10% and unlimited taxation at source beyond this, in accordance with the work undertaken regarding this issue by the OECD.

2.2.3. Arbitration

An arbitration clause to guarantee the elimination of double taxation has been inserted into France's tax treaties with its major partners, such as those with Germany, the United Kingdom and the United States.

2.3. Other policy objectives

2.3.1. Faster negotiation, signing and entry into force

Partner countries have been invited to agree to tight timetables for negotiations. In addition, the period of time between initialising at administrative level and signing at ministerial level has been shortened. The delay between signature and adoption of the ratification bill, which has traditionally been longer than for France's partners, is also now shorter. As an illustration of this, the tax treaty with the United States, initialled in November 2008 and signed in January 2009, entered into force in December 2009, with some of its clauses having effect from 1 January 2009.

5. For example, real estate investment trusts.

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2.3.2 Greater flexibility between treaty and domestic law
This relates to clauses inserted into tax treaties that preserve France’s right to alter its domestic law. Examples of this include reserving the right to adopt taxation on a worldwide basis and not on a territorial basis where company taxation is concerned, or to tax in France capital gains derived from the alienation of rights forming part of a substantial participation in the capital of a company that is a resident of France. This also relates to clauses inserted into tax treaties that allow for the application of France’s domestic law to avoid a double tax exemption (see 3.2.1).

3. Countering International Tax Fraud and Evasion

3.1. Background
Equality in taxation is a core principle in the French constitution. Specifically, under Art. 13 of the 1789 Declaration of the Rights of Man and the Citizen, taxation that is indispensable for the financing of public expenditures ‘ought to be equally apportioned among all citizens, according to their means’. Consequently, tax fraud and evasion by some persons have traditionally been regarded as an attack on the tax compliance of the remainder.

Currently, certain persons may regard the economic freedoms guaranteed by the Treaty on the Functioning of the European Union (TFEU), i.e. the free movement of persons and workers, the freedom to provide services, the freedom of establishment, and the free movement of capital, as an opportunity to avoid the scrupulous fulfilment of their tax obligations.

More recently, the financing requirements of governments have increased as a result of the economic and financial crisis, thereby making the worldwide effort to counter tax fraud and evasion all the more important.

In the multilateral arena, France has been in the forefront of efforts to counter international tax fraud and evasion by calling on those countries that had not yet done so to adopt the OECD standards on the exchange of information, urging the introduction of mechanisms to assess that these norms are properly applied and contributing to the commencement of the work that is intended to make these standards more relevant still.

Similarly, within an EU framework, France has argued in favour of the rapid adoption of the new directives concerning mutual assistance for the recovery of claims relating to taxes and on administrative cooperation in the field of taxation.

3.2. Ways and means

3.2.1. Tax treaties

3.2.1.1. Preventing tax treaties being used for tax evasion
For both tax treaties signed with new partners and protocols to existing ones, France’s first objective is to avoid double tax exemptions. For example, when France or its partner has an exclusive right to tax an income but the right is not exercised because domestic law makes no provision for taxation of such income, France is careful to preserve the other party’s right to tax. Similarly, when France considers that its partner has, in principle, the exclusive right to tax an income received by a resident of France, France strives to preserve its right to tax under domestic law if this partner does not exercise its right on grounds of a divergence over the classification of the income in question. Finally, with regard to income or gains that, in a partner country, are taxed by reference to the amount that is remitted to or received in that country, France limits the relief under the tax treaty to so much of the income or gains that is taxed in the partner country.

In the same spirit, there is a need to review clauses in certain tax treaties, under which the tax credit granted by France as the country of residence may exceed the tax paid in the source state. Such tax sparing and tax matching credit mechanisms, which were originally intended to encourage a partner country’s economic development, may have outlived their usefulness and may give rise to abuse.

France also inserts the anti-abuse rules referred to in Para. 21.4 of the Commentary on Art. 1 of the OECD Model into the tax treaties that it signs. This paragraph provides for the possibility of refusing to apply the cap on tax withheld at source on dividends, interest, royalties and other income if it was the main purpose, or one of the main purposes, of any person concerned with the creation or assignment of the shares, debt claims or rights in respect of which the income is paid, to take advantage of these provisions by means of that creation or assignment.
The concept of a beneficial owner, which France began to apply in 1974 before its introduction into the 1977 OECD Model, is inserted not only into articles dealing with passive income and other income, but may also be included in the article on the elimination of double taxation or that dealing with residence.

In addition, France has begun to introduce more general clauses limiting the benefits available under tax treaties. France was initially rather circumspect in this regard. From the French perspective, treaty benefits should not be unduly difficult to obtain for taxpayers or unwieldy to manage for tax administrations. France was also cautious not to supply, as it were, an unspoken guide to tax evasion.

Accordingly, France agreed to introduce into its tax treaty with Japan a limitation-on-benefits clause whose effects were deliberately circumscribed. Specifically, if the recipient of income fails to satisfy the conditions set out in the clause, the recipient loses eligibility for exemption, but remains entitled to other advantages under the tax treaty, subject to anti-abuse measures.

In its three most recent tax treaties, France has secured from its partners the insertion of a more wide-ranging clause, albeit one more flexible to apply. On the one hand, this clause provides that a resident of a contracting state does not qualify for the tax reductions or exemptions provided for under the tax treaty by the other contracting state if the main purpose, or one of the main purposes, of the conduct of operations by such resident or a person connected with that resident was to obtain the benefits of the tax treaty. On the other hand, the clause states that the benefits of the tax treaty can be denied in respect of an item of income where the recipient is not the beneficial owner of the income and where the operation allows the beneficial owner to obtain a tax burden on this item of income lower than that person would have supported if that person had received such an item of income directly.

3.2.1.2 Ensuring treaties provide for effective administrative cooperation

From the outset, the OECD Model regarded information exchange as the means to secure the correct application of the provisions of a tax treaty and the domestic laws of the parties with regard to the taxes covered by this tax treaty. Since 2000, the OECD Model has sought to facilitate the proper application of the domestic laws of the parties regarding taxes of every kind and description. And since 2005, the OECD Model explicitly denies the possibility of raising the absence of a domestic tax interest or the existence of measures protecting bank secrecy as grounds for refusing to supply information.

Some of France’s partners could previously shelter behind the barrier of banking secrecy, the fact that the requested information was not required for their own tax purposes or the absence of the slightest provision for administrative cooperation in a tax treaty and claim these as grounds for refusing to supply information, or simply discourage the requesting of such information. By means of specific protocols, France has, therefore, introduced an article that is consistent with the latest version of Art. 26 of the OECD Model into its tax treaties with its European neighbours (for example, those with Belgium, Luxembourg, Malta and Switzerland), and its partners in the Arab world (those with Bahrain, Qatar and Saudi Arabia) and in Asia (those with Malaysia and Singapore).

Similarly, France has subordinated the signing of all new tax treaties to the establishment of procedures for effective administrative cooperation. Accordingly, an exchange-of-information article in keeping with the latest version of Art. 26 of the OECD Model is inserted into France’s new tax treaties. Where appropriate, a phrase is also added clearly specifying the obligations of the contracting parties to take all of the necessary measures to ensure the principle of effectiveness. Finally, where possible, an article on assistance in the collection of taxes is inserted into France’s tax treaties.

3.2.2 Information exchange agreements

France has signed tax information exchange agreements with a number of tax havens – 13 in 2009 and 14 in 2010. These agreements cover the exchange of information in both civil and criminal matters. However, such agreements do not deal with the elimination of double taxation, which is still hypothetical given the low, or zero, level of direct taxation in these territories.

These agreements are not only closely based on the 2002 OECD Model Agreement on Exchange of Information on Tax Matters, but also contain the following three improvements: (1) they cover all taxes; (2) they clearly state the obligation of the contracting parties to take all necessary measures to guarantee the availability of information and the ability of their administration to gain access to such information; and (3) the requesting state is not required to incur certain administrative costs entailed by its requests, this being merely an option, and, in some cases, such an option is not provided for at all.

3.2.3 Domestic law

Following on from the G20 London meeting in April 2009 and the Berlin ministerial conference in June 2009, organized jointly by France and Germany, both of which had considered applying certain defensive measures, France has adopted a series of legislative provisions. These provisions are summarized below.

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17. Art. 26 of the OECD Model is inserted into France’s new tax treaties. Where appropriate, a phrase is also added clearly stating the obligation of the contracting parties to take all necessary measures to guarantee the availability of information and the ability of their administration to gain access to such information; and (3) the requesting state is not required to incur certain administrative costs entailed by its requests, this being merely an option, and, in some cases, such an option is not provided for at all.
19. "Each contracting state shall take the necessary measures to ensure the availability of information as well as the ability of its competent authority to access information and to transmit it to its counterpart."
Jurisdictions considered by France to be non-cooperative have been identified. A state or territory is deemed to be “non-cooperative” at 1 January 2010 if it features on the list of states and territories that have not signed 12 treaties or agreements compliant with the international standard, as published by the Secretary General of the OECD and up to date as of 31 December 2009, and if that state or territory has not signed a treaty or an agreement with France at that date providing for the exchange of all information necessary to the application of the tax laws of the parties.

Measures penalizing transactions by French residents with such states or territories have also been introduced into the French Tax Code (Code Général des Impôts, CGI). These include a strengthening of the anti-abuse measures provided for in Arts. 209B and 123 bis of the CGI that permit the taxation in France of income earned in low-tax jurisdictions, reinforced obligations to provide documentation with regard to transfer pricing in respect of transactions with entities located in a non-cooperative state or territory, the introduction of the principle of non-deductibility of charges reflecting the amounts paid to residents of non-cooperative jurisdictions, the non-application of the parent company regime to payments made by entities located in these jurisdictions, and the non-application of the long-term capital gains regime to disposals of securities of companies established in these jurisdictions.

Similarly, transactions with France by those located in these states or territories are penalized. Specifically, a 50% tax is withheld on income streams paid to non-cooperative jurisdictions and on capital gains on disposals of securities and immovable property by their residents.

Finally, the French Monetary and Financial Code (Code Monétaire et Financier) has been amended to impose a new obligation on financial institutions located in France. This requirement is to disclose in the notes to their annual financial statements information on their establishments and activities in jurisdictions that are deemed to be non-cooperative.

3.3. Future developments

France’s first objective is to manage its extensive and largely renewed network of administrative cooperation treaties and agreements, together with the list of non-cooperative jurisdictions, which must be updated annually. In this regard, the following three categories of states and territories are to be added each year to the previous year’s list: (1) those that have concluded a tax treaty with France that does not provide for exchange of the information necessary for the application of France’s tax laws; (2) those that have not concluded an administrative cooperation treaty or agreement with France, and to which France has proposed to conclude such a treaty or agreement in the previous 12 months; and (3) those that have neither concluded an administrative cooperation treaty or agreement with France nor have been approached to this end, but which do not, in the opinion of the Global Forum on Transparency and Exchange of Information in Tax Matters, exchange all of the information required for the application of tax laws.

Conversely, the following three categories of states and territories are to be removed each year from the previous year’s list: (1) those that have recently concluded a treaty or an agreement with France that provides for the exchange of all information required for the application of French tax laws; (2) those that have already concluded a tax treaty with France and that have concluded a protocol to that tax treaty or that have amended their own legislation to remove restrictions on the exchange of tax information; and (3) those that have neither concluded an administrative cooperation treaty or agreement with France nor have been approached to that end, but which, in the opinion of the Global Forum, exchange all of the information required for the application of tax laws. France believes that this approach has the twofold advantage of being dynamic, thereby affording an incentive to cooperate, and of combining assessments made by the French administration with assessments made in a multilateral framework.

France takes great care to ensure the effective administrative cooperation from its partners, bearing in mind that these partners, especially non-Member States of the European Union, can take advantage of the signing of a tax treaty or an agreement, as not only do they gain “respectability” and thereby avoid defensive measures, but they also qualify for certain favourable measures provided for in the CGI, including potential eligibility for certain exemptions and the more moderate application of anti-abuse measures.

At the same time, France intends to contribute to international efforts to specify standards of transparency and information exchange on request with regard to both the availability of information and the exchange of information. Examples of these efforts include making information relating to trusts and conduit companies available and specifying the ability to request information relating to a category of taxpayers.

However, beyond this, the question of the possible role of the automatic exchange of information between tax administrations remains unresolved. This kind of exchange is required in the Savings Directive. It is also required in the new EU directive on administrative cooperation in the field of taxation with regard to income from employment, pensions, directors’ fees, life insurance products, and income from immovable property, subject to availability of such information. Nevertheless, the apparent attraction of the competing project backed by the Swiss federal authorities, which consists of generalizing the withholding tax mechanism, should not be underestimated.

Concurrently, however, efforts to give a greater role to financial intermediaries are gaining momentum inside
both the European Union and the OECD. The mechanisms envisaged seek not only to streamline the granting of the benefits of the tax treaties, but also to improve the countering of tax fraud and evasion by providing for the automatic communication of information to both the source state of the income and the beneficiary’s state of residence.

4. Conclusions

France has sustained a brisk pace in updating its network of double taxation conventions. At the same time, France has responded to increasing demands in terms of administrative cooperation by creating a network of tax information exchange agreements ab initio. This bilateral policy closely complements the work undertaken by France in multilateral forums, i.e. the European Union, the G20, the OECD and its Global Forum, and the United Nations, as well as with the measures adopted within a national setting. In this regard, the objective is to reconcile the competitiveness of economic operators with the need to raise adequate government revenues, and to do so fairly.
France

Interaction between Tax Treaties and Domestic Law

Tax treaties, given their primary object of eliminating double taxation, should logically take precedence over domestic tax law. However, because of this object, tax treaties do not normally give rise to grounds for domestic taxation (the principle of subsidiarity), and, in some cases, domestic law may even be applied to tax treaties.

1. Superiority of Tax Treaties over Domestic Law

1.1. Introductory remarks

France is an example of a country applying a monist doctrine, whereby treaties become part of domestic law following ratification.

1.2. Superiority over statutes

Art. 55 of the French Constitution states that international treaties, following ratification and publication, are superior to French legislation. This is especially important for tax treaties, as, under Art. 34 of the Constitution, the rules regarding taxation must, in principle, be written in a statute, and not a regulation.

Courts, therefore, set aside all statutes that are contrary to a tax treaty, even if the statute was enacted after the treaty (Conseil d'Etat (Supreme Administrative Court), 20 October 1989, Case No. 108243, Nicolo, RJF 11/89 No. 1266). Accordingly, there is no treaty override.

There is a reciprocity clause in Art. 55 of the Constitution. Courts check whether or not the other contracting state has failed to apply a treaty (Conseil d'Etat, 9 July 2010, Case No. 317747, Cheret), in which case the treaty is denied any legal authority in domestic law. However, with regard to tax treaties, it has been decided that the creative identification of a permanent establishment (PE) by the other contracting state is an application of the tax treaty, whatever its merits, and does not give rise to the consequences of the non-application of the tax treaty (Conseil d'Etat, 20 November 2002, Case No. 230530, Soules, RJF 2/03 No. 153). Accordingly, the reciprocity clause does not seriously endanger the application of tax treaties.

1.3. Superiority over regulations and guidelines

Tax treaties are, of course, superior to regulations and guidelines. The most common difficulty is to identify the extent to which guidelines can legally implement or interpret a tax treaty.

It has been decided in case law that a guideline can legally implement a tax treaty, for example, by requiring that taxpayers file an administrative form to be granted a treaty benefit, but only if such implementation is allowed by a provision of the tax treaty and if the guideline is published in the same way as the tax treaty has been (Conseil d'Etat, 16 February 1990, Case No. 68627, SAS France RJF 4/90 No. 393).

Guidelines can interpret a tax treaty, but such an interpretation must not deviate from the treaty and can be challenged in courts through the recours pour excès de pouvoir procedure, whereby any person with sufficient interest can have an administrative Case quashed by an administrative court. In this respect, a recent case involved a direct challenge against a guideline issued by the Ministry of Finance regarding the application of the Brazil–France tax treaty of 10 September 1971 (Conseil d'Etat, 26 July 2006, Case No. 284930, Natexis, RJF 11/06 No. 1421).

1.4. International rules for the interpretation of tax treaties

Tax treaties are not interpreted according to domestic interpretation rules. Although France is not a signatory to the Vienna Convention on the Law of Treaties (the "Vienna Convention") of 23 May 1969, Arts. 31 and 32 of this convention dealing with treaty interpretation are accepted as the codification of international custom. The rapporteurs publics (formerly, commissaires du gouvernement) before the Conseil d'Etat rely on these articles in their opinions on treaty cases and the wording of the Heskes case (Conseil d'Etat, 17 December 2003, Case No. 239677, Heskes, RJF 3/04 No. 249) reveals that the Conseil d'Etat has agreed to follow a discussion based on the various principles of interpretation set out in Art. 31 of the Vienna Convention. This case dealt with the claim by a retired UNESCO employee to an exemption of his UNESCO pension from French income tax. He (unsuccessfully) claimed the benefit of an exemption that he tried to find in the France–UNESCO headquarters treaty. The Court Case followed his discussion of the means of interpretation of Art. 31, with a marked reservation regarding the use of subsequent practice by the French tax authorities (FTA).

1.5. Practical effect on domestic tax law

Tax treaties do not usually affect the contents of domestic tax law. Their primary object is to allocate tax jurisdiction between contracting states to eliminate double taxation.

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Accordingly, they have an effect on the scope of domestic tax law more than on its contents.

This explains why tax treaties are raised ex officio by tax courts (Conseil d’Etat, 28 June 2002, Case No. 232276, Schneider Electric, RJF 10/02 No. 1080). The logic is that courts should not apply a law if it is not applicable, which becomes the case for domestic tax law when France loses tax jurisdiction under a tax treaty.

Domestic tax legislation does not become invalid because it must be set aside under a number of tax treaties. It is deemed to apply to taxpayers with the implicit reservation of the application of tax treaties.

In some areas, tax treaties can affect domestic law more directly. This is the case when tax treaties provide for a tax credit. However, the most sensitive area of domestic law that is affected by tax treaties may be domestic anti-avoidance provisions. In this respect, the unilateral power given to the FTA to challenge the terms of a transaction, to recharacterize an income or to reattribute income can be challenged using tax treaties.

In transfer pricing cases, treaty provisions following Art. 9(1) of the OECD Model Tax Convention (the "OECD Model") may be used to restrict the scope of domestic law that is affected by tax treaties may be domestic anti-avoidance provisions. In this respect, the unilateral power given to the FTA to challenge the terms of a transaction, to recharacterize an income or to reattribute income can be challenged using tax treaties.

2. Subsidiarity of Tax Treaties

2.1. Introductory remarks

In French case law, the principle of superiority coexists with the principle of subsidiarity of tax treaties regarding domestic law, which might appear to be paradoxical. However, subsidiarity means only that, intellectually, the application of domestic law is a first step. The subsidiarity principle is also referred to as the "priority of domestic law".

2.2. Consequence of the object of tax treaties

The superiority principle prevents domestic taxation when a tax treaty denies the right to tax to the contracting state. The issue behind the subsidiarity principle is whether or not the superiority principle means that the allocation of the right to tax by the tax treaty to a contracting state provides sufficient legal grounds for taxation in that state, even if domestic law does not provide for such taxation.

The answer is negative and is derived from the primary object of tax treaties, i.e. the avoidance of double taxation. A tax treaty becomes useless if there is no right to tax under domestic tax law, as there is no risk of double taxation. The subsidiarity principle, which is judge-made, is solemnly stated in the wording of the Schneider case.

2.3. Protective effect for taxpayers

In practical terms, subsidiarity means that the FTA cannot rely on treaty provisions alone to tax a person. This protective effect is explicitly described in the Schneider case. This can result in double non-taxation.

2.4. Domestic stopgap legislation

However, domestic legislation can correct this protective effect. In France, a law of 28 December 1959, codified in Arts. 4 bis, 165 bis and 209 of the CGI, provides that, with regard to personal and company income tax, all income attributed to France by a tax treaty is taxable in France.

Accordingly, in practical terms, the protective effect of the subsidiarity principle is greatly diminished. The consequences of the law of 1959 have been clarified by a recent case (Conseil d’Etat, 31 July 2009, Schneider Electric, RJF 11/09 No. 797). The subsidiarity principle is basically a methodology adopted by French courts to deal with the combination of domestic tax law and tax treaties. In a first step, the right to tax must be ascertained in the ordinary provisions of domestic tax law. Then, in a second step, tax treaties must be checked to ascertain whether or not they allow France to tax. In a third step, when ordinary domestic law does not tax but the tax treaty gives France the right to tax, the stopgap provisions deriving from the law of 1959 must be taken into account and interpreted to see whether or not they provide, in the given case, an alternate legal base for taxation. At this last stage, the resolution of the taxation issue rests solely on the interpretation of the scope of the 1959 stopgap legislation.

The Overseas case clarified that the 1959 law covers all the insufficiencies of domestic territoriality provisions, including the French income of a nonresident. There appears to be no temptation to argue that this law could overrule, on the basis of the treaty allocation of taxing
rights, substantive provisions in domestic law exempting taxpayers for economic or social reasons, for example, small businesses, orphans and war veterans. There is some uncertainty regarding the effects of this law when taxing rights are given to France by a tax treaty, but domestic law does not provide for a specific taxing mechanism. One example is outbound income when there is no specific withholding tax mechanism in domestic law. In this case, does the stopgap provision allow the extension of other withholding tax mechanisms in domestic law, do general income taxation rules apply or is there a technical void in domestic law?

2.5. Principle of non-aggravation?

The subsidiarity principle has given rise to a debate in tax doctrine regarding a potential consequence. This might be that, if tax treaties are meant to avoid double taxation and cannot provide a legal base for domestic taxation, consequently, they should never increase the tax burden of a taxpayer (the principle of non-aggravation).

Such a principle, as discussed in tax doctrine, has not been recognized in case law, which applies only the subsidiarity principle (the priority of domestic law). Consequently, the question is whether or not the subsidiarity principle should (outside, of course, the scope of the law of 28 December 1959) prevent situations where the application of a tax treaty might increase the tax burden of a specific taxpayer.

Although the doctrinal debate is still open, a few cases touch on the issue. In the Soulès case, the Conseil d’Etat admitted that a treaty provision, such as a foreign tax credit clause, could set aside the domestic provision permitting the deduction of taxes (including foreign taxes) from profits. The issue is whether or not a treaty foreign tax credit, whereby tax is deducted from tax, not from profits, always sets aside the domestic provision, even if the foreign treaty credit cannot be fully used, due to a lower level of tax in the state of residence.

Other cases deal with the conflict between domestic domicile and treaty residence. In some situations, taxpayers rely on their French domicile in domestic law to claim the benefit of favourable tax regimes or to avoid French withholding tax on outbound income. The issue is whether or not their foreign residence under treaty provisions prevails over their French domicile in domestic law, although they do not claim, regarding this issue, the benefit of the tax treaty. On these issues of tax benefits granted to residents and of withholding taxes, tax treaties are used by the FTA, whereas taxpayers cite domestic law. Although there is no court decision providing a clear-cut answer to the question, the closest case is the Lecat decision (Conseil d’Etat, 8 July 2002. Case No. 225159, Lecat, RJF 11/02 No. 1202). In this case, the Court decided that the domestic provisions granting tax benefits linked to French domicile must be interpreted in line with the territoriality of the personal income tax, whereby domicile means taxation on worldwide income. If the tax treaty makes France into a source state, only taxing French-source income, the condition is not met any more.

2.6. Influence on characterization of income

The subsidiarity principle has resulted in the concept that income must be characterized first in domestic law before being compared to the categories of income distinguished by a tax treaty. Such a method is written in the general wording of the Schneider case regarding subsidiarity. This wording states that, in ascertaining taxability in domestic law, the court must identify the characterization of income. Then, the court must compare this domestic characterization with the treaty provisions.

This does not mean that treaty concepts cannot be interpreted as wider or narrower than comparable domestic concepts, unless domestic definitions become applicable under Art. 3(2) of OECD Model-type tax treaties. Domestic characterizations are a starting point for looking at the variety of categories of income listed by the tax treaty. In many cases, following legal analysis in domestic law, income may be assigned to several articles in a tax treaty, which requires considering treaty solutions to separate these categories. For instance, capital gains, income from immovable property, dividends and other types of income can also be business profits, and conflicts are normally resolved by applying treaty provisions, not domestic law, unless the tax treaty does not resolve the problem (see 3.2.1.).

In practical terms, the major effect of this prior characterization in domestic law can be seen in the area of domestic tax fictions, such as deeming provisions. It may not be coincidental that the landmark Schneider wording was written in a case concerning CFC legislation (see 3.2.2.).

3. Application of Domestic Law to Tax Treaties

3.1. Introductory remarks

Once legal logic has reached the point of applying and interpreting tax treaties, it could be thought that the stage of domestic law is over. However, in practice, the influence of domestic law remains in many areas.

3.2. Interpretation

3.2.1. Definitions

3.2.1.1. Initial comments

Following domestic characterizations, the stage is set for interpretation and application of treaty provisions. However, tax treaties, when allocating the right to tax, rely on a list of categories of income that are very important, as they determine a specific solution per category, but do not always resolve the problems met when trying to assign income to these categories. Accordingly, the issue of treaty definitions and the temptation to use domestic law references emerge in areas where the mechanisms referred to in the Vienna Convention might not be very useful.

This issue can arise in tax treaties that do not include a provision equivalent to Art. 3(2) of the OECD Model. In such a situation, an attempt could be made to find at all costs some guidance in the tax treaty itself, even if this
might require a degree of creativity. A comparison between the domestic laws of both contracting states could be tried, but knowledge of the domestic law of the other state might not be available and there is no easy method to resolve conflicts between domestic definitions.

Confronted with such an issue, the Conseil d'État decided to return to French domestic law to resolve a problem arising from the absence of treaty definitions (Conseil d'État, 22 May 1992, Case No. 63266, Raffaëlla, RJF 7/92 No. 960). In this case, the old France–Italy tax treaty of 29 October 1958 had no provision defining the boundary between the “business profits” article and the “income from immovable property” article. This gave rise to a problem for the correct treaty treatment of income derived from immovable property owned in France by an Italian company. If the owner of the income is considered, the business profits article might prevail. If the item of income is considered, the income from immovable property article might prevail as more specific. The Court used the domestic concepts, whereby the income from real estate owned by a business is taxed as business income. The taxpayer won as a result of the lack of a PE in France.

Usually, tax treaties do have a provision such as Art. 3(2) of the OECD Model. In this case, and given the fact that the very wording of Art. 3(2) resolves a number of problems, the practical effect of such a provision depends on the concept of the definition, both in the tax treaty and in domestic law, that is accepted, and on the use of the treaty context to limit the use of domestic law.

3.2.1.2. What is a definition?

With regard to the issue of definitions, the very existence of a treaty definition can sometimes be debated. The Conseil d'État took a very domestic line in a 1999 decision (Conseil d'État, 13 October 1999, Case No. 190083, Banque française de l'Orient, RJF 12/99 No. 1587). The issue was income from transfer pricing between a French subsidiary and a Netherlands parent company, Art. 10 of the France–Netherlands tax treaty of 16 March 1973 permits withholding tax on dividends. Was the income from transfer pricing received by the Netherlands parent company a French-source dividend? The Conseil d'État decided that the tax treaty did not give a definition of dividends, but, rather, a list of financial instruments, which did not qualify as a synthetic definition of dividends. This is a view linked to the preference for synthetic definitions in French legislation, so it could be argued that the return of domestic law through Art. 3(2) of the OECD Model is enhanced by the fact that there may be national idiosyncrasies as to what a definition should be. In order to underline the problem, it should be noted that Para. 23 of the Commentary on Art. 10 suggests that the definition of dividends in the OECD Model is not a complete one, but, rather, a list of examples. What, then, is the threshold of a definition?

A further question is what is to be defined in a tax treaty. In the English version of Art. 3(2) of the OECD Model, the recourse to domestic law is allowed on “any term not defined” in a tax treaty. The French version refers to any “term ou expression”, which leaves little doubt as to the application of Art. 3(2) to any wording in the tax treaty, and not just to the headlines designating items of income.

It is, therefore, possible to have a lack of definition inside a definition. An example of this issue is the Golay Buchel case (Conseil d'État, 27 July 2001, Case No. 215124, Golay Buchel, RJF 11/01 No. 1428). This case deals with Art. 12 of the France–Switzerland tax treaty of 9 September 1966, which (at that time) allowed withholding tax on interest by the source state. The issue was the taxation of interest for late payment of a commercial debt owed by a French company to a Swiss company, withheld by the FTA. With regard to the definition of interest, Art. 12 of the tax treaty mirrored the 1963 OECD Model, thereby giving a list of financial instruments, but including at the end of the list the concept of “income from debt-claims of every kind.” Unlike in the dividend case, the Conseil d'État decided that the term “interest” was defined in the tax treaty. However, the Court held that the expression “income from debt-claims of every kind” was not defined in the tax treaty and referred to the national meaning of this very expression, the problem being that interest for late payment could be regarded either as a financial gain or as an addition to the original income (business profits in this case).

The concept of definition also raises the issue of what a domestic meaning or definition is. The easiest situation is where there is in domestic law a written and detailed definition. However, this is not always the case. It may be that the domestic meaning comes from case law. In Golay Buchel, the case was decided according to French case law establishing that interest for late payment is not a financial gain, but, rather, belongs to the same category as the main income, such as, for example, wages or business income. It is a domestic characterization that supplements the written definition of interest in domestic law. Ultimately, the Court applied domestic case law through Art. 3(2) of the OECD Model, as neither the tax treaty nor domestic written law had any full written definition. This is not illogical, as case law is part of the domestic meaning of legal concepts.

But could the notion of domestic definitions be pushed so far as to include domestic tax regimes? Theoretically and in case law, the answer is negative. A domestic definition or meaning must relate directly to the treaty term or expression in question. When looking at the domestic definition of dividends, Conseil d'État decisions, such as in the Banque française de l'Orient case, apply domestic case law on the definition of the term “dividend” in the CGI, which is interpreted as referring implicitly to a narrow company law meaning designating distributions decided by the competent institutions of the company. Tax law provisions that tax deemed or de facto distributions are not considered to be part of the domestic definition of dividends. In Banque française de l'Orient, although income from transfer pricing by a subsidiary is taxed as a concealed distribution in domestic law, it was held that the distributions were not dividends in domestic law and, therefore, not dividends for treaty purposes either.
The line dividing domestic definitions and domestic tax regimes may not be easy to draw. In the case of domestic anti-avoidance regimes, it could be debated whether or not they define a treaty-related term. For instance, does a domestic CFC regime based on deemed distribution define the words ‘paid to’ in Art. 10(1) of the OECD Model or is it simply a tax regime, as it relies on a fiction? Does a domestic exit tax on shares define the term ‘alienation’ in Art. 13(5) of the OECD Model? Does a domestic artiste regime define the term ‘derived’ in Art. 17(1) of the OECD Model?

3.2.1.3. What is context?

Art. 3(2) of the OECD Model states that terms not defined in a tax treaty are interpreted under domestic law, ‘unless the context otherwise requires’. There is little case law in France as to the meaning of ‘context’ and the degree of persuasion implied by the word ‘requires’.

The only significant case is the Golay Buchel case. After deciding that the expression “income from debt-claims of every kind” was not defined in Art. 12 of the France–Switzerland treaty of 9 September 1966, the Golay Buchel decision states that no element of context requires an interpretation that would be different from domestic law. As indicated in the opinion of the commissaire du gouvernement, the Conseil d'Etat researched the Commentaries of the 1963 OECD Model to ascertain if the wide notion of “income from debt-claims of every kind” might have been commented on as including interest for late payment. The answer was that there was no relevant commentary on this issue. Accordingly, the Conseil d'Etat decided to consider domestic law.

This decision adopts a wide notion of context. This is much wider than the same term used in Art. 31 of the Vienna Convention, as Art. 31(2) and the official explanation of this article suggest that context refers to documents that are in a treaty or directly related to the treaty.

The Golay Buchel decision also implies that the 1963 Commentary could have prevented the application of domestic law under Art. 3(2) of the OECD Model. This means that prior OECD Commentaries are accepted as a legitimate instrument for interpreting tax treaties, unlike later Commentaries, which have only persuasive value (see the Andritz case). It also means that the term ‘requires’ in Art. 3(2) is not such a high threshold if the court is convinced that there is a relevant context that solves the definition problem.

This is a functional approach to Art. 3(2) of the OECD Model. This article tries to reach a compromise between the need to use clear concepts, even taken from domestic law, and the danger of splitting the interpretation of a tax treaty into purely domestic, and possibly conflicting, views.

In case of a serious interpretation problem that is not resolved by a treaty definition, the use of domestic definitions may have the merit of legal certainty, more so than a creative interpretation of a tax treaty by the courts, with little guidance from the tax treaty itself. However, when there is a consensus written in prior Commentaries and the relevant treaty provision mirrors the OECD Model, there is a good argument for using this interpretation, rather than returning to domestic law. The prior OECD meaning has the double advantage of being written and of providing (if followed in the other state) an international consistency in the interpretation of a tax treaty. The argument of international consistency may convince a court to follow the Commentaries as context under Art. 3(2) of the OECD Model, even if domestic case law provides another solution.

3.2.2. Characterization and attribution of income

As noted in 2.6., the subsidiarity principle has resulted in the practice of prior characterization of income in domestic law. This practice has been applied to the problem of domestic anti-avoidance tax fictions that recharacterize or reattribute income. When confronting these domestic fictions with tax treaties, various approaches could be considered. Courts could disregard the tax treaty completely, as in the case of notional income, or apply the tax fiction as it is designed in domestic law when looking at treaty provisions, or look at treaty provisions without applying the domestic fiction, i.e. using the real characterization or attribution of income, before the fiction is applied.

French case law has chosen the second option, thereby applying the provisions of tax treaties to the income as characterized in the domestic fiction. This has been done for the branch tax (Art. 115 quinquies of the CGI), as analysed in domestic law as a deemed distribution (Conseil d'Etat, 31 January 2001, Case No. 1995/43, Bank Polska Kasa Opioki, RJF 4/01 No. 489), for the old CFC regime (Art. 209 B of the CGI), as analysed in domestic law as a “look-through” provision (the Schneider decision), and for the artiste provision (Art. 155 A of the CGI), as analysed in domestic law as looking through a company receiving the income (the Aznavour decision). The application of the tax treaty worked to the advantage of the taxpayer in the first two cases, but not in the third. This approach provides treaty protection, whilst adhering to the legal analysis of the domestic provision.

This system might result in the FTA and Parliament drafting legislation that fine-tunes the domestic fiction so as to change the treaty articles that might apply. Following the Schneider decision, the French CFC legislation was changed in 2005 to use the ‘deemed distribution’ approach to avoid Art. 7 of the OECD Model. Some commentators wonder whether or not this might be questionable treaty override.

3.3. Domestic abuse of law rule

France has a domestic abuse-of-law rule, partly judge-made and presently codified in Art. I. 64 of the French Tax Procedures Code (Livre des Procédures Fiscales, LPF). According to this rule, arrangements made by a taxpayer can be disregarded if they are fictitious or if they are made for the sole motive of reducing the normal tax burden by applying the letter of the law against its purpose.
This domestic rule has been applied, not only to abuses of domestic tax law, but also to an abuse of a tax treaty (Conseil d'État, 29 December 2006, Case No. 283314, Bank of Scotland, RJF 3/07 No. 322). In this treaty shopping case, the contract signed by the taxpayer was found to be an abuse of the dividends article of the France–United Kingdom tax treaty of 22 May 1968.

This approach does not find an inherent anti-abuse rule in the tax treaty, but applies the domestic anti-abuse rule, with its specific tests, to the tax treaty. The willingness to do so may be explained by the status of abuse of law as a general legal principle, historically court-made and applying to all areas of law. France being a monist country may also explain why tax treaties, as part of domestic law, should be protected against abuse as all areas of domestic law.

3.4. Use of guidelines by taxpayers

Taxpayers may be protected by various rules related to legal certainty or legitimate expectations. In France, Art. L 80 A of the LPF allows taxpayers to claim the benefit of interpretations given by administrative guidelines. This domestic rule is applied by case law when taxpayers claim the benefit of a guideline interpreting a tax treaty. Accordingly, the outcome of a case involving a tax treaty may be decided by applying, not the correct interpretation of the tax treaty, but a domestic guideline if it is more favourable to the taxpayer than this correct interpretation.

3.5. Burden of proof

When treaty application requires a determination of facts, the burden of proof is assigned in court according to domestic rules. French case law tends to apply a “neutral” burden of proof with regard to tax treaties, which means that each party to the case must justify its own assertions and evidence is required from the party that holds the information (Conseil d'État, 13 October 1999, Case No. 191191, Diebold Courtage, RJF 12/99 No. 1492). However, this is still domestic law.

4. Conclusions

Taxation being grounded in domestic law, the frequent presence of domestic law in the application of tax treaties is neither surprising nor illegitimate. Consequently, when searching for a correct balance between tax treaties and domestic law, one of the main issues is the compromise between the legal certainty of domestic law and the protection of the object and purpose of tax treaties with regard to the prevention of double taxation.
Non-Cooperative Jurisdiction Tax Reform in France

The author, in this article, describes the non-cooperative states or territories tax reform, which was implemented by France at the end of 2009. He also considers the implications, favourable or otherwise, of the reform.

1. Introduction

As a consequence of the 2008 financial crisis and in the context of international efforts against tax havens following the decisions taken at the G20 meeting in London on 2 April 2009, at the end of 2009, France implemented new tax legislation that is intended to deter French companies and individuals entering into transactions with non-cooperative jurisdictions. The jurisdictions falling within the new regime are referred to in French tax law as ‘non-cooperative states or territories’ (NCSTs).

In this regard, the new legislation provides a definition of NCSTs in French tax law. Although certain unfavourable tax treatments under French domestic law were already directed at low-tax jurisdictions, there was previously no definition of what was considered to be an NCST in the French Tax Code (Code Général des Impôts, CGI), nor any tax provisions specifically applying to NCSTs.

The new provisions may be regarded not only as an additional mechanism in the French legal system that is designed to counter tax fraud and evasion, but also as an incentive for long-standing tax haven jurisdictions to agree to sign and apply tax information exchange agreements (TIEAs) with France or other countries. More generally, the provisions may also be regarded as an incentive to comply with the OECD standards on international tax transparency.

The new legislation contains evolving criteria for a jurisdiction to be qualified as an NCST (see 2.) and provides for an extremely detrimental tax treatment of transactions with an NCST (see 3.). Some provisions have been clarified and moderated by the French tax authorities (FTA) (see 4.), but others remain unresolved (see 5.).

2. Definition of an NCST

2.1. Introductory remarks

The definition of an NCST is contained in the new Art. 238-0 A of the CGI.

2.2. Tax rules as at 1 January 2010

As at 1 January 2010, the following four criteria had to be met for a jurisdiction to be considered to be an NCST under French law – i.e. according to Art. 238-0 A-1 of the CGI, the jurisdiction must:

1. not be a Member State of the European Union;
2. have been examined by the Global Forum on Transparency and Exchange of Information in Tax Matters (the “OECD Global Forum”), as established by the OECD on 17 September 2009;
3. have failed to sign a TIEA with France; and
4. have failed to sign a TIEA with 12 other countries.

If a jurisdiction did not meet at least one of these conditions, it was excluded from the list of NCSTs under French law. These conditions raised the following comments:

– It was politically and legally almost inconceivable to include a Member State in the NCST list, in particular, considering Directive of 19 December 1977,¹ which allows for tax cooperation between the Member States.
– It may appear to be paradoxical, but jurisdictions that had not yet been examined by the OECD Global Forum were not included in the NCST list, irrespective of their status and practice in terms of international tax information exchange.
– In practice, jurisdictions that had signed a TIEA with France before 1 January 2010 were excluded from the 2010 NCST list, even if such TIEAs had not entered into force prior to 1 January 2010. As a result, a large number of tax haven jurisdictions entered into a TIEA with France in the last quarter of 2009.
– Similarly, a large number of tax haven jurisdictions entered into TIEAs with other countries so as to be included in the “white” OECD Global Forum list, which consisted of those jurisdictions that had substantially implemented the internationally agreed tax standard in terms of tax transparency and exchange in tax matters.

The first list of NCSTs was published by the ministries for the economy and the budget on 12 February 2010 and had effect from 1 January 2010. In this regard, the NCST list for 2010 included the following jurisdictions:

Aguantilla, Belize, Brunei, the Cook Islands, Costa Rica, Dominica, Grenada, Guatemala, Liberia, the Marshall Islands, Montserrat, Nauru, Niue, Panama, the Philippines, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

¹ Council Directive 77/779/EEC.

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2.3. Tax rules as at 1 January 2011

From 1 January 2011, under Art. 238-0 A-2 of the CGI, the NCST list is to be updated annually according to the following four criteria:

1. NCSTs that have signed a TIEA with France are to be excluded from the NCST list;
2. even where countries have signed a TIEA with France, such countries can be added to the list if the wording or the effective application of the TIEA does not allow the FTA to obtain the information required to implement French tax provisions;
3. if France has proposed to a jurisdiction that it enters into a TIEA before 1 January of the preceding year and the jurisdiction rejects the request, the jurisdiction is to be added to the NCST list; and
4. jurisdictions that have not signed a TIEA with France and that do not fall within (3) must, nevertheless, be excluded from or included in the NCST list, as appropriate depending on the evaluation of their status by the OECD Global Forum.

The following comments may be made regarding these criteria:

- The conditions differ from those that were used to determine the 2010 NCST list. In particular, there is no reference to the signing of 12 TIEAs. It may, however, be assumed that this situation is covered by condition (4). If a jurisdiction has signed more than 12 TIEAs, it would probably be on the white list of the OECD Global Forum and would, therefore, be excluded from the NCST list.
- However, even if a jurisdiction has signed more than 12 TIEAs with other countries, it will be added to the list if it refuses to sign a TIEA with France.
- There is also an element of subjectivity in condition (2). Presumably, only the FTA will be able to determine whether or not a TIEA signed with a foreign jurisdiction is sufficient. In this regard, there is no indication as to what criteria would be used to qualify the sufficiency of a TIEA.
- The NCST list is to be amended depending on the progress report on the jurisdictions surveyed by the OECD Global Forum. This is a rare example where a definition under French law, which has significantly adverse tax implications, directly relies on the "soft law" as adopted by the OECD.
- An NCST that did not appear on the 2010 list because it had signed a TIEA with France in 2009 (and even if such a TIEA did not enter into force before 1 January 2010) would, in theory, qualify as an NCST from 1 January 2011 if the TIEA failed to enter into force in the course of 2010. For jurisdictions that signed a TIEA with France in 2010 or before, the FTA could, however, apply the same tolerance as for the 2010 list and consider that the signature of a TIEA before 1 January 2011 is sufficient, even if it has not yet entered into force at this date.

Finally, even if no longer referred to, Member States cannot be included in the NCST list.

The exclusion of an NCST from the list has immediate effect, which means that the detrimental tax treatment ceases as soon as the jurisdiction is no longer listed as an NCST. However, in contrast, the inclusion of a new NCST in the list only has effect from 1 January of the following calendar year.

2.4. Updated NCST list for 2011

At the time of the writing of this article, the official list of NCST for 2011 had not yet been released by the French government. It is, however, possible to anticipate the contents of the updated list for 2011, taking into account the progress made in 2010 regarding the criteria provided for by Art. 238-0 A of the CGI. The remainder of this section is based on this assumption.

First, following the Global Forum held in Singapore on 29 to 30 September 2010, several progress reports on the jurisdictions surveyed by the Forum have been released. It appears that, as at 10 December 2010, only nine jurisdictions had not yet substantially implemented the internationally agreed tax standards. These jurisdictions are: Costa Rica, Guatemala, Liberia, Montserrat, Nauru, Niue, Panama, Uruguay and Vanuatu.

Second, some NCSTs included in the 2010 list have signed a TIEA with France during 2010. These are: the Cook Islands (15 September 2010), Costa Rica (16 December 2010), Grenada (31 March 2010), St. Kitts and Nevis (1 April 2010), St. Lucia (1 April 2010), and St. Vincent and the Grenadines (13 April 2010).

Third, some jurisdictions have signed at least 12 TIEAs with other countries. These are: Anguilla, Belize, the Cook Islands, Dominica, Grenada, the Marshall Islands, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. From 1 January 2011, as noted in 2.3., this criterion is not normally taken into account according to Art. 238-0 A-2 of the CGI, but, as it resulted in the inclusion of these jurisdictions in the white list of the progress report by the OECD Global Forum, it has resulted in the exclusion from the French 2011 NCST list. Similarly, the Philippines has recently changed its domestic provisions to comply with international tax transparency standards.

Fourth and finally, the criterion regarding the effective application of TIEAs is, at this early stage, difficult to deal with, as most TIEAs have only just been signed or entered into force very recently.

Consequently, the jurisdictions that should be included in the 2011 NCST list are the following: Guatemala, Liberia, Montserrat, Nauru, Niue and Panama. As can be seen, the 2011 NCST list should be even shorter than the 2010 list and should not include any major economic jurisdictions.
3. Tax Provisions Targeting NCSTs

3.1. Introductory remarks

The new tax provisions for NCSTs may be summarized as follows:

- increased withholding tax rates (see 3.2.);
- the presumption that expenses incurred with regard to transactions with NCSTs are not tax deductible for the French entity (see 3.3.); and
- the stricter application of various existing anti-avoidance provisions (see 3.4.).

Some measures applying to NCSTs are similar to those already existing for low-tax jurisdictions, but apply to a greater degree. However, some measures are new in the sense that the unfavourable tax treatment for NCSTs did not previously apply to low-tax jurisdictions.

3.2. Increased withholding taxes

3.2.1. Dividends

Under Art. 119 bis of the CGI, any distribution by a French company to a non-French tax resident individual or entity may be subject to withholding tax. According to Art. 187 of the CGI, the domestic rates are as follows:

- 18% in respect of the distribution of dividends paid to individuals resident in an EU Member State or a Member State of the European Economic Area that has signed a TIEA with France; and
- 25% in respect of the distributions of dividends paid to individuals and companies located in another jurisdiction.2

From 1 March 2010, the withholding tax for French-source dividend distributions paid to an NCST is 50%. The concept of “a payment to an NCST” has also been further explained by the FTA in a public ruling (see 4.3.).

3.2.2. Interest

According to the new legislation, from 1 March 2010, where interest is paid to an NCST, withholding tax is levied at a rate of 50%, unless it can be demonstrated that the relevant transactions do not have as their main purpose or effect the transfer of profits to an NCST.

By way of a reminder, there is generally no withholding tax on French-source interest paid to foreign companies or non-resident individuals. This exemption applies to loans signed abroad before 1 March 2010, even if the payment is made to an NCST. The concept of “a payment to an NCST” has been further explained by the FTA in a public ruling (see 4.2.).

3.2.3. Royalties

The following payments made to individuals residing in or to companies established in an NCST (with no permanent presence in France) are subject to an increased withholding tax of 50%:

1. liberal activities performed in France;
2. intellectual property rights;
3. services provided or used in France; and
4. the services of artistes and sportspersons provided or used in France. This rule does not apply to wages and similar income. The increased rate also does not apply to remuneration for services if the paying party can demonstrate that the transactions are real and their purpose and effect are not tax avoidance. This provision applies from 1 March 2010.

3.2.4. French-source capital gains realized by NCST residents

From 1 March 2010, withholding tax at a rate of 50% applies to capital gains realized by individuals or companies located in an NCST on the sale of shares in a French company.3 Under the standard French tax provisions, only the sales of substantial shareholdings, i.e. more than 25% of the financial rights, in a French company may be taxed in France at a rate of 18%, subject to treaty provisions, which generally grant the right to tax to the state of residence of the seller, and EU law, which can, in certain circumstances, limit the basis of taxation to 5% of the capital gain.

The same 50% withholding tax applies to habitual (from 1 January 2010) or occasional (from 1 March 2010) capital gains realized by NCST resident individuals or companies on the sale of French real estate4 or shares of French real estate companies, i.e. companies, whether French or foreign, the assets of which are primarily composed of French real estate assets. Under the standard provisions, such gains are generally taxed in France at a rate of either 16% or 33⅓%.

3.3. No tax deduction for expenses

3.3.1. Existing provisions targeting low-tax jurisdictions

Art. 238 A of the CGI provides that payments made by French companies to non-resident entities or individuals located in low-tax jurisdictions are presumed not tax deductible. In other words, a general presumption exists that such payments are made for the purposes of tax evasion. This can be reversed if the taxpayer demonstrates that the transactions are real and the payments not excessive.

3.3.2. Specific provisions applying to NCSTs

The provisions outlined in 3.3.1. are further restricted with regard to NCSTs with effect from 1 January 2011. Specifically, new Art. 238 A of the CGI provides that payments made by French companies to non-residents located in an NCST are not deductible, unless the French company: (1) demonstrates that the transaction relating to the payment does not have as its main purpose or its

2. These rates are subject to treaty provisions, which generally provide for lower withholding tax rates, and EU law provisions (the EU Parent-Subsidiary Directive 90/435/EEC and the decision of the Conseil d’État (French Supreme Administrative Court), 6 April 2007, Case No. 235069, Sté Denkavit Internationaal BV following the European Court of Justice decision in Case C-170/05, Denkavit International BV (14 December 2006), according to which, in summary, no withholding tax may apply to dividends paid to companies located in a Member State that has held more than 5% of the share capital of a French company for at least two years).
3. Art. 244 bis B CGI.
4. Arts. 244 bis and 244 bis A CGI.
main effect the transferring of income outside France; and (2) provides a detailed list of these operations in a special tax return to be filed with the annual corporate income tax return.

3.4. Stricter anti-abuse provisions

3.4.1. Dividends received: no parent-subsidiary regime
Under the French parent-subsidiary regime, French companies are normally exempt from corporate income tax on 95% of the dividends received from their subsidiaries, subject to various conditions, including a minimum ownership of 5% of the share capital of the subsidiary and a holding period of at least two years. This regime applies to shares held in French and non-French subsidiaries. There is no subject-to-tax clause on the foreign subsidiary. As a result, dividends from an entity located in a low-tax jurisdiction may benefit from the exemption. However, from 1 January 2011, dividends paid by companies established in an NCST are excluded from the French parent-subsidiary regime.

3.4.2. Capital gains on shares in NCST companies
From 1 January 2011, capital gains realized on the sale of shares held in subsidiaries established in an NCST no longer benefit from the long-term capital gains tax regime and are taxed at the standard corporate or individual income tax rate. Under the standard provisions, capital gains on sales of shares in companies, which are not held as a portfolio investment and which are not French real estate companies, may benefit from a 95% corporate income tax exemption if the shares were held for at least two years.

3.4.3. Controlled foreign companies

3.4.3.1. Controlled foreign companies held by French companies
Under Art. 209 B of the CGI, a French company may be taxed on the income realized by a subsidiary held for more than 50% that benefits from a low-tax regime, i.e. subject to a local tax of less than half of the equivalent French tax. There are a number of safe-harbour clauses that prevent the application of this rule, in particular, to EU subsidiaries and foreign subsidiaries engaged in a real trade or business locally. It is, however, more difficult for subsidiaries that are located in an NCST to benefit from the safe-harbour rule. Specifically, in these circumstances, the burden of proof lies with the French company where the company relies on the "real local trade or business" exemption and such a company must provide additional information to the FTA.

3.4.3.2. Controlled foreign companies held by French resident individuals
Existing provisions targeting low-tax jurisdictions
Art. 123 bis of the CGI states that French resident individuals may be taxed on income realized by a controlled foreign company (CFC) if the following two conditions are met:
(1) the French resident individual, directly or indirectly, owns at least 10% of the shares of a company located in a low-tax jurisdiction, i.e. a company that is subject to a tax of less than half of the equivalent French tax; and
(2) the assets of the company primarily consist of financial investments, i.e. securities, receivables, cash and current accounts.

Provisions for NCSTs
Under the new legislation, where a French individual has transferred assets or rights to a CFC located in an NCST, there is a presumption that at least 10% of the shares are held by this individual. If the income of a CFC located in an NCST is taxable in France, the taxable amount may also not be less than a flat amount based on the value of the net assets of the company multiplied by the interest rate set out in Art. 39-1-3 of the CGI (3.82% for the financial year 2010).

3.4.4. Transfer pricing

3.4.4.1. New general provisions
Before 1 January 2010, there was no mandatory rule under French tax law imposing on French companies the obligation to draft or file transfer pricing documentation, although France does have specific tax provisions dealing with transfer pricing issues. Following work by the EU Joint Transfer Pricing Forum and the practice of numerous other OECD Member countries, a new obligation to prepare general transfer pricing documentation was introduced on 1 January 2010. Specifically, large companies must now justify their transfer pricing policy for transactions realized between related companies, in written documentation to be produced to the FTA with regard to a tax audit. The documentation must include a general description of the group and specific information relating to the enterprise that is subject to audit.

3.4.4.2. New provisions for NCSTs
Under to Art. L 13 AB of the French Tax Procedures Code (Livre des Procédures Fiscales), the general provisions are strengthened by the obligation to provide supplementary documentation for related companies located in an NCST. In practice, a French taxpayer must provide all of the tax documentation generally required from French companies for each NCST entity.

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5. Art. 54 quater CGI.
6. Large companies are defined as those that have a turnover or assets of more than EUR 400 million (companies that are held by, or which hold, an eligible company also fall within the scope of the definition of a large company).
7. Specifically, a description of the activities of the enterprise, a description of the operations undertaken with other associated companies, and a presentation and justification according to the arm’s length principles of the selected transfer pricing method.
8. In particular, the profit and loss account and the balance sheet prepared under French generally accepted accounting principles.
4. Issues Raised and Resolved

4.1. Introductory remarks

When the new legislation was passed, certain questions were raised by French practitioners, banks and companies regarding interest and dividends paid to an NCST. These are considered in 4.2. and 4.3.

4.2. Interest paid to an NCST

4.2.1. Issues

As noted in 3.2.2., the new Art. 125 A III of the CGI provides for an increased withholding tax at a rate of 50% for interest on French securities, such as bonds or other negotiable debt instruments, paid “to an NCST”. In these circumstances, the law also provides for a presumption that the interest payments are not tax deductible.

The concept of “payments to an NCST” appeared very wide and, where the 50% withholding tax was to be applied on a general basis, it could have been detrimental to the French securities market. Specifically, it was unclear for many practitioners as to whether or not the increased withholding tax would still apply where interest was transferred to a bank account located in a cooperative country that potentially benefited a resident of an NCST. The same question arose in respect of a payment through a bank account located in France. The risk was that French paying agents, in the absence of any information on the tax residence of the bank account beneficiary, would decide to apply systematically the 50% withholding tax, even if the beneficiary was not located in an NCST, simply to avoid any future tax liability. It was also unclear as to whether or not the presumption of non-deductibility could apply in the absence of justification of the residence of the final beneficiary of the interest payments.

4.2.2. Solutions

The FTA clarified the issues described in 4.2.1. and reduced the scope of the 50% withholding tax by way of Ruling 2010/11 of 22 February 2010. Consequently, a “payment to an NCST” only means:

- A direct payment made by wire transfer to a bank account located in an NCST, even if the beneficiary is located in a TIEA or treaty state. With regard to “chain payments” in France and/or abroad, the payment to be taken into consideration is the first payment made outside France. Conversely, the 50% withholding tax does not apply, even if the beneficiary is an NCST resident, as long as the bank account is not located in an NCST.

- A payment to a resident of an NCST where no direct transfer to a bank account has been made, i.e. the payment is made through a bank cheque, cash, etc.

According to the law, the 50% withholding tax does not apply if the debtor demonstrates that the transaction does not have as its main purpose or its main effect to transfer income to an NCST.9 Ruling 2010/11 provides that this condition is deemed to be met with regard to the following types of financial instruments:

- Bonds subject to public placements under Art. L 411-1 of the French Monetary and Financial Code (Code Monétaire et Financier, CMF), or similar placements under regulatory control in a foreign country, provided that this country is not an NCST;

- Listed securities, in France or in a foreign country, provided that the market or the market regulator is not located in an NCST; and

- Securities admitted, at the time of their issue, to a clearing system according to Art. L 561-2 of the CMF, provided that the depositary or manager is not located in an NCST.

In these cases, the presumption of non-deductibility does not apply and the debtor must only demonstrate that the transactions are real and that the payments are not excessive, which is the general rule for payments made to low-tax jurisdictions.

4.3. Dividends paid to an NCST

4.3.1. Issues

Similar questions were raised with regard to dividends “paid to an NCST”, as Arts. 119 bis and 187 of the CGI provide for an increased withholding tax of 50%. It was also unclear as to how treaty withholding tax rates would apply.

4.3.2. Solutions

Ruling 2010/30 of 4 May 2010 provided answers to the main questions raised. The definition of “dividends paid to an NCST” was logically the same as that described for interest paid to an NCST in 4.2.2., i.e.:

- A direct payment made by wire transfer to a bank account located in an NCST gives rise to the application of the 50% withholding tax, even if the beneficiary is located in a TIEA or treaty state. Conversely, the 50% withholding tax does not apply to payments made to a bank account which is not located in an NCST – for example, a dividend paid into a French bank account of an NCST resident would not give rise to the imposition of the withholding tax.

- In contrast, a payment by a bank cheque or in cash made to a resident of an NCST would give rise to the application of the 50% withholding tax.

According to Ruling 2010/30, if French-source dividend income is paid to an NCST, the following two situations must be distinguished:

(1) where the effective beneficiary is resident and/or is located in a state that has signed a tax treaty with France, the beneficiary may claim the partial reimbursement of the 50% withholding tax based on the reduced treaty rate; and

9. According to the safe-harbour rule.
(2) where the beneficiary is resident and/or is located in France, the 50% withholding tax is final.

5. Outstanding Issues

5.1. The NCST list: much ado about nothing?

The major difficulty in this context is to try to anticipate what the NCST list will be in the long run. Since 2009, France has signed TIEAs with a large number of tax haven jurisdictions, such as Andorra, Antigua and Barbuda, the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, the Cook Islands, Costa Rica, Gibraltar, Grenada, Guernsey, the Isle of Man, Jersey, Liechtenstein, the Netherlands Antilles, San Marino, the Turks and Caicos Islands, and Vanuatu. As a result, the anticipated NCST list for 2011 should be very limited (see 2.4.) and the numerous tax sanctions described in this article may ultimately rarely apply. However, these measures should probably be regarded as preventative. In this respect, the new regulations could be viewed to be a success, at least at this stage, considering the number of TIEAs signed by France in the last two years.

A further difficulty is that France has chosen to rely on the progress reports of the OECD, which may sometimes be influenced by political and/or diplomatic aspects, and not necessarily only based on a strict legal or tax analysis. Finally, the NCST list may be modified by the FTA in the future, depending on the efficiency of the exchange of information based on a TIEA, which is obviously a very subjective concept to be dealt with solely by the FTA.

5.2. Interaction with existing anti-abuse provisions for low-tax jurisdictions

The tax provisions for NCSTs apply in parallel with other existing anti-abuse provisions dealing with low-tax jurisdictions, such as the CFC rules considered in 3.4.3. As a result, a low-tax jurisdiction that has signed a TIEA with France would not be considered to be an NCST, but would potentially still fall within the scope of French CFC rules. In contrast, income realized by a company located in an NCST that would have been subject to tax in a similar way as if the income had been realized in France (this is somewhat theoretical as NCSTs are also tax havens) and distributed to a French parent company could not benefit from the French parent-subsidiary regime.

A further interesting issue is that low-tax jurisdictions are not targeted as much by the French tax provisions, as those countries that refuse to apply internationally agreed tax transparency provisions. However, NCSTs are generally to be found amongst tax havens.

5.3. Favourable tax consequences for foreign low-tax jurisdictions?

Under current French tax law, a number of favourable tax regimes only apply provided that the taxpayer is a resident of a jurisdiction that has signed a tax treaty including an exchange-of-information clause designed to counter tax fraud and evasion. This is, in particular, true in respect of the rollover regime for mergers and similar transactions under French law and the benefit of the 40% rebate on dividends received by French resident individuals.

TIEAs do not provide for any tax mechanism designed to eliminate double taxation. As a result, TIEAs are not considered to be “real” tax treaties. Considering the current wording of French law and even if it appears to be contrary to the rationale behind these provisions, it is difficult to be certain that such favourable regimes may benefit residents of low-tax jurisdictions that have only signed a TIEA with France and not a comprehensive tax treaty. In contrast, reorganizations involving Switzerland or Swiss-source dividends may benefit from the favourable French regimes, as a protocol to the existing tax treaty, which is designed to implement information exchange between France and Switzerland, was signed on 27 August 2009 and entered into force on 4 November 2010.

Other French tax provisions, such as Art. 990 E 3° of the CGI, which relate to the annual 3% tax imposed on the value of French real property held by French and foreign entities, only refer to “administrative assistance conventions”. Companies could become exempt from such a tax by designating their shareholders to the FTA in a specific tax return, which could either be filed annually or on request by the FTA after the company had committed to do so. Such exemptions were traditionally refused with regard to tax haven jurisdictions that had not signed a TIEA with France. As most of tax havens have now signed a TIEA with France, such companies should be able to rely on this exemption.

6. Conclusions

Major uncertainty remains with regard to the French tax provisions targeting NCSTs. If the list published annually is limited to the jurisdictions that should appear on the anticipated 2011 list (or is even reduced subsequently), the very detrimental provisions designed to counter NCST would, in practice, rarely apply.

However, the list must be updated annually according to the efficient application of TIEAs. If the FTA consider that the exchange of information with some of the tax haven jurisdictions that have signed a TIEA with France is insufficient or inefficient, the FTA could again include such a jurisdiction on the NCST list. This should prove to be a powerful incentive for such jurisdictions to cooperate fully with the FTA to avoid falling within the scope of the French NCST “nuclear option” tax regime.

Is this, consequently, the end of tax haven jurisdictions from a French tax perspective? Probably not.
Beneficial Ownership and Tax Treaties: A French View

In this article, the author considers the nature and implications of the concept of beneficial ownership contained in French tax treaties and discusses whether or not, in light of the case law, it may apply independently from the domestic concept of abuse of law.

1. Introduction

Beneficial ownership is an essential, but difficult, concept to apply under international tax law. Essential, because it is one of the conditions for a tax treaty to apply in respect of, inter alia, a reduction in, or exemption from, withholding tax at source. Difficult because, at least in France, the concept is very ambiguous and uncertain due to unclear case law and the absence of precise administrative guidelines.

The French tax authorities (FTA), most probably so as to retain maximum flexibility, have not precisely defined the scope of the concept and how they intend to apply it, although it is consistently their policy to include the concept in tax treaties. Case law also reveals that the test is generally combined with the domestic "abuse of law" principle, which makes it difficult to clarify the distinction between the two principles, if any.

Some 15 years ago, a question was addressed to the Minister of Finance regarding a situation in which a French company was paying royalties to a Netherlands company interposed between a French debtor and a Netherlands company. The response was that the purpose of tax treaties is to avoid double taxation and the prevention of fiscal evasion and avoidance. However, the term "beneficial owner" is not defined in the OECD Model. The OECD Commentaries only provide some indications on the meaning of the concept. For example, the Commentary on Art. 10 of the OECD Model indicates that the concept of "beneficial ownership" has been introduced to clarify that the source state is not required to give up taxing rights over dividend income merely because that income is immediately received by a resident of a state with which the source state has concluded a tax treaty. According to the Commentary on Art. 10:

The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

The reasoning of the OECD is further explained in the Commentaries, which state that, where an item of income is received by a resident of a state acting in the capacity of an agent or a nominee, it would be inconsistent with the object and purpose of the tax treaty for the source state to grant relief or an exemption merely on account of the status of the immediate recipient of the income as a resident of the other state. For the OECD, it would indeed be inconsistent with the object and purpose of the tax treaty for the source state to grant relief or an exemption where a resident of a state simply acts as a conduit for another person who, in fact, receives the benefit of the income concerned. This is why a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers that make it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

According to the OECD, however, limitation at source remains available where an intermediary, such as an agent or a nominee located in a source state or in a third state,
is interposed between the beneficiary and the payer, and the beneficial owner is a resident of the other state.\(^4\)

In summary, it appears to be clear that, for the OECD, the concept of beneficial ownership may be used to deny treaty benefits in situations where:

- The recipient of the income acts as an agent or a nominee: this, in itself, appears to be straightforward, as, if a person acts as an agent for another person, the agent is acting under a mandate (explicit or implicit) and not on its own account and the agent receives the income to pass it on to the "true" beneficiary. Accordingly, the agent is certainly not the beneficial owner.

- The recipient of the income acts as a "conduit" and has very narrow powers in relation to the income: this is a more complex concept, as it involves a degree of appreciation of the exact powers of the recipient of the income and it introduces uncertainty in many cases. It is precisely in this respect that most of the difficulties arise.

### 3. French Treaty Policy and Administrative Guidelines

As a preliminary remark, it should be noted that France incorporates the concept of "beneficial ownership" not only into tax treaties, but also into certain international tax provisions of its domestic law. For instance, under French legislation, the beneficial-ownership test must be met to qualify for the exemption from withholding tax under the EU Parent-Subsidiary Directive\(^6\) regarding dividends, although the concept is not present in the Directive itself.\(^7\) Similarly, an exemption from withholding tax on interest and royalties paid between EU associated enterprises assumes beneficial ownership.\(^7\) However, the legislation does not provide any indication as to the exact meaning of this test.

Interestingly, there is no reference to the concept in the regulations that were issued in 2007 to deal with the consequences of the ruling of the European Court of Justice in Denkavit International,\(^8\) which resulted in a dividend paid to an EU parent company being treated in the same manner as if it had been paid to a domestic parent.\(^9\) Rather, the regulations merely provide that the exemption only applies where the situation is not characterized as an artificial arrangement. This may indicate that, for the FTA, the concept of beneficial ownership may not be regarded as autonomous, but, rather, should be combined with the "abuse of law" principle discussed in 5.

At any rate, the regulations in regard of domestic law provisions fail to define to the exact scope of the concept. Specifically, the regulations emphasize that the beneficiary of the income must provide appropriate proof that the test is met, but they do not indicate what proof is required or how the test should be satisfied. This is not very helpful in understanding the treaty concept, except that it can be said that the concept of beneficial ownership should probably be given the same meaning with regard to both domestic law and tax treaties.

As far as tax treaties are concerned, the French policy is to generally follow the OECD Model and to regard the beneficial-ownership test as a means to counter "treaty shopping". The OECD wording has, therefore, since 1977, always been included in tax treaties and France can be regarded as approving the Commentaries, as it has made no observations or reservations in this respect.

Certain tax treaties go beyond the OECD recommendations, as is the case with the France–Switzerland tax treaty of 9 September 1966, as amended. According to this tax treaty, a person is not considered to be "resident" for treaty purposes where it is only the apparent beneficiary of the income, as, in reality, this income benefits, either directly or indirectly by way of other individuals or legal entities, a person that cannot itself be regarded as a resident.\(^10\)

In some cases, the concept is regarded as insufficient and consequently its scope is reinforced by additional anti-abuse provisions included in a tax treaty. For example, the France–Hong Kong tax agreement of 21 October 2010 provides that the reduced treaty rate on dividends does not apply if the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights, in respect of which the dividend is paid, was to take advantage of the reduced rate by means of that creation or assignment (the same applies for interest and royalties).\(^11\) The tax agreement also indicates that nothing in it should prejudice the right of each contracting party to apply its domestic laws and measures regarding tax avoidance, whether or not described as such.\(^12\)

It may be concluded that France generally considers that a tax treaty should not apply where the beneficiary is only apparent or acts as an agent or where a company is set up solely to obtain improper treaty benefits. However, the term "beneficial owner" remains unclear, as it is not defined in tax treaties or domestic law.

Unfortunately, the regulations on tax treaties are not explicit either. The FTA have not precisely indicated how the concept should be interpreted. In this regard, the FTA have simply emphasized that they agree with the OECD that the concept should not be interpreted in a narrow sense, but, rather, by taking into account the context and the purpose of a tax treaty, which is generally understood

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4. Para. 12.2 of the Commentary on Art. 10 of the OECD Model.
6. Art. 119 ter of the French Tax Code (Code Général des Impôts, CGI) states that, to benefit from the exemption, the EU parent company must justify to the debtor or to the person that pays the dividends that it is the "beneficial owner" of the dividends.
7. Arts. 119 quater and 182 B bis CGI.
8. Case C-170/05, Denkavit International [14 December 2006].
9. Regulations of 10 May 2007, BOI 4 C: 7-07 and 12 July 2007, BOI 4 C: 8-07. Briefly, the regulations provide that no withholding tax may be applied to dividends distributed to an EU parent company that would have been entitled to benefit from the parent-subsidiary regime had it been in France (a threshold of 5%) and may not otherwise treat the withholding tax as a credit in its country of residence.
10. Art. 4(6)(a) France–Switzerland tax treaty.
11. Arts. 10(6), 11(8) and 12(7) France–Hong Kong tax agreement.
12. Art. 27 France–Hong Kong tax agreement.
to be the avoidance of double taxation. For instance, in
the regulations commenting on the Algeria–France tax
Treaty of 17 October 1999,13 the FTA have indicated that,
"for instance", a person acting as an intermediary, such as
an agent or trustee, interposed between the debtor and
the genuine beneficiary may not be considered to be the
beneficial owner of the income. For the FTA, the test ‘con-
forms’ that the source state is not required to reduce its
taxing rights based on a tax treaty merely because the in-
come has been materially received by a resident of a state
with which it has concluded a tax treaty – for example,
where the income is paid via a financial establishment.
It should, however, be noted that the scope of these regu-
lations is very general, as they also expressly apply to other
tax treaties drafted in the same manner. Accordingly, to a
certain extent, the regulations can be regarded as official
guidelines (albeit very poor) for the interpretation of tax
treaties.

Regulations commenting on the France–Uzbekistan tax
Treaty of 22 April 199614 add that the beneficial-ownership
test excludes a company that should be considered as
owning the income based on the form of the transaction,
but that has very limited powers (this is clearly a reference
to the OECD Commentaries as noted in 2.). According
to the FTA, such a company should be regarded only as a
fiduciary agent or as a mere administrator acting for the
benefit of the interested parties and should, therefore, not
be entitled to treaty benefits.

All this indicates that the FTA intend to closely examine
schemes based on the interposition of persons, but this is
not very helpful in deciding particular cases. Case law
has provided additional guidelines, but such guidance is
specific to the circumstances and generally mixes the con-
cept of beneficial ownership with that of abuse of law.
This is why the test may apply even if it is not included
in a tax treaty, as is explained in 4.

4. Cases of Tax Treaties Not Including the
Concept

The fact that a tax treaty does not include a reference to
beneficial ownership may generally be considered to be
irrelevant under case law.

This principle was first affirmed by the Conseil d’État in
a case involving the payment of royalties by a French
company to a Netherlands partnership (CV), where the
CV was repaying approximately 60% of the royalties to a
Swiss related company (Diebold Courage).15 The main
issue was whether or not the France–Netherlands tax treaty
of 16 March 1973 applied, as the CV was not a Nether-
lands resident because it was a partnership, which is not
a taxable entity in the Netherlands, and, as such, not a
“resident” for treaty purposes. The response was positive,
as the transparency of the CV had to be recognized and
the CV was itself held by two BVs that were eligible for
treaty benefits. Accordingly, in principle, the France–
Netherlands tax treaty applied, thereby preventing France
from levying any withholding tax on the royalties.

At the last minute, however, the FTA tried to argue that
the tax treaty should be disregarded, as the income was
not beneficially owned by a Netherlands resident, but
was mostly repaid to a Swiss affiliate. Interestingly, the
argument advanced by the FTA was examined by the
Conseil d’État despite the fact that the France–Netherlands
tax treaty does not include a reference to “beneficial own-
ership” and does not even include the term “beneficiary”.
In the circumstances, it was held that the FTA had failed
to deliver adequate proof that the CV and/or BVs were
not the true beneficiaries of the royalties. The interesting
aspect of the Court’s ruling is that the argument was not
rejected on the basis that the tax treaty does not include
the concept, but because evidence had not been adduced
to support this view. It can, therefore, be stated that the
concept has per se no real relevance and that the FTA
may apply it irrespective of the strict wording of a tax
treaty.

This principle was recently confirmed by the Conseil d’État
in advising the government on the computation of certain
foreign tax credits.17 Specifically, the FTA asked whether
or not they could deny a taxpayer the right to a tax credit
on the ground that the taxpayer was not the “beneficial
owner” of the income. The FTA were concerned about
taxpayers borrowing money to acquire shares or bonds
immediately before the coupon payment date and subse-
quently reselling the securities following payment of the
coupon. In such circumstances, a taxpayer does not realize
any income, as the income received is, in effect, lower
than the total of the capital loss, interest expense and
commission fees. However, the taxpayer would theoreti-
cally benefit from a tax credit, thereby realizing a taxable
gain on the transaction. In order to counter this tax
scheme, the FTA took the view that the foreign tax credit
should be capped at the amount of the French corporate
income tax on the income received as determined after
deducting the interest paid and the capital loss. However,
the Court adopted a different view, holding that justified
expenses directly linked to the acquisition or maintenance
and to the sale of securities that do not result in an in-
crease in assets, are deductible, such as custodian fees and
cashing fees, but that interest and capital losses should
not be taken into account.18

One of the arguments considered by the Conseil d’État
was whether or not the FTA could argue that a taxpayer
who buys a security shortly before the payment of the

13. Regulations of 22 May 2003, BOI 14 B-3-03 (No. 70 with regard to divi-
dends).
14. Regulations of 9 July 2004, BOI 14 B-5-04 (Nos. 32 to 34 with regard to
dividends).
15. Conseil d’État, 13 October 1999, Case No. 191191, min. c/ SA Diebold
Courage, RJF 12/99 No. 1492.
16. Art. 12 of the France–Netherlands tax treaty merely states that royalties
arising from a state and paid to a resident of the other state shall be taxable
only in that other state. The words ‘beneficiary’ and ‘beneficial owner’
are not used in the tax treaty.
17. Advice No. 382545 of 31 March 2009, published in May 2010 in the annual
report issued by the Conseil d’État (Droit fiscal 2010, No. 22, comm.
No. 339).
18. The law was amended by the Finance Law for 2011 to try to counter such
tax schemes.
The 80% penalty applies to the tax that is due as a result of the payment, together with late-payment interest of 0.4% a month. This is probably because the concept is, in France, closely linked to the tax instrument. In that context, the FTA may apply it anyway. It follows that whether or not the concept is included does not really matter, as the FTA may apply it anyway.

In any event, for the Conseil d’État, the fact that a tax treaty includes Art. 1 of the OECD Model, pursuant to which the tax treaty should apply to persons who are residents of one or both of the contracting states, is regarded as a sufficient ground for denying treaty benefits if the tax treaty has been used in an abusive manner, particularly where an interposed person has the sole purpose of allowing a third party to benefit from the advantages provided by the tax treaty, being advantages to which that person would not be directly entitled. (The advice of the Court simply excludes situations where certain provisions of a tax treaty, or elements arising from the context or the purpose of the tax treaty, would result in an obstacle, but this appears to be rather theoretical).

It follows that whether or not the concept is included does not really matter, as the FTA may apply it anyway. This is probably because the concept is, in France, closely related to the “abuse of law” theory, which gives the FTA the authority to ensure that substance prevails over form.

5. Beneficial Ownership and Abuse of Law

Under the “abuse of law” theory, the FTA have the authority to disregard or reclassify transactions which, even if they are perfectly valid in formal terms, are undertaken solely for the purpose of procuring a tax advantage in comparison to the liability that would normally arise from the substance of the agreement. In its present wording, which derives from a law of 30 December 2008, the statute provides that, to argue successfully that an abuse of law has been committed, the FTA must either demonstrate that the deeds are fictitious or that the deeds, by pursuing the benefit of a literal application of the applicable rules or decisions in a manner which is in conflict with the objectives pursued by the authors of those rules or decisions, were motivated solely to avoid or reduce the tax that the taxpayer would normally have suffered had it not undertaken such actions, taking into account its situation and real activities. In such a scenario, in addition to a corporate income tax adjustment, an 80% penalty applies, together with late-payment interest of 0.4% a month. The 80% penalty applies to the tax that is due as a result of the adjustment. The penalty is reduced to 40% if it cannot be established that the taxpayer was the principal initiator of the actions or that the taxpayer was the main beneficiary of the actions. The concept has been applied by the tax courts on various occasions with regard to tax treaties in combination with, or in lieu of, the beneficial-ownership concept.

A landmark decision in this respect is a Conseil d’État case dealing with a financing transaction involving the sale of a three-year usufruct over French preferred shares by a US parent company to a UK bank to obtain an indirect refund of the (now abolished) avoir fiscal (tax credit).22 In this case, the reasoning of the Court was that the terms and conditions of the sale agreement and the guarantees given to the bank by the US parent could be characterized as an artificial arrangement that was implemented solely with the objective of obtaining the tax credit that would otherwise have been lost. For the Court, such an arrangement revealed that the “beneficial owner” of the dividends was the US parent company (and not the UK bank). Interestingly, the arrangement was first regarded as constituting an abuse of law (the sale of the usufruct being treated as a loan by the bank to the US parent). It was only later that it was concluded that the beneficial owner of the dividends was not the UK bank, but, rather, the US parent. In this case, the beneficial-ownership test was not applied independently of the “abuse of law” concept, but, rather, as a consequence of the “abuse of law” analysis.

The concurrent application of both concepts is also found in an older case, in which a French company paid interest on the day before granting the loan to the French company, borrowed money from a Netherlands Antilles company. The FTA considered that the German company was interposed solely to obtain the benefit of an exemption at source that would not have been available in the event of a direct payment to the Netherlands Antilles. However, the Administrative Court of Appeal of Nancy (Conseil administratif d’appel de Nancy) held that the adjustment was not founded in law, as the FTA had not been able to demonstrate any abuse of law.

A more recent case combining abuse of law and beneficial ownership involved a Luxembourg company interposed between a French company and a company established in Seychelles. It was noted that there was no tax treaty be-

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19. In France, foreign tax credits are available only based on tax treaties.
20. In reasoning in this way, the Conseil d’État explicitly referred to Arts. 31 (“A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”) and 32 (“Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31...”) of the Vienna Convention of 1969. For the Court, the principles set out in the Vienna Convention apply to tax treaties.
22. Conseil d’État, 29 December 2006, Case No. 283314, mm. c/ Sté Bank of Scotland, RJF 3/07 No. 322.
between France and Seychelles, unlike between France and Luxembourg. The scheme was regarded as an artificial arrangement and an abuse of law and the company established in Seychelles was regarded as the “real beneficiary” of a deemed dividend distribution from the French company.

Oddly, in circumstances where the FTA do not base the adjustment on the ‘abuse of law’ theory, they fail. This was, for instance, the result in a situation involving the payment of royalties by a French company to a Netherlands company where the Netherlands company repaid approximately 93% of the income to a Netherlands Antilles entity.26 The FTA denied the application of the France–Netherlands tax treaty on the ground that the Netherlands company should be regarded merely as an agent acting under a mandate. However, the Administrative Tribunal of Lille (Tribunal administratif de Lille) vacated the adjustment on the basis that the FTA had not proved that the Netherlands entity was an agent and that there was a mandate.

Finally, in the advice referred to in 4., the Conseil d’Etat emphasized that, even where the beneficiary-ownership test does not apply, the FTA may always base an adjustment on abuse of law. This is, for instance, the situation where France is the residence country, as, according to the Court, the beneficiary ownership test does not, in any event, apply in this scenario. For the Court, the concept may be used to deny the application of a reduced withholding tax rate or an exemption for income paid to a non-resident, but not to deny a tax credit to a French resident receiving foreign-source income. This may be regarded as being in accordance with the strict wording of tax treaties, as the concept is used only to introduce a condition for the source country to reduce its domestic withholding tax rate (or to exempt at source) and is not in a treaty article on the avoidance of double taxation. The solution is also quite logical, as, if the recipient of the income is not the beneficial owner, there is no reason the recipient should be taxed on such income. In effect, either the income is for the recipient’s benefit, in which case it is taxable, or it is not, in which case the income should be recorded in a third-party account and should, therefore, not be taxable. In other words, the concept of beneficial ownership has no relevance for the residence country because, as a matter of principle, the income is not taxable in any event where the concept may be applied. In addition, for the Court in the advice referred to in 4., where the source state had refused the application of a tax treaty by arguing that the recipient is not the beneficial owner, the state of residence must grant a tax credit as long as it levies tax on the income.27

All this explains why the Conseil d’Etat adopted the view that the FTA may not use the concept to deny a tax credit where the taxpayer has purchased securities solely with the intention of obtaining a tax credit. Denying the tax credit on this ground would imply that the income is not taxable, which was probably not what the FTA had in mind. However, the Court reaffirmed that, in these circumstances, the FTA may, nevertheless, seek to deny foreign tax credits on the ground of the “abuse of law” theory. This is, however, likely to be a difficult exercise for the FTA, as, in a domestic situation, where a taxpayer purchased securities ‘around the coupon’, the Conseil d’Etat held (after having given the advice referred to in 4.) that no abuse of law was committed because, although the transaction was solely tax driven, it did not appear that this was contrary to the intent of Parliament, as there was no requirement in the law that the securities had to be held for a certain period of time.28

6. Conclusions and Open Issues

Currently, it appears that the concept of beneficial ownership is frequently raised in the course of tax audits, but that it gives rise to many unresolved questions. If, inter alia, it is confirmed that the concept is not really distinct from that of abuse of law, a number of practical consequences arise for taxpayers.

This would be the situation, for instance, if a foreign parent of a French subsidiary were to set up a holding company to avoid the French withholding tax that would otherwise be due. If the FTA believe that, in such a circumstance, the foreign holding company is not the beneficial owner of the French-source income (for example, a dividend), what can they do?

Is it possible for the FTA to adjust the French subsidiary’s tax liability on the ground that there is abuse of law and determine that the holding company is not entitled to treaty benefits, as it is not the beneficial owner of the income? In the author’s view, the answer is ‘no’ and the FTA should not be able to find abuse of law in such a case, as: (1) the setting-up of the holding company is totally outside the scope of action of the French subsidiary; (2) the French subsidiary has remained entirely passive and is not a party to any action, as the transfer of its own shares by its foreign parent to the holding company has been made by deeds of transfer (a sale of shares or contribution in kind) to which the subsidiary was not a party; and (3) the subsidiary has not derived

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25. Strictly speaking, it was ‘fraus legis’, as the ‘abuse of law’ concept was not applicable at the time in such circumstances (the idea is the same).
27. The Conseil d’Etat did not say that the credit should be limited to the tax that the source state would be authorized to levy under the tax treaty, but it appears to the author that this should be the case in any event (where the source state has levied tax under its domestic law at a higher rate than that provided for by the tax treaty).
28. Conseil d’Etat, 7 September 2009, Case No. 305586, min. c/ SA Assa, RJF 12/09 No. 1138 and Conseil d’Etat, 7 September 2009, Case No. 305596, Sté Henri Goldfarb, RJF 12/09 No. 1139. It should be noted that, in these cases, the Court found that there were no guarantees in place, unlike in Bank of Scotland, supra note 22.
any tax advantage from the transaction, as the withholding tax that would otherwise have been levied in France is not a deductible expense for its own tax purposes (in effect, the withholding tax reduces the amount of the dividend that is paid to the shareholder, but, as it is taken out of the income paid, has no effect on the distributing entity). If the FTA cannot make an adjustment in respect of the French company based on the “abuse of law” theory and if they can only apply a beneficial-ownership test on grounds of abuse of law, this would mean that no adjustment could be made in respect of the French subsidiary in such circumstances.

This would not suggest, however, that the FTA would be deprived of any means to counter such artificial arrangements, as they could try to make an adjustment in respect of the foreign shareholder by claiming the withholding tax directly from this shareholder. It would also assume that the FTA could argue that abuse of law has occurred based on fictitiousness or the “exclusive tax motive” test noted in 5.

This would be somewhat more difficult for the FTA to do, as it would involve making an adjustment in respect of a foreign entity and not a French one, but it would not be impossible. It would also be an appropriate solution in many cases, as otherwise the beneficial-ownership test could result in particularly unfair situations for taxpayers (for instance, where, in contrast to this example, the situation does not involve related entities). In this regard, it does not appear fair to claim withholding tax in respect of a French debtor of, say, royalties paid to an unrelated Netherlands entity on the ground that the Netherlands entity repaid the royalty to a Netherlands Antilles company, where the French debtor had no means of having knowledge of the situation and was totally unaware of the whole scheme. Treating the beneficial-ownership concept as part of the more general “abuse of law” theory would thereby prevent the FTA from making adjustments in respect of the French debtor and levying penalties, which is only fair.

Finally, the exact scope of the concept needs to be clarified in many respects. Denying treaty benefits to a recipient of income that acts as an agent under a mandate is appropriate, as it is simply the consequence of the mandate. But other situations are more complex – for instance, where the FTA try to treat a foreign recipient as not being the beneficial owner on the basis that it has “very limited powers” and is acting as a “conduit” for the benefit of another party.

In the author’s opinion, a foreign recipient of income should be regarded as the beneficial owner if that recipient has discretion as to the use of the income and if the recipient assumes the risk and control of such income, i.e. where the recipient has an organizational role and bears a certain degree of entrepreneurial risk. Conversely, if the recipient has no discretion (for instance, where the recipient must repay a predetermined or automatically calculated amount to another person), the recipient might not be regarded as the beneficial owner, but as a mere conduit. It is to be hoped that the exact scope of the beneficial-ownership concept in such circumstances will be clarified further by court cases, so that taxpayers may have greater certainty in this respect.
Arbitration under the New Japan–Netherlands Tax Treaty

The authors provide an overview of the new mandatory arbitration clause contained in Art. 24 (Mutual agreement procedures) of the 2010 Japan–Netherlands tax treaty from a Japanese and Netherlands perspective. This clause covers all treaty issues and is not limited to disputes on transfer pricing and profit attribution to permanent establishments.

1. Introduction

On 25 August 2010, the Japanese Ministry of Finance announced that a new Convention between the Kingdom of the Netherlands and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (the “2010 tax treaty”) had had been signed. The 2010 tax treaty will replace the existing Convention signed on 3 March 1970. The full text of the 2010 tax treaty is available electronically on the IBFD Tax Treaty Database.1

Although, at the time of the writing of this article, the 2010 tax treaty had still to be approved in accordance with the legal procedures of both Japan and the Netherlands, this article provides an overview of the new mandatory arbitration clause contained in the mutual agreement procedure (MAP) article, Art. 24, of the 2010 tax treaty. This arbitration clause covers all treaty issues and is not limited to disputes on transfer pricing and profit attribution to permanent establishments, such as under the EU Arbitration Convention (1990).2

2. Background

In 2004, the OECD Committee on Fiscal Affairs recommended adding a process for arbitration to the MAP article of tax treaties to facilitate the resolution of disagreements between governments when a taxpayer is subject to double taxation.

This recommendation had various objectives, the first of which primarily focused on increasing the efficiency of a MAP, given the growing number of taxpayer applications for this process. With the increased attention being paid to transfer pricing by tax authorities around the world, and the consequent increase in the number of assessments being made against taxpayers operating across international borders, a MAP is often the only means for a taxpayer to resolve double taxation. In Japan alone, for example, the number of MAP cases has quadrupled in the past decade, with more than 90% of those cases involving transfer pricing. Consequently, the number of undecided MAP cases in Japan, i.e. the MAP cases carried over to the following year, has steadily increased from 304 cases in 2008, to 351 cases in 2009 and to 380 cases in 2010.3 This large volume of cases inevitably results in delays in the time taken to resolve any particular individual MAP. The situation in the Netherlands is comparable, in the sense that the number of MAP cases is growing. In this respect, during a seminar in 2008, the Netherlands Ministry of Finance stated that it is involved on an annual basis in some 150 MAP cases.

The second objective of an arbitration provision is to provide a solution for the taxpayer where two governments cannot reach an agreement under a MAP. Probably, the most famous example of this type of unfortunate circumstance is the GlaxoSmithKline (GSK) MAP between the United States and the United Kingdom. When the two governments could not agree on a MAP resolution, GSK was left with billions of US dollars in double taxation.4 In addition, although many countries offer a litigation alternative to MAP, this is typically a costly and lengthy process with no guarantee that any double taxation arising will be mitigated.

Finally, when a dispute between two countries is not resolved through a MAP and the taxpayer opts for arbitration, the arbitration panel becomes the focal point of the dispute. As a result, governments lose control over the dispute. A mandatory and binding arbitration mechanism in a tax treaty is, therefore, regarded as a strong incentive for countries to resolve their disputes efficiently and effectively through a MAP, i.e. within two years from the presentation of the case to the competent authorities. There is, indeed, a growing awareness among governments that “...the prospect of impending mandatory arbitration creates a significant incentive to compromise before commencement of the [arbitration] process” and “...mandatory binding arbitration as the final step in the competent authority process can be an effective and ap-
propriate tool to facilitate mutual agreement ... as per the testimony of a US government official. A similar comment has been made by a Netherlands government official: “we love arbitration but we will never use it.” In the meantime, practice reveals that the threat of arbitration is effective. In December 2010, a US official announced that, since August 2010, Canada and the United States had closed 80% of double tax cases that would have been eligible for arbitration under the tax treaty between these countries. For a number of reasons, therefore, the inclusion of mandatory and binding arbitration in a tax treaty is considered to be taxpayer-friendly. This is, however, primarily because it offers a better resolution for the elimination of double taxation than traditional dispute resolution procedures.

3. The 2010 Tax Treaty

3.1. The mandatory arbitration clause

Although the OECD first introduced a provision for arbitration into the 2008 OECD Model Tax Convention (“the OECD Model”) and although a number of OECD Member countries have since incorporated such a provision into their tax treaties, Art. 24(5) of the 2010 tax treaty is the first arbitration provision for Japan. However, the Japanese government has indicated that it plans on making the 2010 tax treaty a model for treaty renewals and new tax treaties going forward.

In contrast, the Netherlands has actively followed the European Unions and OECD’s recommendations in relation to the inclusion of arbitration clauses in tax treaties for several years. Consequently, the Netherlands has now concluded new tax treaties containing a binding arbitration clause with over 20 countries. Other than Japan, the most prominent of these are those with the United Kingdom (2008) and Switzerland (2010). In November 2010, when the new Netherlands–United Kingdom tax treaty was discussed in the Netherlands parliament during the enactment procedures, it was interesting to note that the inclusion of the arbitration provisions did not receive any special attention. Apparently, arbitration is already well accepted as an appropriate and meaningful dispute resolution tool in the Netherlands context.

The objective of a MAP and the arbitration clauses in the 2010 tax treaty is to eliminate double taxation. The 2010 tax treaty does not, however, address the issue of a potential mismatch between interest charged and/or credited by the tax authorities when a case has been dealt with in a MAP and arbitration. Internationally, the issue of interest during a MAP and arbitration is getting more attention, as evidenced by the work programme of the EU Joint Transfer Pricing Forum, the Netherlands country profile on the OECD website on dispute resolution, and the new Netherlands–Switzerland tax treaty (2010). A novel and unique provision of latter tax treaty is that the governments may agree not to impose any interest on the additional tax charge on the primary transfer pricing adjustment as agreed in a MAP if this is necessary, contrary to local legislation.

3.2. The Implementing Arrangement

The Implementing Arrangement attached and signed with the 2010 tax treaty basically follows the OECD’s Sample Mutual Agreement on Arbitration. Accordingly, it can be assumed that independent-opinion arbitration is the method of arbitration to be used under the OECD Implementing Agreement, as opposed to final-offer arbitration used under US tax treaties. The Implementing Arrangement provides detailed guidelines with regard to how an arbitration committee is selected, and how an arbitration decision is treated. These guidelines state that one arbitrator is selected by each government and then those two arbitrators select a third. The governments, not the taxpayer, then provide the arbitration committee with the information necessary for making their decision. The decision is binding.

There are, however, some significant differences. First, in contrast to the comparable arrangement between the Netherlands and the United Kingdom of 2009, there is no role for the OECD Centre for Tax Policy and Administration if the countries fail to appoint arbitrators in time. The OECD also allows government officials of either state to serve as arbitrators, unless they have been involved in the case. However, the Japanese and Netherlands negotiators have chosen not to accept any employee of their respective tax administrations, nor other persons who have dealt with the case in any capacity. A final significant difference is that the arbitration decision has no precedent value and is not made public.

4. Procedural Aspects for Taxpayers

The National Tax Agency of Japan (NTA) has released an outline of the proposed timeline for arbitration proceedings, from the time a MAP request is submitted until completion of any subsequent arbitration. Essentially,
if after two years of MAP negotiations, Japan and the Netherlands have not come to an agreement, the taxpayer may submit a request for arbitration. Certain specific caveats have been omitted from this article for simplicity, but, from the proposed timeline (see Diagram) it would appear that the entire arbitration process should take one to two years.

A key question is when the period of two years starts. The Implementing Agreement provides that this period starts when the case has been 'presented' to the competent authorities. The Implementing Agreement provides that a case has been presented only when certain information has been provided by the taxpayer. A similar rule can be found in the OECD Sample Mutual Agreement Procedure on Arbitration. The sting is, as usual, in the tail. As with the Code of Conduct for the Effective Implementation of the EU Arbitration Convention, the Implementation Arrangement under the 2010 tax treaty provides that the two-year period only starts after the taxpayer has provided 'any specific additional information' requested by the governments. In itself, such provision is logical. The experience in the context of the EU Arbitration Convention is, however, that some taxpayers are concerned that a country can prevent arbitration by arguing that the application is not complete. An example is the different levels of detail and sophistication of transfer pricing documentation. As long as one country argues that it does not meet local requirements, it can also argue that the case has not been presented, as defined.

It should be noted that Japan and the Netherlands share an interesting and taxpayer-friendly approach with regard to the timing of the application for a MAP and arbitration. In general, the process can start only when the tax assessment including the adjustment is final, i.e., local remedies, such as administrative appeal and litigation have been exhausted or have been waived. Japan and the Netherlands, however, allow an expedited procedure. Under such a procedure, the competent authorities are willing to start the procedure before the assessment has become final, i.e., local remedies, including the adjustment is final, i.e., local remedies, as long as one country argues that it does not meet local requirements, it can also argue that the case has not been presented, as defined.

5. What to Expect?

As a Member State of the European Union, the Netherlands has been familiar with the concept of arbitration for many years. The EU Arbitration Convention dealing with transfer pricing cases was approved by the Netherlands parliament in 1992. There is, however, little to no practical experience with arbitration under the EU Arbitration Convention, as only, according to rumour, two cases have been resolved under the Convention in the entire European Union. Nevertheless, for purposes of the EU Arbitration Convention, the Netherlands has already identified five independent individuals who can serve on the arbitration panel. It would appear to be logical that the Netherlands government would also call on those same individuals for purposes of arbitration cases under other tax treaties, such as the new 2010 tax treaty.

In Japan, despite the fact that the 2010 tax treaty has not yet entered into force, the NTA has already established an arbitration team within its international taxation division. It is also expected that more detailed guidance for taxpayers on the procedure and conditions for applying for arbitration will be released by the NTA in the future. In addition, it is possible that, as Japan has no existing arbitration provisions in any of its domestic laws (tax or otherwise), certain general legislative provisions relating to arbitration may be enacted in the future.

Given the lack of experience with arbitration in Japan, it is difficult to draw any inferences on the likely progress or outcome of a double taxation arbitration proceeding involving the Japanese government. However, it is known that the Japanese government has had a relatively successful record of reaching agreement with other countries in MAP negotiations to date. Accordingly, rather than providing a solution to unresolved MAP negotiations, the most likely benefit of such arbitration provisions for taxpayers subject to double taxation involving Japan is

Diagram

MAP starts

Arbitration request by taxpayer

2 years

Receiving competent authority (CA) notifies other CA

10 days

Arbitration to be resolved in arbitration (Terms of Reference)

90-120 days

Appointed arbitrators appoint third arbitrator

60 days

Arbitration decision made

180 days

CAs decide on issues

CAs appoint arbitrators

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It should be noted that Japan and the Netherlands share an interesting and taxpayer-friendly approach with regard to the timing of the application for a MAP and arbitration. In general, the process can start only when the tax assessment including the adjustment is final, i.e., local remedies, such as administrative appeal and litigation have been exhausted or have been waived. Japan and the Netherlands, however, allow an expedited procedure. Under such a procedure, the competent authorities are willing to start the procedure before the assessment has become final, whilst the taxpayer preserves the right to local remedies. The procedure is that, after taxpayer and tax administration have reached an agreement to disagree, the taxpayer files an administrative appeal with the tax administration while also filing for a MAP and/or arbitration. The tax authorities agree to suspend the administrative appeal and start the MAP and/or arbitration with the other country. In addition, both Japan and the Netherlands are willing to suspend payment of the disputed tax pending the conclusion of the MAP and/or arbitration, subject to certain conditions.

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likely to be in the NTA’s increased focus on resolving a particular MAP negotiation within two years to avoid the possibility of the taxpayer making a request for arbitration. Indeed, it should be remembered that various governments, including the Netherlands government, have informally expressed the view that, whilst they want an arbitration clause in all of their tax treaties, they never want to actually go to arbitration. In their view, the purpose of the arbitration clause in a particular tax treaty is to ensure that the two countries do their utmost to resolve any issue of double taxation as efficiently as possible before the taxpayer has the right to transfer the case to the arbitration panel.

6. Conclusions

With the introduction of arbitration in the new tax treaty, the Japanese and Netherlands governments have committed themselves to the elimination of double taxation. Taxpayers will welcome this decision. However, the further growth of arbitration provisions globally is not as certain as might be thought, as only recently India, which is a significant presence in the international tax community, has expressed strong objections against the use of arbitration for resolving international tax disputes.19

Accordingly, whilst arbitration is now an increasing feature of many tax conventions, as the 2010 tax treaty can attest, it is not to difficult to imagine that any government, including both the Japanese and Netherlands governments, would prefer to retain control of bilateral negotiations through a MAP rather than to cede their decision-making power to a third-party arbitration committee.

Finally, it is clear that the purpose of mutual agreement and arbitration procedures is to resolve issues of double taxation, and governments are generally willing to offer assistance in this respect. However, experience has shown that when applying for these procedures, more and more international companies are learning that governments may not consider either the mutual agreement or arbitration procedure as tools for the resolution of cases of double taxation that, in their view, sometimes find their origin in inadequate transfer pricing documentation or in inadequate monitoring of transfer prices.20 Consequently, despite the addition of arbitration to the arsenal of dispute resolution tools available to taxpayers globally, including in Japan and the Netherlands, taxpayers must still ensure that their implementation and documentation of transfer pricing policies are appropriate.

19. BNA, supra note 7, p. 873.
20. See, for example, Para. 2-20 of the Commissioner’s Directive on the Operation of Transfer Pricing in Japan in relation to year-end transfer pricing adjustments that cannot be supported by the taxpayer.
Tax Treaties and Double Non-Taxation: The Case of New Zealanders Investing in Immovable Property in South Africa

This article considers double non-taxation in relation to the New Zealand–South Africa tax treaty. It addresses the application of South African withholding tax to a New Zealand resident disposing of immovable property in South Africa and concludes with some recommendations as to how to rectify the deficiencies revealed.

1. Introduction

The South African Revenue Laws Amendment Act 32 of 2004 introduced Sec. 35A into the Income Tax Act 58 of 1962 (ITA). The amendment gave rise to the imposition of a new withholding tax on the proceeds of disposition by non-residents of immovable property situated in South Africa. The promulgation date of this section was announced by the Minister of Finance in the Government Gazette as 1 September 2007.

The provision of South Africa’s domestic law is, of course, subject to the provisions of a tax treaty, to which South Africa and its treaty partners have committed themselves. One such tax treaty, which is a focus of this article, is the 2002 New Zealand–South Africa tax treaty. Art. 13 of this tax treaty gives South Africa the primary right to tax gains from the alienation of immovable property situated in South Africa, which South Africa has exercised under the ITA. However, New Zealand, which taxes its residents on their worldwide income, does not tax capital gains. Nothing in Art. 13 of the New Zealand–South Africa tax treaty prevents New Zealand from taxing such gains, but it has chosen not to do so under its domestic law. Can New Zealand residents that dispose of immovable property located in South Africa take advantage of the New Zealand–South Africa tax treaty to limit or remove South Africa’s ability to impose tax on their gains from disposal of that property? In other words, does the tax treaty facilitate double non-taxation?

The raison d’être for a tax treaty is the avoidance of double taxation where a transaction affects both tax jurisdictions of the treaty partners. The solution to the problem of juridical double taxation is typically regarded as taxing income only once, which results in the consideration of which state has the primary taxing right. Ostensibly, in the New Zealand–South Africa context, there should be no difficulty in realizing this objective, as capital gains derived on the alienation of immovable property are not taxable under New Zealand domestic law in the hands of a New Zealand resident.

It is often thought that tax treaties are not intended to expedite double non-taxation, but in reality, the wording of many tax treaties is sufficiently loose to allow for the double non-taxation of cross-border income. As it is seen in the following discussion, the New Zealand–South Africa tax treaty is potentially a case in point. Specifically, the tax treaty could be used to ensure that no taxation is imposed at all, i.e. in South Africa, where a resident of New Zealand disposed of immovable property located in South Africa.

This article first addresses the potential tax consequences that arise for New Zealand tax residents, following the promulgation of Sec. 35A of the ITA, as a result of disposals of holdings or investments directly or indirectly in immovable South African property. The effect of Art. 13 of the New Zealand–South Africa tax treaty is then examined to determine whether or not it facilitates double non-taxation and, if so, what solutions could be available to South Africa’s tax policymakers.

The scope of this article is limited to New Zealand residents that do not have a permanent establishment (PE), as defined in the ITA, in South Africa.

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The scope of this article is limited to New Zealand residents that do not have a permanent establishment (PE), as defined in the ITA, in South
Africa. As a result of a conflict within South Africa’s domestic tax legislation regarding the treatment of immovable property for PEs, it is first necessary to address such conflicts before considering the international aspects of PEs and immovable property situated in South Africa. For this reason, the scope of this article has, for the purposes of illustration of the application of Sec. 35A of the ITA, been limited to New Zealand residents that do not have PEs in South Africa.

The article is divided into two general parts. First, the South African domestic tax law is discussed in the context of direct investment in immovable property situated in South Africa, with particular reference to the withholding tax impost. Second, the anti-avoidance measure targeted at indirect investment in immovable property via a saleable entity (for example, a company) is addressed in the context of South African domestic tax law and the New Zealand–South Africa tax treaty. In this respect, the differences between domestic law and the tax treaty are closely examined.

2. South African Domestic Tax Law

2.1. Reasons for the introduction of Sec. 35A of the ITA

The Explanatory Memorandum to the Revenue Laws Amendment Bill 2004, which introduced the legislation in respect of Sec. 35A of the ITA, states that:

- the taxing of locally sourced capital gains generated by non-residents is consistent with international best practice and is well-recognized by international income tax treaties. However, this system of source taxation lacks one essential element – proper administrative enforcement through withholding. Many countries that tax capital gains generated by non-residents impose a special withholding regime when the sale involves immovable property. This withholding regime is often critical because the non-resident’s connection to the source country is often tenuous, making enforcement impossible once the immovable property is sold.

It should be noted that, in South Africa, this withholding tax is not a final tax (unlike other South African withholding taxes on non-residents), but is, rather, an advance payment on the normal income tax liability yet to be determined.

The Explanatory Memorandum to the Revenue Laws Amendment Bill 2004 further provides that:

- this form of withholding is not internationally utilized in the case of capital gains generated by non-residents when those gains are associated with a local permanent establishment. No withholding is required in these instances because the non-resident’s practical connection to the source country is much more extensive.

2.2. Sec. 35A of the ITA in operation

Sec. 35A of the ITA applies where: (1) immovable property is sold by a non-resident; and (2) the gross amount payable to the seller, or the seller’s agent, i.e. for or on behalf of the seller, in total exceeds ZAR 2 million (approximately NZD 366,000 and EUR 206,000 as at 28 January 2011). The purchaser must withhold the tax, which is based on amounts paid. For instance, if the closing date of the sale is 20 January 2011 and the purchaser must pay ZAR 1 million on 30 January 2011 and ZAR 1 million in each of the following two years, even though all amounts accrue to the non-resident seller on 30 January 2011, the purchaser must withhold solely based on actual payment. The rate of withholding depends on the nature of the seller. The rate is 5% for a non-resident natural person, 7.5% for a non-resident company and 10% for a non-resident trust. Assuming the non-resident seller in this example is a natural person, the withholding tax would be ZAR 50,000 (ZAR 1 million × 5%) payable on 30 January 2011 and ZAR 50,000 in each of the following two years.

Where deposits are required upfront, to secure the property, the withholding tax on the deposit amount must be accounted for in the first payment made after conclusion of the contract. From the date that the amount must be withheld, resident purchasers have 14 days in which to make payment to the South African Revenue Service (SARS) and non-resident purchasers 28 days. Foreign-currency amounts must be translated at the spot rate to the South African rand on the date that the payment is made to the SARS (and not the date of the withholding of the tax).

Sec. 35A of the ITA also contains certain other administrative provisions relating to declarations and forms required by the SARS.7

3. Examples of South African Tax Implications and Commentary

3.1. Withholding tax reductions

Sec. 35A of the ITA contains circumstances in which the withholding tax on immovable property disposed of by a non-resident may be reduced (or eliminated). A tax directive is then required from the SARS.8 Four circumstances are contemplated, but some of these may give rise to difficulties for the non-resident seller. The relief provisions apply where:

(1) The non-resident seller provides adequate security for the payment of the final tax liability – for example, a bank promissory note or guarantee (Sec. 35A(2)(a)).

(2) The non-resident has other assets in South Africa, sufficient to provide adequate recourse should the SARS be required to take such action to settle the tax partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor.9

5. The effects for residents of the United Kingdom were considered in J. Roeleveld, "South African Withholding Tax: Adverse Consequences for Non-Residents", British Tax Review 4 (2006), pp. 447-457 and, for residents of the United States, in C. West and J. Roeleveld, "New W/H Tax Has Adverse Tax Consequences for U.S. Sellers of Real Property in South Africa", Journal of International Taxation 19(9) (2008), pp. 48-56. These are articles of similar scope to this one by the South African authors. The same limitations to the study were included in both articles.

6. Such as the withholdings taxes on sportspersons and entertainers, as well as the withholding tax on royalties. South Africa will shortly be introducing withholding taxes on dividends and interest.

7. The most critical forms being NR-03 – Application for Tax Directive for a non-resident Seller of immovable property in RSA and NR-02 – Declaration by Purchaser for the sale of Immovable Property in RSA by a non-resident.

8. NR-03.
liability – for example, the other South African assets of the non-resident that can be seized by the SARS to settle the tax liability (Sec. 35A(2)(b)).

(3) The non-resident would not be subject to tax in South Africa – for example, as a result of the application of a tax treaty, or as the result of the application of reorganization rules (generally between corporate entities), or the disposal may qualify for rollover relief in terms of Secs. 41 to 47 of the ITA, or, in the case of a foreign embassy, exemption in terms of Sec. 10(1)(a) (Sec. 35A(2)(c)).

(4) The actual liability arising from the alienation of the immovable property by the non-resident seller is less than the standard gross withholding required by the section. In this case, the withholding tax is reduced to the final liability or, where such liability is zero, the withholding tax is waived entirely. The onus of proving the final liability to be less than the withholding tax rests with the non-resident seller and must be expedited within the 14 to 28-day period (see 2.2.) to prevent withholding by the purchaser (Sec. 35A(2)(d)).

The NR-03 form allows the non-resident seller to apply for a tax directive to minimize or reduce the withholding. The form makes specific reference to each of the options under Sec. 35A(2), as noted in (1) to (4). If a relevant tax treaty provides partial or full relief from the South African income tax consequences, as indicated in (3), Sec. 35A(2)(c), the non-resident should make the application for the tax directive.

It would appear from Sec. 35A of the ITA that losses from the alienation of other South African-source assets may not be aggregated with the gain on the immovable property for the purposes of an application to reduce withholding tax to the “final tax liability”. This is unfortunately based on the method to determine taxable income, which includes a statutory portion of net capital gains. Capital gains in South Africa form part of the ITA and are included in the calculation of the normal tax liability of a taxpayer.

3.2. Example – direct investment

A non-resident natural person taxpayer owns a single asset, land, which is valued at ZAR 2.5 million. The land was originally purchased on 1 March 2008 for ZAR 1.5 million as a capital investment and no improvements have been made to it. The alienation date of the land is 1 September 2010.

Assuming that the transfer duty incurred would have been ZAR 65,000 and assuming legal fees of ZAR 12,000, the base cost of the property is:

<table>
<thead>
<tr>
<th>Costs</th>
<th>ZAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>purchase price</td>
<td>1,500,000</td>
</tr>
<tr>
<td>transfer duty</td>
<td>65,000</td>
</tr>
<tr>
<td>legal fees</td>
<td>12,000</td>
</tr>
</tbody>
</table>

On the sale of the property on 1 September 2010, the South African tax effect would be as follows:

<table>
<thead>
<tr>
<th>Items</th>
<th>ZAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>sales price</td>
<td>2,500,000</td>
</tr>
<tr>
<td>less: base cost</td>
<td>1,577,000</td>
</tr>
<tr>
<td>capital gain</td>
<td>923,000</td>
</tr>
<tr>
<td>less: annual exclusion</td>
<td>17,500</td>
</tr>
<tr>
<td>net capital gain</td>
<td>905,500</td>
</tr>
<tr>
<td>inclusion in taxable income at 25%</td>
<td>226,375</td>
</tr>
<tr>
<td>tax per the tables for individuals</td>
<td>47,063</td>
</tr>
<tr>
<td>less: primary rebate (assuming taxpayer less than 65 years of age)</td>
<td>10,260</td>
</tr>
<tr>
<td>normal tax liability</td>
<td>36,803</td>
</tr>
</tbody>
</table>

If the non-resident immovable property owner was an entity (say, a company), the final South African income tax effect is:

<table>
<thead>
<tr>
<th>Items</th>
<th>ZAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>capital gain*</td>
<td>868,000</td>
</tr>
<tr>
<td>inclusion in taxable income at 50%</td>
<td>434,000</td>
</tr>
<tr>
<td>tax at 33% (external company tax rate)</td>
<td>143,220</td>
</tr>
</tbody>
</table>

* The transfer duty adjustment for non-natural persons is the cause of the difference between the capital gain for an individual and the company in these examples. Accordingly, ZAR 65,000 is replaced by transfer duty of ZAR 120,000 in the determination of base cost as a result of the purchaser being a non-natural person (i.e. ZAR 923,000 + ZAR 65,000 – ZAR 120,000).

In this scenario, the withholding tax would have been:
- for the natural person ZAR 125,000; a refund of ZAR 88,197 would be due; and
- for the legal entity (a company) ZAR 187,500; a refund of ZAR 44,280 would be due.

If the transaction had taken place one year earlier, using the same sale proceeds and base cost, the income tax liability for the natural person would have been ZAR 38,417 and for a legal entity would have remained the
same. The annual adjustment to the tax rates and rebates for natural persons is the cause of this increasing divergence from the withholding rate. This ‘tax creep’ is already increasing and, unless the withholding rates are monitored and adjusted, the divergence could be considered inequitable.

If the non-resident had realized a capital loss on disposal of the immovable property, with the result that no income tax is payable, the non-resident seller would have to wait until assessed by the SARS before receiving the refund of the withholding tax. This could take anywhere up to six months from the end of the year of assessment. Such a refund would also be contingent on the non-resident registering as a South African taxpayer.

3.3. Practical considerations

The ITA requires a non-resident to register as a taxpayer where the non-resident has become liable for normal tax. As taxable capital gains are included within the scope of normal tax in South Africa, non-residents in the illustration in 3.2. would be required to register for tax. Failure to do so could result in penalties.

A practical difficulty arises in that there is a requirement to register only if the taxpayer is liable for normal tax. Should the taxpayer have incurred a capital loss on the disposal of immovable property or made a taxable capital gain that is below the threshold for normal tax (currently, ZAR 57,000 for persons under 65 years of age), there would be no requirement to register as a taxpayer. However, should the non-resident not have applied for a tax directive, as stated in 3.1., and not register as a taxpayer, the unfortunate result could be that the withholding tax would be treated as a final tax.

It should be noted that the duty to withhold the tax lies with the purchaser, irrespective of whether the purchaser is a resident or non-resident of South Africa. Accordingly, on the basis of South African domestic law, a New Zealand resident that disposes of immovable property located in South Africa is prima facie subject to tax on the capital gain and to a withholding tax deduction at the time that the purchaser, irrespective of whether the purchaser participates such behaviour in stating that:

As seen in the discussion of Sec. 35A of the ITA in 2.

4. Indirect Holdings of Immovable Property

4.1. South African domestic tax law

In order to circumvent the application of Sec. 35A of the ITA, a non-resident could contemplate investing in South African immovable property indirectly, through a holding of shares in a South African resident company that owns the immovable property directly. Sec. 9(2) of the ITA anticipates such behaviour in stating that:

The capital gain or capital loss from the disposal of an asset of a person shall be deemed to be from a source in the Republic, where –

(a) in the case of immovable property held by that person or any interest or right of whatever nature of that person to or in immovable property, that property is situated in the Republic;

(b) in the case of any other asset –

(i) that person is a resident, or

(ii) that person is not a resident, but that asset is attributable to a permanent establishment of that person which is situated in the Republic:

Provided that for the purpose of this subsection, an interest in immovable property held by a person includes any equity shares in a company or ownership or the
right to ownership of any other entity or a vested interest in any assets of any trust, if –

(aa) 80% or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof, is attributable directly or indirectly to immovable property held otherwise than as trading stock; and

(bb) in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person) directly or indirectly, holds at least 20% of the equity share capital of that company or ownership or right to ownership of that other entity.

This means that a New Zealand resident would only be taxed in South Africa on indirect immovable property gains realized on property situated in South Africa if the New Zealand resident meets the requirements of Sec. 9(2) of the ITA. That is, it has a holding of at least 20% in the property-owning vehicle and at least 80% of the holding’s value is derived from the market value of the underlying immovable property.

4.2. Art. 13(4) of the New Zealand–South Africa tax treaty

Indirect holdings of immovable property (for example, through a company, trust or other entity) are also contemplated in Art. 13 of the New Zealand–South Africa tax treaty. Specifically, Art. 13(4) of the tax treaty provides that:

Income, profits or gains derived by a resident of a Contracting State [New Zealand] from the alienation of any shares or other interests in a company, or of an interest of any kind in a partnership or trust or other entity, where the value of the assets of such entity, whether they are held directly or indirectly (including through one or more interposed entities, such as, for example, through a chain of companies), is principally attributable to immovable property situated in the other Contracting State [South Africa], may be taxed in that other State [South Africa].

There is clearly an anti-avoidance principle at work in Art. 13(4) of the New Zealand–South Africa tax treaty. As with Sec. 9(2) of the ITA, this article brings within its scope immovable property not directly held by the non-resident investor. However, the value of the assets of the company, the shares of which are sold,22 must be “principally attributable” to immovable property in South Africa. As the OECD Model Tax Convention (the “OECD Model”) in effect at the time the New Zealand–South Africa tax treaty was concluded did not contain a clause concerning indirect holdings23 and, therefore, cannot be of assistance, it is submitted that the term “principally attributable” in Art. 13(4) of the New Zealand–South Africa tax treaty should refer to the indirect holding deriving more than 50% of its value from immovable property.24 It is also submitted that the term “immovable property” in Art. 13(4) carries the same meaning as in Art. 13(1).25

Art. 13(4) of the New Zealand–South Africa tax treaty states that South Africa may tax the gains derived by a New Zealand resident on the disposal of such indirect holdings of immovable property. This primary right to tax is widely framed, but cannot create greater taxing rights than those contained in the ITA.

4.3. Differences between Sec. 9(2) and Art. 13(4)

Whilst the New Zealand–South Africa tax treaty and the ITA source provision seem to carry similar meanings, there remain inherent difficulties both with the tax treaty and the source provision. Para. 28.4 of the Commentary on Art. 13 of the 2010 OECD Model provides that:

The determination of whether shares of a company derive more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all property owned by the company without taking into account debts or other liabilities of the company (whether or not secured by mortgages on the relevant immovable property).

This Commentary applies to the analysis of the New Zealand–South Africa tax treaty and gives rise to a number of issues. First, in determining whether the value of the assets26 of the subject company is “principally attributable”27 to immovable property situated in South Africa, the meaning of “value of assets” must be ascertained. This requires identification of the relevant assets. Further, as the OECD Model and Commentary, and the New Zealand–South Africa tax treaty, each refer to indirect holdings of immovable property, with the tax treaty going further by referring to a chain of companies, it is critical to analyse how deep the look-through approach in Art. 13(4) extends.

4.4. Value of the assets

The SARS has aligned its interpretation with that of the 2005 (now 2010) OECD Model. Sec. 9(2) of the ITA was, therefore, amended to its current state. The SARS’s “Comprehensive Guide to Capital Gains Tax” of 6 May 2010 demonstrates its view on the quantification of the value of an indirect holding:

The types of interest comprising immovable property in South Africa are summarised in the table below:

<table>
<thead>
<tr>
<th>Right to Ownership</th>
<th>Value Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immovable property</td>
<td>More than 50% of market value of assets</td>
</tr>
<tr>
<td>Other assets</td>
<td>Directly or indirectly linked to immovable property</td>
</tr>
</tbody>
</table>

22. Or other entity, the interest of which is sold
23. The similar clause was only added to the 2003 version of the OECD Model.
24. This interpretation is consistent with the natural and ordinary meaning of the words, the “principal-asset test” for capital gains tax purposes in Sec. 880-30(5) of Australia’s Income Tax Assessment Act 1997 (“the sum of the market values of the test entity’s assets that are taxable Australian real property exceeds the sum of the market values of its assets that are not taxable Australian real property”), and the pre-1 April 2011 principal-purpose test of goods and services acquired by a registered person under New Zealand’s Goods and Services Tax Act 1985.
26. The OECD Model and Commentary refer to the value of the alienated shares.
27. The OECD Model and Commentary use the phrase ‘more than 50 per cent’.
The 80% requirement excludes immovable property held as trading stock.

A non-resident holding an interest of at least 20% of the equity shares in a company in which 80% or more of the market value of its assets comprise leasehold property in South Africa will be subject to CGT on disposal of those shares. This follows from the fact that 80% of the value of the shares is indirectly attributable to immovable property in South Africa. In other words, the lease derives its value from the immovable property of the lessor. The leasehold property may itself comprise immovable property if the lease is for not less than ten years and is registered in the deeds registry.

In determining whether 80% or more of the value of shares in a company are directly or indirectly attributable to immovable property in South Africa, any liabilities in the company must be disregarded. This is in line with the OECD's interpretation of article 13(4) of the OECD model treaty, which provides as follows:

> “4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.”

For accounting purposes self-generated goodwill is not reflected in the financial statements of an entity. However, it is an asset forming part of the market value of the interest in an entity and should not be lost sight of when determining whether or not 80% or more of an entity's assets comprise immovable property.

The reference to ownership or the right to ownership in any other entity is designed to bring within the ambit of the provision interests in foreign entities such as the Liechtenstein stiftung and anstalt.

It is clear from this that the SARS's view is to examine only the market value of the assets held and to ignore any debts or liabilities of the entity. The 80% test is, therefore, determined on the basis of the market value of immovable property (the numerator) over the market value of total assets (the denominator).

In terms of the SARS's approach, the market value of immovable property held as trading stock is excluded from the numerator. Even if the New Zealand–South Africa tax treaty included immovable property held as trading stock in the numerator, it is submitted that this would have little effect on the application of the tax treaty (when examined in isolation). Including immovable property held as trading stock in the interpretation of "value of assets" in the New Zealand–South Africa tax treaty would only increase the chance that the primary right to tax would rest with South Africa (the treaty provision already being broader than that of South African domestic legislation). The exclusion of immovable property held as trading stock in interpreting the tax treaty would simply align with South African practice.

South African practice also excludes debts and liabilities from the determination of the value of the assets. As neither "value" nor "assets" has been prefaced with the word "net" in the phrase "value of the assets of such entity" in the New Zealand–South Africa tax treaty, it is submitted that debts and liabilities are also excluded in the determination of the value of the assets for treaty purposes. It is further submitted that such a determination of the value of the assets must take place at the time of disposal of the interest in an entity.

Valuation of assets, albeit excluding from such valuation any debts or liabilities associated with such assets, is inherently subjective. Many valuations have different methodologies and/or assumptions on which the valuation is based. There is clear scope for manipulation. The determination of such indirect interests under Sec. 9(2) of the ITA can be illustrated by Examples 1 and 2.

Example 1 – Indirect interest of a non-resident in immovable property in South Africa

Facts: Richie, a resident of New Zealand, owns a 25% interest in a South African company, Springbok (Pty) Ltd ("Springbok"), the balance sheet of which appears as follows as at 28 February 2011:

<table>
<thead>
<tr>
<th>Capital employed</th>
<th>ZAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>share capital</td>
<td>1,000,000</td>
</tr>
<tr>
<td>retained income</td>
<td>1,400,000</td>
</tr>
<tr>
<td>long-term loan</td>
<td>1,200,000</td>
</tr>
<tr>
<td>total</td>
<td>3,600,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Employment of capital</th>
<th>ZAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>land and buildings</td>
<td>2,400,000 (market value 3,600,000)</td>
</tr>
<tr>
<td>plant and machinery</td>
<td>1,200,000 (market value 1,700,000)</td>
</tr>
<tr>
<td>total</td>
<td>3,600,000</td>
</tr>
</tbody>
</table>

Is Richie liable for capital gains tax (CGT) on the disposal of his shares in Springbok?

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28. Consider, for example, a company that holds ZAR 30 worth of immovable property as trading stock, ZAR 90 worth of immovable property as capital assets and no other assets. In applying the South African practice, only 75% of the value of assets is attributable to immovable property (excluding trading stock), whereas the New Zealand–South Africa tax treaty would consider 100% of the value of the assets to be attributable to immovable property. As no South African tax has been levied, Art. 13 of the New Zealand–South Africa tax treaty is irrelevant.

29. The examples have been extracted and adapted from the SARS, "Comprehensive Guide to Capital Gains Tax" (6 May 2010).
Result: The market value of the shares in Springbok is attributable to the following assets:

<table>
<thead>
<tr>
<th>Assets</th>
<th>ZAR</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>land and buildings</td>
<td>3,600,000</td>
<td>67.9</td>
</tr>
<tr>
<td>plant and machinery</td>
<td>1,700,000</td>
<td>32.1</td>
</tr>
<tr>
<td>market value of assets</td>
<td>5,300,000</td>
<td></td>
</tr>
</tbody>
</table>

Only 67.9% (ZAR 3.6 million / ZAR 5.3 million × 100%) of the value of Richie’s shares is attributable to immovable property. Richie’s shares are, therefore, not regarded as an “interest in immovable property” and do not attract CGT on disposal. As the disposal of Richie’s shares occurred after 1 February 2006, any liabilities in Springbok must be disregarded in the determination of the attributable value. The high 80% threshold (relative to the treaty requirement) under the ITA means that Richie’s gain is not subject to source taxation in South Africa. In comparison, the “principally attributed” 50% test in Art. 13(4) of the New Zealand–South Africa tax treaty would have preserved South Africa’s taxing right if it had originally conferred one upon itself under its ITA. However, as South Africa has not done so, the tax treaty is of no effect. A tax treaty is a shield, not a sword!

Example 2 – Indirect interest in immovable property through a multi-tier structure

Facts: Hikawera, a non-resident, owns 25% of Bokke, a South African resident company. Bokke’s only assets consist of shares in two wholly owned South African subsidiary companies, King and Protea. King’s asset is land (with a market value of ZAR 1.8 million) over which a mortgage of ZAR 1.6 million has been registered. Protea holds plant and machinery (with a market value of ZAR 200,000) and has no liabilities. Hikawera disposes of his shares in Bokke. Is he subject to CGT on the disposal?

Result: 90% of the value of Hikawera’s shares in Bokke consists indirectly of immovable property (ZAR 1.8 million / ZAR 2 million × 100%). It should be noted that the liabilities are ignored and the gross market values are used. In terms of Para. 2(2) of the Eighth Schedule to the ITA, Hikawera’s shares in Bokke are deemed to be immovable property and he is subject to CGT on the disposal. Again, Art. 13(4) of the New Zealand–South Africa tax treaty offers Hikawera no relief, but for a different reason than in Example 1. It entrenches South Africa’s right to tax under its domestic law calculation. Obviously, in such cases, the tax treaty ratio is relatively larger than that for the domestic law calculation.

4.5. “Relevant assets”

It is clear from the extract in 4.4. that the SARS also considers assets not recorded in the accounting records in determining the ratio of immovable property value to total asset value. Simontacchi makes the point, concerning the OECD Model, but equally applicable to the New Zealand–South Africa tax treaty, that:

... Art. 13(4) and the guidelines provided in the Commentary do not contain any limitation that could lead to the exclusion of property not recorded in the accounting books. On the contrary, it can be assumed that all property is relevant to determining the value of the shares independently of the reporting obligations relating to the property. It is, however, important to consider that, as a practical matter, it may be far from easy to ascertain the existence of such unrecorded assets and to determine their value. 32

It is not clear whether “cash” in South African rands is also counted. The difficulty arises from the treatment of South African rands for CGT purposes in South Africa. The term “asset” for the purposes of CGT in South Africa excludes South African rands, i.e. actual currency held, thereby reducing the denominator in the calculation of the 80% ratio for South African domestic law purposes.

In order to illustrate this, suppose that, in Example 2 in 4.4., immediately prior to Hikawera’s disposal of his shares in Bokke, Bokke borrowed cash of ZAR 1.7 million. At the time of sale, the Bokke group consolidated balance sheet shows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>ZAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,700,000</td>
</tr>
<tr>
<td>King’s land</td>
<td>1,800,000</td>
</tr>
<tr>
<td>Protea’s plant and machinery</td>
<td>200,000</td>
</tr>
<tr>
<td>total assets</td>
<td>3,700,000</td>
</tr>
</tbody>
</table>

When applying the rule in Sec. 9(2), proviso (aa) of the ITA, the result is the same as in Example 2 because, in addition to the liabilities, the cash holding is also ignored. However, whilst the liabilities are still ignored for the purpose of applying Art. 13(4) of the New Zealand–South Africa tax treaty, cash is not. Accordingly, the ratio calculation for treaty purposes is 48.6% (ZAR 1.8 million / ZAR 3.7 million × 100%), which is less than 50%. Consequently, the value of Bokke’s assets is not principally attributable to King’s land. Rather, it is principally attributable to its cash holding and Protea’s plant and machinery. Accordingly, the effect of Sec. 9(2) of the ITA would be limited. Although the gain on the sale of the shares could fall within the scope of the ITA, it would also fall within the scope of the exclusion in the New Zealand–South Africa tax treaty, as the denominator for the calculation of the treaty ratio is relatively larger than that for the domestic law calculation. Obviously, in such cases, the tax treaty overrides the ITA and the issue would appear to be resolved. Clearly, this mismatch gives a New Zealand resident an opportunity to inject (temporarily) South African rands into the immovable-property-owning vehicle prior to the sale of its shares to ensure that the value of the vehicle’s assets is not principally attributable to its immovable property, i.e. at least half of the value of its assets is South African rands or, at least, not immovable property.

30. Prior to 1 February 2006, it was accepted that debts and liabilities could be taken into account in the determination of the 80% requirement in Sec. 9(2) of the ITA. This required a legislative amendment to Sec. 9(2), which had an effective date of 1 February 2006.
31. Para. 2(2) of the Eighth Schedule to the ITA carries the same wording as the proviso to Sec. 9(2) of the ITA.
32. Simontacchi, supra note 25, p. 33.
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In addition, if cash is contemplated as an asset for the purposes of the 80% test, there is scope for manipulation. Apart from general anti-avoidance provisions in the ITA, nothing would appear to prevent a company obtaining loan finance that is held as cash at the time when the New Zealand resident disposes of the shares in the property owning company. The inclusion of a large amount of cash could reduce the ratio of the value of immovable property to the value of total assets sufficiently to remove the disposal of the shares from the scope of the ITA, in which case Art. 13(4) of the New Zealand–South Africa tax treaty is again inconsequential.

4.6. The look-through approach

The New Zealand–South Africa tax treaty clearly anticipates a substantial look-through in determining whether or not the value of the assets of an entity is principally attributable to immovable property. Art. 13(4) provides that the "value of the assets of such entity [is examined] whether they are held directly or indirectly (including through one or more interposed entities, such as, for example, through a chain of companies)".

Accepting the anti-avoidance nature of Art. 13(4) of the New Zealand–South Africa tax treaty, did the treaty negotiators really intend a look-through of numerous interposed entities to reach the ultimate New Zealand resident in all cases, specifically where shareholding interests of more than 20% in public companies are sold? The SARS appears to think so. In its "Comprehensive Guide to Capital Gains Tax", the SARS states that:

No exception is made for the holding of shares in listed South African companies. Thus a non-resident holding shares in a South African-listed company whose assets consist solely of mineral rights would be liable for CGT when disposing of those shares, provided that at the time of disposal that non-resident held at least 20% of the company's shares.33

The practical difficulties that arise from this position are obvious. The onus would be on a New Zealand resident to prove to the SARS that the 80% test fails. In the example of a "chain of companies", the likelihood of the New Zealand resident being able to access the relevant information could be limited. In addition, as indicated in 4.5., the New Zealand resident cannot simply use the accounting records, assuming that the New Zealand resident has access to such records, as any unrecorded assets also form part of the scope of the determination of value.

It is even more unlikely that a New Zealand resident minority shareholder holding shares, albeit more than 20%, in a listed company would have access to a complete breakdown of the group's assets. Can it also be expected of such a resident to try to obtain access to such information at the time that the shares are traded? And even if they did try, would they actually receive the information applicable to that date? In addition, who would bear the costs of any valuations to be performed?

To complicate matters further, indirect holdings may extend further than an immediate holding in a company that owns immovable property located in South Africa. This arises when companies outside South Africa constitute links in the "chain". For instance, suppose that Entity A holds 100% of Entity B (as its only investment). Entity B in turn holds only South African immovable property. Both Entity A and Entity B are not residents of South Africa. The sale of the shares by the shareholder of Entity A, which holds more than 20% of Entity A's equity share capital, would attract the withholding tax in South Africa because more than 80% of the shares' value has been derived from the indirect holding (via Entity B) of immovable property in South Africa. This extended scope may be contrary to principles of international law, as the shares are clearly not situated in South Africa. It remains to be seen whether this section can be effectively enforced by the SARS and the South African judicial system.

5. Double Non-Taxation

South Africa has imposed on itself, through Sec. 9(2) of the ITA, a high threshold before which it taxes gains from the alienation of property held indirectly by a non-resident through an intermediary entity (or entities). Consequently, in most cases, it could be expected that denial of South Africa's ability to levy taxation at source would result because non-residents would plan to avoid the domestic-law thresholds, particularly the 80% test, by manipulating both the types and values of assets, such as self-generated goodwill, held by the intermediary vehicle, which owned the land that in an economic sense produced the gain that is the intended target of the tax impost. The "principally attributable" test in Art. 13(4) of the New Zealand–South Africa tax treaty then plays no role.

In any case, if the "principally attributable" test (taken as more than 50% of the entity's asset value) is not met, thereby denying the source state's (South Africa's) right to tax, no tax would have applied under the domestic law, as, if an entity does not get over the 50% hurdle, logically it cannot get over the 80% hurdle, being the prima facie requirement for South Africa to tax the gain from the indirect investment in immovable property. In other words, South African domestic tax law has already ensured that no taxation is imposed at all in South Africa where the 80% threshold is not met, although the 50% one may well be met. Accordingly, no question of double non-taxation facilitated by a combination of New Zealand's absence of a CGT and the application of Art. 13(4) of the New Zealand–South Africa tax treaty arises.

This general proposition holds where the measurement base for the respective 80% and 50% tests is the same or if sufficiently higher-value variables were included in the denominator of the fraction for the purposes of applying the 80% test than for applying the 50% test. However, where there is a difference in the calculation base in which less value is included in the denominator for the purposes of calculation under the 80% test, it is possible for a New Zealand resident who is not subject to tax on the gain at home to manipulate the asset composition of the immovable-property-owing vehicle to ensure that, although the
value of the immovable property is 80% or more of the value of market value of the entity's shares or ownership rights for South African ITA purposes, the value of the immovable property is less than 50% of the value of the entity's assets for the purposes of Art. 13(4), so that the New Zealand–South Africa tax treaty overrides South Africa's ability to tax the gain from the alienation of the shares under the ITA. This situation could arise, as seen in 4.5., where South African rands are injected into the company to change the asset value composition. That cash is disregarded for South African domestic tax law purposes, but is taken into account for treaty purposes, thereby facilitating double non-taxation.

Intuitively, it would not appear that double non-taxation is inherently an objective that tax treaties are designed to achieve. That would appear to be a widely held view, although it is by no means unanimous. For example, there are politico-economic reasons to allow double non-taxation, such as one state permitting tax sparing or matching tax credits where knowingly no tax has in fact been paid in the other state by the taxpayer in question. Similarly, to achieve broader economic or political goals, certain kinds of cross-border income may not be taxed in either contracting state – for example, income derived by teachers, researchers and students, war veteran pensions, and maintenance payments.

The relevant question in relation to the discussion in this article, however, is whether or not Art. 13(4) of the New Zealand–South Africa tax treaty is being used by a taxpayer abusively to circumvent the source state's right to otherwise tax under its domestic law. On the face of it, it does not appear that the treaty negotiators would have intended that taxpayers could take advantage of a mismatch between the wording of the compilation of the tax base in Sec. 9(2) of the ITA and Art. 13(4) to realize double non-taxation of the type of gain that one state (South Africa) clearly wishes to tax.

Assuming that the intention of the tax policymakers of South Africa (and New Zealand) is that Art. 13(4) of the New Zealand–South Africa tax treaty is not to be used to realize double non-taxation, given South Africa's domestic tax law position, there are three potential solutions to the problem open to South Africa:

(1) South Africa could negotiate with New Zealand a protocol to the New Zealand–South Africa tax treaty, specifying that, insofar as determination of the South African tax liability is concerned, the calculation under Art. 13(4) is undertaken on the same basis as that under Sec. 9(2) of the ITA, i.e. South African rands are omitted in both cases.

(2) South Africa could seek to renegotiate the wording of Art. 13(4) of the tax treaty by adding a "subject to tax"-type provision, or even denying the application of Art. 13, whilst New Zealand does not tax the gains falling within its ambit. A "subject to tax" provision normally allows one state (the state of residence) to give tax relief only if tax has been paid in the other state (the state of source). However, such a standard "subject to tax" approach would not be appropriate given that New Zealand (the state of residence) does not tax capital gains. Accordingly, the rule would have been "inverted", i.e. Art. 13(4) could not apply against the source state (South Africa) to defeat Sec. 9(2) of the ITA as long as the residence state (New Zealand) did not tax capital gains sourced in South Africa.

(3) South Africa could avoid addressing Art. 13(4) altogether and attempt to invoke its own anti-tax avoidance measures to defeat the asset composition arrangements. Although this would involve (undoubtedly protracted) legal argument as to whether the arrangement was one of tax avoidance or treaty abuse, it would circumvent New Zealand involvement in what is essentially a South African revenue loss problem.

Given the unlikelihood of a timely resolution of the issue and no assurance that the South African revenue would ultimately be protected after prolonged litigation, which would inevitably arise under option (3), option (2) is more attractive in that it ensures that the gains are taxed and taxed only once, and that South Africa retains its source state taxing right. As long as New Zealand does not implement a regime that taxes capital gains, there would appear to be little difference from its point of view between a benign Art. 13 and no Art. 13 at all.

Nevertheless, option (1) is likely to be the most pragmatic and achieved more expeditiously by comparison to the alternatives. Option (1) ensures that the trigger for the imposition of South African tax is calculated consistently under the ITA and the New Zealand–South Africa tax treaty, and preserves South Africa's taxing right. Again, no question of double taxation arises, as New Zealand has chosen not to tax capital gains under its domestic law.

6. Conclusions

Apart from any relief (or abuse) of a tax treaty, the South African domestic income tax consequences are final. The only variable is the extent to which a taxpayer is subject to the withholding tax. Certainly, using one of the four options in Sec. 35A(2) of the ITA, a non-resident seller of South African immovable property could minimize the withholding obligation of the purchaser in applying for a tax directive from the SARS. Such minimization could at least reduce the withholding to an amount similar to the final liability and, as such, the time...
value of money loss caused by the delay in obtaining a refund would be prevented.

The significant discrepancy (as seen in the examples) between the effects for a natural person and non-natural person demonstrates that the withholding rates should already be reviewed and should ideally be subject to annual revision following adjustment to tax rates for both types of person. This would provide better alignment with the predicted final tax liability and minimize administrative difficulties for both the taxpayer, in terms of forced registration and completion of returns, and the revenue offices.

Except in the case of using South African rands to massage the composition of asset values, the New Zealand–South Africa tax treaty does not provide any relief from the withholding tax. This is because the Art. 13(4) measurement criterion is ineffectual in overriding the measurement criteria in Sec. 9(2) of the ITA.

Where a New Zealand immovable-property investor uses an intermediary entity to hold its interest in immovable property situated in South Africa and arranges to adjust the composition of its asset values prior to the sale of the investor's equity interest in the vehicle, there is a loss of revenue borne by South Africa as a result of using Art. 13(4) of the New Zealand–South Africa tax treaty and double non-taxation arises. Unlike double non-taxation driven by government politico-economic objectives, use of the tax treaty in this way cannot have been intended by the treaty negotiators. It is open to South Africa to consider the application of its anti-abuse measures in this case and/or to consider renegotiation of Art. 13 with the New Zealand government. The most expeditious outcome would likely be a protocol to the tax treaty, which ensures that the taxing threshold is calculated consistently under Sec. 9(2) of the ITA and Art. 13(4).
Zimmer à la Belge: Could a Commissionaire Arrangement Create an Agency Permanent Establishment in Belgium?

The authors, in this article, consider the implications of the decision of the French Supreme Administrative Court in the Zimmer case in relation to Belgium and, specifically, whether or not a commissionaire arrangement could give rise to an agency permanent establishment in Belgium.

1. Introduction

On 2 February 2007, the Paris Administrative Court of Appeal (Cour Administrative d’Appel de Paris) held in the Zimmer case that a French company, acting as a commissionaire, constitutes an agency permanent establishment (PE) for its foreign principal. The reasoning of the Court in arriving at this decision was based on a purely economic approach. That is, in determining whether or not the French company had the authority to bind the principal, only the factual circumstances and the economic involvement of the UK company in France were taken into consideration. This decision was indisputably open to criticism.

Three years later, on 31 March 2010, the Conseil d’Etat (French Supreme Administrative Court) overruled the decision of the Paris Administrative Court of Appeal in Zimmer, arguing that it was based on a misinterpretation of Art. 4(4) (provision on agency PE) of the 1968 France–United Kingdom tax treaty. According to the Conseil d’Etat, the case should essentially be analysed from a legal perspective, thereby considering, in the first place, the meaning of the term “concluding contracts in the name of” and its interpretation under domestic civil law. The Conseil d’Etat held that this term, and therefore, the presence of an agency PE, requires that the principal should be directly bound by the contracts concluded by the agent.

This landmark decision of the Conseil d’Etat could also be important for other civil law jurisdictions, such as, inter alia, Belgium. Taking into consideration the fact that a commissionaire arrangement is a widely used structure amongst multinational enterprises (MNEs) that has frequently been challenged by local tax authorities over the past few years, the authors believe that close attention should be given to this decision from a purely Belgian perspective. In this regard, the authors enthusiastically welcome the decision of the Conseil d’Etat, as it appears to confirm the position that they had previously adopted on the occasion of an earlier publication. The authors, therefore, feel confident that the decision will contribute to creating legal security in a highly debated area of tax law.

2. The Zimmer Case

2.1. Facts, issues and decision of the Paris Administrative Court of Appeal

The facts in Zimmer and the disputed decision of the Paris Administrative Court of Appeal can be summarized as follows. In the remote past, Zimmer Ltd, which was located in the United Kingdom, organized its sales through a “buy-sell” structure (an “independent distributor model”). In other words, Zimmer Ltd sold its products to a French group company, Zimmer SAS, which subsequently sold the goods in its own name and for its own account to French customers.

From 27 March 1995, the “buy-sell” model was replaced by a commissionaire arrangement, whereby Zimmer SAS commercialized the products in France in the capacity of a commissionaire. Consequently, Zimmer SAS sold the goods to the French customers in its own name, but for the account of Zimmer Ltd. The commissionaire arrangement between the companies gave Zimmer SAS the authority to accept orders, make proposals within the framework of tender offers and conclude contracts for the account of Zimmer Ltd. Zimmer SAS also had the right to negotiate prices, price reductions and payment...
facilities with the French customers. For all these functions, Zimmer SAS received an arm’s length remuneration (a commission fee).

From this situation, the Paris Administrative Court of Appeal concluded that, through the actions of Zimmer SAS, the UK company was involved in French business activities and should, therefore, be considered as having an agency PE within the meaning of Art. 4(4) of the 1968 France–United Kingdom tax treaty in France. The fact that Zimmer SAS concluded contracts in its own name and not in the name of Zimmer Ltd, which is a logical consequence of the commissionaire arrangement, was considered to be irrelevant by the Court, as it had no bearing on the ability of Zimmer SAS to bind the UK company de facto in France.

The Paris Administrative Court of Appeal also held that in casu the exception in respect of independent agents provided for in Art. 4(5) of the 1968 France–United Kingdom tax treaty could not be applied, as the commissionaire arrangement and the factual circumstances revealed that Zimmer SAS was in a dependent position towards Zimmer Ltd. The Court based this finding on the following three elements: (1) Zimmer SAS received strict instructions from Zimmer Ltd and had to justify its sales methods and advertising policy; (2) all of the risks with regard to the execution of the sales contracts were borne by Zimmer Ltd; and (3) Zimmer SAS acted exclusively for Zimmer Ltd. Accordingly, Zimmer Ltd could not rely on the negative proviso of Art. 4(5) of the 1968 France–United Kingdom tax treaty.

2.2. Decision of the Conseil d’Etat

The Conseil d’Etat commenced its decision by quoting the only relevant treaty provision. Specifically, Art. 4(4) of the 1968 France–United Kingdom tax treaty reads:

A person acting in a Contracting State on behalf of an enterprise of the other Contracting State – other than an agent of an independent status to whom paragraph 5 applies – shall be deemed to be a permanent establishment in the first-mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise (emphasis added).

The Conseil d’Etat stated that, in principle, a commissionaire does not fall within the scope of this provision, as Art. 4(4) of the 1968 France–United Kingdom tax treaty requires that contracts are concluded "in the name of" the foreign enterprise, whilst a commissionaire acts "in its own name" and does not create a direct contractual relationship between the principal (Zimmer Ltd) and the third-party customers (the French clientele). In this respect, the Court referred to Art. L. 132-1 of the French Commercial Code (Code de Commerce, FCC), which provides that "a commissionaire is someone who acts in his own name or under a business name but for the account of his principal" (authors’ unofficial translation). Stated otherwise, a commissionaire does not entail a direct representation, which is a prerequisite to constitute a PE for the principal.

The Conseil d’Etat continued by stating that an exception to this rule can only be made, and, therefore, a PE could be deemed to be present, if it could be substantiated (by way of either the terms of the contract or any other element of the inquiry) that the principal was de facto personally bound by the contracts concluded by the commissionaire. This would imply that the parties have characterized the contract erroneously as a commissionaire arrangement, whilst the facts and circumstances indicated that the (alleged) commissionaire was de facto an agent directly binding the principal.

According to the Conseil d’Etat, the Paris Administrative Court of Appeal violated this reasoning by including other (apparently decisive) elements in its judgement, notably the fact that Zimmer SAS, although concluding contracts in its own name, could engage the UK company in commercial transactions on French territory. From this, the Paris Administrative Court of Appeal drew the erroneous conclusion that Zimmer Ltd had a taxable presence in France, without examining whether or not Zimmer SAS created any direct obligatory relationship between Zimmer Ltd and the French customers. Consequently, the Paris Administrative Court of Appeal had violated the scope of Art. 4(4) of the 1968 France–United Kingdom tax treaty.

In the opinion of the Conseil d’Etat, the fact that (1) Zimmer SAS sold products exclusively for Zimmer Ltd, which was also the only activity of Zimmer SAS; (2) Zimmer Ltd bore the costs, and, therefore, also the risks of the commercialization of these products; and (3) Zimmer Ltd largely determined the sales conditions, did not imply that the contracts concluded by Zimmer SAS gave rise to a direct legal relationship between Zimmer Ltd and the third-party customers. This conclusion remains valid, even if the commissionaire were controlled by the principal. Stated otherwise, the alleged “dependence” between both group companies, which was not disputed in Zimmer, did not make Zimmer SAS a direct representative of Zimmer Ltd. Consequently, Zimmer SAS could not be considered to constitute a PE within the meaning of Art. 4(4) of the 1968 France–United Kingdom tax treaty.

3. Legal Characteristics of Commissionaire Arrangements

A commissionaire arrangement is a civil law concept that has no direct counterpart in common law. In particular, a commissionaire is an intermediary which acts towards clientele in its own name, but for the account of a princi-
Stated otherwise, the title of the goods passes directly to the customer. The principal is not a party to the contracts before, the only one that is engaged personally with the customer, which conducts business with the commissionaire (in casu the customer which buys goods from the commissionaire). Under the law of contracts, there are two separate contractual relationships: (1) one between the principal and the commissionaire, i.e. the commissionaire agreement; and (2) another between the commissionaire and the third-party customer. A commissionaire arrangement, therefore, entails an “indirect representation”. As the commissionaire acts in its own name, it is the only one that is personally liable towards the third-party customer (and vice versa). Consequently, if the principal does not deliver the product to the customer, the customer cannot initiate legal action against the principal. The customer can only sue the commissionaire in the event of, for example, faulty delivery. In addition, if the customer does not pay (the full amount of) the price on the stipulated date, only the commissionaire can file a claim against the customer. Conversely, the third-party customer is only relieved of its debt if it pays the sales price to the commissionaire, hence not to the principal. A commissionaire cannot be placed on a par with the common law concept of an “undisclosed agent”. Under common law, no distinction is made between direct and indirect representation. Specifically, under the law of agency, an agent, whether disclosed or undisclosed, is any person that receives from its principal an authority to conclude contracts and by doing so automatically engages that principal personally. Having the authority to act on behalf and/or at the risk of the principal is, therefore, sufficient to legally bind the principal. Even if the agent concludes contracts in its own name (an undisclosed agency), the principal would still be bound. This conclusion is, however, conditional on the agent acting within the authority that is (either explicitly or implicitly) granted by the principal. When the agent acts outside the scope of its authority, the agent can, in principle, not bind the principal under common law, except in cases of apparent authority.

A civil law commissionaire, however, acts for the account of the principal, but does so in its own name. It is, therefore, the only one that is engaged personally with the customers. The principal is not a party to the contracts between the commissionaire and the customers. The principal is only engaged with the commissionaire. As it acts in its own name, the commissionaire issues invoices to the customers. In the flow of goods, however, there is only a link between the principal and the customer. Stated otherwise, the title of the goods passes directly from the principal to the customer. As the commissionaire is only an intermediary, the entire turnover related to its sales activities are attributable to the principal (i.e. after the deduction of an arm’s length fee for the commissionaire).

4. Advantages and Disadvantages of Commissionaire Arrangements

4.1. Introductory remark

Sales activities organized on the basis of a commissionaire arrangement have both commercial and tax advantages for MNEs.

4.2. Commercial aspects

The main commercial reason to adopt a commissionaire arrangement is probably cost savings, which can be realized by centralizing the marketing and sales strategy at the level of the principal/central entrepreneur. At the same time, the latter has more control over local sales strategies, the determination of sales targets, the training of sales staff and the determination of sales techniques, customer service, etc.11

Besides, the conversion to a commissionaire arrangement usually implies a restructuring of the functions and risks. Conversion to a commissionaire arrangement is often induced by a concern to limit the risks borne by the sales affiliates in the various countries and to centralize these risks at the level of the principal/central entrepreneur. In a commissionaire arrangement, the inventory, credit, foreign exchange and product liability risks are typically borne by the principal, and not by the commissionaire. Another advantage of the commissionaire arrangement is the ability to keep the identity of the principal/central entrepreneur confidential.12 Consequently, the customer does not experience any difference compared to the “buy-sell” structure and remains only acquainted with the local sales entity that acts in its own name. Furthermore, the customer will still receive invoices from the local sales entity.

A final commercial aspect of the commissionaire arrangement is that new clients are considered to belong automatically to the principal/central entrepreneur, whilst this is not the case for a distribution agreement.13

8. For example, Art. 12 (Book I, Title VII) of the Belgian Commercial Code (Code de Commerce) and Art. 1, 132-1 of the FCC.
10. Although the authors have no ambition to cover VAT aspects in this article, the key VAT treatment of a commission structure can be summarized as follows. For VAT purposes, the commissionaire is considered to be the buyer of the goods and/or services with regard to its principal and as the seller of the goods and/or services in respect of the client. In a scenario in which the commissionaire and the customer are located in Belgium and the principal in another Member State (for example, Italy), the invoice flows for goods would, in principle, be the following: (1) invoice from principal to commissionaire: VAT-exempt intra-Community supply in Italy with intra-Community acquisition on the part the commissionaire in Belgium, and (2) invoice from commissionaire to customer: local supply subject to Belgian VAT. With regard to services, the following invoice flows would, in principle, arise: (1) invoice from principal to commissionaire: supply in respect of which Belgian VAT would be due by the commissionaire (the reverse charge mechanism); and (2) invoice from commissionaire to customer: local supply subject to Belgian VAT.
13. Id., p. 212.
ever, as the commissionaire acts in its own name, the existing clientele is not transferred to the principal/central entrepreneur, which obviously has an effect on the amount of the termination indemnity (see subsequently).

4.3. Tax aspects

In addition to commercial matters, a commissionaire arrangement is also advantageous from a tax perspective. The first benefit compared with the ‘buy-sell’ model is that the determination of transfer prices between the group entities is simplified. There is no transfer of legal ownership of the goods sold between the principal and the commissionaire, as ownership is transferred directly from the principal to the customer. As the sales price paid to an independent third party is by definition considered to be at arm’s length, these transactions do not give rise to transfer pricing issues.14 Consequently, by implementing a commissionaire arrangement, and compared to a ‘buy-sell’ model whereby the distributor takes legal title of the goods, strict transfer pricing regulations, burdensome documentation obligations and fines with regard to potential abnormal profit shifting can, to a large extent, be avoided. “To a large extent”, because, as with any form of intermediary (agent or representative), benchmarking must still be undertaken with regard to the commission that must be paid to the affiliated commissionaire. This commission must be determined in accordance with the arm’s length principle as if it were paid to an independent intermediary, thereby taking into account the level of sales intervention, the risks borne and assets used by the commissionaire. In other words, by converting a traditional ‘buy-sell’ structure into a commissionaire arrangement, an MNE may circumvent the difficult search for a comparable commission fee than to find a comparable sales price. In this regard, it should be considered if and to what extent the conversion of a fully fledged local distributor into a commissionaire implies the transfer of intangibles (goodwill) and whether or not the conversion is taxed as goodwill settlement.15

Another important advantage of the commissionaire arrangement is that, generally, the remuneration of the commissionaire is considerably less than the arm’s length profit margin of a distributor. This can be explained by the fact that a commissionaire on conversion performs possibly less sales-related functions and assumes less risks and distribution-related responsibilities, as it no longer takes title to the goods and sells for the account of the principal. From an arm’s length perspective, this transfer of risks justifies a reduction in profit margin for the commissionaire.16 A low commission fee implies higher residential profits for the principal/central entrepreneur. Consequently, such a conversion creates the opportunity to centralize the profits of the group at the level of the principal/central entrepreneur in respect of which, in some countries (inter alia, Belgium), an advantageous tax regime is available.17

A prerequisite to benefit from these tax advantages is that the commissionaire should not give rise to the existence of a PE for the principal, as a result of which the principal would become taxable in the source state. If a PE were deemed to exist, the next question would be whether or not additional profits should be attributed to that PE, i.e. in addition to the arm’s length commission fee that has supposedly already been paid to the commissionaire. Although this is a very interesting debate,18 it is outside the scope of this article and is, therefore, not considered any further. In 5., the authors demonstrate that a civil law commissionaire should, in general, not give rise to an agency PE in Belgium, and, therefore, as a matter of principle, the authors avoid this debate.

4.4. Potential goodwill settlement?

In concluding this section, attention should be paid to a possible side effect, which should be monitored, of converting an existing ‘buy-sell’ structure into a commissionaire arrangement, i.e. the eventuality of a goodwill settlement. In this regard, it should be considered if and to what extent the conversion of a fully fledged local distributor into a commissionaire implies the transfer of intangibles (goodwill settlement) of the distributor to the principal/central entrepreneur. In practice, the local tax authorities of the country where the distributor is located usually endeavour to either: (1) tax the alleged goodwill or know-how, under the pretext that client lists were transferred; or (2) tax a hidden dividend distribution, given the absence of a compensation payment for the termination of the distribution agreement.19

From a Belgian perspective, it should be considered whether or not the conversion into a commissionaire arrangement gives rise to the application of the Law of 27 July 1961 regarding the unilateral termination of (quasi-)exclusive distributorship agreements. The Law of 1961 provides that, in the case of unilateral termination of the agreement by the principal, the distributor is entitled to: (1) a reasonable period or a termination indemnity calculated accordingly; and (2) an additional indemn-

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17. Under the Belgian ruling practice, MNEs with a Belgian central entrepreneur can apply for an advance pricing agreement (APA) on the basis of which the Belgian company can obtain a tax exemption in respect of a substantial part of the new profit potential resulting from a supply chain restructuring. Needless to say, such an APA can substantially reduce a group’s overall effective tax rate.


or gratuitous advantage” should be understood as follows: directly, taken into consideration when determining the normal or gratuitous advantages granted by a Belgian company to companies located in Belgium or abroad are re-instated in the taxable base of the company granting such advance.

Under Art. 26, first indent of the Belgian Income Tax Code (Wetboek van de Inkomstenbelastingen, ITC), abnormal or gratuitous advantages granted by a Belgian company to companies located in Belgium or abroad are re-instated in the taxable base of the company granting such advantages, unless the advantages are, directly or indirectly, taken into consideration when determining the taxable base of the beneficiary. The concept of “abnormal or gratuitous advantage” should be understood as follows:

- An advantage within the meaning of Art. 26 of the ITC is described by the Belgian tax authorities as an enrichment of the recipient company without any equivalent (adequate and effective) consideration for the company granting the advantage.
- Such an advantage is considered to be abnormal when it is contrary to: (1) common practice, rules and customs; or (2) what is common in similar circumstances.
- An advantage is gratuitous if it is granted without being the execution of a commitment to do so or without any compensation or consideration. A gratuitous advantage could, therefore, be considered to be a specific case of an abnormal advantage.

According to Art. 26, second indent of the ITC, the latter exception, whereby the advantages granted are not reinstated in the taxable base of the grantor, does not apply with regard to: (1) foreign taxpayers that the Belgian entity is directly or indirectly affiliated with; (2) foreign persons that are not subject to income tax or that are subject to a tax regime substantially more advantageous than the common Belgian tax regime; or (3) foreign persons that have common interests with persons referred to in (1) and (2).

Accordingly, if a conversion from distributor to commissionaire occurs between affiliated companies and the Belgian commissionaire (the ex-distributor) does not demand a termination indemnity and, possibly, an additional indemnity, the Belgian company may be deemed to have granted an abnormal advantage to the lender, which may, in such circumstances, be reinstated in its taxable base.

Whether or not the conversion also requires the payment of an additional remuneration for an alleged disposal of assets (intangibles) appears to be more questionable. Conversion from a distributor into a commissionaire does not result in the transfer of assets or value drivers from the distributor to the principal/central entrepreneur. As noted in 3., the commissionaire continues to be the owner of the existing client base, as it acts in its own name and merely operates under a different heading. Often, the customers are not even aware of the conversion and continue to regard the commissionaire as their supplier. On conversion, the commissionaire most likely also retains the “soft intangibles” that drive the value of its business, such as market know-how, market power, workforce, etc.20

5. OECD Analysis of the PE Risk

5.1. Introductory remarks

In this section, the authors analyse whether or not a civil law commissionaire that operates in Belgium on behalf of a foreign principal (for example, the parent company/central entrepreneur) could be considered to be an agency PE under Art. 5(5) of the OECD Model Tax Convention (the “OECD Model”). It should, however, be noted that the perspective of the Belgian tax authorities deviates to a certain extent from the OECD approach.

This is due, in the authors’ opinion, to the fact that, unlike the OECD Commentaries, the Belgian administrative commentary on tax treaties is not updated on a regular basis. Accordingly, the position taken by the Belgian tax authorities in this document reflects (mostly) the 1963 OECD line of reasoning. This is clearly inconsistent with the current OECD perspective. In any event, to obtain a good understanding, the authors believe it is material to discuss and criticize, first, the Belgian approach. Subsequently, the authors scrutinize the PE risk relating to the commissionaire arrangement under the OECD Model and the latest version of the OECD Commentaries by reference to Zimmer.

### 5.2. Perspective of the Belgian tax authorities and comments

The Belgian tax authorities’ commentary on tax treaties states that only intermediaries that are both legally and economically dependent on the enterprise for whose account they act may give rise to an agency PE. In order to do so, the intermediary must also have the authority to conclude contracts in the name of the enterprise and must habitually exercise this authority, i.e. it must regularly and repeatedly act as such and not only occasionally. All of the criteria must be met simultaneously. Consequently, according to the Belgian tax authorities, a representative cannot be independent and have the authority to bind its principal at the same time, as this would imply that it was acting outside the normal course of its business.

Based on a literal interpretation of the Belgian tax authorities’ commentary and the principle of “patere legem quem ipse fecisti” (tax authorities should comply with the rules they have made themselves), a commissionaire arrangement should not give rise to a PE where one of the following (alternative) conditions is satisfied:

- the commissionaire retains its legal independence (according to the Belgian tax authorities, legal independence is a necessary condition for a PE); or
- the commissionaire only concludes contracts in its own name.

Due to its simplicity, this administrative perspective gives legal certainty to foreign MNEs that wish to set up a commissionaire arrangement in Belgium (the certainty being that the commissionaire is not considered to be a Belgian PE). The authors would, nevertheless, like to comment on it, as it appears to contradict the wording of Art. 5(5) of the OECD Model and current legal practice.

First, the authors believe that the assertion that only agents that are both legally and economically dependent can give rise to a PE should be questioned. Art. 5(5) of the OECD Model does not require that the agent is in a dependent position. Traces of this requirement can be found in the 1963 OECD Commentary, but it is generally accepted that this is a mistake. Roberts is very clear on this: “[t]he statement in paragraph 15 is an obvious error.” This paragraph of the OECD Commentary was also modified in 1977. Ever since, the “legal and economic dependency” test is only carried out to determine whether or not an agent is independent. However, the fact that Art. 5(6) of the OECD Model concerns independent agents does not imply, a contrario, that Art. 5(5) only refers to dependent agents. The Belgian administrative commentary was never adjusted in this respect. Consequently, when an agent is legally independent of the foreign principal, whilst the facts indicate that it is in an economically dependent position, the agent can still constitute an agency PE. In order to assess whether or not this is the case, the agent’s activities should be tested against the conditions of Art. 5(5) of the OECD Model. Contrary to the opinion of the Belgian tax authorities, the existence of a PE cannot a priori be excluded in these circumstances.

Second, the Belgian tax authorities state in their commentary that there is no PE risk when the agent only concludes contracts in its own name. A literal reading of Art. 5(5) of the OECD Model, indeed, results in such a conclusion. Consequently, if the agent acts as a commissionaire, no agency PE can be deemed to exist. It is not surprising that this perspective is not always the same."}

21. The discussion on the ambulatory interpretation of tax treaties in the light of subsequent changes to the OECD Commentaries falls outside the scope of this article.
22. Belgian administrative commentary on double taxation conventions (Algemeen Commentaar van de overeenkomsten tot het vermind van dubbele belasting, “Kom. Ow.”, No. 5/401).
25. This conclusion appears to be confirmed by the administrative guidelines with regard to the concept of a "Belgian establishment" in the regulation on the taxation of non-residents (Belgian Commentary on the Income Tax Code (Commentaar op het Wetboek van de Inkomstenbelastingen), No. 228/60). See 7.
26. Para. 15 of the Commentary on Art. 5 of the 1963 OECD Model reads: "Persons who may be deemed to be permanent establishments, must be strictly limited to those who are dependent, both from the legal and the economic point of view..."
28. This modification aligned the Commentary with the model tax treaties of the League of Nations. See Société des Nations, Double imposition et évasion fiscal. Rapport présenté par le Comité des Experts Techniques sur la double imposition et évasion fiscal (Geneva: 1927). The accompanying commentary states that "les mots 'vraiment autonome' impliquent une autonomie de bonne foi (bona fide), c'est-à-dire absolue au double point de vue juridique et économique" ("the words 'truly independent' imply a bona fide independency, i.e. an independency that is absolute, both from a legal and an economic point of view" – authors’ unofficial translation).
29. Para. 36 of the Commentary on Art. 5 of the 1977 OECD Model (Para. 37 of the Commentary on Art. 5 of the 2008 OECD Model).
30. Similarly, an independent agent who habitually concludes contracts in the name of the principal cannot automatically be considered as acting outside the ordinary course of its business. What is relevant for this test is only whether or not the activities performed by the agent are customary in its trade. This is the only correct interpretation following the addition of Para. 38.8 of the Commentary on Art. 5 of the OECD Model in 2003. See B. Van Der Gulik, "Qualification of a Dutch Commissionaire Under the OECD Model Convention", Tax Notes International (2007), p. 90.
31. For the purpose of illustration, the authors refer to the PE definition in Art V of the Mexico and London Model treaties of the League of Nations. This provision, which is clearly based on the civil law tradition, states: "the fact that a commission agent (commissionaire) acts in his own name for one or more enterprises and receives a normal rate of commission does not constitute a permanent establishment for such enterprise (League of Nations, Fiscal Committee – Report on the Work of the Tenth Session of the Committee held in London (Geneva: 1946), pp 15-16). A similar point of view can be found in the report the Tax Committee of the League of Nations represented in 1929 (Société des Nations, Comité Fiscal – Rapport au Conseil sur les Travaux de la Première Session du Comité (Geneva: 26 October 1929), p. 4).
that in this administrative document a legalistic approach is adopted. When interpreting terms and concepts used in law or regulations, the Belgian tax authorities tend to let legal reality take precedence over economic substance. However, this standpoint should be put into perspective. The critical factor in determining whether there is an agency PE is not whether the agent acts in the name of the principal, but whether the contracts concluded by the agent are directly binding on the principal. This is explained in more detail in 5.3.3.

Third and finally, the authors cannot agree with the idea that an agent cannot be independent and have the authority to bind its principal at the same time. The independence condition is only to be found in Art. 5(6) of the OECD Model and is unrelated to the authority to conclude contracts binding on the principal, which is a condition set out in Art. 5(5). In practice, the authors deem it possible that an agent who disposes of a large portion of independency towards its principal still concludes legally binding contracts on behalf of the latter. Whether or not that person constitutes an agency PE for the principal in such a case solely depends on the concept of “acting in the normal course of his business”, which is the test provided for in Art. 5(6) of the OECD Model.

5.3. The PE risk under the OECD Model

5.3.1. Initial comments

In order to determine whether or not a commissionaire could give rise to a PE, three treaty provisions must be analysed, i.e. Art. 5(5), (6) and (7) of the OECD Model. In sections 5.3.2. to 5.3.4., the authors do not discuss each provision in length, but rather focus on their effect on a commissionaire arrangement. In this regard, the factual circumstances of Zimmer as set out in 2 serve as the working hypothesis.

5.3.2. Art. 5(7) of the OECD Model

Art. 5(7) of the OECD Model states that:

The fact that a company which is a resident of a contracting state controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

In other words, the existence of a subsidiary does not make the subsidiary as such a PE of the parent company (and vice versa). This follows from the fact that subsidiaries are independent legal entities that should also be treated as such for taxation purposes. Even if there is extensive commercial cooperation between the two group entities, which is typically the case when the subsidiary sells (as a commissionaire) the products manufactured by the parent company, the former is, nevertheless, deemed to conduct its own business.

This does not preclude that a group company can constitute an agency PE for another affiliate. However, for such a PE to exist under these circumstances, it is necessary that the group company meets the conditions in Art. 5(5) of the OECD Model or, alternatively, that those in Art. 5(1) (basic rule PE) are satisfied.

5.3.3. Art. 5(5) of the OECD Model

As noted in 5.2., the critical factor in determining whether there is an agency PE is whether the contracts concluded by the agent are binding on the principal. This is inarguably the case when contracts are concluded literally in the name of the foreign enterprise and, therefore, are de jure binding. The wording “in the name of” refers to the civil law concept of direct representation. In this respect, Avery Jones and Ward state the following:

By using a term of art derived from civil law in the [OECD] Model, there can be no doubt that it was intended to have the civil law meaning, as there is no sense in making the liability of the principal to tax turn on a purely descriptive, rather than a legal difference.

This implies that the contracts concluded by the agent should legally be considered to be contracts concluded by the principal. The dealings of the agent should be attributed directly to the principal, which is only the case if the agent acts “in the name of” the principal. The Conseil d’État confirmed this in Zimmer.

However, it should be remembered that this civil law concept is embedded in the OECD Model that also serves as a base for common law countries. In common law countries, the concept “representation” implies that the agent binds its principal by concluding contracts for which it has been given explicit authority, irrespective of whether the agent acts in its own name (an undisclosed agency) or in the name of the principal (a disclosed agency). When the intermediary makes use of this authority, the contracts it has concluded are legally considered as being concluded by the principal.

Accordingly, and specifically at the insistence of the United Kingdom, a new paragraph was included in the 1994 Commentary. This paragraph clarifies, especially for countries with a common law tradition, that:

32. This was recently illustrated by the answer of the Ministre of Finance to a parliamentary question regarding the scope of the concept of “beneficial owner” in tax treaties. See Parl. Q. No. 802. Beknopte Verslag, Commission of Finance of the House of Representatives, COM 906 (28 March 2006).
34. This corresponds to Art. 4(6) of the 1968 France–United Kingdom tax treaty.
35. Wustenberghs, Heffingsbevoegdheid bij grensoverschrijdende ondernemingswinsten, supra note 5, p. 182, No. 195.
36. Para. 41 and 42 of the Commentary on Art. 5 of the 2010 OECD Model.
38. Paras. 41 and 42 of the Commentary on Art. 5 of the 2010 OECD Model.
40. The authors do not elaborate on the basic rule regarding the concept of a PE in this article.
the name of”). This implies that France and the United
of “has been replaced by the words “on behalf of” , whilst
their different approach regarding “agency” . In the current
law).
In other words, it is crucial that the representative can
ally exercises, an authority to
establishment of the principal if the agent has, and habitu-
ment in that State ... (emphasis added).
In addition, Art. 5(5) of the US Model reads:
where a person – other than an agent of an independent status
to whom paragraph 6 applies – is acting on behalf of an enterprise
and has and habitually exercises in a Contracting State an au-
tority to conclude contracts that are binding on the enterprise,
that enterprise shall be deemed to have a permanent establish-
ment in that State ... (emphasis added).
In other words, it is crucial that the representative can
bind its principal, either as a direct representative (civil
law) or as disclosed and/or undisclosed agent (common
law).
Finally, it can be derived implicitly from the 2008 France–
United Kingdom tax treaty that both states are aware of
their different approach regarding “agency” . In the current
English text of this tax treaty the reference to “in the name of” has been replaced by the words “on behalf of”, whilst the French text still uses the wording “au nom de” (“in the name of”). This implies that France and the United
Kingdom consider both words to have the same mean-
ing: i.e. the authority to conclude contracts that are di-
rectly binding on the principal, and that the difference
only refers to their different legal systems.

Briefly, the key question is whether or not the contracts
concluded by the agent create a direct binding relationship
between the principal and the third-party customer. It
should, however, be noted that the question should not
only be addressed from a strictly legal perspective. Many
tax authorities have adopted a ‘substance over form’ ap-
proach. Such an interpretation implies that, to assess the
ability to bind the principal, the economic nature of a
contract should be examined, as this could reveal the gen-
ue intentions of the parties, i.e. the investigation could
reveal that the principal is de facto personally committed
to the third-party customers under the terms of contracts
negotiated by the intermediary. Para. 33 of the Commen-
tary on Art. 5 of the OECD Model clarifies that:
A person who is authorised to negotiate all elements and details
of a contract in a way binding on the enterprise can be said to
exercise this authority ‘in that State’, even if the contract is signed
by another person in the State in which the enterprise is situated ...

Accordingly, a foreign principal who is de facto bound
by the activities of the intermediary, can have a PE in the
other state if it transpires that, for example, the interme-
diary can negotiate all of the essential elements of the
contract and that the signing of the contract is a mere
formality (‘rubberstamping’). An analysis of the eco-
nomic nature of the contract implies that attention should
be given to: (1) the content and/or substance of the con-
tract, rather than to formal criteria; and (2) the activities
de facto performed by the intermediary respectively the
involvement (that is still required) of the principal.46 In
the same context, the soliciting of orders (at fixed prices)
could result in a PE if practice reveals that all of the order
forms forwarded to the principal are accepted by it (or
through its IT system) without any exception.47

The Conseil d’Etat in Zimmer appears to endorse this “sub-
stance over form” approach in stating that “the terms of
the contract or any other element of the inquiry” must
serve as a basis to examine the authority to bind the prin-
cipal. The Court appears to indicate that, with regard to
the authority to conclude directly binding contracts, it is
necessary to consider the position both as a matter of

42. Para. 32.1 of the Commentary on Art. 5 of the 2010 OECD Model.
43. It would be advisable to modify the text of Art. 5(5) of the OECD Model
accordingly by simply replacing ‘an authority to conclude contracts in
the name of the enterprise’ with ‘an authority to conclude contracts binding
the enterprise’ See A. Pleijser, ‘The Agency Permanent Establishment (Maa-
44. Avery Jones and Ward, supra note 24, p. 161.
45. “The Agency Element of Permanent Establishment: The OECD Com-
mentaries from the Civil Law View’ by Sidney I. Roberts” , supra note 5, p. 2 and A. Pleijser, “The Agency Permanent Establishment: The
46. Wustenberghs, “La structure du commissionnaire remise en cause”, supra
note 3, p. 2 and A. Pleijser, “The Agency Permanent Establishment: The
47. It would obviously be different if the principal would have the power, and
exercises that power, to change the terms of or reject the order. In such a
case, the principal has clearly the power to conclude the contracts and
not its agent.
form (the terms of the contract) and as a matter of substance (any other element of the inquiry).

However, specifically with regard to commissionaire arrangements, the question arises as to whether or not the "substance over form" approach can serve as a basis to state that an agency PE could exist, even if the intermediary only concludes contracts in its own name, such as a commissionaire.

Pleijsier answers this question affirmatively in his doctoral thesis. When the factual circumstances reveal that the intermediary engages the foreign enterprise to some extent in the business activities of the source state, even without it concluding contracts in the name of the principal, a PE could be deemed to exist. In Pleijsier's opinion, this can be derived from the Commentaries to the effect that the nature of the activity of the representative is an alternative, but sufficient criterion for a PE to exist.49 Although there could be sound arguments to agree with this interpretation, the wording of Art. 5(5) of the OECD Model appears to leave no room for such an interpretation.

Except in case of a sham or where parties erroneously characterized their internal relationship as a commissionaire arrangement, it would, in the authors' view, be impossible to consider a civil law commissaire as creating a PE on the basis of the "substance over form" approach. Specifically, as the commissaire acts in its own name, it can, at the most, be considered to be an "indirect representative". The legal characteristics of a commissionaire agreement, as set out in 3., reveal that the principal is not directly bound towards the third-party customer and that it does not have any legal rights (or any legal obligation thereby resulting) from the contract between the intermediary and the third-party customer.

Additionally, in a strictly legal sense, the commissaire is not even a representative, as any representation implies, in principle, the direct attribution of the legal consequences to the principal and, therefore, not only an attribution of the economic risk of the contracts concluded by the intermediary. This does not apply when the intermediary acts in its own name. For the same reason, a commissaire falls outside the scope of the definition of "agent" in Art. 5(5) of the OECD Model, the history of which reveals that the emphasis is on the legally direct binding nature of its authority, in accordance with the civil law concepts of representation. A reference to the economic consequences of the commissaire's actions cannot alter this. The commissaire does involve the principal in business activities in the source state, but its actions do not create a direct contractual bond between the principal and the third-party customer. This is why the commissaire cannot be considered to be a PE.50

5.3.4. Art. 5(6) of the OECD Model

Hypothetically speaking, it could occur that a commissaire would fall within the scope of Art. 5(5). This could arise, for example, if the internal contractual arrangement between the principal and the commissionaire provided that the commissaire would transfer its receivables in respect of its customers automatically to the principal, without profit-and-loss effect at the level of the commissaire, and that only the principal were liable for damages or losses incurred by the third-party customer. Even in this unlikely event, Art. 5(6) still provides for an exclusion ground. The paragraph is formulated as a negative PE proviso.

Under Art. 5(6) of the OECD Model, a broker, a general commission agent or any other agent of an independent status does not constitute a PE of the foreign principal, provided that such persons act in the ordinary course of their business. This provision is intended to exclude from the scope of Art. 5(5) of the OECD Model intermediaries that, even if generally concluding contracts legally binding the principal: (1) are both economically and legally independent; and (2) act in the normal course of their business.

The independence of the agent towards the principal should be considered from both a legal and economic perspective. An agent is "legally" independent if it can conduct the business of the principal according to its own view, expertise and methods. The principal can certainly give instructions, but these should be confined to the final business result. Accordingly, they should not relate to how to achieve this result. If the principal frequently intervenes when the agent conducts its business and the agent must comply, the agent does not meet the legal-independency test.51 The main criterion for assessing an agent's "economic" independence is the way in which its business relations with the principal are shaped from an economic point of view.52 An independent agent must take entrepreneurial risks to run its business. The elements that generally indicate the absence of economic independency are: (1) the agent only has one principal; (2) the principal provides most of the necessary equipment to run the agent's business; or (3) the agent is remunerated in such a way that it has no entrepreneurial risk – for example, if a cost-plus-based compensation is used.

Apart from this, the independent agent should also act in the ordinary course of its business. The Commentaries clarify that a person cannot be said to act in the ordinary course of its business if such a person performs activities that, economically, belong to the sphere of the enterprise rather than to its own business operations.53 In order to determine whether the activities of an agent comply with the "ordinary course of business" test, these should be compared with the business activities customarily carried out in the agent's trade as a broker, commission agent or other independent agent, rather than the other business activities carried out by the agent.54 Consequently, it is possible that similar activities may or may not result in a

52. Para. 38.7 of the Commentary on Art. 5 of the 2010 OECD Model.
53. Vogel, supra note 36, Art. 5, No. 172.

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PE, depending on the trade or the industry in which the agent performs its activities.

The authors would like to emphasize that the exclusion ground of Art. 5(6) of the OECD Model is only relevant if the agent habitually concludes contracts binding on the principal. If this is not the case, as it would be under a regular commissioner arrangement, the conditions in Art. 5(5) of the OECD Model would, in general, not be met. Consequently, there would be no PE issue and no need to apply any exclusion ground.

In theory, therefore, if there is any form of intermediary, it would be best to start by analysing whether or not this intermediary meets the conditions in Art. 5(5) of the OECD Model. Only if these conditions are met, Art. 5(6) of the OECD Model could be relevant, as, perhaps, it is an independent agent that acts in the ordinary course of its business. The decision of the Paris Administrative Court of Appeal in Zimmer appears to confirm this approach. Before the Conseil d’État, the dependency between both group companies was not debated. But even if Zimmer SAS were legally and economically dependent on Zimmer Ltd, there would still not be any PE risk, as Zimmer SAS does not, as a matter of principle, fall within the scope of Art. 5(5) of the OECD Model (see 2.2.).

6. Treaty Abuse

It is common knowledge that an enterprise can reduce its taxable income abroad significantly by converting a traditional “buy-sell” model into a commissioner arrangement. The question, therefore, arises as to whether or not such a restructuring can be regarded as treaty abuse.

In order to challenge a supply chain restructuring on the basis of treaty abuse, the tax authorities of the source state must demonstrate that the foreign enterprise intentionally violated the scope and purpose of the allegedly abused treaty provision. This means that the source state should be able to demonstrate that the foreign enterprise is doing something that was not intended by the legislator. Such a demonstration does not, however, appear to be practicable.

The history of the development of Art. 5(5) of the OECD Model reveals that the authors of the OECD Model opted for a typical civil law criterion (“contracts in the name of”) as a threshold in allocating the taxing jurisdiction to the source state. As noted in 5.3.3., this criterion refers to “direct representatives” in civil law countries, i.e. persons that, in view of the scope of their authority, involve the enterprise to a particular extent in business activities in the source state, as if the enterprise is performing the activities itself (“replacement theory”). This implies that, traditionally, a PE has been deemed not to exist when the principal could not be held directly responsible for the contracts concluded by the intermediary. By restructuring its sales model into a commissioner arrangement, which cannot be considered to be reprehensible and, as indicated in 4., is often also inspired by business motives, the enterprise places itself in a situation that is nolens volens not envisaged by the drafters of the OECD Model and/or a tax treaty. The authors feel that treaty abuse is not possible in these circumstances. Unless an explicit deviation or reservation is made in the applicable tax treaty, it can scarcely be contended that the treaty states had the common intent to allocate the taxing jurisdiction to the source state in the case of indirect representation.

Additionally, in the authors’ opinion, treaty abuse only arises if it relates to an artificial “construction” inspired by tax evasion (or fraudulent) purposes. In the case in question, this implies first of all that the tax authorities should be able to demonstrate that the parties did either not respect the consequences of their commissioner agreement or had completely undermined their agreement by behaving in a contradictory manner. This could be the case if the commissioner proves to be only an “instrument” or “puppet” of the foreign principal (due to strict instructions and the lack of any form of independence), thereby disguising a true agency relationship. In such a case, the tax authorities must consider the transactions undertaken and should disregard the terms or legal classification/title of the commissioner’s agreement. It is clear that this should be analysed on a case-by-case basis, but is, in any case, quite exceptional. Evidently, in Zimmer, a “construction” was in place, but there was no indication of any fraudulent motive, nor was it evidenced that the parties did not accept all of the consequences resulting from their commissioner arrangement. Opting for a different supply chain model cannot as such be regarded as an indication of treaty abuse. Second, tax evasion motives should be identifiable for treaty abuse to exist. This is particularly interesting, as a conversion from a distributor to a commissioner could well result in tax advantages, but not in a fraudulent manner. Tax base erosion in the source state is merely the result of the transfer in (functions and) risks. As the commissioner has less risks, it should receive lower remuneration. In this context, reference should be made to Chap. IX of the 2010 OECD Transfer Pricing Guidelines (the “2010 OECD TP Guidelines”), which relates to the transfer pricing aspects of business restructurings. In Para. 9.65 of the 2010 OECD TP Guidelines, it is clearly stated that a reduction in profit potential is, as such, no reason for an exit charge.

54. “In theory”, as, in practice, it is first necessary to start by analysing if the agent is an independent agent according to Art. 5(5) of the OECD Model. If this is the case, there is no need to further analyse Art. 5(5) of the OECD Model, as the agent is already excluded from the definition of a PE. On the other hand, if the agent does not meet the conditions of Art. 5(6) of the OECD Model, Art. 5(5) should determine whether or not that agent constitutes an agency PE (see Wustenberghs, Heffingsbevoegdheid bij grensoverschrijdende ondernemingsvormen, supra note 5, pp. 168-169).

55. The replacement theory implies that an agent can conduct business to the same extent as the foreign enterprise itself. The fact that the agent acts as the replacement of the foreign enterprise is the key element of the agency PE concept. If an agent has the same competence or power as the foreign enterprise, there is no difference between the enterprise and the agent regarding the actual management or business operation. See Pleijser, supra note 43, pp. 26-27.

56. The Belgian Supreme Court (Hof van Cassatie) has repeatedly held that taxpayers have the right to choose the most tax-favourable option as long as they do not infringe any legal obligations and they accept all of the legal consequences of their contracts, even if their form is not the most common one.

57. OECD, “Transfer pricing Guidelines for Multinational Enterprises and Tax Administrations” (Paris: 22 July 2010), Chap. IX.
In the authors’ view, this reveals that for the time being, i.e. under the existing Art. 5(5) and (6) of the OECD Model, it should not be a concern that a commissioner arrangement would systematically be subject to PE taxation based on the concept of treaty abuse.

In concluding this section, the authors would like to draw the attention to Para. 1.65 of the 2010 OECD TP Guidelines, which provides for the following two particular circumstances in which the tax authorities could legitimately disregard the structure adopted by a taxpayer: (1) when the economic substance of a transaction differs from its form; and (2) when, despite the fact that the form and the substance of the transaction are the same, the arrangements in relation to the transaction differ from those that would have been adopted by independent enterprises acting in a commercially rational manner. This paragraph explicitly indicates that such reasoning can only be applied by the tax authorities in exceptional circumstances. In this respect, it should be noted that the OECD considers the conversion of a full-fledged distributor into a commissioner as a typical, i.e. normal, business restructuring.

7. Further Comments
The first issue to consider is that the Belgian ITC provides for the concept of a “Belgian Establishment” (BE) to indicate that a foreign enterprise has a taxable nexus with Belgium. Although the definition of a BE is very similar to that of a PE within the meaning of Art. 5 of the OECD Model, the concept of a BE under Belgian law is broader than that of a PE, so that any establishment that qualifies as a PE under the OECD Model should a fortiori be deemed to be a BE, but the reverse is not necessarily true. One of the situations in which the concept of a BE is undeniably broader, is the taxable presence an agent might give rise to. In contrast to the agency PE concept in the OECD Model, an agency BE can arise, even if the agent has no power to enter into contracts in the name of the foreign company. Consequently, it cannot be precluded that a commissioner, although only concluding contracts in its own name and not in the name of the principal, could constitute an agency BE under Belgian domestic tax law.

It should, however, be noted that the concept of a BE is only relevant in the absence of an applicable tax treaty. Given Belgium’s extensive treaty network (Belgium has tax treaties with approximately 90 states), the significance of the BE concept is, therefore, less important. Accordingly, Belgium may not levy taxes if a foreign company has a BE under Belgian domestic law, but does not have a PE under the relevant tax treaty.

Second, particular attention must be paid to the issue of private international law, i.e. which legal system should apply to determine whether or not there is an authority to conclude contracts binding on the principal? This issue was not discussed by the Conseil d’État in Zimmer. Nevertheless, it could have important implications. As noted in 3., common law countries do not recognize the difference between direct and indirect representation. Under a common law approach, there is binding representation when the agent acts within the scope of its authority, regardless of whether it acts as a disclosed or undisclosed agent. Consequently, when the commissioner’s activities are governed by common law, it cannot be excluded that the tax authorities and the courts of the commissioner’s country, even if this were a civil law country, could decide that the conditions of Art. 5(5) of the OECD Model are met. Obviously, this should be monitored closely when setting up a commissioner arrangement.

8. Conclusions
An associated company acting as a commissioner can only give rise to an agency PE if the conditions in Art. 5(5) of the OECD Model are met. In principle, a commissioner only has the authority to act “in its own name”. As the commissioner does not conclude contracts in the name of the foreign principal, it does not create a direct legal relationship between the principal and the third-party customer. Consequently, one of the constitutive conditions for the existence of an agency PE within the meaning of Art. 5(5) of the OECD Model is not satisfied.

The fact that the commissioner acts for the account of the foreign enterprise is not relevant to determine whether or not Art. 5(5) of the OECD Model applies. In this regard, only the legal consequences of the civil law qualification as direct representation (and not the economic reality) are important. The key question is whether or not the principal is bound by the contracts concluded for its account, quod non in the case of a commissioner agreement.

The Belgian tax authorities endorse this interpretation in their administrative commentary on tax treaties. As the commissioner acts in its own name, the following two agreements are concluded: (1) one between the principal and the commissioner; and (2) one between the commissioner and the third-party customer. As such, there is no direct contractual relationship between the principal and the third-party contractor. In accordance with the decision of the Conseil d’État in Zimmer, a civil law commissioner will, from a Belgian perspective, in principle not constitute an agency PE. This has been also explicitly confirmed by the Belgian Ruling Commission.

59. 2010 OECD TP Guidelines, supra note 57, Chap. IX, 237, No. 9.2.
60. Art. 229 ITC.
62. However, the foreign company will, in principle, be requested to submit a Belgian non-resident income tax return, which it can file on a ‘nihil’ basis by referring to Art. 23 of the applicable tax treaty.
However, the authors still would advise caution when implementing a commissionaire arrangement in practice. In order to support the position of the foreign principal/central entrepreneur, on the one hand, and to reduce any attempt by the Belgian tax authorities to argue for a taxable presence in Belgium, on the other, the authors strongly recommend:

- having the commissionaire agreement reviewed by a tax lawyer (to screen for anomalies and any ‘tax sensitive’ wording);
- ensuring that the spirit and/or text of the contract is in line with the reality (the facts should, therefore, perfectly link with the contractual terms and conditions);
- retaining remuneration for the commissionaire that is commensurate with the functions performed, the risks assumed and the assets used (preferably, such remuneration should be supported by an appropriate transfer pricing documentation); and
- providing for an appropriate termination indemnity in case of a conversion from a fully fledged distributor into a commissionaire arrangement.
The Indian Judicial System and Tax Disputes

In this article, the author provides an overview of the Indian judicial system with regard to tax cases. The article was originally written as a supplement to the IBFD's Tax Treaty Case Law Database and is intended to provide general information on the Indian judicial tax structure.

1. Legal Forms

1.1. Constitutional framework

India, the world's largest democracy, is a "Union of States" with a strong federal (central) government at the centre of affairs. The three aspects of the state – the legislature, the executive and the judiciary – have clearly defined powers and function within the ambit of a written Constitution. Whilst the functions of the legislature and the executive in several areas overlap, the judiciary, on the other hand, is permanent, independent and free from the other two pillars of the state.

1.2. Organization of the courts

1.2.1. In general

At the summit of the judiciary is the Supreme Court of India, which administers justice throughout India. The Supreme Court is based in India's capital, New Delhi, and comprises a Chief Justice and 30 associated judges. It has original, appellate and advisory jurisdiction. Original jurisdiction extends to any disputes between the government of India and the government of any province (state) or between the central government and the states or between two or more states relating to any question on which the existence or extent of a legal right depends. The President of India is also authorized to seek advice (an opinion) from the Supreme Court on any matter that is of public importance and on which it is considered expedient by the President to consult the Supreme Court.

1.2.2. The Supreme Court

The Supreme Court is empowered under Art. 32 of the Constitution to enforce the fundamental rights guaranteed under the Constitution. Under Art. 136 of the Constitution, the Supreme Court has the power to allow special leave to appeal against any judgement, determination or order of any court or tribunal in India. The Supreme Court may also transfer its jurisdiction any case, appeal or other proceedings pending before any High Court, as provided for under Art. 139A of the Constitution. Accordingly, the Supreme Court has the final say on every civil, criminal, constitutional, commercial or tax matter, or any matter of public importance. The Supreme Court has not only judicial, but also administrative control over all courts in India.

1.2.3. The High Courts

The judiciary in India is vertically integrated. Below the Supreme Court, and for (almost) each of the states, there is a High Court. The territorial jurisdiction of the High Courts is limited to a given state, but, in other respects, is as powerful as the Supreme Court. The High Courts are also courts of record like the Supreme Court. They are vested with original and appellate jurisdiction in almost all matters, possessing inherent and plenary powers. Unless expressly and impliedly barred, the High Courts have unlimited jurisdiction, including jurisdiction to determine their own power. The following observations from *Halsbury law of England* have been approvingly cited by the Supreme Court regarding the jurisdiction of the High Courts in India: "Prima facie, no matter is deemed to be beyond the jurisdiction of a superior Court unless it is expressly shown to be so."

Both the High Courts and the Supreme Court have the power of judicial review. This has been held to be "basic features of the Constitution" and, therefore, cannot be modified or taken away through ordinary legislation of Parliament.

1.2.4. District and session courts

At district level and below the High Courts, there are district and session courts, which, with the help of sub-judges, munsifs and magistrates, deal with the administration of civil, criminal and associated justice in every district in India. Civil claims or criminal trials are started in the district courts, and for (almost) each of the states, there is a High Court. The territorial jurisdiction of the High Courts is limited to a given state, but, in other respects, is as powerful as the Supreme Court. The High Courts are also courts of record like the Supreme Court. They are vested with original and appellate jurisdiction in almost all matters, possessing inherent and plenary powers. Unless expressly and impliedly barred, the High Courts have unlimited jurisdiction, including jurisdiction to determine their own power. The following observations from *Halsbury law of England* have been approvingly cited by the Supreme Court regarding the jurisdiction of the High Courts in India: "Prima facie, no matter is deemed to be beyond the jurisdiction of a superior Court unless it is expressly shown to be so."

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be made to the Supreme Court. The memorandum of appeal should state precisely the substantive question of law involved in the appeal. The administration of justice in India is governed by common law principles, as applies to all formerly UK-ruled countries. The same courts at all levels enforce both central (federal) and state laws without distinction.

2. The Administrative Phase

2.1. Tax assessments

In India, the Finance Ministry is the administrative authority in respect of the levying and collection of taxes, including income tax. The Indian Income Tax Act 1961 (the “Act”) provides the mechanism for imposing and collecting taxes. Every year, through the Finance Act, the Indian Parliament prescribes the rate of income tax payable by corporate and non-corporate taxpayers on the income for the year ending 31 March of that year.17

All taxpayers must self-assess and submit their returns by the date specified in the Act with the Assessing Officer (AO) who has territorial jurisdiction. Returns can be filed via the Internet. Small taxpayers with no “business” income are required to submit a simple one-page return.8 Corporations, multinational enterprises (MNEs) or taxpayers claiming special exemptions must support the return with audited accounts.9 Approximately 95% of returns are accepted without notice being sent to the taxpayer; only 5% to 6% of cases are selected for scrutiny on the basis of the government’s assessment policy. In these cases, a notice of deficiency is issued to the taxpayer.

2.2. Administrative appeals

The AO must make an assessment after providing a reasonable opportunity to the taxpayer of being heard and after due consideration of the principles of natural justice. Any material and/or evidence gathered by the AO from any source that is intended to be used against the taxpayer must be brought to the notice of the taxpayer, so that the taxpayer has a reasonable opportunity to clarify its view-point. There are several provisions in the Act under which the AO, before acting adversely in respect of a taxpayer, must obtain the approval of a superior officer for the proposed action.10

Any person aggrieved on account of an assessment may go in appeal before the Commissioner of Income Tax (Appeals) (CIT(A)) and state their grievances in the prescribed form. There is no statutory bar or restriction on the filing of an appeal. However, the income tax due per a return filed must be paid before an appeal can be registered.11 A nominal fee is charged for the appeal, varying from INR 250 to INR 1,000. The appeal must be made within 30 days of the receipt by the taxpayer of the notice of demand.12 The CIT(A) has the power to condone a delay in the filing of the appeal for any good or sufficient cause. The CIT(A) sits singly and has the power either to confirm, enhance, reject or annul an assessment, or allow partial or full relief. The CIT(A)’s power to set aside an assessment was removed with effect from 1 June 2001.13

2.3. Settlement Commission

Where a taxpayer initially did not disclose the correct income in his tax return, the taxpayer may approach the Settlement Commission with a full, true and complete disclosure of the relevant income and pay tax on the additional income disclosed. The Settlement Commission consists of senior and distinguished officers of the Revenue. The Commission has the power to settle the taxpayer’s income and to waive or reduce the penalty imposed on the taxpayer and grant the taxpayer immunity from prosecution.14

The approach of the taxpayer must be bona fide and an application for settlement, once made, cannot be withdrawn. All of the pending assessments of the taxpayer must be subject to the order of the Settlement Commission, whose decision is final. The Finance Ministry had found the working of the Settlement Commission to be slow and, therefore, introduced Sec. 245H of the Act, which provides for the abatement of all matters pending before the Settlement Commission on 31 March 2008. The application of this provision has been stayed by the higher courts and the Settlement Commission is still in operation. In this regard, it should be noted that, in the new Tax Code Bill 2010, which is pending before Parliament, there are provisions for the maintenance of the Settlement Commission.

3. The Tax Courts

3.1. Income Tax Appellate Tribunal

If the taxpayer is not satisfied with the order of the CIT(A), a second appeal may be filed with the Income Tax Appellate Tribunal (ITAT). The Revenue may also challenge the order of the CIT(A) in a second appeal before the ITAT. In addition, both parties may file cross-appeals.15 In practice, almost 30% of the appeals before the ITAT are made by the Revenue, which demonstrates that the first appellate authority acts in a fair, reasonable and independent manner. The ITAT is an independent tribunal over which neither the Revenue nor the Finance Ministry has any control. Appointments of members of the ITAT are made by a panel headed by a sitting judge of the Supreme Court. The ITAT follows a very simple procedure; no strict or technical rules of evidence or of procedure apply in the hearings before the Tribunal.

The ITAT adjudicates both on facts and on law. Its decision on facts is final, unless the decision can be shown to be invalid. Two members of a Tribunal constitute a Bench.
for the purpose of hearing and disposal of appeals. The President of the ITAT is authorized to constitute larger Benches of three or more members to hear on substantial matters. Hearings before the ITAT are primarily informal: the parties may appear themselves and argue their own case. The ITAT has 63 Benches, which are based all over India, and normally deals with 50,000 or more appeals annually. Any person aggrieved by the decision of the ITAT may file a further appeal to the High Court and ultimately to the Supreme Court, but only on a substantial question of law.16 The fees for filing of an appeal are nominal. All ITAT decisions must be supported by reasons.

3.2. The High Courts and the Supreme Court

Both in the High Courts and in the Supreme Court, tax appeals are heard by a Division Bench comprising two judges. Sometimes, three judges sit in tax appeals in the Supreme Court. The decision of two judges is binding3 if it related to a transaction or an issue designed to avoid tax. The AAR is required to pronounce its decision within six months of the filing of the application. The AARs decision is binding22 and has increased certainty in respect of the law for MNEs.

An alternative mechanism for resolving doubts and disputes which has grown in acceptance by foreign and MNEs in India is the Authority for Advance Ruling (AAR). The AAR is headed by a retired judge of the Supreme Court and has two other senior officers – one from the Law Ministry and the other from the Finance Ministry – as members. Any non-resident with doubts as to how provisions of a tax treaty or of domestic law should be applied to a transaction entered into with a resident may approach the AAR.

The issue on which the non-resident has doubts may be raised in the prescribed application form, accompanied by a fee of INR 2,500. The question raised should not be one pending in any proceedings before the tax authorities or before the ITAT. An application would also not be entertained if it related to a transaction or an issue designed to avoid tax. The AAR is required to pronounce its decision within six months of the filing of the application. The AARs decision is binding22 and has increased certainty in respect of the law for MNEs.

5.3. Writ jurisdiction

An important alternative mechanism that is very effectively used in India is the writ jurisdiction of the High Courts and the Supreme Court. Any person or party aggrieved on account of failure of a public authority to follow procedural or substantive statutory provisions, or on their taking unauthorized actions that violates the principles of natural justice or that are arbitrary or unjust or unfair, may challenge such actions by filing a writ of mandamus or similar writ before the High Court or the Supreme Court and ask for the appropriate relief if an ordinarily available remedy is ineffective.23 The success of such writs in India is quite high and there are several cases in which a reassessment notice, penalty notice, etc. have been directly challenged before courts.

The unique aspect of this procedure is that a party has the option, subject to the discretion of the Supreme Court, to approach the High Court under Art. 226, or the Supreme Court directly under Art. 32 or 136 of the Constitution. The Supreme Court has stated that, where such an option is exercised, this would not mean that the jurisdiction of the Supreme Court in an appeal preferred from the order of the High Court is any different from what it would have been had the taxpayer first approached

5. Other Forms of Tax Dispute Resolution

5.1. Introductory remarks

So far in this article, the ordinary or regular methods of resolving tax disputes have been considered. The law, however, also provides alternative and special mechanisms that can be used by taxpayers in specified circumstances.

5.2. The Authority for Advance Ruling

An alternative mechanism for resolving doubts and disputes which has grown in acceptance by foreign and MNEs in India is the Authority for Advance Ruling (AAR). The AAR is headed by a retired judge of the Supreme Court and has two other senior officers – one from the Law Ministry and the other from the Finance Ministry – as members. Any non-resident with doubts as to how provisions of a tax treaty or of domestic law should be applied to a transaction entered into with a resident may approach the AAR.

The issue on which the non-resident has doubts may be raised in the prescribed application form, accompanied by a fee of INR 2,500. The question raised should not be one pending in any proceedings before the tax authorities or before the ITAT. An application would also not be entertained if it related to a transaction or an issue designed to avoid tax. The AAR is required to pronounce its decision within six months of the filing of the application. The AARs decision is binding22 and has increased certainty in respect of the law for MNEs.

5.3. Writ jurisdiction

An important alternative mechanism that is very effectively used in India is the writ jurisdiction of the High Courts and the Supreme Court. Any person or party aggrieved on account of failure of a public authority to follow procedural or substantive statutory provisions, or on their taking unauthorized actions that violate the principles of natural justice or that are arbitrary or unjust or unfair, may challenge such actions by filing a writ of mandamus or similar writ before the High Court or the Supreme Court and ask for the appropriate relief if an ordinarily available remedy is ineffective.23 The success of such writs in India is quite high and there are several cases in which a reassessment notice, penalty notice, etc. have been directly challenged before courts.

The unique aspect of this procedure is that a party has the option, subject to the discretion of the Supreme Court, to approach the High Court under Art. 226, or the Supreme Court directly under Art. 32 or 136 of the Constitution. The Supreme Court has stated that, where such an option is exercised, this would not mean that the jurisdiction of the Supreme Court in an appeal preferred from the order of the High Court is any different from what it would have been had the taxpayer first approached
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the High Court under Art. 226 of the Constitution and then come up via an appeal to the Supreme Court under Art. 136. A party does not and cannot gain any advantage by approaching the Supreme Court directly under Art. 136 of the Constitution, instead of approaching the High Court under Art. 136. The scope of an enquiry in an appeal before the Supreme Court remains the same, i.e. whether the order impugned is contrary to any of the provisions of the statute or is bad on the grounds of bias, fraud, malice, etc., thereby prejudicing the petitioner and/or appellant.

5.4. Dispute resolution panel

The final alternative mechanism is the recently introduced dispute resolution panel (DRP). The DRP consists of a college of three Commissioners of Income Tax. Foreign companies, on receipt of a draft order of the AO, may challenge transfer pricing adjustments before the DRP, which must decide on the dispute within a specified time.24 If a taxpayer is not satisfied, a decision of the DRP may be challenged before the ITAT (before the AAR under the new Tax Code Bill 2010). If still not resolved satisfactorily, the matter may be appealed to the High Court and the Supreme Court.

6. Publication and Citation

Most of the decisions of the ITAT and all the decisions of the High Courts and the Supreme Court are available on the Internet.25 The decisions are also regularly published in journals. All India Report (AIR) is one of the oldest journals reporting decisions of the High Courts and the Supreme Court. It is cited as "(2010) Vol – Supreme Court – 1020", which means that a particular decision of the Supreme Court is available at page 1020. Supreme Court Cases (SCC) is another popular journal. Income Tax Reports (ITR) is another old journal exclusively publishing decisions relating to tax matters. Income Tax Decisions (ITD) has, since 1970, been the official journal of the ITAT. Taxmann and Tax Tribunal Judgments (TTJ) are some of the other well-known journals.

7. Conclusions

All of the authorities, administrative and judicial, and the courts in India attempt to make the procedural environment consistent, congenial and compliance-friendly. In this regard, the decisions of foreign courts are often cited and are considered with respect; they are applied if warranted by the facts and circumstances of the case.
The Pursuit of Harmonization Regarding Taxes on Death and the International Implications

The discussion on Subject 2 of the 64th IFA Congress regarding the tax issues arising on the death of an individual and the international implications revealed that the topic is more far reaching than expected. In this article, the author explores various issues that were not covered at the Congress.

1. Introduction

At the 2010 International Fiscal Association (IFA) annual congress held in Rome, Italy, from 29 August to 3 September, the topic of Subject 2 (the “Subject”), discussed on 31 August, was “Death as a taxable event and its international implications.” In this regard, the scope and range of the Subject proved to be very wide and extensive. Consequently, the author, who was the general reporter, in this article examines some of the important issues relating to the topic that could not be considered due to time constraints.

2. Pluralism of Succession Law: Federal versus Regional Rules

The author would like to start his consideration of the various topics that were not covered during the Subject by examining succession law and its influence on inheritance and estate taxation. In countries that are characterized by pluralism, the differences between local rules are generally limited to the procedures regarding the administration of estates, such as the appointment of a testamentary executor, so that substantive rules in respect of, for example, the validity of a will and the forced heirship rules are generally the same. Differences also arise due to the efforts of local legislators to coordinate and approximate their rules so as to ensure a uniform approach. (In Australia and the United States, this has included the development of model legislation, which, in the United States, has been adopted by 17 states.)

There are, however, some exceptions to this rule. In Spain, for example, local legislations differ with regard to the reserved portion of estates, although all the main principles and features of the rules are the same. A similar situation exists in the United Kingdom, which is characterized by the coexistence of the three separate legal systems of England and Wales, Scotland, and Northern Ireland, which are structurally different, so that the substantive rules vary to a great extent, especially in relation to the scope of the spouses’ and issue’s legal rights. This is also the case in the United States, but, there, is limited to the laws of the State of Louisiana, which follows the civil law system and, for example, therefore, provides for forced heirship rules in respect of persons other than spouses that are traditionally absent in the common law rules of the other States of the Union. In Canada, Quebec, unlike the other provinces, follows the civil law system, although the local legislation was amended in 1981 to depart partially from the civil law tradition, thereby abolishing the forced heirship rules.

The pluralistic structure of the private law regimes in the same legal system is relevant for tax purposes, as the tax consequences of the death of a person rely on the legal effects as governed by succession law. Accordingly, several private law rules in the same country may determine a different application of the same tax, depending on the relevant law governing the succession. In this regard, the uniform application of federal taxes is a constitutionally protected principle in the United States. However, the US Supreme Court has held that, in the absence of overriding federal legislation, the principle should be observed, even though variations in state law result in differences in tax consequences between the states. No other pluralistic countries reported that similar issues have arisen in their constitutional case law.

A local private law regime is a “way of being” of a person that gives rise to consistency with regard to the general principle of equality. For this reason, discrimination is rarely found, or argued, when, by virtue of differences in local private law regimes, taxation is not applied consistently to persons who are nationals or residents of the same country.

3. The Consequences of Death and Prolonged Absence

Again with regard to succession law and its tax implications, all countries have rules dealing with the consequences of death and situations in which the prolonged absence of a person may result in a presumption of death and a judicial declaration that results in the application

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1. The panel members consisted of Leigh-Alexandra Basha (United States, Partner, Holland & Knight), Catherine Brown (Canada, Professor, Faculty of Law, University of Calgary), Christian Comolet-Tirman (France, Director for European and International Affairs, Tax Policy Directorate, Ministry of Economy, Finance and Industry), Rik Dellaloue (Belgium, Tax Partner, Altius/Tiberghien) and Jorge Gebhardt (Argentina, Partner, Ernst & Young). Subject 2 was chaired by Frans Sonneveldt (the Netherlands) with the help of Nicola Saccardo (Italy) as panel secretary. The general reporter was Guglielmo Maisto (Italy).

of private law rules of succession. Conditions differ, but generally a prolonged absence is required (six months to three years in Ukraine, one to five years in Finland and the Netherlands, two years in Mexico and Peru, four or six years in Uruguay, five years in Switzerland, five or ten years in Portugal depending on the age of the person, and ten years in Brazil), ascertained through judicial review.

Tax laws rely on the legal characterization of death, possibly with the exception of Chile, which has a tax fiction whereby the decease of the person is disregarded until three years after the time of decease, or the acquisition of the estate assets by the heirs, whichever occurs first. Discrepancies in the private law meaning of death may, therefore, give rise to tax issues in cross-border situations. For instance, if a person is regarded to have passed away under the rules of the state of residence, but not the rules of the state of source, income may be attributed to the heirs in one state, but not in the other. The distortion is only apparent when the conflict of private law rules means that only one law applies to the status of the person, so that the source state recognizes foreign law as the law governing the succession. This is also true for any subsequent reappearance of the person whose death had been previously declared. Whilst a conflict of law rules should result in only one law applying to the situation, tax rules may provide different regimes and limit the redetermination of the taxes previously paid on the assumption of death.

4. Tax Policy Trends

Notwithstanding the limited amount of the revenue raised by taxes on death, which is barely more than 1% of total tax receipts, states continue to amend their domestic rules and debate on possible reforms. Discussion also focuses on whether or not inheritance tax is preferable to an estate tax. A recent study in South Africa supports the preference for an estate tax, which is less complex to administer, as it involves fewer persons.

In almost all of the countries that have inheritance or estate taxes and wish to preserve them, there is a tendency to consider a reduction in, or exemption of, tax in respect of transfers to close relatives of the deceased person (for example, France and Poland in 2007, Finland in 2008, Germany in 2009, the Netherlands in 2010, and generally the communities in Spain and many cantons in Switzerland), or to make the payment of the tax subject to realization so as to eliminate the issue of the heirs being forced to sell assets forming part of the estate to finance the payment of tax. These discussions are also common in some countries (for example, Sweden) that have abolished inheritance tax, but are considering its possible reintroduction and are, therefore, trying to eliminate the disadvantages that had led to the repeal. (In Sweden, political parties have proposed adopting an estate tax, which is regarded as easier to administer, and to exempt transfers to the surviving spouse or partner.)

It should be noted that countries that levy and collect inheritance taxes at a local rather than a federal level are, in general, not considering the repeal of these taxes, as

the revenue that might otherwise be regarded negligible if the taxes were to be levied by a federal government is an essential source for local public expenditure. Accordingly, most changes are intended to grant exemptions or deductions to certain close relatives of the deceased, such as the spouse of the deceased person (for example, as in Spain). These changes are to some extent influenced by the competition amongst regions in attracting residents. (This is the case in Belgium, where the changes made to inheritance tax in the Flanders region in 1996 have resulted in the other regions following with similar reforms.) However, in countries that levy inheritance tax at a local level, the replacement of the local inheritance tax with a federal tax has been the subject of some discussion and has been justified as a more equitable solution to avoid the situation that residents of the same state are subject to different tax regimes.

5. Transfers of Family-Owned and Closely Held Businesses

Several countries grant exemptions or special reliefs to mortis causa transfers of family-owned and closely held businesses. Such rules express the clear legislative intent that taxes should not have an adverse effect on the continuity of business across generations. This policy is also reflected in the Commission’s Recommendations and Communications of 1994 and 2006, which recommend that the Member States should amend internal laws to eliminate tax obstacles to a mortis causa transfer of a business within the same family. Domestic laws, however, vary greatly and require action at an EU level (see 8.).

In some countries, the exemption is limited to the transfer of a business conducted directly by the deceased as a sole entrepreneur. In other jurisdictions, the scope of the exemption is extended to majority stakes in a company carrying on an active business. Lower thresholds are established by the internal laws of Finland, France and Germany. It is desirable that the exemptions or other reliefs do not require that the estate consists of a majority shareholding, as such a restriction could impair the continuity of the business. This is the case when a deceased person owned a minority stake and the remainder of the share capital was already in the hands of the relatives or when the company ownership included third parties. Accordingly, the inability to obtain relief and the concurrent obligation of the heirs to pay the inheritance tax would, in any event, reduce the capital available for reinvestment or force the family of the deceased person to sell their participation. Such a situation would give rise to a strong impediment to the continuity of the carrying-on of the business by the heirs.


Some countries grant relief only to participations in holding companies that have substantial participations in a company carrying on a business, so that the purpose of the relief is, in practice, frustrated. In Poland, for example, the exemption is restricted to farm activities.

Exemption is generally available only to the spouse or children or close relatives of the deceased and is contingent on the beneficiary carrying on the business activity or holding the participation for a determined period. Conditions are sometimes stringent and may considerably affect the efficacy of the relief. For instance, in some Belgian regions, not only must the business continue for at least five years, but also the level of employment and capital structure cannot fall below specified thresholds. These conditions, except for those in relation to the capital structure of the company, must also be met for five years in Germany. In most countries, recapture rules apply unconditionally, so that, on the one hand, the beneficiaries cannot demonstrate that the failure to meet the requirements was not due to abusive conduct and, on the other, that there is no graduation of the recapture (for example, situations in which the condition was not met for a short time over a long period). It would, therefore, be desirable to adjust such legislative provisions by taking into account that, over a long period, a decline in employment or changes to the capital structure of the entrepreneurial activities are the result of changes in the trends of the business sector.

Exemptions for family-owned businesses also exist outside the European Union and sometimes provide restrictions that may impair free movement of persons. In Switzerland, for example, some cantons make the exemption contingent on the beneficiary being a resident of the canton and maintaining executive responsibility in respect of the company whose shares are transferred as a result of the succession.

6. The 1982 OECD Estate, Inheritance and Gift Model Convention

6.1. Art. 2 (Taxes covered)

Issues have arisen in respect of the application of Art. 2(2) of the 1982 OECD Estate, Inheritance and Gift Model Convention (the "1982 OECD Estate, Inheritance and Gift Model") regarding the meaning of the term "taxes imposed ... on the corpus of the estate, of taxes on inheritances, of transfer duties, or of taxes on donations mortis causa". The provision requires the assessment of the nature of the tax not only with primary reference to the taxable event, but also considering the determination of the taxable base and the timing of taxation. For instance, the circumstances that the death of a taxpayer is the basis for assessing the tax does not make it automatically similar to an inheritance or estate tax. Indeed, taxes exist that apply on the death of a person the purpose of which differs from thecircumvention of the enrichment of the heirs, which apparently denotes an inheritance tax, or the transfer of the estate, which arguably denotes an estate tax. This is the main reason why capital gains taxes levied on death are not covered by Art. 2(2) of the 1982 OECD Estate, Inheritance and Gift Model.

Such a conclusion is also supported by considering the taxable base, which is the gain accrued on death and not the value of the estate that is being transferred. In this regard, the decision of the US Tax Court in Estate of Claire M. Ballard v. Commissioner is relevant. Specifically, the US Tax Court found the then existing Canadian capital gains tax levied on death to be ineligible for a credit against the US estate tax under both the (then existing) 1961 Canada–United States inheritance tax treaty and US domestic law. This conclusion is not relevant in countries (for example, Germany and the United Kingdom) that extend unilateral relief to capital gains levied on the occasion of death in place of inheritance or estate taxes.

Bilateral tax treaties sometimes clarify the scope of the application of taxes covered. This is, for example, the case for some tax treaties concluded by the United States that expressly include the generation-skipping tax in the "taxes covered" provision. In this respect, see the tax treaties concluded by the United States with Austria, Denmark, France, Germany and the United Kingdom.

Ad valorem charges levied as compensation for the provision of public services, such as the probate fees that exist in Canada or the state fees in Estonia, are not covered. This is because such taxes are neither based on the enrichment of the heirs nor on the transfer of property.

A special issue arises in respect of Austria with regard to the land transfer tax and the foundation entrance tax that apply on the mortis causa transfer to a foundation and may, therefore, be regarded as a tax "imposed by reason of death in the form of taxes on the corpus of the estate ..." and, in particular, 'donations mortis causa'. This conclusion should also apply to tax treaties that follow the 1966 OECD Estate and Inheritance Model Convention (the "1966 OECD Estate and Inheritance Model"), which applies to taxes levied "on the occasion of death".

Under the 1982 OECD Estate, Inheritance and Gift Model, transfer taxes that apply on any transfer of property (whether inter vivos or mortis causa) are not "similar" to inheritance or estate taxes. They apply to the value of the property and not exclusively on death, as the fundamentals of the tax are neither the enrichment nor the transfer of the property on decease.

The 1982 OECD Estate, Inheritance and Gift Model provides for a different scope of application of the "taxes covered" provision compared to the 1966 OECD Estate and Inheritance Model. Specifically, taxes imposed "by reason of death form a narrower definition than taxes imposed "on the occasion of death", as the latter expression also includes taxes in respect of which the death of the person is not the only reason for the taxable event to occur. In
this regard, registration taxes levied on the transfer of property are imposed 'on the occasion' of the death, but not by reason of death, as death is not part of the taxable event, which occurs in the event of any transfer. In addition, Art. 2(4) has a different scope in the 1982 OECD Estate, Inheritance and Gift Model compared to the 1966 OECD Estate and Inheritance Model, which applied only to 'taxes on estate or inheritance ... imposed in addition to, or in place of, the existing taxes', whilst the 1982 Model also applies to 'substantially similar' levies.

6.2. Art. 4 (Fiscal domicile)

Art. 4(1) of the 1982 OECD Estate, Inheritance and Gift Model excludes treaty residence if the domestic law of the contracting state exercises its taxing rights on persons who, although not 'domiciled in a Contracting State', are considered to be residents of that state only 'in respect of property situated therein'. The provision is modelled on Art. 4 of the OECD Model Tax Convention (the "OECD Model"), which was added in 1977. The test must be made in accordance with the domestic law of that contracting state, so that a person would be treaty resident if the foreign-situs property were taxable under the law of residence of that state, notwithstanding the fact that the property was exempt from such tax pursuant to the tax treaty.

Para. 8 of the Commentary on Art. 4 of the OECD Model states that the exclusion from residence is intended to deal with foreign diplomatic and consular staff, but that the exclusion is not meant to apply to countries that adopt a territorial principle in their taxation system. The same conclusion is true for Art. 4(1) of the 1982 OECD Estate, Inheritance and Gift Model, which expressly states that the amendments to the 1966 OECD Estate and Inheritance Model were made to adapt the 1982 Model to the 1977 OECD Model. Consequently, the Commentary on the 1977 OECD Model dealing with these changes was intended to have been implicitly incorporated into the Commentary on the 1982 OECD Estate, Inheritance and Gift Model. This would, however, not prevent the application of an inheritance tax treaty to taxable persons who, under the domestic law of a contracting state, are subject to tax only on assets situated in the territory of that state.

6.3. Art. 16 (Termination)

In some countries, where the treaty regime is the result of the application of the reciprocity principle, the abolition of the tax by the other contracting state would necessitate termination, as the legal constitutional basis for concluding the tax treaty and restricting the power to tax would no longer exist. Such is the situation in Greece, but other countries could face a similar issue. This is because such countries could, in these circumstances, no longer comply with the observance of the ability-to-pay principle and justify an alleviation of taxation on non-residents derived from the wish to obtain a similar alleviation in the other state. Certain tax treaties that depart from the 1982 OECD Estate, Inheritance and Gift Model provide for the non-application of the treaty taxing provisions in the event that the deceased is not subject to tax according to domestic law of the state of residence (for example, the Italy–United Kingdom inheritance tax treaty).

Tax treaties adopting provisions based on Art. 4(1) of the OECD Model would, if any event, prevent the application of a tax treaty based on the 1982 OECD Estate, Inheritance and Gift Model, which requires a person domiciled in a Contracting State' to be liable to tax therein, with the exception of provisions that apply regardless of residence, such as nationality non-discrimination. For tax treaties not following the 1982 OECD Estate, Inheritance and Gift Model, special issues may arise if they also cover inheritance taxes and gift taxes or income taxes, in which case issues of the partial termination of the tax treaty would arise. This may suggest that special provisions should be included in such tax treaties.

6.4. Simultaneous application of two tax treaties

Are there situations in which two treaties could apply simultaneously? This may arise in practice between countries in respect of which the death of a person is a taxable event for estate or inheritance tax purposes and for income tax purposes, respectively. This is the case, for example, with the United Kingdom, which applies an estate tax, and South Africa, which regards death as a taxable event for income tax purposes. Accordingly, if a UK-domiciled person receives South African-situs property, not only would South African estate tax not give rise to double taxation in respect of the property under Art. 5 of the South Africa–United Kingdom inheritance tax treaty, but double taxation in respect of income tax under the South Africa–United Kingdom income tax treaty would also be avoided.

7. Tax Immunities and International Organizations

The state or political subdivisions, such as regions or communes, are exempt from taxation in certain countries under review. For instance, the United States exempts transfers to foreign governmental bodies, provided that the property is used for charitable purposes that are specified in a will. In other countries, the customary international law principle of tax immunity makes transfers to foreign states eligible for exemption, but the extension to international organizations relies on the international agreements establishing the organization to provide for exemption from taxes, including inheritance tax, with regard to the organization or its employees.

Non-tax treaties occasionally deal with taxation on the death of individuals. The most significant examples are the provisions in the Vienna Conventions on Diplomatic (1961) and Consular Relations (1964) and specific bilateral conventions dealing with the same subject. These provide for exemption from inheritance tax in respect of the estates of diplomatic and consular personnel that is limited to movable property, the presence of which in the receiving state was due only to the presence there of the
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deceased as a member of the mission or the family of a member of the mission.8

Treaties establishing international organizations also contain tax exemptions for personnel, but do not generally apply to inheritance taxes. A notable exception is Art. 14 of Protocol No. 7 on the Privileges and Immunities of the European Union. This states that, in applying income tax, wealth tax and death duties, officials and other servants of the European Union who only for the reason of the performance of their duties establish their residence in the territory of a Member State other than their country of domicile for tax purposes at the time of entering the service of the European Union shall be considered both in the country of their actual residence and in the country of domicile for tax purposes as having maintained their domicile in the latter country provided that it is a member of the Union.9

The same provision stipulates an exemption from death duties in respect of that movable property situated in the territory in which such individuals reside. The Convention on the Privileges and Immunities of the United Nations provides for an income tax exemption on salaries and emoluments paid by the United Nations, but no reference is made to death duties. (This Convention, however, contains certain general provisions disregarding the presence in a state in respect of discharge of duties for determining tax residence.)

Treaties concluded by an international organization and the country of its establishment may also contain special rules. This is the case, for example, in respect of the treaty concluded by France with UNESCO in 1947.

Exemptions may also exist with regard to the organization itself, which may be the beneficiary of assets in respect of a succession. Disregarding the debate on the extension to international organizations of the immunities, including tax immunities, enjoyed by sovereign states, it is doubtful that, in the absence of a specific provision in the treaty establishing the organization, such exemption could apply to inheritance tax, as immunity in respect of an international organization relies on the requirement to avoid creating an impediment to its functioning and not on the principle of equality that governs immunity of sovereign states.

A survey of the various treaties establishing international organizations indicates a lack of consistency between the treaties in dealing with tax privileges. This suggests that harmonization is necessary and that such harmonization should be undertaken by the tax community. (In this regard, a similar effort should be made by the OECD in respect of the exemptions for diplomatic and consular officers within the context of the revision of Art. 13 of the 1982 OECD Estate, Inheritance and Gift Model.)

Finally, some countries have included provisions dealing with death taxes in their treaties with the Catholic Church. An example of this is Art. 26 of the convention concluded by Portugal with the Catholic Church (Concordata) of 18 May 2004.

The treaties in respect of international organizations reveal remarkable discrepancies, but it is acknowledged that harmonization is not possible. This is because such harmonization would require revision of the international multilateral rules and there is no international forum that may undertake this work, with the exception of the International Law Commission of the United Nations (ILC), which deals with international organizations but is limited to the issue of their responsibilities9 and state immunities.10 Perhaps harmonization could be realized through a model domestic tax law provision governing the immunities of foreign organizations and their officials.

8. EU Law

8.1. Commission public consultation paper

In June 2010, the Commission published a public consultation paper entitled "Possible approaches to tackling cross-border inheritance tax obstacles within the EU".11 In the public consultation paper, the Commission identified the following three possible solutions: (1) completing the network of bilateral tax treaties on inheritance tax between Member States; (2) including inheritance tax rules within the scope of income tax treaties; and (3) adopting domestic mechanisms to eliminate double taxation in cross-border situations when domestic relief was not granted.

With regard to option (1), completing the network of inheritance tax treaties does not appear to be a viable solution, as the effort required by Member States would be disproportionate to the tax revenue covered by such bilateral tax treaties. In respect of option (2), including inheritance amongst the taxes covered by income tax treaties is equally undesirable. The renegotiation of tax treaties takes more than 15 years on average, so that the bilateral solution would not be effective in the medium term. The author has more sympathy with option (3), i.e. the concept of unilateral relief, but the efforts should not be confined, as the Commission appears to suggest, to situations in which domestic relief is not granted. Accordingly, the Member States should be encouraged to revisit their current unilateral relief mechanisms, which experience reveals are inadequate to avoid double taxation. In general, domestic unilateral relief provisions on income taxes are more detailed compared to unilateral relief provisions in respect of inheritance tax and countries that have adopted comprehensive mechanisms to avoid double taxation on inheritance are less exposed to criticism on

8. Art. 39 of the Vienna Convention on Diplomatic Relations and Art. 51 of the Vienna Convention on Consular Relations, respectively.


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the inability to alleviate the tax burden arising on a cross-border succession.

It has been argued that Member States have no incentive to refine their unilateral relief mechanism, which would give rise to a loss of revenue by virtue of the exempting or crediting of foreign taxes. This is a disincentive which in the income tax context is offset by the desire to promote foreign investment. It could, however, be possible to adopt unilateral relief provisions that are subject to reciprocity, as was the case in the early 20th century when states wanted to eliminate unilaterally double taxation on shipping income. Such a solution, based on reciprocity, would result in a Member State providing relief to residents of certain Member States, whilst denying the same to residents of other Member States. The differentiation between non-resident persons would be tantamount to horizontal discrimination, which is currently not forbidden in the case law of the Court of Justice of the European Union. A model unilateral relief provision could, therefore, be drafted and promoted by the Commission.

Alternatively, the Member States could focus on administrative guidance on existing unilateral relief, thereby resolving issues of double taxation with no recourse to legislative changes. The rather generic and rudimental structure of current unilateral relief provisions in several Member States permit administrative guidance so as to eliminate issues of interpretation and permit the more effective application of either credit or exemption. In a few Member States, it is the administrative practice that, in the absence of statute, provides for the crediting of foreign local taxes or that defines the situs of assets and other similar fundamental facets of relief. A good example is Finland, where the tax authorities issued guidelines in March 2010 that deal with several issues on inheritance tax with special reference to its international implications. This administrative guidance addressed, inter alia, the definition of residence for inheritance tax purposes, the crediting of foreign taxes and the effect of tax treaties.

Some comments submitted to the Commission advocate that common rules on the tax nexus and/or the definition of "residence" or "domicile" should be adopted by the Member States. Such proposals are unlikely to be pursued successfully, as they would either impinge on the core of the principle of territoriality as governed by domestic tax law or on concepts, such as residence and domicile, that are based on the historical legal traditions of the Member States, which would increase the resistance to legislative changes.

8.2. Action on specific issues

The list of alleged violations at the level of EU law is significant and has implications that may require selective action. For instance, in some Member States, assets that have been temporarily imported in the Member State retain their extraterritorial character exclusively for customs duties purposes. This means that assets are temporarily transferred from another Member State as domestic-situs assets and are, therefore, subject to inheritance tax. The adverse effects on the Single Market are self-evident and are especially evident if the loaning of works of art for temporary display at museum exhibitions and other cultural events is considered.

8.3. Cross-border succession: income tax issues

Violations of EU law may also relate to income taxes. A good example is the rule in some Member States according to which the transfer of certain inherited assets may give rise to income taxation on the unrealized capital gain. This could be the case in Estonia, where the transfer of certain immovable properties located in Estonia is taxed only if the property is transferred to a non-resident. As this represents investment in real property that is covered by the free movement of capital, such legislation could be considered to be contrary to EU law. Similarly, the Luxembourg rules that provide for the taxation of gains accrued to substantial participations in resident companies exclusively if the beneficiary is a non-resident is contrary to EU law. (Austria has a similar provision that does not apply to residents of the European Union and the European Economic Area (EEA), but the restriction of its application does not eliminate a violation of the free movement of capital if the beneficiary is a resident of other countries and the gain is related to an asset that may fall within the scope of this freedom.)

9. The European Court of Human Rights

The European Court of Human Rights (ECHR) has considered the compatibility of certain domestic tax provisions relating to inheritance tax with the Convention for the Protection of Human Rights and Fundamental Freedoms (the "Convention"). In particular, the ECHR has stated that a violation of the Convention occurs when "criminal charges", as defined in Art. 6 (a meaning wider than that commonly intended as a criminal charge and which is can include certain administrative penalties), are applied to the heirs in respect of tax violations attributable to the deceased person.13

The ECHR has also stated that a violation of the Convention – in particular, of Art. 14 taken in conjunction with Art. 1 of Protocol No. 1 regarding the enjoyment of possessions and discrimination – does not arise when unmarried sisters living together in a stable, committed and mutually supported relationship are treated differently from an inheritance tax viewpoint to married couples or cohabitants.14 This is, however, a highly controversial subject, as the several dissenting opinions to the judgement clearly indicate.

10. Conclusions

The survey of the country reports reveals a striking lack of harmonization in respect of the domestic tax rules regarding inheritance and estate taxes. Such rules were often drafted long ago and, for this reason, little attention was paid to the international tax implications of the decease of an individual. This is echoed by the several provisions that contain absolute presumptions of law, which, in the international context, give rise to double taxation and to the significant discrepancies in the rules regarding the territorial nexus.

The situation is no better in the treaty context, as tax treaties are limited in number and there is no expectation that states will invest time on the topic and make efforts to improve the treaty network in the future. Revisiting the 1982 OECD Estate, Inheritance and Gift Model is unrealistic, as the small amount of revenue generated by inheritance and estate taxes is a disincentive for states to invest time and effort in concluding tax treaties on this subject. For this reason, it could be argued that it is desirable to amend the OECD Model and include in it some provisions dealing with inheritance and estate taxes.

With regard to the income tax issues arising from the death of a person, only a few countries have specific rules dealing with such matters. Generally, this is the case for countries that regard decease to be a taxable event. In the treaty context, there is no need to amend the OECD Model, as most issues could be dealt with through the Commentaries and the OECD could consider drafting a report specifically on the income tax issues arising from the death of an individual. An international forum on the revision of inheritance tax rules regarding international organizations and their officials could also be considered.

Finally, within the context of the European Union, the country survey reveals a challenging task for the EU institutions. As a conclusion to this article, it should be noted that a way forward may be found in the Commission’s public consultation paper on this topic.
The Common Consolidated Corporate Tax Base: A Desirable Alternative to a Flat EU Corporate Income Tax?

In this article, the author considers the most relevant alternative to an EU corporate income tax, the Common Consolidated Corporate Tax Base (CCCTB). Specifically, he examines the theory and practicalities regarding the CCCTB, and other options that could resolve the problems encountered by companies doing business in the European Union.

1. The Internal Market and Taxation

1.1. Introductory remarks

A flat EU corporate income tax levied by the Commission would appear to be out of place in this day and age. This article, therefore, considers the most relevant alternative to such a tax: the Common Consolidated Corporate Tax Base (CCCTB). The CCCTB should make companies in the European Union more competitive in the global market. The first question that arises is whether or not businesses really need this. Such a system would drastically change the tax regimes in the Member States, so there would have to be good reasons for doing this. Companies in the European Union, in general, and in the Netherlands, in particular, are faced with too many restrictions to be able to operate as freely as companies in Japan or the United States. Tax boundaries play a major role in this. Whether operating within the European Union (and thereby competing with Japanese or US companies) or competing outside the European Union, in both cases, EU-based companies are prejudiced by the lack of economies of scale.

What causes this economic disadvantage with its tax background? The separate-accounting allocation method, which is generally accepted in tax circles, is one of the major elements of this issue. Separate accounting is the rationale behind the system of determining mutual tax positions on an arm’s length basis in situations of affiliation. Obviously, such a system is also the standard for the allocation of profits within a group in the European Union. The application of this system precludes horizontal loss compensation and results in exit taxes, transfer pricing issues, interest deduction limitations, etc. Two conceivable alternatives are available to circumvent all of these issues. The first is the harmonization of corporate income tax and its imposition by the European Union, thereby resulting in the disadvantage that the Member States are completely disregarded in terms of the levying of corporate income tax. For the time being, this is clearly a bridge too far. The second alternative is the CCCTB, which harmonizes the tax base. The Member States would still play a role, as they could levy taxes at the rates prevailing in their jurisdictions. In both cases, tax boundaries would be removed, thereby making the presence of 27 independent Member States less of a disadvantage to the business community.

Another advantage of the CCCTB is that it could be applied optionally by companies that believe they could benefit from the regime. For these companies, the system of separate accounting would be replaced by a system of formula apportionment. Under this system, the profits of all of the EU companies of a group would be determined as if it were a single enterprise. Next, an established allocation key would be used to distribute these profits among the various Member States in which this group is active. In this regard, it should be noted that the system of separate accounting is, in itself, not why EU companies fail to benefit from economies of scale, but, rather, this is the result of the borders and the differences in tax regimes. The CCCTB would be a less drastic solution to a range of issues than a flat EU corporate income tax. And although such a new system would obviously give rise to
many new obstacles for the Member States, it would be a preferable alternative for many multinational enterprises (MNEs). In this article, the author, therefore, raises the question of whether or not the CCCTB is a valuable alternative to a flat corporate income tax at an EU level and how this system would comply with the *acquis communautaire*.

### 1.2. What is status of the CCCTB in 2011?

Currently, developments regarding the CCCTB are limited. The subject is somewhat controversial and not very well received in some Member States, such as Ireland. Following the debate on the EU Constitution and an unprecedented financial crisis, it is also wise, politically, to take minimal action for a while. After all, the CCCTB is a system that affects the Member States financially. On top of this, a number of technical issues would have to be resolved. The author does not have space in this article to describe all of the particulars of the introduction of the CCCTB. Yet, the author would like to share the following example with the reader.

**Example**

The EU group of a US group applies the CCCTB. As a result, the profits in the Member State where the holding is established are higher under the CCCTB than under separate accounting. Can the US holding company settle the higher corporate income tax under the CCCTB in the United States or only the corporate income tax that would be due under separate accounting?

The example reveals the complexity of the issue. As hard as it is for both lawyers and economists, regrettably it is even more difficult politically. A number of Member States are proclaimed CCCTB opponents. For this reason, the Commission decided in 2008 to postpone further steps until Ireland had signed the Lisbon Treaty. Some Member States are opposed to CCCTB, but participate in the working groups. The main reason for opposing the CCCTB is the fear that the Member States would forfeit part of their tax revenues.

Another much-heard argument is that the CCCTB is the first step towards full harmonization, with the harmonization and revenue division decisions being taken at an EU level. A further anxiety concerns the suppression of tax competition. Fear is a bad counsellor, but the Member States clearly still need much clarity and certainty on these points.

What can be regarded as a practical problem is that, in all of the Member States where a CCCTB enterprise has its primary establishment, a secondary tax system would exist alongside the national system. This would obviously be difficult, but, with only a limited group of companies opting for this system, the author believes the problem would not be insurmountable. The ensuing consequences are at any rate minor compared to those of home state taxation. This system would permit relatively small companies with cross-border activities to opt for paying taxes in the respective foreign Member State based on the tax regime of the home state. In this regard, Vermeend, Van der Ploeg and Timmer recently addressed the issue of the CCCTB. In their book, they point out that the administrative advantages of the CCCTB are being exaggerated. In their words:

> Competitive economies need a tax system that is flexible and can rapidly adapt in response to changing conditions on world markets. Since changing the CCCTB would in principle require the approval of all 27 member states, any changes to the system in the near future are close to impossible. The author does not believe this last statement holds true. Realization of the CCCTB would certainly take a substantial effort, but once the system is in place, the Member States could more easily apply the necessary changes (for example, as another economic crisis would cause companies to want extensive loss relief facilities) because these would be in the interest of all Member States who have MNEs within their borders. Perhaps it would not always be easy in such a situation, but the author does not believe it would be "close to impossible." In this respect, the authors in question also state: "the system could therefore drive investment out of the EU to jurisdictions with more flexible and competitive tax systems."

The author is not really convinced of this. First, MNEs would not have to opt for the CCCTB. If they did, the system would, in principle, apply for at least five years and obviously a company would only opt for the system if it thought that it was more beneficial. After five years, the enterprise would not disappear into other regions just like that. If the CCCTB system were disadvantageous, it would appear to be more logical for the company to revert to separate accounting. On top of this, it should not be forgotten that companies that would use the CCCTB would primarily be active in the manufacturing industry, research or trade. Such companies cannot that easily be relocated to other regions in the world. Pure capital companies may disappear to another continent without further ado, but the author does not envisage a company such as Shell leaving the European Union just like that.

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8. The last official “activity” sponsored by the European Commission was a workshop held on 20 October 2010. In this respect, see [http://ec.europa.eu/taxation_customs/taxation/company_tax/common_taxx_base/ccctb_en.htm](http://ec.europa.eu/taxation_customs/taxation/company_tax/common_taxx_base/ccctb_en.htm).

9. At the time of the writing of this article, a draft directive was awaited, which was expected to have been published at the beginning of 2011.

10. The Czech Republic, Estonia, Ireland, the Slovak Republic and the United Kingdom, and also Malta.


12. The UK Paymaster-General Dawn Primarolo confirmed this in the House of Commons on 28 June 2006.

13. Example apportionment mostly is the arena of economists who try to find out the most reasonable formulae and starting points so as not to short-change any state. States, for example, where much traditional labour is used rate the factor of labour very highly.

14. Formula apportionment mostly is the arena of economists who try to find out the most reasonable formulae and starting points so as not to short-change any state. States, for example, where much traditional labour is used rate the factor of labour very highly.

15. This is remarkable, as many Member States disapprove of tax competition between civilized states.

16. This is a random example, but the author would also like to refer to the explicit view of T. Keijzer (Vice-president Tax Policy within Shell) as expressed, inter alia, in the *Confédération Fiscale Européenne Newsletter* (May 2010), p. 3.
Finally, the author would argue that the Member States should wonder why there is a need to implement a system such as the CCCTB in those areas where the business community believes this should be done. Companies do not want the full harmonization of taxation. Differences in tax systems result from variances in social-demographic infrastructures in the various Member States. Such differences justify differences in taxation.

Without tax competition and with a fully harmonized EU corporate income tax rate, companies would not be eager to invest in, for example, Greece or Portugal. After all, such companies would incur high infrastructural costs in so doing for which the tax system would not provide compensation. Companies are also aware of their roles in society. They are willing to pay taxes and use of the CCCTB would, therefore, not be intended to save taxes. All companies want is to avoid high costs for complying with their various tax liabilities within the separate Member States. For example, all kinds of functional and economic analyses are required in determining the transfer pricing system, whereas companies want to be able to set off profits and losses realized in different Member States. All of these are valid arguments for improving companies’ financial situation, so as to be able to compete properly with other companies, including those in Japan and the United States.

But for the time being, things appear to be in the doldrums at an EU level. The period introduced in the past to wait for an Irish ‘yes’ to the EU Constitution has long been exceeded. The EC Treaty and the EU Treaty have now been fully renewed and replaced by the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU). Luckily, in the author’s opinion, the new Lithuanian member of the Commission, Algirdas Semeta, is a convinced advocate of the CCCTB. It is to be hoped that the Commissioner will be able to find at least nine Member States agreeing with him that the European Union should take this important step.

2. EU Strategy and the CCCTB

The CCCTB is a revolutionary system within the European Union: it is a form of harmonization. Although the business community may be eager to introduce it, a question that should be answered is whether the introduction of such a system fits in with the rules stipulated by the Treaties and, obviously, whether the European Union is competent to do so. The EU strategy is set out in various places – for example, Art. 3(3) of the TEU reads as follows:

The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress ... Art. 4 of the TFEU states the following regarding the division of competences between the European Union, on the one hand, and the Member States, on the other:

1. The Union shall share competence with the Member States where the Treaties confer on it a competence which does not relate to the areas referred to in Articles 3 and 6. 17

2. Shared competence between the Union and the Member States applies in the following principal areas:
(a) internal market.

The internal market is defined in greater detail in Art. 26 et seq. of the TFEU. In particular, Art. 26(2) of the TFEU reads:

The internal market shall comprise an area without internal borders in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties.

The phrase “provisions of the Treaties” refers to the known four freedoms. The internal market competences being shared competences also means that the principle of subsidiarity plays an important role here. 18 Specifically, Art. 5(3) of the TEU states:

Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.

These should serve to build the fundamentals for a new tax facility at an EU level. The author believes that it is evident that when the question whether or not a CCCTB is to be introduced within the European Union is subjected to the subsidiarity test, such a decision should be taken at an EU level rather than at that of a Member State. As the reasons for introducing the measure are also rooted in encouraging cross-border business, the subsidiarity test would likely turn out positively for the European Union. In other words, exercising this competence would be most efficient at an EU level. Bringing about such a major effect for the international business community would require the introduction of the CCCTB, as the Member States cannot individually realize this.

This is not to say that it provides a panacea for all issues. This is because, although it would be logical to resolve this problem for large MNEs, taxation is at the very heart of each Member State. Treasury competences can be transferred to an EU level, but the Member States refuse to do so with powers to tax. Art. 114 of the TFEU deals with the approximation of legislation and reads as follows:

1. Save where otherwise provided in the Treaties, the following provisions shall apply for the achievement of the objectives set out in Article 26. The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by

17 Factually: with an equal tax burden Member State A clearly offers a better infrastructure than Member State B.
19 Art. 3 of the TFEU concerns exclusive competences – for example, the customs union. Art. 6 of the TFEU relates to the competence of the European Union to support, coordinate or supplement actions by the Member States. Here, the term "industry" is also referred to.
20 See for more details V.J.M. Bekkers, G. Leenknegt and H.T.P.M. van den Hurk, Subsidiariteit en Europese integratie (Zwolle: Tjeenk Willink, 1995). The booklet is not ‘new’, but is still reasonably up to date with regard to the approach, in principle, to subsidiarity.
law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market. [the harmonization provision]

2. Paragraph 1 shall not apply to fiscal provisions, to those relating to the free movement of persons nor to those relating to the rights and interests of employed persons. [the exemption provision]

Art. 115 of the TFEU states that:

Without prejudice to Article 114, the Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.

The interests of Member States sometimes diverge. Why should a Member State with few important MNEs cooperate in a system that may impair its financial position? Regardless of the way in which the profits of the business would be allocated, there would always be Member States that would feel worse off financially. A simple Internet search for terms such as ‘CCCTB’ and ‘Ireland’ soon reveals how some Member States regard the CCCTB. Because of Art. 115 of the TFEU, Ireland also has a fairly strong position. The author does not think that it would be pessimistic to state that, given the current political relationships, the CCCTB would not receive EU-wide support. It would simply be impossible to reach agreement amongst all of the 27 Member States.

3. The Alternative: Enhanced Cooperation

3.1. Introductory remarks

It is fairly easy for the Member States to fend off new tax harmonization measures. But how “safe” should Ireland really feel? For several years now, EU law has provided for the possibility of applying a two-speed European Union. Under the system of enhanced cooperation, nine to more Member States can opt for creating a form of internal market within the internal market under the terms of the non-exclusive competences. 21 By using this possibility, a group of nine or more Member States can decide to introduce a system of CCCTB. 22 This would not have great effects for the Member States that did not cooperate. Of the large Member States, the United Kingdom appears to be the only opponent. 23 If a number of smaller Member States also agreed to the proposal, at least nine Member States could easily be found to adopt the CCCTB.

3.2. Legal obstacles to enhanced cooperation

Enhanced cooperation is already a factor in EU law. Ever since the Treaty of Amsterdam of 1997, it has been a special element of EU law and an instrument to encourage further harmonization. 24 Enhanced cooperation is, however, in effect, an admission of weakness.

The European Union has evidently grown too fast, not only in terms of the number of Member States, 25 but also with regard to the ‘playing field’. In some policy areas, this made it impossible to achieve any further integration essential to realize the much-desired European Union without internal borders. Enhanced cooperation was, therefore, introduced to offer some solace. But to the author, it appears to be more like a measure to disguise the fact that the European Union has outgrown its competences. 26

To date, only one initiative based on enhanced cooperation has come into force. This concerns a regulation on divorce law. 27 Lessons can be learned from the manner in which this regulation is designed. First, it indicates how Art. 20 of the TFEU is to be interpreted within the framework of this proposal. The “last resort” provision 28 of Art. 20(2) of the TFEU factually states that the Commission can only propose enhanced cooperation and that the Council of Ministers can only adopt it if the Council considers the issue and cannot see any possibility to reach further harmonization within a reasonable period. Next, the regulation describes how the principles of subsidiarity and proportionality have been tested. The “last resort” provision is difficult to explain. Especially the textual changes made to the provision over the past few years and, of course, the fact that the provision has not been used before add to the lack of clarity. 29 The fact that Art. 20 of the TFEU refers to the “objectives of the cooperation” instead of the “objectives of the Treaty” marks a substantial improvement compared to the first version of the enhanced cooperation provision. The relaxation is effective because the original text had a significant crippling effect.

In order to answer the question of whether or not enhanced cooperation could be a way out for the CCCTB, Art. 326 of the TFEU is particularly relevant. This article reads:

Any enhanced cooperation shall comply with the Treaties and Union law. Such cooperation shall not undermine the internal market or economic, social and territorial cohesion. It shall not constitute a barrier to or discrimination in trade between Member States, nor shall it distort competition between them.

The question is how to interpret the provision. Barents argues that the condition is one of the most important

21. Compare Art. 20 of the TEU and Arts. 326 to 334 of the TFEU.


23. That is, is as evident to the author so far.

24. In a way, enhanced cooperation has already existed for many years. Just think of the Schengen Convention or the euro zone Member States.

25. The growth of the European Union always made the author think of a baby conceived to save the marriage. In the author’s opinion, the European Union should never have been expanded knowing that a range of issues was just not in order in the acceding countries.


28. This is expounded in E. Philippart, ‘Optimizing the mechanism for enhanced cooperation’ within the EU: recommendations for the constitutional treaty’, Centre for European Policy Studies Policy Brief, No 33 (Brussels: May 2003).

29. Initially, the text was simply very unclear and appeared to be unworkable. This is why no initiative was taken earlier.
reasons for the limited practical application of enhanced cooperation. A subject such as divorce law would hardly impair the internal market or disrupt the competition between Member States. A highly controversial subject as the CCCTB would, however, be quite a different matter.

It is difficult to answer the question as to whether or not the introduction of the CCCTB would result in discrimination. An earlier report, in respect of which the Commission had commissioned Deloitte, reveals that discrimination could occur. Still, the author is not too concerned about this. As an example, Member State A has two MNEs. One opts for the CCCTB, whilst the other does not. If the latter is consequently faced with a higher relative tax burden than the first, in the author's view, this would not qualify as discrimination according to the prevailing views. Such a different treatment would be the result of a deliberate choice made by the taxpayer. Nor does the author think that introduction of the CCCTB would be likely to impair competition. The Member States that introduced the possibility to apply the CCCTB would not create a tax haven for themselves. Ultimately, it would only be about a different allocation of profits within the European Union.

For the time being, the author thinks that enhanced cooperation could be positive for the CCCTB. In addition, if various Member States introduced the system, other Member States would not want to stay behind, so it could evidently be strong tool. Accordingly, would everything go well? Unfortunately, history could repeat itself. Member States' sole purpose in participating could be to frustrate decision-making within the small group of supporting Member States (the "Trojan Horse" effect). Where a group of Member States decided on proposals through the "weighted qualified majority" voting system, this would not normally be an issue. Regrettably, however, decisions regarding tax legislation require unanimity and this also applies to enhanced cooperation in the area of corporate income tax.


The Netherlands Bureau for Economic Policy Analysis (the CPB) recently examined the economic effects of the CCCTB and reached various conclusions. Remarkably, the CPB found that consolidation could produce a minor, positive wealth increase within the European Union, provided that the improved loss relief facilities in the new system were not compensated for by higher rates, but, rather, by lower lump-sum expenses. Similarly, if cooperation were limited to those Member States bound to benefit from such a system, as the CPB supposes, this could result in a lower average increase in wealth. In this respect, the CPB's view is that this could give rise to a chain reaction of adverse selection, as a result of which an increasingly smaller number of Member States would participate in the profits tax reform. Finally, the CPB concludes that coalitions are most likely to succeed if they are formed by equal Member States. These Member States could even be better off in this situation than with an EU-wide profits tax reform.

But to the author, the most striking conclusion is that introduction of the system could result in a small wealth increase within the European Union. Should it, therefore, be effectively concluded that the introduction of this tax system overhaul would be a waste of effort from an EU perspective?

Yet doubts can be cast on the conclusions of the CPB. First, a macroeconomic investigation is a matter of analysing models. It does not really provide a solid basis for examining the question of how individual taxpayers would receive a regime change. This is probably the reason why the CPB only researched the effect at an EU level. One of the CPB's relevant premises raises doubts in the author's mind. The CPB states that "evasive behaviour" or more specifically Netherlands companies that move to Greece to benefit from a more favourable tax climate, would partly eliminate the advantages of formula apportionment. The author thinks that this assumption is not entirely realistic. In their strategic decisions, companies definitely include the tax climate, but relocating a plant for a lower tax rate is unlikely. Other factors are more important. In addition, as the factor of economies of scale comes into play, it is not entirely clear whether or not the models applied by the CPB can take account of the indirect consequences of financially more efficient operations.

Finally, the author believes that the growing enthusiasm of the business community for a solution such as CCCTB is the best evidence of this system providing a good alternative for the current national systems and a flat EU profits tax. After all, the business community would benefit most from a suitable rule at an EU level. Although the Confederation of Netherlands Industry and Employers (VNO-NCW) was firmly against the initiative some 15 years ago (arguing that intra-European tax planning would disappear), in the current time frame the CCCTB appears, in the author's opinion, to be best suited for VNO-NCW members.


30. H.T.P.M. van den Hurk
33. Not to be confused with the effect of discovering the Greek finances were in disarray, although for many years the Greeks managed to convince the European Union otherwise. Such a "surprise attack technique" is not Trojan by nature.
34. CPB Discussion Paper No. 132 (November 2009).
35. Id., p. 30. Here, the CPB reports that harmonizing both the tax base and the tax rates is the sole key to eliminating all efficiency distortions. The author is inclined to disbelieve this conclusion, as establishing business locations is governed by more important factors.
36. Partially due to ever-increasing transfer pricing requirements.
37. As an academic, the author has the great benefit that he does not have to worry about the question of whether or not the introduction of the CCCTB is politically appropriate. To the author, all that matters is the public-interest benefit, as companies would become more efficient.
5. The Acquis Communautaire: Is the CCCTB Really Necessary?

5.1. Introductory remarks

If the acquis communautaire is considered, it may well be decided that the “internal tax market” in the European Union has come a long way. Various directives attempt to avoid double taxation and enable cross-border mergers. Yet, these are not perfect. The Interest and Royalties Directive, which is less relevant to the Netherlands given its internal tax policy to prefer not to levy withholding tax on interest and royalties, includes provisions on attestation that apparently go against everything the European Court of Justice (ECJ) has argued for, which are also based on the information exchange directives.

The EU Merger Directive in itself functions well, despite some problems. For instance, in some Member States it is, regrettably, common practice that entitlements to loss relief disappear after a merger, which effectively eliminates the possibility of tax-neutral mergers. This causes friction, all the more so as the EU Merger Directive assumes that the merger leaves the companies’ competitive positions unaffected, whereas the absence of loss relief inevitably results in tax charges for the merging parties. Conversely, the EU Merger Directive provides fair assurance for claims by tax authorities.

The ECJ also has tried to improve the internal tax market. Specifically, the Court has removed a number of tax barriers through a vast body of case law. Against the will of many Member States, the ECJ has regarded the four freedoms as some sort of constitutional rights against which national tax laws may be tested. As a result, most Member States have had to stop, virtually in their tracks.

In this regard, this article appears to be an appropriate place to investigate whether or not certain elements of economies of scale could also be realized by using the comprehensive body of secondary EU law in the directives and ECJ case law.

5.2. Horizontal discrimination

Obviously, no tax boundaries should exist within an internal tax market and, in addition, a real EU profits tax should be levied. Unfortunately, it will take some time before the latter will be realized. Still, the acquis communautaire has resulted in some form of unification. But this has not resolved all of the relevant issues. In order to answer the question as to whether or not a problem requires a solution at an EU level, the needs of the business community should be considered. Not that taxation should be abolished, but the European Union should be considered to be a collection of Member States without internal borders, at least for the purpose of corporate income tax and international tax laws. Accordingly, discrimination should be prohibited. When it comes to vertical discrimination, the acquis communautaire is already fairly well developed and provides adequate solutions. An undisputed issue requiring resolution is, however, horizontal discrimination. Even though, within the context of the European Union, it is hard to explain this discrimination to civilians, the ECJ deliberately upholds it. Here, horizontal discrimination refers to a different treatment in Member State A of a resident from Member State B with regard to a resident from Member State C.

One of the arguments why the ECJ allows horizontal discrimination to persist is that, due to the lack of harmonization of direct taxes, tax treaties are more or less the only tools for Member States to avoid double taxation. Many authors have considered this reasoning to be acceptable. Amongst scholars, this is a controversial matter. One way or the other, good arguments are available. Nevertheless, the author finds the choice by the ECJ to allow horizontal discrimination to continue very discomforting.

First, the Member States ignored the old Art. 293 of the EC Treaty, which contained clear objectives, or, at least, they were unwilling to use it, and even managed to avoid its inclusion in the current EU Treaties. Art. 293 of the EC Treaty stated that the Member States should have negotiated the drafting of a multilateral double tax treaty. This would, at the least, have removed horizontal discrimination within the European Union. Evidently, it would be the tail wagging the dog if such negligence on the part of the Member States frustrated the internal market for individuals and companies.

Second, many authors refer to the “package deal” argument. This implies that concluding a tax treaty is a matter of give and take, so that it is not necessary to take offence at differences in the wording of the same provision under different tax treaties. The author is not impressed by...
this argument. Concluding a tax treaty evidently involves much more than tax considerations alone, but, on the other hand, it is not necessary to harmonize everything to achieve a better internal market from a tax perspective. The business community should be able to operate without discrimination (both vertically and horizontally). The good news is that, to realize this, only parts of tax treaties have to be amended.

Third, the ECJ would have brought a real tax internal market much closer had it ruled otherwise in D.57 Such an outcome would have forced the Member States to put an end to the different treatment of residents from two different Member States, prohibiting such differences in the internal tax market, instead of using a system that offers Member States the possibility to create differences between residents of one Member State and another.48

The bottom line is that, when weighing the interests of the Member States against those of entrepreneurs, the ECJ decided in favour of the Member States. However sympathetic this may appear,49 it is one of the reasons why there is now a need to align further the tax rules for MNEs in the European Union.

What solution does the CCCTB offer on this point? The CCCTB would theoretically make tax treaties redundant for MNEs within the European Union. Accordingly, the issue of horizontal discrimination would be resolved for participating companies.50

5.3. Cross-border consolidation

Another apparently interminable issue concerns cross-border consolidation. Marks & Spencer,51 in itself, was obviously clear and ground-breaking, but its consequences were not. For instance, the question remains unanswered as to how it must be demonstrated that a foreign loss can never be used again in that foreign Member State. In the situation of Marks & Spencer, it should have been demonstrated that, in the United Kingdom, the loss component relating to the German losses would not qualify for set-off against Germany. Various methods are possible for doing this. The company could request a statement from the tax authorities in the other Member State or, even better, the tax authorities of the homeland could do so.

Many cases followed Marks & Spencer. In Lidl Belgium,52 the use of Belgian losses by the German head office was rejected and, although the Netherlands Supreme Court (Hoge Raad) and other courts used this to disallow a cross-border fiscal unity, the arguments advanced by the ECJ were quite different. In the year in question, 2000, Germany no longer taxed the profits of the permanent establishment. The year before, 1999, was the last year for Germany to tax the worldwide profits of German companies. Apparently, the Supreme Court overlooked this.53

The ECJ also disallowed a cross-border fiscal unity in X Holding.54 Again, there were just as many reasons why the ECJ could have decided otherwise. The author argues that it should have decided otherwise, as the likelihood of abuse is very small in the Netherlands legal system, so it would appear that the Netherlands has a proportional system.55 For this reason, it is interesting to read the opinion of Advocate-General Sharpston in Lidl Belgium.56 The Advocate-General referred to a system from the EU tax history as an example of what a proportional system can look like without hurting the Member States too much:

24. Such a rule, which allowed the deduction of losses while providing for the recapture of the loss relief in future profitable periods, would manifestly be a less restrictive means of avoiding the risk that losses might be used twice than a rule altogether excluding relief for such losses. Although a deduction-and-recapture rule involves a loss of symmetry and hence does not wholly attain the objective of the balanced allocation of the power to tax, that asymmetry is merely temporary where the permanent establishment subsequently becomes profitable. Moreover provision could be made for automatic reincorporation of amounts previously deducted if reincorporation had still not occurred after, for example, five years, or if the permanent establishment ceased to exist in that form.57

Reading this is like reading a slightly inaccurate description of the Netherlands system. So, in the meantime, Marks & Spencer has produced much case law, which prompts the conclusion that cross-border loss set-off is not or hardly possible. This is unacceptable for international corporations. It cannot be justified that profits are generated and taxation is paid in Member State A, whilst losses are incurred in Member State B.

This problem would also be resolved if the CCCTB were introduced. The profits made throughout the European Union would then be determined on an EU basis and subsequently allocated to the various Member States.

5.4. Exit taxation

Another issue still awaiting a satisfactory resolution relates to exit taxes. A company relocating from Member State A to Member State B is usually also charged tax on the goodwill transferred in the transaction. This contravenes the principle of an internal market, as the goodwill is not realized on the transfer. When it eventually is, it may very well be less than on emigration. The ECJ, therefore, ruled

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47. Case C-376/03, D (5 July 2005).
49. After all, it concerns the budgets of the Member States and these are rather tight in many Member States today.
50. Obviously, this would depend on the final model selected for the CCCTB.
52. Case C-414/06, Lidl Belgium (15 May 2008).
53. Netherlands Supreme Court, 2 October 2009, Case No. 08/00900, BNB 2010/166.
54. See C-337/08, X Holding (25 February 2010).
55. For a more extensive exposition of the Netherlands fiscal unity regime and its compatibility with EU law, see “ECJ Upholds Dutch Fiscal Unity Regime,” Intertax 6:7 (2010), p. 384 et seq.
56. Advocate-General Sharpston, Case C-414/06, Lidl Belgium (14 February 2008).
57. This quotation is from the Proposal by the Commission to the Council, COM (90) 595 def. (24 January 1991). The reader will notice that there is great similarity with the Netherlands system.
in N⁶⁰ (also referred to as Van Dijk) that an exit tax on a capital gain arising from emigration may not be collected immediately. The case in question concerned the emigration of a majority shareholder, which for tax purposes is on a par with the sale of the shares and, therefore, the transfer of a company. The transfer of, for example, goodwill was not considered in this case. The Member State of departure is not entitled to levy the tax immediately, but it may claim an amount equal to the hidden reserves, which may not be collected until that claim is effectively realized. If the goodwill effectively realized is less than the amount previously claimed, tax may be collected only on the lower amount. If the goodwill realized turns out to exceed the claimed amount, the claim is limited to that lesser claimed amount and the Member State of residence can still levy tax on the excess of the goodwill realized.

This is a fine proportional system. Regrettably, not yet all of the Member States have implemented it. The Commission is, therefore, currently bringing a number of infringement proceedings against various Member States.⁵⁹ This appears to be perfectly correct, as many aspects are still unclear. N concerned the transfer of both a shareholder and the company in which he held the shares. But what will happen if a Netherlands company transfers a patent, which was initially acquired at a value of EUR 1,000 and whose value now is EUR 1 million, to a Luxembourg company? From the Netherlands perspective, it could be argued that sound business practice governs such an asset, whereas the transfer of a company is subject to the Netherlands “total profit” principles. Comparable differences may exist in other Member States. So, many exit tax-related problems still have to be explored.

The Commission is, nevertheless, working hard to eliminate such infractions by taking various Member States before the ECJ. However, the Commission has not been entirely successful in its efforts. For instance, infringement proceedings have been initiated against Sweden. Sweden subsequently amended its legislation in such a way that the exit tax claim on emigration will gradually be added to the profits for several years. Although this may sound proportionate – causing the Commission, therefore, to refrain from taking further action – this does mean that more tax could effectively be levied than is currently the case in Sweden. For that reason, the author is not very content with this solution.⁶⁰

The CCCTB could resolve this. Relocation of an asset from one Member State to another would not generate any profits until it was effectively realized and only then would it be allocated to the various Member States and taxed.

5.5. Interim conclusions

Overall, there are several issues that the acquis communautaire cannot settle. Following N, the Member States receive their money at a later date (or not at all). But on the other hand, earlier levying would adversely affect companies in the sense that they have to pay tax on a benefit they have not realized in the same ratio or may not realize at all. The author argues that companies should get the benefit of the doubt in this area of tension between liquidity and risk (for the government, collecting at a later date at the risk of receiving nothing and, for companies, paying earlier at the risk of paying for something they would not realize). After all, companies are the engine of the economy and the internal market is meant to make it easier for companies to operate within an EU context, to stimulate the economies of the Member States. From this perspective, it would be odd not to give companies the benefit of the doubt.

6. Does the CCCTB Provide an Alternative to an EU Corporate Income Tax?

It should be asked whether or not the CCCTB would present a better alternative than an EU corporate income tax levied by and for the European Union. What is most beneficial to the business community? Companies have to pay taxes, no doubt about that. The trick is setting up a structure without creating an additional barrier that does not restrict Japanese and US competitive companies.

The choice is obvious: in the end the best option is an EU corporate income tax or, better still, an EU tax on operating profits. Only then would there be equality within the European Union – one fair level playing field, as other large countries also have.

Unfortunately, the political arena considers such a choice not to be an option. The Member States may be willing to go to great lengths, but the demolition of their fiscal sovereignty is regarded as being a little too radical. Whatever the outcome, the author does not think that an EU corporate income tax is necessarily a “must”. Nevertheless, the areas that require an extensive solution do need a sound alternative, or, at least, companies desiring an extensive solution need this.

An option for large MNEs to file a return in a single Member State⁶¹ for all of their EU activities, based on a single set of standards,⁶² appears to have the best chances. The author regards the CCCTB as being merely second best.

7. Can the CCCTB be Realized?

Many arguments can be given for implementing the CCCTB. Still, the question is whether or not it will materialize. This appears to be primarily based on the anxiety that some Member States have with regard to extensive

59. See the following cases (infrarction numbers cited): Case No. 2007/2365 (Portugal); Case No. 2007/2382 (Spain); Case No 2008/2157 (Denmark); Case No 2008/2207 (the Netherlands); and Case No 2008/4250 (Belgium).
60. This Swedish legislation, effective from 1 July 2010, provides for the possibility to annually defer tax. However, for some types of assets, the deferral is limited. As a result, the system is more proportional, but still not neutral.
61. One-stop shopping.
62. That is, the CCCTB.
harmonization and this process spinning out of control. One thing is certain: something will have to change. The “most dynamic and competitive economy in the world” is hardly a catchphrase that the Commission will use in the new strategy. The euro has been very stable over the past years. In many ways this is a great achievement, but it is a drawback for selling EU products to US companies. As the author is writing this, even faced by the Greek problems, the euro is regaining some of its strength instead of falling.63 How the economic developments in Portugal and Spain, and, beyond the euro zone, in Hungary will turn out is, however, still opaque.64

The European Union’s economic Babylon needs a solution to compete with other economies – a solution offering EU companies the opportunity to profit from the competitive edge provided by an internal tax market. If the Member States anxiety to offer an inch and lose a yard eliminates the CCCTB as a solution, only one option appears to be left to encourage cross-border enterprises within the European Union. The current EU Treaties may no longer contain Art. 293 of the EC Treaty, but the Member States could, of course, start negotiations to arrive at a regulation65 removing certain barriers. Such a regulation could encompass a number of issues currently dealt with in tax treaties. In some cases, it could even be effective in areas beyond the scope of a tax treaty. As a minimum, the author’s wish list has the following three components:

1. cross-border, temporary settlement of losses (one of the ways to avoid double settlement is the exchange of information);
2. non-discrimination (horizontal and vertical discrimination would have to be avoided);
3. the Member State of residence assesses the transfer pricing documentation. If this Member State accepts the documentation, the other Member States follow suit. If another Member State objects to the documentation, it automatically informs the principal state. The company is only directed to make a correction, which is compensated through an opposite correction in one of the other Member States.66 Consequently, a “one-stop shop” is achieved.

An article such as this one is too concise to elaborate fully on such a regulation. The author certainly believes, however, that this alternative warrants closer examination. The CCCTB is a second-best solution, but, if all else fails, such a solution is preferable to no solution.67

8. Horizontal Monitoring: A New EU Solution?

The Netherlands now has much experience with horizontal monitoring.68 If companies communicate about their tax plans with the tax authorities in an open relationship, surprises later can be avoided. With companies and the tax authorities either trying to reach agreement on certain issues beforehand, or “agreeing to disagree”, traditional tax audits may become a thing of the past.

What if other Member States were also to start implementing horizontal monitoring as extensively as the Netherlands does? The results could be interesting, as companies in these Member States would then also have to consult with the tax authorities to discuss the consequences of their tax plans. If two Member States separately apply horizontal monitoring, this is unlikely to smooth the path for companies wanting to resolve matters of international law. Only if these Member States would subsequently discuss the cross-border consequences of actions taken by companies, could many of the issues that companies have been resolved without a specific EU solution. This could very well give rise to an EU version of the Netherlands’ “polder model.” For example, a company could, conceivably, notify the Netherlands tax authorities of its implementation of a new transfer pricing policy, as it would wish to use the “innovation box” more extensively. This would obviously affect other Member States. What is more, would the tax authorities approve of a change of the business operations with which, for example, fewer profits would be allocated to that Member State? Or would any issues arise regarding the final settlement? The list is endless.

Regular consultation regarding an MNE taxpayer between tax authorities of two (or more) Member States in which the MNE is active, thereby applying a comparable and similarly extensive system of horizontal supervision in the respective Member State as applies in the Netherlands, should enable the mitigation of any transfer pricing effects in such Member States. This would avoid a possible transfer pricing dispute, whilst neither a mutual agreement procedure would have to be initiated, nor would the Arbitration Convention69 have to be invoked.70

Such an alternative would not be a cure-all. Levies over final settlements could continue to exist, but, based on ECJ case law, these could be challenged (agree to disagree).71 What is more, for horizontal monitoring to be a true alternative, the cooperation of many Member States would have to be involved.

The author’s practical experience with German-based companies indicates that some of these are still not quite comfortable with “horizontal monitoring” as a form of

63. For example, “Euro stands firm against dollar”, Financieel Dagblad (30 April 2010) and “Yen down against Euro”, Financieel Dagblad (1 May 2010).
64. Still, even if the euro appears to be a little more volatile since 1 July 2010, it is much stronger against the US dollar than in its early days.
65. The question as to why a regulation should be opted for instead of a directive is a simple one. The interpretation of a regulation must be the same in every Member State. This results in a comparable form. In this case, a directive would constitute a form of minimization, which could, therefore, result in differences. Naturally, the latter can never be deliberate.
66. As a result, tax gains or losses may obviously arise due to differences in rates.
67. See also the report of M. Monti, “A new strategy for the single market” (9 May 2010), pp. 81-83. This report was commissioned by José Manuel Barroso, president of the European Commission.
68. See on this issue the collection by various authors, “De onzichtbare opmars van horizontaal toezicht”, 196e Maatschappelijke Viscad Symposium op 6 November 2009 (Deventer: Kluwer, 2010). In this, the protagonists and antagonists, hands-on experts and tax authorities’ staff describe their experiences.
69. Convention 90/436/EEC.
70. It has also been referred to as an advance pricing agreement “light”, but this does not do justice to the real power of horizontal monitoring.
open communication with the tax authorities. If the Netherlands could export horizontal monitoring to other Member States – for example, France, Germany and the United Kingdom – this would automatically mean that a number of other Member States would voluntarily join in, thereby giving rise to a new cooperation without any EU involvement that may be highly effective for the business community.

An additional advantage is that any hesitations other Member States may have in opting for a solution at an EU level, such as Ireland, which has no transfer pricing rules and, therefore, is highly critical of an EU solution, would evaporate if a bilateral solution for horizontal monitoring was chosen. Likewise, comparable solutions could also theoretically be opted for in relationship with countries such as the United States. All in all, this is another issue that deserves thorough examination.

9. Conclusions

The **acquis communautaire**, in the author’s view, offers the international business community too little if it is to think of the European Union as an internal tax market. An EU corporate income tax would be ideal, but this really is a bridge too far. The CCCTB is a fair alternative. If nine Member States agree, others are bound to follow. Any Member States that do not participate would increasingly be left out; it would appear that such Member States would eventually be unable to avoid the CCCTB.

Horizontal monitoring in cross-border relationships is a further interesting avenue. Although within the European Union it offers too few solutions to be an alternative for the CCCTB, the advantage is that it may play a role in relation to third-party states as well.

72. Many Member States have many forms of horizontal supervision. It is obviously essential for these Member States to reach a similar level. As the Netherlands is at the forefront, to the author, it appears to be a shining beacon for the other Member States.
The Role of Good Governance in the Tax Systems of the European Union

The objective of this article is to examine the global “tax governance movement”, looking at the concept from different angles, with particular consideration of developments in this regard in the European Union.

1. Tax Systems and Current Challenges

Many countries are currently considering various options to stimulate economic growth at this time of crisis, and are searching for ways to renew and revitalize their economies. Driven by rapid technological change and policy liberalization, the increasing economic integration of markets provides great opportunities. Many countries profit from the liberalization of flows of capital and goods, even though there are economic and social disadvantages to globalization. Other countries are becoming increasingly vulnerable to economic instability, as well as tax avoidance, evasion and fraud. The financial crisis turned into one of the worst recessions in history, from which the global economy is now gradually recovering.

In this regard, governments need to consider carefully the role that tax systems can play to mitigate and overcome the effects of the crisis in the global economy. Taxation has an important role to play in such considerations and it could be said that the economic crisis and globalization are the two main challenges tax systems must face in the second decade of the 21st century. In addition to supporting the basic functions of an effective state and setting the context for economic growth, taxation can also give rise to more responsible and accountable governments and expand the capacity of a state to act.

According to a recent OECD report, taxation can improve governance in three ways. First, it develops a shared understanding of economic growth, as governments that depend greatly on taxes have a greater incentive to promote economic growth. Second, it develops the state apparatus, as tax collection requires a well-functioning administration. Third, it develops accountability and responsiveness, as taxation engages taxpayers in politics and governments that rely heavily on taxes have an incentive to improve governance to ensure tax compliance.

The current attention of governments to these issues is evident. A first step was the agreement by the G20 countries in their action plan of November 2008 to work on the international application of rules in respect of transparency in financial matters and administrative cooperation with regard to taxation. At an EU level, the EU Finance Ministers, meeting in Council (ECOFIN) on 14 May 2008, defined good governance in taxation as embracing the principles of transparency, the exchange of information and fair tax competition. In December 2008, the EU Finance Ministers presented a paper to the meeting of the European Council, which advocated continuing to counter illicit finance risk-taking stemming from non-cooperative jurisdictions and tax havens. Later, in their contribution to the G20 Ministers and Governors meeting of 14 March 2009, the EU Finance Ministers emphasized the need to “protect public finances and international standards against the risks posed by non-cooperative jurisdictions.” They sought a “toolbox of sanctions” and stressed the need to reinforce “action to achieve international good governance in the tax area (transparency, exchange of information and fair tax competition).”

The European Council of 19 and 20 March confirmed this approach. At the London G20 Leaders summit of 2 April 2009, the leaders agreed “to take action against non-cooperative jurisdictions, including tax havens” and they declared themselves to be “ready to deploy sanctions to protect public finances and financial systems.” They also stated “the era of banking secrecy is over.” In reaction, even in advance of the G20 meeting, many jurisdictions announced their willingness to apply the international standards of transparency and information exchange.

Not only governments, but also EU institutions are making progress in this area. Following the ECOFIN definition of good governance with regard to taxation, in April 2009, the Commission issued Communication (2009) 201 final, “Promoting Good Governance in Tax Matters” (the “Communication”). More transparency, better exchange of information and fair tax competition are the cornerstones of the Commission’s initiative in relation to promoting good governance with regard to taxation.

In the words of László Kovács, the economic crisis presents an opportunity – i.e. the opportunity to create the basis for robust, efficient and fair tax systems. Such systems should guarantee that governments have sufficient

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2. See www.g20.org/Documents/Fin_Dep_Fin_Reg_Annex_020409_1615_final.pdf.
revenue in the future, whilst phasing out inefficient tax measures.

This ambitious target has encouraged many countries to adopt measures to stimulate economic growth. Although such measures are not only fiscal in nature, taxation profoundly affects a country's economy. Accordingly, the adoption of schemes to minimize the effects of the economic crisis is currently one of the biggest challenges for tax policymakers.

Tax systems and the design of tax bases may play an important role in achieving an efficient, robust and fair tax system that can deal with the current economic situation. These factors influence economic growth and employment and finance the budgets of governments, which may currently be a daunting task. Nevertheless, besides the implementation of legislative measures in respect of direct and indirect taxation, the adoption of good governance by tax authorities appears to be the perfect complement to achieve such a target. Accordingly, good governance practices play an increasingly important role with regard to taxation.

A good example is the new approach adopted by the Commission in its proposal of February 2009 for a Council Directive on administrative cooperation in the field of taxation. 8 This would implement an entirely new method for Member States to cooperate efficiently to overcome the negative effects of ever-increasing globalization.

Existing Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation and taxation of insurance premiums has proven to be ineffective in ensuring sufficient administrative cooperation between the Member States. The Commission has observed the need for an instrument that fosters confidence amongst Member States, thereby setting identical rules, obligations and rights for all states involved. Directive 77/799/EEC, even in its amended form, was designed in a different context, as at that time the flows in capital, goods and services were comparatively small and economies were much less integrated. Accordingly, the Directive does not match the present requirements of the internal market.

Furthermore, the scope of Directive 77/799/EEC is limited to direct taxes and insurance premiums, whereas the current proposal also covers all indirect taxes that are not yet dealt with under EU law, i.e. indirect taxes other than VAT and excise duties.

The Commission's proposal resulted in a political agreement on a draft Directive that is intended to strengthen administrative cooperation in respect of direct taxation, to enable Member States to better combat tax evasion and tax fraud. This agreement was reached by the Council of the European Union in December 2010. 10

The objective of this article is, therefore, to examine the global 'tax governance movement', looking at the concept from different angles, with particular consideration of developments in this regard in the European Union.

2. Good Governance as a Fundamental Principle of Tax Systems

The OECD, in the recently published paper "Improving Governance through Tax Reform", 11 concluded that measures that are intended to strengthen national dialogue regarding taxation and that support more integrated administrative structures are indispensable to any long-term strategy for achieving revenue stability and self-sufficiency. In this regard, as noted in 1., the EU Finance Ministers, meeting in ECOFIN on 14 May 2008, in their conclusions regarding tax issues in agreements with third countries, emphasized the importance of implementing, on as broad a geographical basis as possible, the principles of good governance in respect of taxation, i.e. "the principles of transparency, exchange of information and fair tax competition, as subscribed to by Member States at Community level." 12 In addition, the Ministers considered that the role of good governance in respect of taxation goes further than countering cross-border tax fraud and evasion: it can also strengthen efforts against money laundering, corruption and the financing of terrorism.

The global economy, which is slowly recovering from the financial and economic crisis, is now dealing with the risks posed to national budgets and tax, and, therefore, in international debates the need to strengthen tax cooperation is continuously being emphasized. Cooperation mechanisms should be based on similar rules, obligations and rights for all parties if they are to be efficient and their scope should cover third countries in addition to Member States.

From an EU perspective, as the ECOFIN recognized in its meeting of 14 May 2008, the way to realize this objective is to include a specific provision on good governance in respect of taxation in relevant agreements to be concluded with third countries by the European Union and its Member States, without prejudice to their respective competences. In this regard, the following text is considered to be appropriate:

With a view to strengthening and developing economic activities while taking into account the need to develop an appropriate regulatory framework, the Parties recognize and commit themselves to implement the principles of good governance in the tax area as subscribed to by Member States at Community level. To that effect, without prejudice to Community and Member States' competences, the Parties will improve international cooperation in the tax area, facilitate the collection of legitimate tax revenues, and develop measures for the effective implementation of the abovementioned principles. 13

From the perspective of the Member States, it should be recalled that direct tax policy is traditionally the domain of the state and lies at the heart of state sovereignty. Taxation determines the capacity of a state to fund its policies and redistribute resources. However, tax competition within the single market, with its low level of harmonization amongst Member States, could give rise to and does, in fact, lead to distortions and externalities. There is, therefore, a need to implement better administrative practices, such as harmonization and exchange of information. In order to do so, some form of intervention by EU institutions is likely required.

As can readily be imagined, the main obstacle to progress towards “the best of governance” is political; there is a lack of consensus on the major objectives of tax governance at the EU level. The various debates have given rise to different approaches and deep divisions amongst Member States. Some intend to reduce harmful tax competition, whilst others believe that the objective is a single market without tax frontiers. Other controversial topics are what the appropriate role of the European Court of Justice (ECJ) is in reviewing the direct tax laws of Member States and how much initiative should be left to the Commission, as opposed to intergovernmental negotiation outside the EU institutions.

Accordingly, the Member States and the EU institutions face a long and difficult journey. Some important steps forward have, however, been taken. In April 2009, the Commission issued the first Communication to promote good governance in tax matters. A new Directive 2010/24/EU, replacing Directive 2008/55/EC, was finally approved on 16 March 2010 with the objective of extending the scope of the mutual assistance provisions in respect of the recovery of claims. As noted in 1., political agreement on a draft for a directive on administrative cooperation in the field of taxation was reached by ECOFIN in December 2010. This agreement underscored the need for administrative cooperation with regard to taxation, whilst preserving full national sovereignty over the types and level of taxes levied. Due to the lack of harmonization in this area, enhanced tax-administrative cooperation appears to be the only way of assessing taxes correctly, thereby preventing and countering tax fraud and tax evasion. Such methods for good governance in respect of taxation are considered in 4.2. and 4.3. Hopefully, it will be recognized that cooperation is crucial to the interests of Member States and the European Union, thereby protecting the financial interests of Member States and avoiding market distortion.

3. The Academic Approach to Good Governance in Direct Taxation

3.1. Introductory remarks

From an academic perspective, the parties involved in direct taxation in the European Union should come to the inescapable conclusion that cooperation is better than competition and agree on the best way to cooperate.

Radaelli and Kraemer have researched these issues. Their thesis begins by distinguishing the different fields or areas of cooperation with regard to direct taxation; determining the ways in which the main actors, public and private, intervene; and analysing how they intervene and outlining how they balance their positions with regard to each area of taxation. Their approach departs from other traditional lines of research, which focused on how to put into practice good governance with regard to isolated issues of direct taxation, such as tax rates, tax bases and the elimination of double taxation. Radaelli and Kraemer focus, instead, on the governance dimension of tax policy, which represents the “new modes of governance” school of thought.

The starting point for good governance is to move away from policies based on authoritarian and coercive principles. Instead, policies should be based on principles of cooperation and coordination. In practice, the participation of all parties involved is required in the development of tax systems, to guarantee that they can adapt to different economic cycles. As all parties involved should successfully emerge from the present critical situation, it must be avoided that one or more actors act against the others, as this will give rise to a worse result for all involved.

In the context of this article, the major actors are the Member States, the Commission, the business community and the ECJ. The European Parliament could also be included (although its role in respect of direct taxation is minor), as could civil-society organizations for fiscal justice. However, the latter have little political influence in the European Union.

On the one hand, the tax authorities of the Member States have two main goals. One is to preserve tax revenue or, for the more ambitious, to increase their tax bases. The other is to design tax measures that attract corporations and mobile capital.

On the other hand, the Commission has its own objectives, i.e. to make progress regarding cooperation and harmonization in direct taxation, to formulate policy and to ensure that political discussion amongst the various actors with different interests ends in agreement. In the experience of the Commission’s tax policymakers, no progress can be made if the power relationships between key parties are not balanced. Accordingly, an essential condition for the Commission to achieve its objectives is to appropriately balance the power relationships between the EU institutions, the Member States and the business community.

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17. C. Radaelli, Director of the Centre for Regulatory Governance, University of Exeter, United Kingdom, gave an interesting lecture on this topic at the Tax Forum 2009 conference, entitled “Benchmarking EU direct tax policy with governance standards,” available at http://ec.europa.eu/brusselstaxforum. U. Kramer is a Research Fellow at the Centre for Regulatory Governance, University of Exeter, United Kingdom; in this regard, see www.eu-newgov.org.
The business community plays an important role in supporting tax reforms that are intended to eliminate tax obstacles in a single market. However, within the business community itself, preferences with regard to tax competition differ, depending on the involvement of companies in international trade.

Finally, the ECJ’s role in direct taxation has greatly increased in importance. In this respect, the ECJ’s primary object is to guarantee the fundamental freedoms. Through its case law, the Court either constrains or enables the other actors.

In practice, political coordination regarding direct taxation within the European Union has generally proven to be impossible. The main obstacles to real cooperation are formed by inadequate institutional competences and conflicts of interests between the Commission, the business community and the Member States (that often also have diverging positions). A good example of the proposal to create a specialized tax body within ECOFIN, which would have the primary task of encouraging broad debate on EU taxation, and where genuine interests could, in principle, be balanced by considering all tax issues.

In this context, the Commission has chosen a pragmatic solution, by distinguishing between two functionally differentiated tax governance areas, namely, harmful tax competition and corporate tax reform. The Commission has adopted this approach due to the lack of overall institutional solutions in respect of tax coordination and previous experience that no progress can be made if the power balance is too much in favour of the interests of just one of the actors.

These two areas feature distinct rules for the selection of participants, the modes of interaction and decision-making. They follow a different political logic and, therefore, empower actors differently, although no actor is dominant. The areas differ in important ways regarding the quality of governance, including with regard to such factors as participation, problem-solving efficiency, accountability and transparency. The parties involved are allowed to select their own policy problems (specifically, harmful tax competition and corporate tax reform) and, importantly, their own modes of governance. Accordingly, the proper balance between the Member States, the Commission and the business community, which is a condition sine qua non for cooperation and coordination with regard to direct taxation, appears to be easily attainable.

In addition to these two areas (harmful tax competition and corporate tax reform), the ECJ’s role in direct taxation has emerged as a third area of governance.

3.2. Harmful tax competition

This subject has taken shape around academic and institutional doctrine, which notes the negative effects of tax competition in the European Union and its consequences for employment and the welfare state. Here, the main actors are the Member States and the Commission, whilst the business community has only a passive role.

It is necessary to outline the positions of the primary actors in this area at the outset. First, the tax authorities find it important to counter harmful tax competition, thereby safeguarding their tax bases and revenues. Second, the subject provides specific meaning to the otherwise vague concept of direct tax policy coordination. Third, it addresses what is necessary to avoid a situation where some Member States implement harmful tax measures for the sole purpose of attracting taxpayers that do not belong naturally to their jurisdictions, which leads to a risk of “a race to the bottom” regarding taxation.

This field covers important mechanisms that, subject to various degrees of effectiveness, meet the four principles of quality governance stated in 2. These include the Code of Conduct,18 the 2003 Savings Directive19 and the Commission’s commitment regarding fiscal aids included in the 1997 tax package to counter harmful tax competition.20

In terms of the modes of governance, a combination of instruments, both hard (coercive mechanisms) and soft (less coercive), are available, with no clear preference for one over the other. Rather, what matters is the political result of combining different modes.

A good example of this is the Code of Conduct, which is, in essence, a non-coercive instrument. In order to achieve the Code’s main objective, i.e. to roll back the tax measures characterized as harmful, soft tools have primarily been employed, such as negotiating agreements or practices informed by open coordination and consensus-based deliberation within the Code of Conduct Group. However, these soft mechanisms are complemented by certain other hard ones, such as the state aid procedure, which is one of the most coercive instruments at the Commission’s disposal. In this respect, the state aid procedure and its tax component have been used to successfully pressurize the Member States in the context of the rollback process under the Code. Specifically, in July 2001, the Commission launched a state aid procedure against 15 fiscal aid regimes. The Commission’s reasoning was to increase pressure on the Member States to finalize the tax package and implement the Code of Conduct by way of the state aid procedure. In this context, the Commission noted in its 2004 report on state aid relating to business taxation that “[t]he Commission’s state aid work, carried out in parallel with the Code of conduct, has to some extent helped to facilitate the conclusion of an agreement on the code of conduct”.21

3.3. Corporate tax reform

This topic emerged in 2001, after that of harmful tax competition, in response to a new strategy by the Commission.

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It was based on creating political impetus for coordination at the level of the Member States and then attempting to rebalance the relationship between Brussels and the business community (in particular, multinational enterprises (MNEs)), which was encountering tax problems in dealing with the single market.

This is why, as soon as the Commission felt that progress was being made with regard to harmful tax competition, it devoted effort to corporate tax reform. Consequently, a Commission Communication was published, which stated that:

Now that the work on the tax package seems to be progressing satisfactorily, increased attention must be paid to the removal of these obstacles. It is high time to put much more emphasis on the concerns of the EU tax payers.22

In October 2001, the Commission, in its Communication, “Towards an Internal Market without tax obstacles”,23 published the results of a comprehensive study. This included an economic analysis of taxation and the results of the deliberations of a panel of business experts on the key tax obstacles to the single market.

Since then, the Commission has launched several corporate tax reform initiatives – for example, in respect of transfer pricing and a common consolidated corporate tax base (CCCTB) – that are clear examples of good governance. In developing these initiatives, on the one hand, a high degree of transparency and participation has been established, at least in relation to the Transfer Pricing Forum and the consultation process for the pilot project on home state taxation. On the other hand, certain measures do not reflect good governance – for example, the refusal of the Common Consolidated Corporate Tax Base Working Group to include permanent non-governmental experts or the request of some members of the Group and of the Joint Transfer Pricing Forum not to publish meeting records until informed of the obligation to disclose working documents by the Council and the European Parliament.

The main actors, namely, the business community, the Commission and the Member States, are often, but not always, reluctant to cooperate. In this regard, the active role of the business community in the conceptual aspects of this subject, by supporting task forces, the research of tax experts, pilot projects and suggesting practical ideas to minimize tax barriers and administrative burdens for companies, is remarkable.

The dominant mode of governance used is soft governance, which is the result of the political logic prevalent in this field. So far, there is no evidence of hard modes of governance being used. There is coordination based on benchmarking, technical exercises on the creation of a common tax base in the European Union and agreements on best practices amongst all actors. Soft governance, based on exploration and pragmatic solutions, will hopefully prevail, as more than one Member State has expressed concern that any deviation from soft exploratory governance could be used to implement directives in respect of the harmonization of tax bases and rates. In fact, the use of directives in this area has been included in the Commission’s agenda for 2011.

### 3.4. ECJ case law

To a certain extent, the Commission has succeeded in balancing the powers in the areas analysed in 3.2. and 3.3. However, the Commission does not have, and will never have, any control over the third emerging field, the case law of the ECJ on direct taxation, which is governed by the principle of hierarchy, and is exclusively dominated by the ECJ. The Commission has, however, tried to intervene in this area by coordinating the responses and reactions of the Member States to ECJ case law and by adopting relevant Communications and Recommendations.

As is well known, the DG-Taxud has sought to use ECJ decisions to coordinate reforms in the Member States. The strategy is simple: in response to ECJ case law emphasizing the areas in need of reform, the Member States should agree on a common position as to how to realize this in the working groups orchestrated by the Commission. In its 2003 Communication, the Commission clearly supports the adoption of soft governance, especially recommendations to provide guidance and the “pro-active coordination of those features of the tax systems of the Member States that are or are likely to be in conflict with EU law”.24 Accordingly, the Commission has issued Communications on the tax treatment of occupational pensions,25 investment funds26 and the taxation of dividends.27 In 2006, another three relevant Communications on direct taxation were issued on: (1) coordinating the direct tax systems of the Member States in the internal market;28 (2) the offsetting of cross-border losses;29 and (3) exit taxes and the need to coordinate the tax policies of the Member States.30 All of these Communications directly relate to important ECJ cases.

In spite of the significant efforts on the part of the Commission, the response of the Member States has been half-hearted. The reason for this is the clear doubts that have been raised as to whether or not the Commission has a specific role to play in this delicate area – an area where the Commission usually agrees with the ECJ’s negative decisions on the compatibility of national tax provisions with the fundamental freedoms of the Treaty on the Functioning of the European Union.

In 2005, the Member States attempted to start intergovernmental contacts, thereby circumventing the Commission, so as to adopt a coordinated position in relation to the requirements of ECJ jurisprudence. However, after long and intense debate, these contacts appear to have

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In its approach to this matter, the Commission takes into account the regulatory work carried out by the OECD in the 1960s and, in collaboration with the United Nations, has tried to implement such principles worldwide. In general, it can be stated that the guidelines in these matters have their origins in the innovative suggestions regarding tax administration in their relations with third countries and in their participation in international organizations.

The Communication is intended to identify the particular EU contribution to good governance in their relations with the Member States and the EU institutions to promote good governance in tax matters in April 2009. In presenting the Communication, László Kovács, Commissioner for Taxation and Customs at the time, stated that:

EU Member States cannot afford to act alone when designing policies to prevent their tax revenues disappearing to tax havens or non-cooperative jurisdictions. If they do not cooperate with each other, including in international fora, their actions to protect their revenues will not produce effective results.

This call for cooperation requires an approach of the Member States that is coherent and in agreement with the principles of good governance in their relations with third countries and in their participation in international organizations.

The Communication is intended to identify the particular EU contribution to good governance in the area of direct taxation, improve good governance in the European Union and promote this internationally. Within this framework, the Commission has adopted the definitions and scope set out by the ECOFIN on 14 May 2008 (see 1.). This is based on the principles of transparency, the exchange of information and fair tax competition, and is subject to the widest possible geographical scope.

The Commission, in designing suitable tools and actions to improve tax cooperation, follows the policies that the OECD, the main actor on tax governance, has implemented since the Second World War. The OECD has been informally in charge of the implementation of good governance principles in tax matters in developed countries and, in collaboration with the United Nations, has tried to implement such principles worldwide. In general, it can be stated that the guidelines in matters have their origins in the innovative suggestions regarding taxation made by the League of Nations in 1928 and in the regulatory work carried out by the OECD in the 1960s and 1980s.

In its approach to this matter, the Commission takes into account temporal scope and differentiates between mechanisms that have already been implemented to enable the Member States and the EU institutions to promote good governance in the tax field, and those that, by virtue of the commitment adopted at the ECOFIN meeting of April 2008, are in the process of being implemented. The Commission also included in its Communication various proposals to strengthen the principles of governance, which entail action both within and outside the European Union, and at the level of the European Union and the individual Member States.

The Opinion of the European Economic and Social Committee (EESC) on the Communication was published in the Official Journal of 22 September 2010. In general, the EESC positively evaluated the Communication and gave its support and full agreement to all that the Commission noted and the measures it proposed, though making certain suggestions and recommendations in respect of some matters. The EESC noted that the European Union has done and is doing much in countering tax evasion and the financial aspects of dealing with organized crime and terrorism. However, the EESC drew the attention of legislators to the lack of effective coordination between the drive against tax evasion and that against crime, as well as a lack of clear distinction between the tasks and competences of the authorities responsible for dealing with these different issues. These authorities often undertake tasks that relate to both tax evasion and crime or terrorism. Such tasks are, therefore, difficult to assign. The EESC regretted that there was no reference to such cooperation in the Communication or Council programmes and noted that there was no clear reference to a global strategy. The EESC believed that the actions in hand or planned in the field of taxation should run parallel and be consistent with those in the area of money laundering, and those countering corruption, organized crime and terrorism.

4. EU Approach to Good Governance in Direct Taxation

4.1. Introductory remarks

The wide acknowledgement of the relevance of good governance in taxation and its contribution to the strengthening of tax systems in the context of globalization and the financial crisis, as experienced by the different stakeholders involved, resulted in the Commission issuing the first Communication to promote good governance in tax matters in April 2009. In presenting the Communication, László Kovács, Commissioner for Taxation and Customs at the time, stated that:

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4.2. Existing methods of tax cooperation in the European Union

The Communication, first, focuses on the methods that the Member States have agreed on and implemented in respect of good governance. These mechanisms have been developed as a result of evidence that, despite the fact that Member States are under EU law largely free to design their own direct tax systems, they have, in the last decade, reached agreement on preventing the erosion of tax bases and investment allocation distortions. However, the individual national and bilateral measures that have been implemented can only partly address tax erosion problems. Accordingly, EU-wide cooperation is essential. Within this framework of tax cooperation, both binding legal instruments and soft instruments can be found.

Amongst the binding instruments, Mutual Assistance Directive 77/799/EEC was one of the first in the area of information exchange regarding direct taxation between

33. OJ C 255/61 (22 September 2010).
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tax authorities. Other good examples are the Savings Directive, which enables tax administrations to exchange information automatically within certain limits, and Directive 2008/55 on the recovery of tax claims, which establishes a regime whereby one Member State may request assistance from another in the recovery of claims relating to taxes, duties and levies.

Amongst the soft law instruments, which complement the legal instruments on administrative cooperation by means of political agreement between Member States, the Code of Conduct for business taxation is the most important. The Code defines harmful tax measures as measures, including administrative practices, that affect or may affect, in a significant way, the location of business activity in the European Union and that provide for a significantly lower level of taxation than that generally applicable in the Member State concerned. Under the Code, which applies both to Member States and to their dependent and associated territories, over 400 business taxation measures have been assessed and more than 100 of these have been found to be harmful have been abolished or amended. In addition, the state aid policy on taxation has been used by the Commission to increase pressure on reluctant Member States to remove distortions in competition resulting from specific business tax regimes.

EU encouragement in respect of tax governance internationally is a more recent phenomenon. The European Unions international policy is not to target tax havens per se, but, rather, to reach agreement with as many third countries as possible on common principles of cooperation and transparency.

In this respect, the Commission proposes coordinated action by the Member States to ensure an appropriate follow-up to the two OECD initiatives at the international level. In this respect, the OECD first proposes to dismantle the preferential tax regimes of its 30 Member countries and, second, the OECD has contacted numerous countries and has already arranged for 35 non-member countries, including several tax havens, to commit politically to cooperate regarding transparency and the exchange of information in respect of taxation. A number of other countries have also recently committed to complying with the OECD standards on the exchange of information on request without regard to domestic requirements or bank secrecy.

In this respect, it should be noted that, since 2004, particularly in 2006, the Commission adopted several Communications, including those on preventing and countering corporate and financial malpractice, on an EU-Caribbean partnership for growth, stability and development, on EU relations with the Pacific Islands, on cooperation with Hong Kong and Macau (2007-2013), on governance and development, and on EU competitiveness. These Communications form the basis for the agreements on good governance that have been proposed regarding third countries promoted by the ECOFIN in May 2008.

Accordingly, the Commission is proposing expansive action in relation to international policy, and there are several areas in which it has taken measures to ensure that third countries adhere to good governance principles in the tax field.

Some of the most ambitious advances concern savings taxation. Measures that are equivalent to those set out in the Savings Directive now apply in a number of third countries and the associated territories of Member States, such as Andorra, Liechtenstein, Monaco, San Marino and Switzerland (some of which were previously identified by the OECD as tax havens). The Commission has also, on the basis of a mandate from the ECOFIN, opened exploratory talks with Hong Kong, Macau and Singapore on the application of provisions equivalent to those in the Savings Directive, but without result so far.

Another important area is relations with the European Economic Area (EEA) (Iceland, Liechtenstein and Norway, together with the 27 Member States) and with Switzerland. The fact that the EU law relating to the internal market applies directly to the countries in the EEA and that rules equivalent to state aid rules are contained in the EEA agreement and enforced by the EFTA Surveillance Authority has facilitated progress in this regard. Similar rules also apply to Switzerland under the 1972 European Union–Switzerland free trade agreement. This limits the scope for distortive tax regimes and the Commission has recently challenged certain Swiss business tax regimes that grant benefits that it regards as state aid. ECOFIN has also urged Liechtenstein to increase its cooperation with the European Union regarding administrative and judicial tax matters and the drive against fraud. In this context, negotiations on a new European Union–Liechtenstein anti-fraud agreement are ongoing, including the issue of information exchange in respect of direct taxation. Finally, the recent commitment of Liechtenstein to the OECD standards of transparency and information exchange should be regarded as a notable step forward towards good governance.

The third method that the European Union uses to implement good governance is the inclusion in relevant agreements of clauses of commitment to such principles in the different policy areas. These clauses differ in terms of intensity and obligation. A good example is the European Neighbourhood Policy. A number of Action Plans, which are instruments of economic and political cooper-
ation between the European Union and partner countries, have been concluded with countries covered by this policy. These include general references to cooperation in tax matters. Many plans also make specific reference to the principles of transparency, the exchange of information and the Code of Conduct for business taxation. Another example is the Enlargement Policy strategy of the European Union, which is intended to address good governance in tax matters at an early stage of the pre-accession process.

The most ambitious action that the European Union is undertaking in this area is the negotiation of provisions on good governance in respect of taxation with third countries within general agreements stemming from the Council Conclusion of May 2008. Specifically, the Commission has commenced negotiations with a number of third countries on a provision concerning good governance in the tax area. This process has just begun and some third countries have reacted positively. However, the high level of commitment required by states has also resulted in rejection by some jurisdictions. Accordingly, the Commission recommends referring to good governance in respect of tax as early as possible in the process to guarantee its effectiveness.

The European Union's promotion of the principles of good governance in the tax area is even reaching developing countries. In this regard, as an incentive, the Commission has provided additional support to developing countries that are willing to commit to these principles. To this end, the European Neighbourhood and Partnership (ENP) Governance Facility provides funding to partner countries that are assessed as having made the most progress in implementing the governance-related objectives of their agreed reform agenda as set out in their ENP Action Plans, which contain both general and specific commitments on governance-related reforms. The 10th European Development Fund (EDF, 2008-2013) also offers additional funding to support a dialogue on governance and reform, including in respect of taxation. In addition, countries eligible for development aid that make detailed commitments pursuant to the Governance Action Plan may receive an additional allocation, depending on the quality of their commitment. The response to these commitments has, however, been inconsistent. A number of Caribbean and Pacific countries have undertaken such commitments, but others – for example, Antigua and Barbuda and Barbados – have, to date, refused to do so.

4.3. Internal actions to be urgently adopted

In this section, the author examines the mechanisms considered by the Commission in the Communication to be necessary for the principle of cooperation to be strengthened. In this respect, it should be appreciated that cooperation is one of the most important aspects of good governance.

For this purpose, the Commission has issued three Directive Proposals to the Council, which affect three Directives that are in force, the adoption of which it considers to be urgent. At the time of writing this article, an important update to the contents of the Communication had just been made in this respect, which is addressed in this section.

The first proposal noted in the Communication was presented in February 2009. On 2 February 2009, the Commission published the proposed Directive on administrative cooperation in the field of taxation to replace Directive 77/799 on Mutual Assistance. The proposal is intended to bring administrative cooperation regarding all taxes into line with the existing cooperation on VAT and excise duties, which have already been dealt with at the EU level. The proposed directive also introduces procedures for automatic and compulsory exchange of information, enables the officials of one Member State to participate actively in administrative enquiries in the territory of another, and prohibits the Member States from refusing to supply information on the grounds that the information is held by a bank or other financial institution.

Significant developments regarding this proposal have been made. On 10 November 2009, the Council reached general agreement on the proposal, whilst noting the political objections of Austria and Luxembourg and observing that further work was required on the provisions regarding the automatic exchange of information. The Council discussed the proposal again on 19 January 2010, but failed to persuade Austria and Luxembourg to change their position. On 10 February 2010, the European Parliament adopted a resolution. Amongst the 27 amendments to the Commission proposal, the European Parliament included requirements to ensure the protection of customer privacy, the protection of individuals regarding the processing of personal data, the free movement of such data and limitations on the specific categories of information subject to automatic exchange.

It was anticipated that political agreement would be reached at the ECOFIN meeting of 19 October 2010. However, earlier discussions held by the Committee of Permanent Representatives of the Member States on 13 October 2010 revealed that substantial differences of opinion remained. The matter was subsequently discussed at the meeting of 19 October 2010, where conditions relating to the automatic exchange of information on certain income and capital categories were considered. On 7 December 2010, the Council finally reached political agreement on the Proposal for a Council Directive, which will introduce a completely new approach to administrative cooperation regarding taxation by creating new provisions that give the Member States powers to cooperate efficiently at an international level so as to negate the adverse effects of ever-increasing globalization on the internal market.

The second Directive Proposal in the Communication, which was presented by the Commission at the same time

44. See the clause suggested by the ECOFIN, supra note 13, Sec. 1.
as that referred to in the previous paragraph, is intended to replace Directive 2008/55/EC on the recovery of tax claims to increase the efficiency of assistance so as to enhance the ability of tax authorities to recover unpaid taxes and thereby to contribute to the drive against tax fraud.

Directive 2010/24/EU was finally approved on 16 March 2010 and extends the scope of mutual assistance provisions for the recovery of claims relating to taxes and duties not covered by Directive 2008/55/EC to better safeguard the financial interests of the Member States and the neutrality of the internal market. Its other objective is to deal with the increasing number of requests for assistance and to deliver better results, which necessitates making assistance more efficient and effective and facilitating it in practice. In this respect, it was thought that amendments to existing Directive 2008/55/EC would be insufficient to meet these objectives.

The new legal instrument provides clearer rules that are intended to promote a wider information exchange between Member States. The new rules also ensure that all legal and natural persons in the European Union are covered, taking into account the ever-increasing range of legal arrangements, including not only traditional arrangements, such as trusts and foundations, but also any new instrument that may be established by taxpayers in the Member States. In addition, the new rules would make it possible to take account of all forms of claims by the public authorities in respect of taxes, duties, levies, refunds and interventions, including all pecuniary claims against taxpayers or against third parties that are in substitution of the original claim. It is thought that clearer rules are necessary to better define the rights and obligations of all of the parties involved.

The Member States have been given a period of time to transpose these measures, i.e. to adopt and publish the laws, regulations and administrative provisions necessary to comply with the Directive. The deadline is 31 December 2011 and the Member States must apply the provisions from 1 January 2012.

The third Directive Proposal noted in the Communication is that of 2008 to amend the Savings Directive. This is intended to extend the scope of the Savings Directive to certain interest payments made to EU residents that are channelled through intermediate tax-exempted structures established in third countries.

The Savings Directive has been in force in all Member States since 1 July 2005. Under the Savings Directive, all Member States must provide information to other Member States on interest paid from that Member State to individuals savers resident in other Member States. Austria, Belgium and Luxembourg were allowed to apply a withholding tax, rather than provide information, for a transitional period until certain criteria were satisfied. On 1 January 2010, Belgium changed from withholding tax to the automatic exchange of information. Here, it should be noted that the scope of the Savings Directive is broad, covering interest from debt claims of every type (for example, cash deposits and corporate and government bonds).

On 15 September 2008, the Commission published a review of the Savings Directive that identified certain failures, on 13 November 2008, the Commission published proposals to amend the Savings Directive and, on 24 April 2009, the European Parliament adopted a resolution regarding the proposal making certain amendments.

A compromise was discussed by the representatives of the Member States on 12 May 2010, but was not considered at the ECOFIN Council of 18 May 2010 because of objections from Austria and Luxembourg. Luxembourg has proposed the adoption of a withholding tax of 25% on a wide range of types of non-resident income, which, it argued – on the basis on its experience with the temporary measure allowing it to apply a withholding tax instead of engaging in information exchange – has demonstrated its value as against the untested automatic information sharing proposed by the Commission. It was also proposed that the application of any such withholding tax should end on 1 January 2014, the date on which automatic exchange of information would apply. The application of any directive would be conditional on third countries, such as Switzerland, agreeing to apply a similar, but not identical, regime. Belgium, which took over the rotating Presidency on 3 July 2010, prioritized work on the Savings Directive in its six-month Work Programme.

In the Communication, the Commission urged the Council to quickly reach political agreement on amendments to the Savings Directive. This would ensure that any improvements to savings measures could be extended to other jurisdictions that apply the same or equivalent measures as quickly as possible. However, at the time of writing this article, discussions were still ongoing at Council level, building on the unanimous conclusions adopted on 2 December 2008 and on 9 June 2009.

Finally, amongst the internal actions to be adopted on a less urgent basis, the Commission is of the opinion that the Council should give priority to the continuation of the work on the standstill and rollback of harmful business tax measures in the Member States under the Code of Conduct for business taxation.

4.4. External EU-level agreements to be adopted

With regard to external relations, the Commission recommends that the Council give the issue of good governance in the tax area political priority. Accordingly, in the Communication, the Commission makes several suggestions, including the following: (1) the issue of good governance in respect of taxation should be brought up as early as possible in the process of negotiating general
agreements; (2) the promotion of political dialogue between the European Union and third countries should address the issue in advance of trade-related negotiations; (3) the Commission should be flexible in its negotiations on wording in order to negotiate solutions that best fit the specific situation of each country; (4) the content of such agreements should include provisions similar to those applying within the European Union under the state aid rules; and (5) specific agreements in respect of taxation should be considered that contain, if appropriate, provisions on transparency and the exchange of information for tax purposes at the EU level.

The Communication strongly suggests that there should be a coherent link between EU financial support and the provision of access to EU markets for particular countries and their level of cooperation with the principles of good governance in the tax area. The Commission also believes that the promotion of good governance in respect of taxation in third countries that are eligible for development should establish a more unified approach to third countries that is linked to whether or not those countries apply the principles of good governance in respect of taxation. Consequently, the Commission’s view is that better coordination of the position of the Member States in discussions with the G20, OECD and UN on international good governance regarding taxation is necessary to ensure greater leverage in dealings with non-cooperative countries.

5. Conclusions

Is good governance one of the keys to the development of tax systems in the third millennium? Starting the conclusion to this article with a question may seem paradoxical, but the answer provides a good summary of the present situation.

More transparency, better exchange of information, fair tax competition and coordination are unanimously regarded as the cornerstones of the promotion of good governance in the tax area. The main actors involved in the implementation of these policies are the Member States, the Commission, the ECJ and the business community. Nevertheless, why are they interested in promoting good governance? The answer is clear: all these actors obtain some benefit from the application of such principles in the different arenas in which they operate.

The Member States are protecting their revenue base with regard to harmful tax competition. The business community is attempting to obtain optimal solutions to the tax problems of MNEs in the single market in respect of corporate tax reform. The Commission is pursuing its objective of coordination and harmonization regarding direct taxation by balancing power relationships between the Member States and the business community. The ECJ, in respecting the fundamental freedoms, is exercising direct influence over the sovereignty of the Member States, thereby giving rise to a form of harmonization in respect of the tax systems of the Member States.

With regard to case law, coordination and the use of a cooperative mode of governance by Member States in amending their tax systems in accordance with ECJ case law are undeniably positive. However, progress in this area is slow, due mainly to the fact that the Member States insist that cooperation should be exclusively intergovernmental, whilst the Commission is of the view that it directs the process and controls the agenda.

Nevertheless, the author foresees a fruitful immediate future for tax governance. With regard to the main fields of tax governance, the author would like to draw attention to several recent developments. Although the Code of Conduct is considered by some Member States to be outdated, recent events have put it back on the agenda. On 2 December 2008, ECOFIN adopted the Work Package in respect of the Code of Conduct Group, which was to be pursued over an 18-month period. On 18 November 2009, the Code of Conduct Group presented a progress report, which was discussed at the ECOFIN meeting of 2 December 2009. On 8 June 2010, ECOFIN considered the latest progress report and asked the Code of Conduct Group to continue monitoring standstill and the implementation of rollback, as well as continuing the activities agreed under the Work Package.

In his report on the single market,52 Prof. Mario Monti recommended re-examining the role and status of the Code of Conduct to increase coordination in this area. He expressed the need to look at the effects of harmful

regimes, mismatches and other negative effects of tax competition. He also recommended increasing the scope of the Code of Conduct Group to include personal income taxation and definitions of tax abuse.

At the ECOFIN meeting of 7 December 2010, the Council welcomed the progress achieved by the Code of Conduct Group in the second half of 2010 and again asked the Group to continue to monitor standstill and the implementation of rollback, as well as to carry on the activities under the Work Package as agreed by the Council in 2008. A new progress report by the group is expected by the end of the Hungarian Presidency (in July 2011).

With regard to cooperation, the approval of Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures is an important advance. The political agreement of ECOFIN on 7 December 2010 regarding the Proposal for a Council Directive on administrative cooperation in respect of taxation constitutes a further tool for good governance in the tax area.

The latest developments regarding corporate tax reform are also important. The 2011 Commission Work Programme sets out the intention to publish a proposal, which at the time of the writing of this article was anticipated for the first quarter of 2011, for a Directive on a Common Consolidated Corporate Tax Base with the intention of making the tax rules simpler, reducing compliance costs and removing the tax obstacles that companies currently face when operating across borders. Despite the well-known difficulties in reaching an agreement on this issue due to technical problems and the diverging political views of the Member States, an agreement appears to be closer than ever, as France and Germany have recently renounced their previous demand for a common minimum rate for the CCCTB.

With regard to Proposal No. 19 of COM (2010) 608, for a Single Market Act, the Commission committed to take the steps necessary to improve the coordination of national tax policies, notably by proposing a Directive on a Common Consolidated Corporate Tax Base in 2011. At the same time, the Commission has stated that the initiatives that it will propose will not have the objective of harmonizing corporate tax rates.

The author believes that this is the right time for the European Union to establish a governance policy in respect of taxation as a top priority. Currently, the main challenge for tax systems is how to overcome the global economic and financial crisis and how to adapt to the new economic order following the crisis. In this regard, the crisis presents the Commission and the Member States with an opportunity to work together to accelerate the implementation of good governance mechanisms in respect of taxation so as to make both the Member States and the European Union stronger. This would also help to rebalance all of the EU economies. Accordingly, this is the time, not only for Member States, but also for third countries, to accept, promote and strengthen international standards for good governance with regard to taxation. In the author’s opinion, the world is at the beginning of the ‘good governance era’ for tax systems within the widest meaning of the concept.

Finally, the author would refer to the conclusions of Communication (2009) 201. These state that, if good governance in respect of taxation is improved internally within the European Union, the Member States and their tax systems will benefit and be strengthened and, consequently, other jurisdictions will be willing to engage in efficient and effective administrative cooperation regarding taxation with the European Union. The author believes this will result in the realization of the best governance in relation to taxation.

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International Assistance in the Collection of Taxes

This article reviews the discussion on international assistance in the collection of taxes, which was the subject of Seminar I of the 64th Congress of the International Fiscal Association, held in Rome, Italy on 2 September 2010.

1. Introduction

International cooperation in the assessment and collection of taxes was the topic of Seminar I of the 64th Congress of the International Fiscal Association in Rome in 2010.1 Recently, there has been an unprecedented move towards transparency in the international exchange of information, together with improvements in the recovery of taxes in cross-border scenarios. The controversy over the tax data on the Liechtenstein CD and the global financial crisis led the G20, the European Union and the OECD to decide to renew the drive against tax evasion and tax avoidance at an international level. This article describes, specifically, improvements in international cooperation in the collection of tax debts.

2. The General Framework of Mutual Assistance

There are three typical forms of mutual assistance: (1) exchange of information; (2) assistance in the recovery of taxes; and (3) notification of liabilities. The primary effect of assistance is to widen the area in which the domestic power of the tax authorities can be effective. However, mutual assistance must respect national sovereignty and the legal framework of a state. The competent authority of a state may apply or be requested to cooperate with the competent authority of another state. For the sake of simplicity, this article refers to "applicant state" or "requested state". Each authority must act within its own set of rules and remains responsible for its own actions. Any review of its actions must also be carried out in accordance with domestic rules.

In dealing with the assessment and collection of taxes, there is a basic presumption that there is a tax debt (understood in a broad sense and including social contributions) that may be levied by the state or by a territorial subdivision (at the regional or municipal level). As a starting point, the applicant state (the country of the tax authorities requesting assistance in the collection of a tax debt) must take reasonable measures to recover the tax debt, or completely exhaust the internal means of recovery of such debt. The tax claim should also not be in dispute. In practice, this may be satisfied where the prescribed time limits for appealing against a tax assessment have expired.

If the procedure for cross-border assistance has, however, started and the taxpayer contests the claim, the procedure may be stopped in the requested state and "precautionary or conservancy" measures may be adopted. In order to ensure that there are sufficient assets to recover the debt at the end of the procedure, these measures make it impossible for the owner to conceal assets or put them out of reach of the tax authorities. The applicant state may not be satisfied with these provisional measures and may insist on enforcement. However, that state becomes liable if this action is declared to be wrongful by a court in a judgement in favour of the taxpayer. Such a liability could comprise not only reimbursement, but also compensation for damages (or compensatory damages).

Once the basic conditions for enforcement are met, the applicant state can make the request and send the instrument permitting enforcement, together with other pertinent information. A distinction must be made between an original executive title to a claim, which is usually employed in the internal recovery procedure, and an enforcement title that also allows for recovery in a foreign country. Previously, some difficulties arose regarding the latter. However, tax authorities currently agree on standard uniform documents in respect of cross-border tax claims to promote and enhance efficiency. The same uniform executive title may be valid in both countries. There is then no need to complement, convert or substitute the new uniform title in respect of the claim in the requested state, as could initially have been the situation. Translation is also no longer a problem, as multilingual forms are used.

The requested state applies its procedural rules for similar taxes in its territory or, if appropriate, rules that specifically refer to a recovery procedure.

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1. The Panel Members consisted of Philip Baker (United Kingdom, Barrister and QC from Grays Inn Tax Chambers), Ernst Czakert (Germany, Head of Division, Federal Ministry of Finance), Arie van Eijsden (the Netherlands, Senior policymaker Ministry of Finance) and Maria Amparo Grau Ruiz (Spain, PhD, Associate Professor of Law, Universidad Complutense de Madrid). Seminar I was chaired by Liselott Kana (LLM, Head of Department for International Taxation, Internal Revenue Service of Chile) with the help of Lino Lunardi (Italy) as Panel Secretary.
In general, foreign tax claims do not have priority in the requested state. Unless the states otherwise agree, this means that, in principle, a foreign tax claim does not have the privileges or preferences granted to domestic tax claims (in many jurisdictions revenue claims have priority over other claims).

Although the requested state must assist the applicant state in recovering the foreign tax debt, there are important limitations. Such limitations include, for example, a claim that is over a certain number of years old (where the statute of limitations may limit the obligation), circumstances of serious economic or social difficulties (this could be a concern in the current context of crisis if a government were, for example, to try to initiate a policy based on employment protection) or a minimum threshold (this is obvious, as it would not make sense to initiate an expensive assistance procedure abroad to recover a small amount of money; an elementary cost-benefit analysis often results in the fixing of a threshold in the rules).

Once the amounts are recovered, the requested state must remit the funds to the applicant state, including interest, costs, administrative penalties, fees and surcharges. Mutual assistance is provided free, though, in special cases, the states may agree to some form of cost sharing.

The scope of the mutual assistance clauses in international agreements for the collection of taxes may be broad in terms of the subjects of recovery. In the European Union, for example, the scope is understood to include claims owed by individuals, legal persons, associations with the capacity to perform legal acts, and any other legal arrangement of whatever nature and form with or without legal personality that owns or manages assets and that derives income that, in turn, is subject to a tax covered.

Often these provisions are not restricted according to the residence or nationality of the taxpayer or other persons involved. Mutual assistance in the recovery of taxes can even apply with regard to a deceased person. In such a scenario, however, a limit may be set. With regard to the Mutual Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters, the limit is set at the value of the estate.

3. The Revenue Rule and Some Exceptions

The old established "revenue rule", pursuant to which foreign tax debts are not enforceable in other jurisdictions, is illustrated in international jurisprudence by the 2007 Australian case of Jamieson v. Commissioner for Internal Revenue. This case dealt with a taxpayer who died after having lived for several years in the United States, but with his primary assets situated in Australia. The US Internal Revenue Service obtained a judgement of over USD 1 million against the estate for unpaid taxes. However, the New South Wales court allowed the Australian executor to distribute the assets without regard to the US tax debt on the ground that Australia applies the revenue rule, under which foreign tax debts are not enforceable in that jurisdiction.


However, the rule is subject to exceptions – for example, the exception found in Pasquantino, a US Supreme Court case from 2007 where the issue was whether or not a plot to defraud a foreign government of tax revenue violated the Federal Wire Fraud Statute. The Pasquantino brothers were indicted and convicted of federal wire fraud in the United States using interstate telephone wires in the United States to purchase and arrange the smuggling of goods (alcohol) into Canada, thereby evading Canadian taxes and duties. The Supreme Court had to decide whether or not the conviction was barred by the revenue rule as being an enforcement of foreign taxes, albeit indirectly. The wire fraud statute prohibits the use of interstate wires to defraud or obtain property by means of false or fraudulent pretences. Was there a property loss and, if so, did the revenue rule bar the enforcement of that property loss (as it was a tax claim by a foreign government)?

The US Supreme Court (by a narrow margin of five judges to four) held that the wire fraud statute is domestic criminal law in the United States and the prosecution was brought by the United States, in its sovereign capacity, to punish criminal conduct in the United States. The fact that Canada could receive restitution for the revenue lost as a result of the fraudulent behaviour was not relevant.

4. Measures for Assistance in Cross-Border Collection

Although there are exceptions to the revenue rule (as illustrated by the Pasquantino case considered in 3.), these are of limited application. Consequently, states concerned about the enforceability of cross-border tax claims have adopted different instruments, the main ones being:

- Art. 27 of the OECD Model Tax Convention (the “OECD Model”). The UN Committee of Experts has also decided to adopt an equivalent to Art. 27 on assistance in tax collection in its next update. The League of Nations initially planned that there would be a parallel evolution of tax treaties and mutual assistance agreements. Historically, the former have developed more rapidly than the latter; the treatment of mutual assistance has, for a long time, been reduced to a clause in most tax treaties. In recent years, mutual

assistance has gained importance, as demonstrated by the conclusion of specific agreements on the exchange of information. In the future, these could be complemented by rules for more developed tax collection assistance:
- EU Council Directive 2008/55/EC (to be replaced from 1 January 2012 by EU Council Directive 2010/24/EU) regarding mutual assistance for the recovery of claims relating to taxes, duties and other measures; and
- the Mutual Convention, which has recently been modified by a protocol.

5. Collection of Taxes under Tax Treaties

Under the OECD Model, assistance in the collection of taxes is found in Art. 27. The inclusion of Art. 27 in existing bilateral tax treaties is not widespread. This is because Art. 27 is relatively new, having been inserted into the OECD Model in 2003. Most existing bilateral tax treaties are much older. An additional problem is that, in order to implement Art. 27, close cooperation between the tax authorities is essential. Assistance in the collection of taxes requires a decision on a range of practical details. Accordingly, Art. 27(1) of the OECD Model states that, “[t]he competent authorities of the contracting states may by mutual agreement settle the mode of application of this Article.”

Another problem is national instruments permitting enforcement. Normally, the national instrument permitting enforcement has to be transformed into an instrument accepted by the requested state. This transformation process is normally the responsibility of a court located in the requested state. This, and the need to translate all relevant documents, make the recovery assistance procedure under Art. 27 of the OECD Model ineffective and slow.

Assistance in the recovery of tax claims will become more important in the future as more states implement Art. 27 of the OECD Model in their tax treaties. A culture of trust between states must be fostered so as to allow for enforcement measures based on legal acts originating in another state. States need a common understanding of each other, especially where their legal cultures differ.

6. EU Directives and the ECJ decision in Kyrian

An example of procedural issues that can arise with regard to cross-border enforcement is found in the recent European Court of Justice (ECJ) case of Kyrian. The applicant authority (Germany) sent an assessment notice to “Milan Kyrian” (in the Czech Republic) requiring him to pay excise duty. The instrument permitting enforcement subse- quently sent by the applicant authority was served by the competent authority of the requested state. Subsequently, the applicant authority issued a payment notice asking the requested authority to recover the excise duty under the instrument permitting enforcement. In the recovery documents, the debtor was identified by his forename, surname, address and date of birth. Milan Kyrian brought the case to the court in the Czech Republic. He claimed that the identification of the addressee in the instrument permitting enforcement by forename, surname and address was insufficient, as the instrument could equally apply to his father or son, all of whom were called Milan Kyrian and lived at the same address. He also complained that the documents had to be translated into the Czech language.

The Czech court referred the following questions to the ECJ for a preliminary ruling:

1. Must Article 12(3) of Council Directive [76/308] be interpreted as meaning that, where measures for enforcement of a claim are contested before the court of a Member State in which the requested authority is situated, the court is entitled, in accordance with the legislation of that Member State, to review whether the instrument permitting enforcement ... is enforceable and has been properly served on the debtor?

2. Does it follow from general legal principles of Community law, in particular from the principles of a right to a fair trial, sound administration and the rule of law, that service of the instrument permitting enforcement ... on the debtor in a language other than one he understands, which, moreover, is not an official language of the State in which it is served on the debtor, constitutes a defect which makes it possible to refuse to enforce on the basis of such an instrument permitting enforcement?

The ECJ (First Chamber) held as follows:

1. Article 12(3) of Council Directive 76/308/EEC of 15 March 1976 on mutual assistance for the recovery of claims relating to certain levies, duties, taxes and other measures, as amended by Council Directive 2001/44/EC of 15 June 2001, must be interpreted as meaning that the courts of the Member States where the requested authority is situated do not, in principle, have jurisdiction to review whether the court of a Member State in which the requested authority has its seat, that court is entitled, in accordance with the legislation of that Member State, to review whether the instrument permitting enforcement ... is enforceable and has been properly served on the debtor?

2. In the framework of the mutual assistance introduced pursuant to Directive 76/308, as amended by Directive 2001/44, in order for the addressee of an instrument permitting enforcement to be placed in a position to enforce his rights, he must receive the notification of that instrument in an official language of the Member State in which the requested authority is situated. In order to ensure compliance with that right, it is for the national court to apply national law while taking care to ensure the full effectiveness of Community law.

The primary question that the ECJ had to decide was who the correct defendant was. The situation is clear for a complaint against an instrument permitting enforcement – the correct defendant is the applicant authority, i.e. Germany. It is also obvious, with regard to a complaint against enforcement measures, that the correct defendant is the requested state (in the case in question, the Czech Republic). In this regard, the ECJ stated:

10. Id., Para. 32.
11. Id., Judgement.
In accordance with Article 8(1) of Directive 76/308, the instrument permitting enforcement is to be directly recognised and automatically treated as an instrument permitting enforcement of a claim of the Member State in which the requested authority is situated. Although, according to Article 8(2) thereof, the instrument may, where appropriate and in accordance with the provisions in force in the Member State in which the requested authority is situated, be accepted as, recognised as, supplemented with, or replaced by an instrument authorising enforcement in the territory of that Member State, such formalities may not be refused where the instrument is properly drawn up. It follows from the same provision that, if any of these formalities should give rise to a challenge concerning the claim and/or the instrument permitting enforcement thereof issued by the applicant authority, Article 12 of that directive is to apply.

Article 12 of Directive 76/308 provides for a division of powers between the bodies of the Member States where the applicant authority is situated and those of the Member State where the requested authority is situated to hear any disputes concerning the claim, the instrument permitting enforcement or the enforcement measures.

According to Article 12(1) of that directive, if the claim and/or the instrument permitting its enforcement issued in the Member State in which the applicant authority is situated are contested by an interested party, the action is to be brought by the latter before the competent body of that Member State, in accordance with the laws in force there. Article 12(2) provides that as soon as the requested authority has received the notification of such action either from the applicant authority or from the interested party, it is to suspend the enforcement procedure pending the decision of the body competent in the matter, unless the applicant authority requests otherwise.

On the other hand, under Article 12(3) of Directive 76/308, where it is the enforcement measures taken in the Member State in which the requested authority is situated that are being contested, the action is to be brought before the competent body of that Member State in accordance with its laws and regulations.

That division of powers results from the fact that the claim and the instrument permitting enforcement are established on the basis of the law in force in the Member State in which the applicant authority is situated, whilst, for enforcement measures in the Member State in which the requested authority is situated, the latter applies, pursuant to Articles 5 and 6 of Directive 76/308, the provisions which its national law lays down for corresponding measures, that authority being the best placed to judge the legality of the measure according to its national law (see, by analogy, Case C-184/05 Tvolh International [2007] ECR I-7897, paragraph 36, and Case C-318/07 Pische [2009] ECR I-0000, paragraph 63). The division of powers does not, in principle, permit the requested authority to question the validity or enforceability of the measure or the decision of which notification is sought by the applicant authority.\(^\text{12}\)

The ECJ then held that notification constitutes one of the enforcement measures referred to in Art. 12(3) of Directive 76/308 and that, therefore, in accordance with that provision, any action challenging that notification is to be brought before the courts of the Member State in which the requested authority is situated (in this case, the Czech Republic).

This decision is not acceptable in all circumstances. Notification in the European Union depends on the relevant national law. For example, if it is permissible to notify the debtor by mail of the recovery process without making a request to the competent authority of the requested state, a complaint can be made only at a court situated in the applicant state, as all relevant actions take place in the applicant state and under its responsibility.


7.1. Introductory remarks


7.2. Background

Within the European Union, close cooperation of the tax authorities in respect of the effective taxation and recovery of tax debts is essential. Cross-border transactions and the mobility of workers lead to tax claims in one Member State that can only be recovered in another Member State. The current legal basis for assistance in the recovery of debts in the European Union is Council Directive 2008/55/EC of 26 May 2008 on mutual assistance for the recovery of claims relating to certain levies, duties, taxes and other measures.\(^\text{14}\) In 2003, 3,355 requests for recovery were made. By 2007, the number of requests had risen to 11,794, but the amount of money recovered was only 5% of the requested amount. The inefficiency of the procedure is due to its slowness, differences in implementation amongst Member States and a lack of cooperation and transparency. For this reason the Commission made a proposal on 2 February 2009 to revise Council Directive 77/799/EEC of 19 December 1977 for the Exchange of Information. Following a year of negotiations, on 16 March 2010, the Council adopted the new Directive for assistance in recovery of revenue claims within the European Union.

The new Directive should protect the financial interests of the Member States and should protect the neutrality of the Internal Market. In particular, the recovery procedure ought to be more efficient and effective. Above all, a clear and consistent legal basis for the recovery procedure in the Member States should be established.

7.3. General provisions

Art. 1 of the new Directive sets out the rules pursuant to which Member States are required to provide recovery assistance to other Member States. Art. 2 defines the scope of the Directive. It applies to claims relating to:

- taxes and duties of any kind;
- refunds, interventions and other measures forming part of the system of total or partial financing of the

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\(^{12}\) Id., paras. 36-41.

\(^{13}\) Official Journal EU L 84, 31 March 2010, p. 1.

European Agricultural Guarantee Fund and the European Agricultural Fund for Rural Development, including sums to be collected in connection with these actions; and
- levies and other duties provided for under the common organization of the market for the sugar sector.

Art. 2(2) of the new Directive includes administrative penalties, fines, fees and surcharges relating to claims. The new Directive does not apply to compulsory social security contributions, miscellaneous fees and criminal penalties. 15

Art. 3 of the new Directive contains a list of defined terms, for example, "applicant authority," "requested authority" and "person." The term "person" includes not only natural and legal persons, but all other rights, irrespective of form and shape, that could be subject to tax. This should prevent assets of a debtor from falling outside the scope of the new Directive.

Art. 4 of the new Directive regulates the organization of recovery procedures. Member States must define a "Competent Authority" and a "Central Liaison Office." Liaison offices are also to be designated as responsible for particular types or categories of taxes or levies or have a specific territorial or functional jurisdiction. Member States, therefore, can organize the recovery procedure in accordance with their specific national conditions. There is an obligation to inform the Commission of the organizational structure and responsibilities. The Commission, in turn, informs all other Member States. This ensures that each Member State knows who its partner is in another Member State.

7.4. Provision of information

Art. 5(1) of the new Directive states that, upon request of the applicant authority, the requested authority shall provide any information that is foreseeably relevant to the applicant authority in the recovery of its claims. The requested authority shall take for this purpose all necessary measures. The requested authority is not, however, required to provide information:
- which it would not be able to obtain with regard to the recovery of similar claims of its own;
- which would disclose any commercial, industrial or professional secrets; and
- which would violate their security or public order. 16

However, these rules should not be interpreted to mean that the provision of information may be refused solely on the basis that the information is held by a bank, other financial institution, nominee or person acting in an agency or fiduciary capacity, or because it relates to ownership interests in a person. 17 This provision implements, into the Directive, the OECD standard for an effective and transparent information exchange.

7.5. Assistance in the notification of documents

Art. 8 of the new Directive provides for the possibility to notify documents that are relevant to the recovery procedure. At the request of the applicant authority, the requested authority notifies the addressee of all necessary documents. This is done with the aid of a standard electronic form that includes all relevant data related to the document. Such notification should only take place if no other means of notification is available.

7.6. Recovery or security measures

At the request of the applicant authority, the requested authority recovers claims that are the subject of an instrument permitting enforcement in the applicant Member State. 18 A request for recovery is accompanied by a uniform instrument permitting enforcement in the requested Member State. This uniform instrument permitting enforcement contains the same substantive information included in the initial instrument permitting enforcement and constitutes the sole basis for the recovery and precautionary measures taken in the requested Member State. It does not require an act of recognition in that Member State and does not need to be supplemented or replaced.

7.7. Interim conclusions

The main advantage of the new Directive is the introduction of a uniform instrument permitting enforcement in the European Union. Each national instrument permitting enforcement is transformed into a uniform instrument permitting enforcement that is a standard electronic form and transmitted electronically to the requested Member State. The standard form is designed such that essential information can be entered by way of a tick, formulated in accordance with text fields. Free text is kept to a minimum. Automatic translation largely resolves one of the biggest problems with regard to the current procedure, i.e. the different languages of the Member States. Overall, it is anticipated that the new Directive will significantly enhance recovery assistance between the Member States of the European Union.


The original Mutual Convention was opened for signature in Strasbourg on 25 January 1988. It entered into force in 1995 and was updated on 27 May 2010 by way of a protocol. The signatory status is shown in an annex to the Mutual Convention for further reference. The Mutual Convention provides for comprehensive assistance (exchange of information, service of documents and assistance in the recovery of taxes).

The amendment to the Mutual Convention was in response to the call of the G20. The objective was to allow developing countries to take advantage of the increasingly cooperative tax environment. In order to do so, the prin-
ciple of flexibility needed to be embraced, so as to take into account asymmetrical situations. The Mutual Convention is now open to non-members of the Council of Europe and OECD. This is a powerful tool that can be applied even in the European Union, as it allows for wider cooperation than exists under EU laws and directives.

In accordance with the Explanatory Report of the Mutual Convention, competing interests must be balanced. The contracting states must apply their national laws, without undermining the object of the Mutual Convention. In order to preserve domestic rights (i.e. to a proper procedure), the contracting states must enter a declaration (i.e. the authority may inform its resident or national before transmitting data) or a reservation (i.e. for recovery purposes).

9. A Practical Example: Netherlands Policy on Collection of Taxes under Tax Treaties

9.1. General overview

Netherlands policy is to incorporate mutual assistance provisions for the collection of taxes into all tax treaties. Nevertheless, the Dutch Tax and Customs Administration (DTCA) is sometimes confronted with a situation where requested states cannot even collect their own taxes. The DTCA has made some reservations in this context.

In the Netherlands, imprisonment for up to one year is available as a sanction to coerce a tax debtor to pay his outstanding tax debt. This is a remedy of last resort and can only be used when other, less severe measures of seizure and collection are not available. The DTCA does not, however, apply this sanction with regard to foreign tax debts.

9.2. Present experience

The DTCA’s staff sometimes complain about the complexity of tax treaty rules (the new Directive should partially resolve these problems). Generally, the procedures are too complicated. There is often a lack of awareness concerning existing opportunities. This implies that sometimes there are possibilities that some civil servants are not aware of. Occasionally civil servants complain that other states (Member States) are not dynamic enough. The handling of requests is also experienced as a time-consuming activity.

Within the European Union, the results of requests for mutual assistance in the recovery of taxes are relatively minimal. Some Member States are unwilling to implement rules regarding mutual assistance for the collection of taxes. The primary reason for this is simply that it is impractical for those countries to provide mutual assistance.

9.3. Are there alternatives?

A significant number of farmers live in the Netherlands. Due to the fact that the economic climate has been, and remains, rather unfavourable for farmers, a number of farmers have, since 1990, left to live in countries that are more favourable to farming, such as other Member States or countries outside Europe.

A number of farmers have left the Netherlands without paying exit taxes upon winding up their activities in the Netherlands. Primarily, this relates to émigrés to countries outside the European Union. This obviously is due to the fact that the EU Directive, in general, operates well. Consequently, the DTCA has, in the last 20 years, been confronted with many farmers who, in a rather “sneaky” way, have emigrated to countries outside the European Union without paying their tax debts. As this applies to tax levied on the termination of the activities of a company; the tax claim is, in most cases, substantial. Specifically, the claims range from EUR 100,000 to millions of euro.

9.4. Formulation of the problem

With regard to some countries emigrated to, bilateral tax treaties have been concluded that include provisions on mutual assistance for tax claims. The problem is, however, that the destination countries are not necessarily keen to assist in numerous tax collection requests (between 10 and 100 requests per year). The hesitation of some destination countries is reinforced by the fact that these countries cannot file similar requests in the Netherlands, as citizens of foreign countries who move to the Netherlands do not have tax debts in the countries they lived in before emigration. It appears, therefore, that there is, in effect, no reciprocity. In other words, the requesting state asks the requested state to exert efforts to collect tax debts, whilst the latter does not have any interest with regard to mutual assistance in tax collection in the first state.

9.5. Alternative methods of collection

In order to resolve this problem, the DTCA adopted a solution pursuant to which the requested state only has to exert minimal effort, whilst the requesting state pursues an active collection policy against the émigré farmers. The starting point is that the requesting state, i.e. the Netherlands, has no jurisdiction in the territory of the other state. The DTCA is well aware of and respects this.

As a first step, the DTCA consulted with the states of residence of the émigré farmers. During the consultations, the following was agreed:

1. the DTCA would write a letter to the farmer/tax debtor that provided that the farmer was to pay the tax within six weeks. In the event of failure to pay the tax, all necessary collection measures would be taken;
2. after six weeks, the tax authorities of the state of residence of the farmer would send a letter to the farmer informing the farmer to pay the outstanding Netherlands tax debt; otherwise, under the tax treaty, mutual assistance would be requested and other measures would not be ruled out;
3. in the letter of the foreign tax authorities to the farmers, a second payment deadline was given;


19. Such as milk quotas, high land prices, strict environmental rules and the lack of available land for expansion.
these letters were relatively successful, as they resulted in nearly half of the farmers paying their tax debts;

two Netherlands government officials visited the new states of residence of the farmers and took the following collection measures:

- the farmers who still had not paid their tax debt were invited, during office hours, to see the officials at a hotel;
- meetings were held with the bankers who financed the farmers and, with regard to those bankers that were not aware of the fact that the farmer still had (significant) Netherlands tax debts, it was agreed that, if a farmer applied for new credit or wanted to extend existing credit, this would only be granted once the farmer forwarded a declaration from the DTCA that proved that no tax debts were outstanding, which needed to be requested by the farmer himself;
- with regard to farmers with a lack of funds, meetings were held with life insurers who offered insurance policies to the farmers that provided that a loan could be taken out for payment of the tax combined with a life insurance policy;
- meetings were also held with institutes that had statistical data and analysis at their disposal that provided insight into the profitability of farming in general and those farmers who specialized in dairy, cattle, pig, agriculture and chicken farming, in particular; and
- meetings were held with the advisers of the farmers in question;

the measures in (5) gave an accurate impression of the profitability and the payment possibilities of the farmers;

these actions also resulted in much commotion in the Netherlands émigré communities in the foreign countries in question and, therefore, many farmers decided to pay their outstanding tax debts; and

in this respect, this approach has had a strong deterrent effect.

Ultimately, more than 90% of the farmers paid their outstanding tax debts. With regard to the remaining tax debtors, mutual assistance was requested. An agreement was reached with the tax authorities of the foreign states to the effect that swift action should be taken.

The benefit of this “direct approach” is that it does not significantly impose on other states. This approach does not, however, work if there are only a small number of taxpayers abroad. In this event, the costs are too high in relation to the end result. Ultimately, however, this exercise demonstrated that, in a short period of time, it is possible to collect significant amounts of money using this approach.

9.6. Important factors for the tax authorities

The example of the Netherlands experience highlights several important factors in relation to requesting authorities:

- there is no competence abroad;
- it is not possible to enforce tax liabilities abroad without mutual assistance;
- it is necessary to seek the commitment of the foreign tax authorities;
- the foreign tax authorities should be fully informed (there should be no surprises); and
- the foreign tax authorities should be informed of the proposed actions in their state.

9.7. Collection by “wrongful act”

Another method of collecting tax debts from taxpayers who have emigrated is to convert the tax debt into a civil law claim. This can be done by establishing the tax debt before a civil court and claiming that the tax debt has arisen as a result of a wrongful act of the taxpayer that has resulted in a claim for damages by the state. The court decision can subsequently be transformed into an exequatur and can, as such, be used as a replacement for the distress warrant from the tax bailiff. By way of the exequatur, the DTCA can collect the tax debt in the foreign country via existing multilateral treaties and/or bilateral agreements, and EU directives.

10. Conclusions: Where Might This Issue Be Headed?

It is evident that requests for recovery assistance are increasing, both in number and amount, as the mobility of capital and persons grows. This trend is likely to continue. Where multiple legal instruments may apply, it is advisable to establish a single legal basis in the requests made by applicant states. This should assist in clarifying the legal regime to be followed in a particular case. In general, it is preferable to taxpayers if the implementation arrangements were published, as many details of the arrangements are often left to the agreement of the competent authorities and are, therefore, unknown to others.

Finally, if developing countries are to join this global movement, a certain degree of flexibility must be incorporated into the classical scheme relating to reciprocity, both in law and in practice. This will allow the state-building capacity of developing countries to be improved.
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