FEDERATION
BANCAIRE
FRANCAISE

Le Directeur Général délégué

Paris, le 19 décembre 2008

Monsieur,

La Fédération Bancaire Française (FBF), organisme professionnel regroupant l'ensemble des établissements de crédit en France, est heureuse de l'opportunité qui lui est offerte de présenter ses commentaires dans le cadre de la consultation organisée par l'Organisation de Coopération et de Développement Economiques (OCDE), sur le projet d'un nouvel Article 7 du Modèle de Convention Fiscale.

Le document de l'OCDE « Appel à commentaires sur un projet de nouvel Article 7 (Bénéfices des Entreprises) du Modèle de Convention fiscale de l'OCDE » daté du 7 juillet 2008 et publié sur votre site internet fait l'objet d'un certain nombre d'observations de notre part que vous trouverez dans la note ci-jointe, établie en anglais pour votre convenance.

Nous restons à votre entière disposition pour tout renseignement complémentaire dont vous auriez besoin.

Je vous prie d'agréer, Monsieur, l'expression de mes sentiments distingués.

Pierre de Lauzun

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# FBF'S POSITION AS REGARDS THE OECD'S « DISCUSSION DRAFT » ON ARTICLE 7 OF THE MODEL CONVENTION

## 1. COMMENTS ON THE NEW RULE SET FORTH BY ARTICLE 7 § 3

A new rule is provided for by Article 7 § 3 with respect to the attribution of "free" capital. As explained in point 45 of the Commentary, it provides that a Contracting State must accept the attribution of free capital derived from the application of the approach used by the other State in which the permanent establishment (PE) of an enterprise of the first State is located if the following two conditions are met:
*(i) the difference in capital attribution between the two States must result from conflicting domestic law choices of capital attribution methods*
*(ii)* ***the States must agree*** *that the State in which the permanent establishment is located has used an authorized approach to the attribution of capital and that that approach produces a result consistent with the arm's length principle in the particular case.*

As regards this proposed text, we think there is a lack of clarity with respect to certain concepts (3.1). Further, we have doubts as to whether the new rule will actually work and will be useful, especially for banks. Indeed, the question is whether such a rule will help if an agreement (or compromise) between both contracting States is set forth as condition. (3.2.)

### 1.1. Clarification needed as to the concept of "domestic law" and as to the concept of "method" versus "approach"

As regards the first condition of Article 7 § 3, it is stated that the difference in capital attribution between the two States must result from conflicting domestic law choices of capital attribution methods. Clarification is needed from the OECD as to what should be understood by "domestic law".

For instance, rules pertaining to the attribution of capital in France derive from the French tax administration's audit practice; there is no formal law or regulations with respect to capital allocation to branches. Therefore, if the States interpret strictly the term "domestic law" used by the OECD, this means that Article 7 § 3 would not apply in cases where France is involved, which is obviously not acceptable.

Therefore, we would like the provisions of Article 7 § 3 to clearly mention that the term "domestic law" refers to any law, regulation, judicial doctrine or audit practice applicable in that State.

Furthermore, we note that the wording used in Article 7 § 3 refers to "methods" and "approach" for attributing capital to the PE, while the Commentary (notably at point 45) uses the word "approach". This discrepancy may create confusion. We think that the word "approach" is more relevant since the OECD essentially provides for general frameworks and the word "method" may be interpreted too strictly by certain Member States (see comments hereafter).

### 1.2. Comments as to the second condition of the new rule

As explained in point 45 of the Commentary, the new rule provided for by Article 7 § 3 provides that a Contracting State must accept the attribution of free capital derived from the application of the approach used by the other State in which the PE of an enterprise of the first State is located if two conditions are met. The second condition pertains to both States agreeing that the State in which the PE is located used an authorized OECD approach to the

attribution of capital and the fact that that approach produces a result consistent with the arm's length principle in the particular case.

According to this paragraph, for the dotation of capital of the PE, the State of the head-office company has to follow the method of the PE if both States agree that this approach produces an arm's length result in conformity with paragraph 2 in the particular case involved.

In practice, we fear that Contracting States may often not agree (for valuable reasons or not) on the fact that the second condition is met. Specifically, they could refuse to admit that (i) the result is arm's length and/or (ii) that the method used by the State of the PE is an acceptable method.

For instance, in practice, certain Member States may argue that the method used by the State of the PE is not a method in conformity with OECD principles and/or does not produce an arm's length result because the taxpayers has carried out minor adjustments which were made necessary by the specific facts and circumstances of the case. In such a situation, there is no protection for the taxpayer although he may have followed an acceptable OECD approach.

Therefore, we think that in many cases, the rule of Article 7 § 3 may not be applied and this would mean that the position of the taxpayers may often be insecure.

### 1.3. FBF's proposed amendments to Article 7 § 3 and corresponding Commentary

- First, the OECD should clarify the meaning of "domestic law" and extend this concept to regulation, judicial doctrine, audit and administrative practices. The OECD should also favor the use of the word "approach" rather than "method".

- Secondly, with respect to the second condition of Article 7 § 3, we suggest that it be re-drafted so as to reverse the burden of the proof. To actually reach the objective of relieving double taxation, it is in our view necessary to make it compulsory that the State of the head-office has to make a correlative adjustment whenever the taxpayer has applied an "acceptable OECD approach" (i.e. the requirement to make this adjustment should not depend upon the agreement between both States), unless this State can prove that the taxpayer has used a method which significantly differs from OECD general recommendations, in a way which does not produce an arm's length result. **We think this is indeed the only way to provide efficient protection for taxpayers.**

  Furthermore, whether the taxpayer has applied an "acceptable OECD approach" has to be interpreted with flexibility: States should not be allowed to reject a method simply because taxpayers have made adjustments made necessary by the case at hand. The question should be whether the taxpayer is in line with an acceptable "OECD approach". In this respect, we favor the use of the word "approach" rather than "method" which may be interpreted too strictly by certain States.

  It seems reasonable to consider that any capital allocation realized based on an authorized OECD approach is assumed to be at arm's length, unless otherwise demonstrated by the State. This would also be consistent with classical burden of proof rules in the area of transfer pricing.

  In short, one could propose that – as a second condition – **it be provided that the State of the head-office is bound by the method applied by the taxpayer in conformity with the regulations or administrative practice of the State of the PE**

**and has to grant a symmetric adjustment to the taxpayer, unless the State of the head-office can prove that this is not an authorized OECD approach and that it does not produce a result consistent with the arm's length principle in the particular case.** The second condition should therefore be amended so as to place the "burden of proof" onto the tax administrations.

## 2. COMMENTS RELATING TO OPTIONAL PARAGRAPHS TO ARTICLE 7 § 3

The OECD proposes two optional paragraphs that States may adopt bilaterally if they wish to do so. These alternatives are commented respectively at points 53 and following and points 67 and following of the Commentary.

### 2.1. First optional paragraph (Points 53 to 66 of the Commentary)

Point 53 and following refers to double taxation cases resulting from certain reassessments or conflicting rules between the PE State and the head-office State not covered by the rule of Article 7 § 3, which the OECD proposes to solve by an additional paragraph.

Certain comments of point 53 and following remain unclear to us and it may be worthwhile the OECD clarifies them: First, we would like to have confirmation that this additional paragraph does not apply to the question of attribution of free capital (which is what we understand from the wording of points 54 and 57 for instance).

Second, it is unclear how the example provided for in point 57 should be understood. It notably indicates (line 18) that: *"Since the difference is not attributable to different domestic rules concerning the allocation of "free" capital, paragraph 3 does not apply. In that particular case, the last part of the additional paragraph put forward in paragraph 53 above will deem each State to have adjusted the profits attributable to the PE, thereby imposing a reciprocal obligation on the other State to make an appropriate adjustment. Since that obligation only exists to the extent necessary to eliminate double taxation, the obligation of one State will be extinguished by the other State making an appropriate adjustment. If neither State is willing to do so, the additional paragraph will allow the taxpayer to use the mutual agreement procedure to require the two States to eliminate any double taxation since failure by these States to do so would results in taxation not in accordance with the Convention, thereby triggering the application of paragraph 1 of Article 25".*

We understand this rule would apply: (i) if a Contracting State adjusts the profits attributable to a PE or (ii) if double taxation arises from conflicting domestic laws (in which case, profit is "deemed adjusted").

As indicated above for Article 7 § 3, we would like it be mentioned that the term "domestic law" refers to any law, regulation, judicial doctrine or audit practice applicable in that State.

Furthermore, on the adjustment mechanism itself, we understand that if one State is deemed to have made an adjustment, the other State must also make a symmetric adjustment to eliminate double taxation (and if neither of them is willing to do so, the taxpayer can then use the mutual agreement procedure). However, it is not clear how this second State must make the adjustment: will this be on the basis of Article 23, and if so, is the Member State required to do so, on such basis? From point 61, **it seems that it is only a possibility to make the adjustment on the basis of Article 23 A and B.**

At this stage, we think that greater protection for the taxpayer is only guaranteed if the second State is required to make the symmetric adjustment on the basis of such Article 23.

If not, that means in practice that taxpayers will most probably have to use the mutual agreement procedure (MAP), which is not the best solution as this is a lengthy procedure in which States are not obliged to reach an agreement.

**Actually, in practice, we have seen more and more taxpayers suffering double taxation situations, either because some States (tax audit departments) put some pressure onto taxpayers not to enter into MAP procedures, or if a MAP procedure is introduced, because States cannot manage to reach an agreement.** Moreover, even in few cases where States manage to fully relieve double taxation in a MAP, this remains negotiated / compromise solutions i.e. isolated solutions rather than an objective and consistent approach. This often results in treating differently taxpayers which are in very similar situations. For all these reasons, the MAP appears not to be a satisfactory and protective solution for taxpayers.

Therefore, the optional paragraph should be amended so as to provide for a compulsory symmetric adjustment on the basis of Article 23. If the adjustment relates to subjects where there is no clear OECD approach, it may be possible to consider that such a reciprocal adjustment is also compulsory, unless the States manage to agree on a revised reciprocal adjustment reflecting a better arm's length result and fully relieving double taxation for the taxpayer.

### 2.2. Second optional paragraph (Points 67 and following of the Commentary)

We understand that points 67 and following refer to an alternative wording of the additional paragraph, where only the MAP would be used. Here again, we think that in practice, taxpayers will not benefit from any extra protection since the MAP is a lengthy procedure in which States are not obliged to reach an agreement.

### 2.3. FBF's proposed amendments to OECD's optional paragraphs

With respect to the **first alternative** (points 53 and following i.e. first optional paragraph), our suggestion is that **it should be made compulsory rather than optional**, and that a **compulsory adjustment on the basis of Article 23** must be provided for, so that a greater protection is granted to taxpayers. Besides, in line with the above, we do not see the advantages that the second alternative (points 67 and following) would offer as now drafted.

## 3. COMMENTS PERTAINING TO THE IMPACT OF TERRITORIAL RULES FOR THE APPLICATION OF ARTICLE 7

### 3.1. Impact of territorial rules

Certain provisions of the Commentary relating to Article 7 may not take into account the impact of territorial rules such as the French territorial rules.

In particular, we note that point 49 of the Commentary states that: *" paragraph 3 also does not apply to affect the computation of the exemption or credit under Article 23 A or B except for the purposes of providing what would otherwise be unavailable double taxation relief for the tax paid to the Contracting State in which the PE is situated on the profits that have been attributed to the PE in that State.* ***This paragraph will therefore not apply where these profits have been fully exempted but the Other State or where the tax paid in the first mentioned State has been fully credited against the other State's tax (...) and in accordance with Article 23 A or B".***

First, we are not fully sure what the OECD means here and this should be clarified.

Second, we would like to point out that under French territorial rules, the profits of a PE are not taxed in France but only in the country where the PE is located (conversely, the PE's losses are not deducted in France).

However, the fact that the profits of the PE are not taken into account in the French base does not mean that a capital attribution to a foreign PE has no impact on the French base. Indeed, when a third State requires the attribution of capital to the PE of a French company situated therein, which is higher that what is authorized under French audit practice, the French tax authorities will challenge the deduction of the refinancing costs "in excess" related to the "excess" capital attributed to the PE.

We fear that the wording of point 49 may be misleading (notably the second sentence), as it may imply that the rule of Article 7 § 3 may not apply in situations involving France or countries applying the same specific territorial rules.

### 3.2. FBF's proposed amendments

This point needs to be clarified, in order to make sure that States which have adopted tax territorial rules, such as France, be also obliged to follow the mechanism provided for in Article 7 § 3 to determine the taxable basis in head-office country and avoid double taxation.

## 4. COMMENTS ON ARTICLE 7 § 2: DOCUMENTATION REQUIREMENTS

We think that the current wording of point 23 of the Commentary would lead to a *de facto* standard of documentation requirements for dealings between the PE and other parts of the enterprise which would partly go even beyond the documentation that is required for transactions between two associated enterprises/banks.

Furthermore, it is stated that the absence of legal consequences of those dealings of the enterprise/bank as a whole implies a need for greater scrutiny of these dealings than of transactions between two associated enterprises/banks and also greater scrutiny of documentation. We fear that this might encourage some Contracting States to request documentation that might even be more detailed than that which is currently seen as appropriate for transfer pricing documentation as according to the respective law of many OECD States.

We believe that the need for the same scrutiny of these dealings compared to transactions between two associated enterprises as well as the same scrutiny of documentation would go too far in respect of applying the separate entity approach and arm's length principles to PEs.

In addition, point 23, sentence 4, mentions an accounting record and contemporaneous documentation showing dealings that transfer economically significant risks, responsibilities and benefits.

In our view, this should not be the "useful starting point", as set out in point 23, but the general level of documentation accepted by Contracting States. Greater documentation requirements than this would lead to an additional compliance burden.