THE RELATIONSHIP BETWEEN THE ARM'S-LENGTH PRINCIPLE IN THE OECD MODEL TREATY AND EC TAX LAW (PART 1)

GEORG W. KOFLER

Despite the complexities inherent in practical and procedural application of the arm's-length principle, issues may arise regarding the relationship of this generally accepted standard, as set forth in Article 9 of the OECD Model Treaty, and the principle of nondiscrimination under the EC Treaty and applicable secondary EC law, such as directives, since profit adjustments under the arm's-length principle are in many instances applied (only) in cross-border situations.

It is generally recognized in international tax law that affiliated companies conducting cross-border business must adopt market principles, that is, act as if the business were being conducted between independent parties. The price charged for goods and services—the transfer price—therefore must be in accordance with the "arm's-length principle."[1] Though not without criticism due to the practical problems of its application,[2] the arm's-length principle is globally accepted in international taxation. This is reflected not only in Article 9 of the OECD Model Income Tax Convention ("OECD Model"),[3] but also in Article 9 of the UN Model Convention,[4] Article 9 of the U.S. Model Convention,[5] and Article 4 of the EC Arbitration Convention.[6] Its importance is also maintained and developed in the OECD Transfer Pricing Guidelines (OECD Guidelines"),[7] and was recently confirmed by the Commission of the European Communities.[8]

Part 1 of this article below starts with the premise that the arm's-length principle is globally accepted when determining the price charged for goods and services between affiliated companies conducting cross-border business, though the principle is not without criticism due to the practical problems of its application. It covers background on the internal market and transfer pricing in the EU, the arm's-length principle in Article 9 of the OECD Model Income Tax Convention and Article 4 of the EC Arbitration Convention, and begins a discussion of the *Lankhorst-Hohorst* case and the incompatibility of the German thin capitalization rules with EC law and the relevance of Article 9 OECD Model in the case. Part 2 in a future issue of JOIT will pick up with conclusions from *Lankhorst-Hohorst* regarding arm's-length adjustments; analyze potential application of the EU Parent-Subsidiary Directive to the facts of the case; and conclude with some remarks on the interplay between the Parent-Subsidiary and Interest and Royalties Directives.

GEORG W. KOFLER is assistant professor of tax law with Johannes Kepler University of Linz in Austria. This article is the result of a research project in the International Tax Program at New York University Law School under the supervision of Professor H. David Rosenbloom. The author thanks Professors Rosenbloom, Ruth Mason, and Kees van Raad for discussing the topic, providing insightful comments, and critically reviewing the preliminary draft of this article. Prof. Rosenbloom is a member of Caplin & Drysdale in the firm's Washington, D.C., office, and a member of THE JOURNAL's Board of Advisors.

Internal Market and Transfer Pricing in the EU

With regard to the European Union (EU), the Commission identified the increasing importance of transfer pricing tax problems as an internal market issue in its study on "Company Taxation in the Internal Market,"[9] noting that transfer pricing issues often give rise to double taxation, which in turn is a serious obstacle for the internal market. In this respect, the Commission strongly believes that double taxation created by transfer pricing rules (even if legal) should be avoided in principle. If this is not possible in practice, it is imperative to have appropriate dispute settlement mechanisms that relieve double taxation as quickly and efficiently and in as many cases as possible, and with the lowest possible costs for business and tax administrations.[10]

Such double taxation generally arises in two settings. First, when a tax administration makes an income adjustment (a "primary adjustment"),[11] the multinational enterprise is immediately subject to double taxation. This double taxation can be relieved if the tax authorities of the other state accept a converse income adjustment ("corresponding adjustment"), or if the tax authorities making the primary adjustment subsequently reverse that adjustment. Second, to make an actual allocation of profits consistent with the primary adjustment, some tax legislation might assert a constructive transaction, which may take the form of dividends, loans, or equity contributions. This "secondary transaction"[12] might lead to source taxation or affect the availability of loss relief claims, and the other tax jurisdiction involved might not accept it. Therefore, although all EU member states apply and recognize the merits of the OECD Guidelines, the different interpretations of the Guidelines often give rise to cross-border disputes that are detrimental to the smooth functioning of the internal market and create additional costs both for business and national tax administrations.

Based on these considerations, the Commission has concluded that many of the problems in transfer pricing could be addressed through closer cooperation between tax administrations and business. Thus, in a 2001 communication paper, it proposed the establishment of the "EU Joint Transfer Pricing Forum" (JTPF) with member states and business representatives,[13] the overall objective of which is a more uniform application of transfer pricing tax rules within the EU. The Council Conclusions of the General Affairs Council of March 11, 2002, welcomed this proposal.[14]

The first meeting of the JTPF was in 2002, and a working program has been established through 2004.[15] An intermediate report by the JTPF on its activities and on pragmatic, non-legislative recommendations contains conclusions and recommendations in the form of a draft Code of Conduct, which is intended to ensure a more uniform application by member states' tax administrations of the EC Arbitration Convention and the mutual agreement procedures in double taxation conventions between the states.[16] The JTPF's future work will focus on documentation requirements and possible preventative measures to avoid double taxation in transfer pricing (e.g., advance pricing agreements).

Apart from these attempts at harmonizing cross-border transfer pricing, the fundamental freedoms laid down in the EC Treaty may also play a central role in evaluating transfer pricing issues within the EU. Despite the complexities inherent in practical and procedural application of the arm's-length principle, issues may arise regarding the relationship of this generally accepted standard, as set forth, *inter alia*, in Article 9 OECD Model, and the principle of nondiscrimination under the EC Treaty and applicable secondary EC law, such as directives, since profit adjustments under the arm's-length principle are in many instances applied (only) in cross-border situations.[17] The European Court of Justice (ECJ) recently addressed these issues in *Lankhorst-Hohorst*[18] (discussed below), which dealt with German thin capitalization rules. In that decision, the ECJ held that thin capitalization rules that apply only in a cross-border setting are not in compliance with the freedom of establishment in Articles 43, 48 EC.[19]

The court mentioned Article 9 OECD Model but rejected the German government's argument that the basic ideas underlying this provision may justify reclassification of interest payments on cross-border loans to thinly capitalized subsidiaries. Even assuming that the German thin capitalization rules comply with Article 9 OECD Model, the Advocate General pointed out that "the fact that the rules are consistent with the provisions of the OECD model convention does not also mean that they comply with Article 43 EC. Neither the provisions nor the objectives of the OECD model convention, on the one hand, or of the EC Treaty, on the other, are in fact the same."[20] Article 43 EC forbids member states from exercising their remaining power in the field of direct taxation in a discriminatory way, "irrespective of anything which the provisions of the OECD model convention may permit."[21] Moreover, the Advocate General suggested that if interest payments were reclassified as profit distributions under national thin capitalization rules, the Parent-Subsidiary Directive[22] should apply, which would lead to prohibiting the imposition of withholding tax on the constructive distributions.

Although *Lankhorst-Hohorst* concerned thin capitalization rules and not classical transfer pricing issues, the case raised two general questions with regard to the relationship between EC law and profit adjustments under Article 9 OECD Model. The first is whether Article 9 OECD Model as an embod-

iment of the globally accepted arm's-length principle may influence the verdict of discrimination when arm's-length adjustments are made in intra-EU settings. Subsets of this question include the relevance of "corresponding adjustments" under Article 9 OECD Model and the potential influence of the EC Arbitration Convention. The second question is whether reclassification or secondary adjustments in the form of constructive dividends are to be judged under the Parent-Subsidiary Directive. With regard to a reclassification of interest payments, the issue of the interplay between the Parent-Subsidiary Directive and the Interest and Royalties Directive also may arise.[23]

Arm's-Length Principle in OECD Model and EC Arbitration Convention

Discussed below is the principle under Article 9 of the OECD Model and Article 4 of the EC Arbitration Convention.

Article 9 OECD Model. Article 9 OECD Model ("Associated Enterprises") deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's-length terms.[24] When conditions are made or imposed between associated enterprises "in their commercial or financial relations which differ from those which would be made between independent enterprises," under Article 9(1) OECD Model, "any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Article 9(1) OECD Model thus provides that the tax authorities may, for the purpose of calculating tax liabilities of associated enterprises, re-write the accounts of the enterprises if, as a result of the special relations between the enterprises, the accounts do not reflect the true taxable profits arising in the state. However, this provision applies only if special conditions have been made or imposed between the two enterprises, thus leaving no space for adjustment if transactions between the enterprises have taken place on normal open-market commercial terms, i.e., at arm's length.[25] The issues addressed by Article 9(1) OECD Model are the "primary adjustments." Article 9(2) OECD Model deals with "corresponding adjustments" in the second tax jurisdiction. Not covered are "secondary adjustments," which usually take the form of constructive dividends, constructive equity contributions, or constructive loans.[26]

However, primary adjustments may give rise to economic double taxation, that is, taxation of the same income in the hands of different persons, insofar as an enterprise of one jurisdiction whose profits are revised upwards will be liable for tax on profits that have already been taxed in the hands of its associated enterprise in the other taxing jurisdiction.[27] Article 9(2) OECD Model provides that, in these circumstances, the second taxing jurisdiction will make an appropriate adjustment to relieve the double taxation if it agrees with the primary adjustment.

Unraveling the complex language of Article 9(2) OECD Model, where State A includes in the profits of one of its enterprises profits on which an enterprise of State B has been subject to tax in State B, and the profits so included are profits that would have accrued to the enterprise of State A if the conditions made between the two enterprises had been at arm's length, State B will make an appropriate adjustment to the tax charged therein on those profits. Article 9(2) OECD Model further provides that in "determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other."

Article 9(2) OECD Model does not necessarily lead to a relief of economic double taxation. Authorities from different tax jurisdictions often do not share each other's views on the arm's-length price, or even on the method to determine that price.[28] Although Article 25 OECD Model requires the authorities "to endeavor" to solve the problem by mutual agreement, there is neither a time limit nor an obligation to reach a solution eliminating double taxation.[29] The situation may be frustrating since in many instances the states have no financial interest in settling the dispute. Thus, corresponding adjustments under Article 9(2) OECD Model are not mandatory, mirroring Article 25 OECD Model, under which tax administrations are not required to reach agreement under the mutual agreement procedure.[30] However, the situation improves for the taxpayer when treaties provide for an arbitration clause for situations in which the authorities do not reach mutual agreement.[31] A clear example is the Austria-Germany income tax treaty, which provides for mandatory referral of a dispute to the ECJ based on Article 239 EC if the authorities do not reach agreement within three years.[32]

Thin cap rules. As mentioned above, *Lankhorst-Hohorst* dealt with German thin capitalization rules. On the question of whether thin capitalization may be considered a transfer pricing issue, and before analyzing the implications of *Lankhorst-Hohorst*, it seems generally beneficial to take a brief look at the

1 On the origin and development of the arm's-length principle, see Hamaekers, "Arm's Length—How Long?," 8 Int'l Transfer Pricing J. (2001), page 30.

2 On the alternative approach of formulary apportionment, see Hamaekers, *supra* note 1, at 38 *et seq.*; McLure, "Replacing Separate Entity Accounting and the Arm's Length Principle With Formulary Apportionment," 56 IBFD Bulletin for Int'l Fiscal Documentation (2002), page 586 *et seq.*; see also OECD Transfer Pricing Guidelines ("OECD Guidelines") (2001) III-19 *et seq.*

3 The latest version is the 2003 Model.

4 United Nations Model Double Taxation Convention Between the Developed and Developing Countries (2001).

5 U.S. Model Income Tax Convention (1996).

6 Convention 90/463/EEC of July 23, 1990 on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, OJ L 225 (August 20, 1990). The Official Journal of the EC has two parts. "L" stands for "Legislation" and "C" for "Information and Notices" (in French, "Communications et informations").

7 The OECD Guidelines include the conclusions of the OECD Committee, which examined the conditions for the application of Article 9 OECD Model, its consequences, and the various methodologies that may be used to test and adjust profits where transactions have been entered into between related parties. The Guidelines are periodically updated to reflect the Committee's progress in this area and are considered to represent internationally agreed principles and provide guidance for application of the arm's-length principle of which Article 9 OECD Model is the authoritative statement.

8 See "Company Taxation in the Internal Market," SEC(2001) 1681, 256 *et seq.*; see also Commission of the European Communities (ed.), "Report of the Committee of Independent Experts on Company Taxation" ("Ruding Report") (1992), page 205.

9 SEC(2001) 1681, 255 *et seq.*; see also Oliver, "Transfer Pricing and the EC Arbitration Convention," 30 Int'l Tax Review (2002), page 340. For a prior discussion of the EU and transfer pricing, see Lebovitz, MacLachlan, and Scheer, "EU Enlargement: Issues and Opportunities for Multinationals," 14 JOIT 18 (October 2003).

10 SEC(2001) 1681, 274; *cf.* Ruding Report, *supra* note 8.

11 A primary adjustment may generally be defined as an "adjustment that a tax administration in a first jurisdiction makes to a company's taxable profits as a result of applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction." OECD Guidelines G-7.

12 See also OECD Guidelines G-8.

13 See "Towards an Internal Market Without Tax Obstacles—A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities," COM(2001) 582, 14.

14 Press Release Nr. 6596/02, III.

15 See Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, "An Internal Market Without Company Tax Obstacles: Achievements, Ongoing Initiatives and Remaining Challenges," COM(2003) 726 final, 10.

16 For the draft Code of Conduct, see Communication from the Commission to the Council, the European Parliament, and the European Economic and Social Committee, "On the Work of the EU Joint Transfer Pricing Forum in the Field of Business Taxation from October 2002 to December 2003 and on a Proposal for a Code of Conduct for the Effective Implementation of the Arbitration Convention," COM(2004) 297 final.

17 See, e.g., Koerner, "The ECJ's *Lankhorst-Hohorst* Judgment—Incompatibility of Thin Capitalization Rules with European Law and Further Consequences," 31 Int'l Tax Review (2003), page 167.

18 ECJ, December 12, 2002, C-324/00, ECR 2002 I-11779.

19 "EC" references herein, unless otherwise stated, are to the EC Treaty. See Menger, Woywode, and Wachter, "Germany Finalizes Memo on Application of New Thin Cap Rules," 15 JOIT 55 (October 2004); Menger and Woywode, "Germany: Second Wave of Changes Enacted in 2003 Rocks the Boat," 15 JOIT 34 (April 2004).

20 Opinion of AG Mischo, September 26, 2002, C-324/00, ECR 2002 I-11779, para. 80.

21 *Id.* para. 82.

22 Council Directive 90/435/EEC of July 23, 1990, on the common system of taxation applicable to parent companies and subsidiaries of different member states, OJ L 225, 6 (August 20, 1990), amended, *inter alia*, by Council Directive 2003/123/EC of December 22, 2003, OJ L 7/41 (January 13, 2004).

23 Council Directive 2003/49/EC of June 3, 2003, on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states, OJ L 157, 49 (June 26, 2003).

24 OECD, Commentaries to the Model Tax Convention on Income and on Capital 2003 (2003), Article 9(1).

25 *Id.* para. 2.

26 See also OECD Guidelines IV-22, para. 4.67 *et seq.*

27 See Commentaries, *supra* note 24, para. 5.

28 See Terra and Wattel, *European Tax Law* (3d ed., Kluwer Law Int'l, 2001) page 404 *et seq.*

29 For a detailed survey, see Zueger, "Mutual Agreement and Arbitration Procedures in a Multilateral Treaty," in Lang (ed.), *Multilateral Tax Treaties* (Kluwer Law Int'l, 1998) at 159 *et seq.*; *cf.* Gouthiere, "Thin Capitalization and the OECD Model Convention," 18 Int'l Tax Review (1990), page 297.

30 See OECD Guidelines IV-12 para. 4.35.

31 For a comprehensive survey, see Groen, "Arbitration in Bilateral Tax Treaties," 30 Int'l Tax Review (2002), page 3.

32 See Zueger, "The ECJ as Arbitration Court for the New Austria-Germany Tax Treaty," 40 European Taxation (IBFD, 2000), page 101; *cf.* Lehner, "The Influence of EU Law on Tax Treaties from a German Perspective," 54 IBFD Bulletin for Int'l Fiscal Documentation (2000), page 469.

33 OECD (Committee on Fiscal Affairs), *Issues in International Taxation No. 2: Thin Capitalization* (Paris, 1987).

34 See also survey provided by Smith and Dunmore, "New Zealand's Thin Capitalization Rules and the Arm's Length Principle," 57 IBFD Bulletin for Int'l Fiscal Documentation (2003), page 503.

35 See Commentaries, *supra* note 24, para. 3; OECD, *supra* note 33, para. 49; see also Thoemmes, Stricof, and Nakhai, "Thin Capitalization Rules and the Non-Discrimination Principles," 32 Int'l Tax Review (2004), page 132.

36 See Commentaries, *supra* note 24, para. 3; OECD, *supra* note 33, para. 48.

37 See OECD, *supra* note 33, para. 50.

thin capitalization rules within the framework of Article 9 OECD Model. The OECD Committee on Fiscal Affairs took a quite generous approach in its 1986 report on thin capitalization;[33] the basic positions of this report are also reflected in the Commentary to Article 9 OECD Model.[34] The Commentary explicitly states that there is an interplay between tax treaties and domestic rules on thin capitalization within the scope of Article 9, and that Article 9 does not prevent the application of national rules on thin capitalization insofar as their effect is to assimilate the profits of a borrower to an amount corresponding to the profits that would have accrued in an arm's-length situation.[35] Further, Article 9 is considered relevant not only "in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital."[36] Finally, finding a compromise solution between the different approaches of the OECD member states,[37] "the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and...this principle should be followed in applying existing tax treaties."[38] There has been some criticism of the generous approach of the OECD Commentary,[39] and in thin capitalization situations, the interest rate is usually at arm's length.[40]

Article 4 EC Arbitration Convention. Following the pattern of Article 9(1) OECD Model, Article 4(1) of the EC Arbitration Convention embodies the arm's-length principle in identical words. The Convention clearly shows that the arm's-length principle is regarded as a major factor in international taxation within the EU. The aim of the EC Arbitration Convention is to eliminate international double taxation arising when tax authorities of one or more member states adjust the profits of associated enterprises established in their respective territories under the arm's-length principle by providing a mechanism for resolving disagreements between EU member states in regard to transfer pricing.[41] When double taxation arises, the affected enterprise presents its case to the tax authorities concerned; if those authorities cannot solve the problem satisfactorily, they endeavor to reach mutual agreement with the authorities of the member state where the associated enterprise is taxed. If no agreement can be reached, the authorities present the case to an advisory commission, which suggests a way of solving the problem. Although the tax authorities may subsequently adopt, by mutual agreement, a solution different from that suggested by the advisory commission, they are bound to adopt the commission's advice if they cannot reach agreement. Thus, the EC Arbitration Convention puts the obligation on the competent authorities to eventually eliminate double taxation within a given time frame.

However, the EC Arbitration Convention had not been in force since 2000 because not all member states had ratified a protocol to extend its application until very recently (see sidebar). During this time of suspension, companies had to rely on the dispute settlement provisions in double taxation conventions that, unlike the Convention, mostly do not impose a binding obligation to eliminate double taxation. Further, member states differ in their practical application of the Arbitration Convention and the mutual agreement procedures in their double tax conventions. Thus, the JTPF's first report contains conclusions and recommendations in the form of a draft Code of Conduct to ensure more uniform application by member states' tax administrations of the EC Arbitration Convention and the mutual agreement procedures in double taxation conventions. The draft Code of Conduct that the Commission has proposed to the Council for adoption therefore aims to establish common procedures.[42] "The proposed Code of Conduct should ensure that EU dispute settlement procedures operate more efficiently so as to eliminate double taxation of company profits within the Internal Market," stated Taxation Commissioner Frits Bolkestein.[43]

In connection with *Lankhorst-Hohorst* (discussed below), it is not clear whether the EC Arbitration Convention might be applied where thin capitalization rules lead to double taxation. The prevailing opinion seems to hold that double taxation resulting from causes other than arm's-length adjustments is not covered by the EC Arbitration Convention. However, others argue in favor of applying the Convention where thin capitalization rules

38 Commentaries, *supra* note 24, para. 3; OECD, *supra* note 33, para. 50.

39 See De Hosson and Michielse, "Treaty Aspects of the Thin Capitalization Issue—A Review of the OECD Report," 17 Int'l Tax Review (1989), page 480 *et seq.*

40 See Sommerhalder, "Approaches to Thin Capitalization," 36 European Taxation (IBFD, 1996), page 92.

41 See Adonnio, "Some Thoughts on the EC Arbitration Convention," 43 European Taxation (IBFD, 2003), page 403.

42 See note 16, *supra.* These procedures concern the starting point of the three-year period that is the deadline for a company incurring double taxation as a result of a transfer pricing adjustment to present its case to a competent authority; the starting point of the two-year period during which member states' tax administrations must attempt to reach mutual agreement on how to eliminate the double taxation that is the subject of the complaint; arrangements to be followed during this mutual agreement procedure (the practical operation of the procedure, transparency, and taxpayer participation); practical arrangements for the second phase of the arbitration procedure (the advisory commission) that must follow if there is no mutual agreement between the tax authorities within two years; and suspension of tax collection during cross-border dispute resolution procedures. However, the draft Code of Conduct would be a political commitment and would not affect the member states' rights and obligations or the respective spheres of competence of the member states and the European Community. Nevertheless, the Commission's preference has always been to turn the Arbitration Convention into an instrument of EU law to make its provisions subject to ECJ interpretation and thus strengthen the position of taxpayers. So far, this has proved impossible for political reasons.

43 See press release, "Company Taxation: Commission Proposes Code of Conduct to Eliminate Double Taxation in Cross-Border Transfer Pricing Cases," April 27, 2004, IP/04/542. As to the new member states, the draft Code of Conduct recommends that member states should endeavor to prepare, sign, and ratify a legal instrument applying the Arbitration Convention to new EU member states as soon as possible and in any event no later than two years after the new member states' accession to the EU. Moreover, the Commission recommends that the Council should provide in this instrument for the immediate bilateral application of the Arbitration Convention between those member states (new and current) that have completed ratification. See note 16, *supra.*

44 For a recent survey of thin capitalization rules of EU member states, see Wenehed, "Thin Capitalization and EC Law," 30 Tax Notes Int'l 1145 (June 16, 2003) at 1148 *et seq.*; see Thoemmes *et al.*, *supra* note 35, page 127 *et seq.*

45 *Köerperschaftsteuergesetz* (Corporate Income Tax Act).

46 Under section 8a(1)(2) KStG, the reclassification of interest payments on a loan that has been obtained by a German corporation "from a shareholder not entitled to corporation tax credit that had a substantial holding in its share or nominal capital at any point in the financial year" into a covert distribution takes place "where repayment calculated as a fraction of the capital is agreed and the loan capital is more than three times the shareholder's proportional equity capital at any point in the financial year, save where the company limited by shares could have obtained the loan capital from a third party under otherwise similar circumstances or the loan capital constitutes borrowing to finance normal banking transactions."

THE EC ARBITRATION CONVENTION

The "Arbitration Convention" has quite a history. In 1976, the Commission proposed a draft EC Council Directive, the "Proposed Council Directive concerning the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises," which was submitted to the Council on November 29, 1976 (OJ C 301/4, December 21, 1976). However, for political reasons, the member states chose to conclude a multilateral convention, since there was collective hesitation to surrender a significant part of their fiscal sovereignty in matters of transfer pricing where there had not been any common rules.*

Nearly 15 years later, on July 23, 1990, the then 12 EC member states signed in Brussels the "Convention 90/463/EEC of 23 July 1990 on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises" (OJ L 225/10, August 20, 1990). The Arbitration Convention, according to its preamble, was based on Article 293 EC, under which the member states, where necessary, will enter into negotiations with each other with a view to securing, for the benefits of their nationals, the abolition of double taxation within the Community.

Following lengthy ratification procedures in the relevant member states, the Arbitration Convention entered into force on January 1, 1995, initially for a period of five years. On December 21, 1995, another convention concerning the accession of Austria, Finland, and Sweden to the Arbitration Convention was signed in Brussels (OJ C 26/01, January 31, 1996); Greece, however, has not yet ratified it. The Arbitration Convention expired at the end of its initial five-year term on December 31, 1999, but a protocol extending the convention was signed in Brussels by all then 15 member states (OJ C 202/01, July 16, 1999). The protocol provides for a tacit and automatic renewal of the Arbitration Convention for successive five-year periods. However, the protocol provides in Article 3 that it will not enter into force until the beginning of the third month following ratification by the last member state; once the protocol enters into force, the Arbitration Convention will—again—apply, retroactively as of January 1, 2000.

In 2004, three contracting states still needed to ratify the protocol before it could enter into force. Thus, until recently, there was still the possibility that not all "old" member states would ratify, meaning that the Arbitration Convention would have been effectively terminated as of January 1, 2000.*** However, the EC Arbitration Convention will soon fully re-enter into force after a transition period that lasted more than four years. Portugal, the last EU member state to ratify the protocol, did so on June 7, 2004. The protocol will enter into force on the first day of the third month following that in which the instrument of ratification is deposited, by the last signatory state to take that step, at the office of the Secretary-General of the Council of the European Communities. According to the latest information, neither Italy (which ratified the protocol shortly before Portugal) nor Portugal has carried out this formality. Finally, the ten new EU member states that joined the EU on May 1, 2004 (Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia) are not automatically "contracting" states with respect to the Arbitration Convention. For the Convention to apply in these countries, it is, in principle, necessary to conclude an Accession Convention. The European Commission has urged all member states to commit themselves to ratify an Accession Convention with the new member states within two years.**

***For background of the convention, see Schelpe, "The Arbitration Convention: Its Origin, Its Opportunities and Its Weaknesses," 4 EC Tax Rev. (1995), page 68.**

****See Huibregts and Offermanns, "What Is the Future of the EU Arbitration Convention?," 11 Int'l Transfer Pricing J. (2004), pages 77, 79, 86; see also Melloni," Status of the EC Arbitration Convention," 9 Int'l Transfer Pricing J. (2004), page 96 *et seq.***

*****See Oliver, "Transfer Pricing and the EC Arbitration Convention," 30 Int'l Tax Review (2002), page 340 *et seq.***

lead to a result that is identical to that derived from denying the deductibility of costs exceeding the arm's-length standard. Recently, the JTPF and the majority of representatives of EU member states, as well as the Commission, have taken the view that the application of the Arbitration Convention and the proposed Code of Conduct should not be limited to transfer pricing cases, but should also cover other cases of double taxation resulting, for example, from a member state's application of its domestic thin capitalization rules.

Lankhorst-Hohorst

To prevent multinational enterprises from avoiding source taxation by excessively leveraging subsidiaries, which results in deductible interest payments that erode the subsidiaries' tax base, the source country may enact "thin capitalization" legislation.[44] If a corporation is thinly capitalized according to a state's legislation, all or part of the interest paid is not deductible or is recharacterized as a dividend for tax purposes.

The methods to measure whether a company is thinly capitalized for tax purposes can be subjective or objective. The subjective method poses a comparison between the actual financing structure and the structure that would have arisen between independent parties, thus allowing for proof that the loan would be available on the same conditions from a third party. The objective method applies a fixed debt-equity ratio. Combined rules exist under which the fixed-ratio method is considered a safe harbor, so that if the relation between debt and equity is within the fixed ratio, the subjective method would not apply.

Thin capitalization rules can result in qualification conflicts and a risk of double taxation if the other taxing jurisdiction does not accept the reclassification. Despite the OECD's generous approach, under current bilateral treaties, many countries clearly will not follow the reclassification by the source state under its domestic thin capitalization rules by applying "corresponding adjustments," and economic double taxation to date is the rule rather than the exception. Obviously, the aim of thin capitalization rules is to prevent shifting profits within a multinational enterprise at the cost of a subsidiary's country of residence. This cross-border orientation of many EU member states' thin capitalization rules has also put the focus on the compatibility of these rules with the nondiscrimination principle of EC law. Thus, it was only a matter of time before a fitting case—*Lankhorst-Hohorst*— reached the ECJ.

Facts of the case. Lankhorst-Hohorst GmbH, a German company, was a direct subsidiary of a Dutch company, Lankhorst-Hohorst BV, which in turn was owned by another Dutch company, Lankhorst Taselaar BV ("LTBV"). In the mid-1990s, Lankhorst-Hohorst GmbH had an outstanding debt to a bank that was refinanced by a subordinated loan from LTBV; that subordinated loan bore interest at a rate lower than the bank loan, and Lankhorst-Hohorst GmbH paid interest to LTBV. The German tax authorities reclassified the interest payments as hidden distributions under section 8a(1)(2) KStG as then in force.[45] Application of section 8a(1)(2) KStG was straightforward. The provision required interest payments on debts due to parent companies to be reclassified as "hidden distributions" when the subsidiary paying the interest was thinly capitalized, as measured by a fixed debt-equity ratio of 3:1, subject to limited exceptions.[46] One of those exceptions was that the subsidiary could have obtained the loan from a third party under otherwise similar circumstances; unfortunately for Lankhorst-Hohorst GmbH, it was established that it could not have obtained the loan from an unrelated party due to its loss situation, overindebtedness, and inability to provide security.[47] The other exception applied if the parent company making the loan was entitled to a tax credit on dividends received from the subsidiary. However, under German tax law as then in force, only two groups of corporations were not entitled to such a tax credit: tax-exempt resident corporations and all nonresident corporations. Accordingly, German domestic law permitted the recharacterization of interest paid by Lankhorst-Hohorst GmbH to LTBV as a distribution. The local tax authority applied the usual domestic rules on "hidden profit distributions" to the interest payments, which meant that at the distributing-corporation level, the deduction of interest payments had to be disallowed and the usual tax burden on profit distributions, then 30%, had to be applied.[48]

ECJ holding. The conformity of section 8a KStG with EC law had long been questioned in legal writing and by the German tax courts. The core issue in regard to the German thin capitalization rules was whether national tax provisions may differentiate based on whether the recipient of the interest payments was liable to tax on the interest in Germany. The question referred to the ECJ, therefore, was whether German law was in conflict with freedom of establishment under Article 43 EC, which provides that "restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited," and that such "prohibition shall

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[47] However, *Lankhorst-Hohorst* is a good example of a situation in which there are valid business reasons for related parties not to deal at arm's length; see Vinther and Werlauff, "The Need for Fresh Thinking About Rules on Thin Capitalization: The Consequences of the Judgment of the ECJ in *Lankhorst-Hohorst*," 12 EC Tax Rev. 97 (2003) at 105.

[48] The "*Ausschuettungsbelastung*" under section 27 KStG.

[49] The freedom of establishment under Article 43 EC, in principle, does not protect nationals of and companies resident in third countries outside the EU, e.g., the U.S. and Switzerland. On the other hand, Article 56 EC prohibits restrictions on the movement of capital not only between EU member states but also between EU member states and third countries and possibly could be invoked in situations involving third-country parent companies or third-country interest recipients. The extent to which this prohibition can be relied on in the context of the financing of EU subsidiaries remains untested, so the potential interposing of EU companies in finance structures should still be considered in future tax planning. For a possible infringement of the freedom of capital movement under Article 56 EC, see Cordewener, "Company Taxation, Cross-Border Financing and Thin Capitalization in the EU Internal Market: Some Comments on *Lankhorst-Hohorst GmbH*," 43 European Taxation (IBFD, 2003), page 104 *et seq.*

[50] For detailed analysis of the decision, see Craig, Rainer, Roels, Thoemmes, and Thomsett, "ECJ Renders Wide-Reaching Decision on German Thin Capitalization Rules," 28 Tax Notes Int'l 1163 (December 23, 2002); Green and Levy, "The End of Thin-Capitalization Rules as We Know Them," 14 Int'l Tax Rev. 24 (December 2003).

[51] See Menger *et al.* supra note 19. The systematic logic of such extension may nevertheless be questioned, since the classical feature of thin capitalization rules is to disallow avoidance of taxation by multinational enterprises in the source country, while such argumentation is generally not valid in a domestic setting.

[52] See for this argument Thoemmes, *supra* note 35, page 135 *et seq.*, who, in contrast, focuses on the restriction resulting from economic double taxation.

[53] See Halmind and Bjornholm, "Denmark Enacts EU Directives, New Tax Rules for Foreign Investment," 34 Tax Notes Int'l 150 (April 12, 2004).

[54] Silvestri, "Italy's New Thin Capitalization Rules," 15 JOIT 44 (August 2004).

[55] See Palacios and de la Cueva, "Reform Enhances Spain's International Tax Standing, 15 JOIT 24 (May 2004).

[56] See Nichols and Forrest, "ECJ: If Tax Is Paid Once in the EU, Does It Matter Where?," 32 Tax Notes Int'l 899 (December 8, 2003); these changes were introduced in the policy paper "Corporation Tax Reform: A Consultation Document," published in August 2003 (see www.inlandrevenue.gov.uk/consult_new/corp-tax-reform.pdf). This document touched on several aspects of the U.K.'s corporation tax system and announced that "the Government proposes to extend the scope of the transfer pricing legislation to transactions between all related enterprises, even where both are in the UK." Also, "while the thin capitalisation restrictions operate in a slightly different way from transfer pricing rules, the Government sees the extension of transfer pricing to UK transactions (and the minor modifications to the transfer pricing rules that would be required as part of that extension) as an opportunity to subsume the necessary protection against thin capitalisation within the transfer pricing regime. So with these changes in the transfer pricing rules, the Government will be able to repeal the existing thin capitalisation legislation."

[57] In *Bosal* (September 18, 2003, C-168/01), the ECJ held that a differentiation between the deductibility of financing costs for domestic subsidiaries and for subsidiaries resident in other member states, is not in compliance with EC Law. See Snel, "*Bosal Holding* Case—Landmark or Business as Usual?," 43 European Taxation (IBFD, 2003), page 420; Snel, "Non-Deductibility of Expenses Relating to the Holding of Foreign Participations: Preliminary Ruling Requested from ECJ," 41 European Taxation (IBFD, 2001), page 403.

[58] See, e.g., Vrouwenvelder and Van Casteren, "Netherlands Introduces Post-Bosal Thin Capitalization Rules," 32 Tax Notes Int'l 205 (October 20, 2003)

[59] See, e.g., Van der Donk and Kroon, "Thin Capitalization in the Netherlands: A Response to Bosal," 31 Tax Planning Int'l Rev. 10 (January 2004). The compatibility of the new Dutch rules with EC law is nevertheless questioned regarding compliance with the Interest and Royalty Directive; see De Wit and Tilanus, "Dutch Thin Capitalization Rules 'EU Proof'?," 32 Int'l Tax Review (2004), page 191 *et seq.*

[60] The French Conseil d'Etat recently held that the French thin capitalization rules contradict Article 43 EC, which makes it seem inevitable that France's thin capitalization will have to be changed; see Bjrengier, "French Supreme Court Decisions Undermine Thin Capitalization Rules," 33 Tax Notes Int'l 365 (January 26, 2004) at 367; *cf.*, Noul, "French Court Holds Thin Cap Rules Contravene France-U.S. Tax Treaty," 30 Tax Notes Int'l 304 (April 28, 2003); see generally Gouthiere, "France: Thin Capitalization Rules and the Non-Discrimination Principle," 42 European Taxation (IBFD, 2002) page 159.

[61] See Brynska, "EU Accession Prompts Review of Polish Thin Cap, Transfer Pricing Rules," 32 Tax Notes Int'l 413 (November 3, 2003).

[62] *Id.* at 1166.

[63] The Commission's argument was that the German subsidiary is subject to German corporation tax on profits distributed while the foreign shareholder still has to declare in the Netherlands, as earnings, amounts received in the form of interest. In the Commission's view, a member state that classifies an interest payment as a covert distribution of profits must ensure that there is liaison on the matter with the state where the parent company is registered, so that a corresponding adjustment can be made.

[64] See, e.g., ECJ, November 21, 2002, Case C-436/00, X, Y v. Riksskatteverket [2002] ECR I-10829, para. 50.

[65] In two earlier cases concerning Belgian tax rules, the court held that a discriminatory provision could be justified by the public interest in preserving the fiscal coherence of a member state's tax system (ECJ, January 28, 1992, C-204/90, ECR 1992, I-276, Bachmann—para. 21 *et seq.*; ECJ, January 28, 1992, C-300/90, ECR 1992, I-314, Commission/Belgium—para. 14 *et seq.*). In these cases, the justification was accepted on the ground that there was a need to ensure that a tax deduction granted in respect of pension or life assurance premiums was matched by ultimate taxation of the benefits paid out under the relevant policy. However, these cases have been widely criticized because they were decided on an erroneous factual and legal determination of the facts (see, e.g., Knobbe-Keuk, "Restrictions on the Fundamental Freedoms Enshrined in the EC Treaty by Discriminatory Tax Provisions—Ban and Justification," 3 EC Tax Rev. (1994), page 79 *et seq.*), and the ECJ has subsequently shown great reluctance to accept the fiscal coherence position and ever since has denied justification on the ground of the cohesion of the tax system.

also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State." Based on this wording, a difference in tax treatment because of the tax residence of a corporate entity—either of the parent from the subsidiary's perspective or the subsidiary from the parent's perspective—may therefore amount to covert discrimination. Consequently, the ECJ—following the Advocate General—found that section 8a KStG was a discriminatory restriction on free establishment[49] because it differentiated, in substance, according to the tax residence of the profit-seeking parent company. Even if, in very specific cases, loans granted by German parent entities were restricted in a manner similar to loans from foreign parent companies, the ECJ found that the Dutch parent companies of *Lankhorst-Hohorst* suffered from discrimination because their situation was not comparable to that of German tax-exempt parent entities, and the thin capitalization restriction applied to the foreign parent entities independently of other conditions that might have led to a similar reclassification in a domestic context.

The ECJ also considered—and denied—whether the difference in taxation of German companies with foreign owners could be justified under the "rule of reason." The court disagreed with the argument that German thin capitalization legislation is intended to prevent tax evasion, since the legislation does not have the specific purpose of preventing wholly artificial arrangements aimed at circumventing German tax legislation, but applies generally to any situation in which the parent company is resident outside Germany. The court also dismissed the argument that the legislation could be justified by the need to ensure coherence of the tax system on the ground that there is no direct link between any tax advantages to the German subsidiary to compensate for the disadvantage imposed by the German thin capitalization legislation. The third argument, that the German thin capitalization legislation could be justified by a need to ensure the effectiveness of fiscal supervision, was dismissed for lack of any proof.

Effect of *Lankhorst*. The ECJ's landmark decision in *Lankhorst-Hohorst* has resulted in not only extensive legal writing,[50] but also a restructuring of the German thin capitalization rules. As an explicit, although temporary, response to the judgment, the German tax authorities first issued instructions to not apply section 8a KStG in intra-EU settings. However, Germany recently enacted new thin capitalization rules that extend the scope to domestic settings.[51] It was argued that such rules do not discriminate against foreign EU parent companies anymore and are therefore in compliance with EC law.[52] Thus, Germany followed the Advocate General's suggestion in *Lankhorst-Hohorst* by stating that it "falls to the German authorities to determine whether the provision in issue should be replaced by, for example, a provision extending to subsidiaries with a resident parent company the rules on the reclassification of interest as dividends."

Lankhorst-Hohorst also has implications that reach far beyond Germany, as it contains a general interpretation of Article 43 EC that sets the standard for similar rules in other EU member states and thus for taxation of intragroup financing all over Europe. This is especially relevant for member states that used to or still use similar thin capitalization rules that include safe harbors, which are in one way or another applied in cross-border, but not domestic, settings.

Against this background, it has been reported that several member states have either changed their thin capitalization rules or are considering adaptations. For example, Denmark has enacted a tax bill under which the Danish thin capitalization rules also apply to loans in a domestic setting;[53] Italy recently introduced thin capitalization rules that also include loans granted by Italian companies;[54] Spain amended its thin capitalization rules to generally not apply to loans from EU resident entities;[55] and the U.K. has included its thin capitalization rules in its transfer pricing regime, which in turn has been extended to cover domestic as well as cross-border transactions.[56]

The situation in the Netherlands is especially interesting. As a reaction to the revenue loss resulting from the ECJ's decision in *Bosal*,[57] the Netherlands recently introduced new thin capitalization rules,[58] which—in recognition of *Lankhorst-Hohorst*—apply irrespective of whether the loan has been taken out from a Dutch or foreign-related company.[59] Further, pressure will be put, for example, on the legislatures in Belgium, France,[60] Poland,[61] and Portugal, all of which apply their thin capitalization rules only in cross-border settings.

Relevance of Article 9 OECD Model in *Lankhorst-Hohorst*. *Lankhorst-Hohorst* also highlights that EC law prevails over Article 9 OECD Model,[62] since Article 9 was unsuccessfully cited as a possible justification for the discrimination effected by section 8a KStG. The German government made a twofold argument in this regard. First, section 8a(1)(2) KStG should be seen as the embodiment of the principle of Article 9 OECD Model, which provides for the add-back of profits for tax purposes when transactions take place between associated enterprises on other than arm's-length terms. Thus, the basic concepts underlying Article 9 OECD Model should justify reclassification of interest payments on cross-border loans to thinly capitalized subsidiaries. Similarly, the Commission joined the German argument by considering that the difference of treatment under section 8a KStG might be justified by its purpose, which was to ensure the taxation of profits in Germany for undertakings not entitled to a tax credit, and accordingly, to ensure the correct allocation of the right to tax and related tax revenue. However, the Commission also referred to the risk of double taxation in this situation[63] and submitted that Article 9(2) OECD Model could afford the outline of a solution, since this provision may ensure the correct sharing of the right to tax. Second, with regard to justification under the principle of fiscal coherence, the German government maintained that section 8a KStG is in compliance with the internationally recognized principle of Article 9(1) OECD Model, which allows a state that has lost potential tax revenue because of transactions between associated enterprises on other than arm's-length terms to adjust the profits of the enterprise within its territory.

The Advocate General, however, rejected these contentions, arguing that the "real purpose" of the thin capitalization rule in section 8a(1)(2) KStG was to prevent Germany from losing a portion of its tax revenue through a taxpayer's (or its shareholder's) use of a financing mechanism that is not in itself prohibited. Since it is settled ECJ case law that diminution of tax revenue cannot be regarded as a matter of overriding general interest that may justify a measure contrary to a fundamental freedom,[64] the Advocate General concluded that the objective of maintaining the tax base did not represent an overriding requirement of general interest. The Advocate General also rejected the German government's argument based on the principle of fiscal coherence,[65] since under the ECJ's settled case law, fiscal coherence must be established in relation to one and the same person by a strict correlation between a tax advantage and unfavorable tax treatment,[66] which was not true with section 8a KStG.

That the thin capitalization rules supposedly complied with Article 9 OECD Model did not alter the Advocate General's position, and he gave a clear-cut statement on that point. For clarity, he assumed that the German thin capitalization rules comply with Article 9 OECD Model,[67] but stated that "the fact that the rules are consistent with the provisions of the OECD model convention does not also mean that they comply with Article 43 EC. Neither the provisions nor the objectives of the OECD model convention, on the one hand, or of the EC Treaty, on the other, are in fact the same." Moreover, Art 43 EC restricts the ability of member states to exercise their power in the field of direct taxation in a way that gives rise to discrimination, "irrespective of anything which the provisions of the OECD model convention may permit."[68] The ECJ did not further consider Article 9 OECD Model, but simply followed the position of its Advocate General and denied a justification under the principle of fiscal coherence. ●

66 Under the tight prerequisites for a justification based on the fiscal coherence of a member state's tax system, applicability of the coherence defense is limited to situations where a discriminatory rule denying a deduction for a payment is justified by inability to tax the recipient of the payment. A justification of a discriminatory measure on the grounds of "fiscal coherence" requires a direct link between deduction and taxation within the same tax system. The ECJ has repeatedly held that the aim of ensuring coherence of taxation is not sufficient to justify a difference in treatment between residents and nonresidents unless the tax disadvantage resulting for a national of a member state is compensated for by a corresponding tax advantage for the same person, with the result that he suffers no discrimination (see, e.g., ECJ, November 14, 1995, C-484/93, ECR 1995, I-3955, Svensson und Gustavsson—para. 15 *et seq.*). Thus, an indirect link between the tax advantage accorded to one taxable person and the unfavorable tax treatment of another cannot justify a discrimination (see, e.g., Case C-294/97 Eurowings Luftverkehrs [1999] ECR I-7447, para. 20). As the ECJ case law indicates, in national rules there is rarely a strict correlation between deductions and benefits, and even less so if tax treaties are considered (see ECJ, August 11, 1995, C-80/94, ECR 1995, I-2493, Wielockx—para. 24).

67 In German legal writing, however, it is questioned whether section 8a(1) KStG was compatible with Article 9(1) OECD Model. First, section 8a(1) KStG concerned only the debt-equity ratio of each individual shareholder and not of the German corporation as a whole, which might lead to the effect that one shareholder may exceed his personal safe harbor with a loan granted to the corporation while the equity of all shareholders taken together is still comparably higher than that loan. Second, the arm's-length principle is not applied as a positive criterion for tax liability but only negatively by using a standardized safe harbor to shift the burden of proof to the corporation, which may take great pains to then demonstrate that it would have received the loan capital under equal terms from an unrelated third party. Thus, it is argued that section 8a(1) KStG may exceed the limits of Article 9(1) OECD Model.

68 See Mischo, *supra* note 20, para. 82.