European Banking Federation

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Brussels, 23 December 2008

Subject: ***Comment letter on the discussion draft on a new Article 7 of the OECD model tax convention***

Dear Mr Owens,

We appreciate the opportunity to comment on the Discussion Draft for a new Article 7 of the OECD Model Tax Convention.

In general, we think that the proposals need to be clarified.

First of all, we would like to recommend including a summary of the content of Part II and Part III of the final report on the attribution of profits to permanent establishments.

Second, we would recommend clarification of certain concepts used in § 3, like "domestic law" and "method" versus "approach".

We are particularly concerned that the proposals in their current form will not enhance the protection of taxpayers. You will find attached our detailed comments.

Yours faithfully,

Guido Ravoet

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COMMENT LETTER ON THE DISCUSSION DRAFT ON A NEW ARTICLE 7 OF THE OECD MODEL TAX CONVENTION

I. GENERAL OBSERVATIONS

1) The EBF welcomes the opportunity to comment on the discussion draft on a new Article 7 (Business Profits).

2) Text of report

Both the update on the new Commentary on Article 7 and the discussion draft contain only a reference to part II (banks) and part III (global trading) of the final report on Attribution of Profits to Permanent Establishments instead of a summary [or extracts] of its contents. This concerns above all the attribution of income and (dotation) capital of banks and consequently the functional analysis, including the determination of assets used and conditions of use and risks assumed by banks, "internal loans" and "free capital". We recommend including a summary [or extracts] of the content of part II and part III of the final report on Attribution of Profits to Permanent Establishments.

II. COMMENTS ON ARTICLE 7 PARAGRAPH 3

3) Comments on the new rule set forth by Article 7 paragraph 3

A new rule is provided for by § 3 of Article 7 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 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 in the text with respect to the concept of “domestic law” (3.1). Further, we have doubts as to whether the new rule will actually work: A fundamental question with respect to the potential application of this new rule and interpretation in points 45 and following of the Commentary is whether it would be of any use, especially to enterprises/banks? Will such a rule help if enterprises/banks are referred to an agreement (or a compromise?) between both contracting states as condition for taxation? I.e.: Cui bono? Where (will) do such agreements exist? (3.2.)

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

In § 3 of article 7, 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. A new rule is provided for by § 3 of Article 7 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 PE of an enterprise of the first State is located if the two conditions are met. First the difference in capital attribution between the two States must result from conflicting domestic law choices of capital attribution methods. In its wording, the new rule set forth by § 3 of Article 7 refers to "conflicting domestic law choices". 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. It is also the case in countries such as Austria, Germany and Italy. Therefore, if the States interpret strictly the term "domestic law" used by the OECD, this means that § 3 of Article 7 would not apply in cases where these countries are involved, which is obviously not acceptable.

Furthermore, we note that the wording used in § 3 of Article 7 refers to "methods" and "approach" for attributing capital to the permanent establishment, while the Commentary (notably at point 45) uses the word "approach". This discrepancy may create confusion. We think 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 our comments hereafter).

3.2. Comments as to the second condition of the new rule

As explained in point 45 of the Commentary, the new rule provided for by § 3 of Article 7 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 the two conditions are met. The second condition [refers 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 (or come to a compromise?) 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.

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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. In such a case, 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.

3.3. EBF's proposed amendments to § 3 of Article 7 and corresponding Commentary

With respect to the first condition, the OECD should clarify the meaning of "domestic law" and extend this concept to regulation, judicial doctrine, audit and administrative practices.

With respect to the second condition, 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.

Secondly, 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 grant a symmetric adjustment to the taxpayer, unless the State 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.

4) Additional paragraphs proposed by the OECD (points 53 and following and points 67 and following)

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

4.1. 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 PE State and State of the parent firm not covered by the rule of § 3 of Article 7, 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 clarifying them with the OECD: 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 to us how the example provided for in point 57 works. 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 § 3 of article 7, 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 <u>possibility</u> 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. 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, whether because some States (tax audit departments) put some pressure onto taxpayers not to enter into MAP procedures, or if an MAP procedure is introduced, because States cannot manage to reach an agreement. Moreover, even in few cases where State manage to fully relieve double taxation in an MAP, this remains a negotiated / compromise solutions, and not an objective and consistent approach, which may often lead to treat differently taxpayers which are in very similar situations. For all these reasons, 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.

4.2. 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 mutual agreement procedure would be used. Here again, we think that in practice, taxpayers will not benefit from any extra protection since the mutual agreement procedure is a lengthy procedure in which States are not obliged to reach an agreement.

4.3. EBF's proposed amendments to OECD's optional paragraphs

With respect to the first alternative (points 53 and following), our suggestion is should be made compulsory rather than optional, and that a compulsory adjustment on the basis of Article 23 is provided for, so that a greater protection is granted to taxpayers.

Based on our comments above, we do not see the advantages that the second alternative (points 67 and following) could offer.

5) Comments on elimination of double taxation issues: Adjustment mechanisms

5.1. Impact of territorial rules

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Point 49 of the Commentary indicates 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"*.

We would like to point out that under territorial rules of the head office like in France, Germany or other countries, the profits of a PE are not taxed in the states of the head office but only in the country where the PE is located (conversely, the PE's losses are not deducted in these countries; France, Germany etc.). However, the fact that the profits of the PE are not taken into account in the tax base of the country of the head office does not mean that a capital attribution to a foreign PE has no impact on the base of the country of the head office like in France, Germany or other countries. Indeed, when a third State requires the attribution of capital to the PE of a e.g. 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 § 3 of Article 7 may not apply in situations involving France, Germany or countries applying the same specific territorial rules.

Therefore, 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 § 3 of Article 7 for determining the base taxable in the country of the head office and avoid double taxation.

5.2. EBF's proposed amendments on elimination of double taxation issues

The OECD should take into account and clarify that: The protection of Article § 3 of Article 7 must also benefit to countries which have territorial tax rules. Point 49 of the Commentary should be reviewed accordingly.

III. COMMENTS ON ARTICLE 7 PARAGRAPH 2

6) Documentation requirements

We think that the current wording of point 23 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. Further, 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.

Point 23, sentence 4, mentions an accounting record and contemporaneous documentation showing dealings that transfer economically significant risks, responsibilities and benefits. We think that this kind of documentation should not only 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. We are of the opinion that this would not be in line with the scope and intention of many, especially minor or preliminary, PEs.

7) Profit / Loss situations

According to point 15 CD, profits may be attributed to a PE even though the enterprise/bank as a whole has never made a profit (sentences 2 and 3). Conversely, point 2 may result in no profits being attributed to a PE even though the enterprise/bank as a whole has made a profit. Looking at the overall loss situation of an enterprise/bank, which sentence 2 of point 15 deals with, it should be clarified that if profits are attributed to a PE, the loss of the enterprise/bank to be taxed in its contracting state increases correspondingly. This is the only way for the overall loss situation of the enterprise/bank to be accounted for appropriately, since profits in the contracting state of the PE on the one hand means increased losses in the contracting state of the enterprise/bank on the other hand. For the purpose of clarity, these comments do not affect the application of territorial rules.

Point 16, sentence 2 eliminates (in accordance with either Article 23A or 23B) double taxation of the profits properly attributable to the PE in case of a profit situation in both contracting states - in the contracting state of the parent firm as well as the contracting state of the PE. This leads to fair taxation. Consequently, if in an overall profit situation of the enterprise/bank as a whole the separate entity approach leads to the attribution of no profits to the PE (point 15 sentence 3), it should be clarified that the profit to be taxed in the contracting state of the parent firm will not increase accordingly as long as a loss is attributed in the contracting state of the PE. For the purpose of clarity, these comments do not affect the application of territorial rules.

IV. OTHER ISSUES

8) Inconsistent reporting

As far as the points about dotation capital are concerned, we would like to suggest future discussion about a supplementary point on the determination of dotation capital on going back to the regulatory basis of the risk weighted assets when using a so-called waiver regulatory regulation by the bank in accordance with Article 69 of the EU Directive 2206/48/EC of the European Parliament and the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast). The waiver enabled a reduction in the regulatory burden on banking groups by partially waiving the prudential requirements on a solo basis. (Art. 69 para 1 sentence 1: The Member States may choose not to apply Article 68 para. 1 to any subsidiary of a credit institution, where both the subsidiary and the credit institution is included are subject to authorisation and supervision by the Member State concerned, and the subsidiary is included in the supervision on a consolidated basis of the credit institution which is the parent undertaking, and all of the following conditions are satisfied, in order to ensure that own funds are distributed adequately among the parent undertaking and the subsidiaries. Article 68 para. 1: Credit institutions shall comply with the obligations laid down in Articles 22 and 75 and Section 5 on an individual basis.) Banks which use the so-called waiver could have the problem of a lack of data for calculating the appropriate dotation capital of a PE.

9) Income and items of income

Furthermore we suggest a supplementary point with regard to "items of income" of a PE and concerns the connection of Article 7 an 23 of the Convention, especially points 32.2, 32.6 and 32.7 of the Commentary: If a so-called "switch-over" clause is applied in a double taxation convention, the interpretation of the word "income" could differ between the contracting states, as is the case e. g. in the new treaty between the United States of America and Germany. The so-called "switch-over" clause is intended to deal with cases of double exemption of income.

In Article 23 para. 4(b) of the Treaty between the USA and Germany, It is stated that "income" is not to be exempt but only credited if the USA applies the provisions of the Convention to exempt such income or capital from tax, or applies paras 2 or 3 of Article 10 (dividends) to such income, or may under the provisions of the Convention tax such income or capital but is prevented from doing so under its law. It is stated in the Technical Explanation of the US Treasury Department (July 17, 2007 page 26 concerning dividends) that it was not intended to apply this to cases where profits have been subject to the general US corporate-level taxing regime, and that, for example, the fact that an US corporation pays a reduced level of US corporate-level tax because of the nature or source of its income (e.g. because it is entitled to a dividends received deduction, a net operating loss carry forward, or a foreign tax credit) will not entitle Germany to switch from exemption to credit. In the German Finance Ministry´s view, the so-called "switch-over" clause is already applicable if "items of income" of an US-PE of a German enterprise/bank are not to taxed in the USA - even if the "income" as a whole is taxed in the USA.

The OECD should take into account and clarify that the switch-over-clause is not applicable in cases where profits have been subject to the general corporate-level taxing regime of a PE and that the fact the PE pays – corresponding to an national enterprise in the country of the PE – a reduced level of corporate-level tax because of the nature of source of its income (e.g. because it is entitled to a dividends received deduction, a net operating loss carry forward, or a foreign tax credit).