GEORG W. KOFLER

THE RELATIONSHIP BETWEEN THE ARM'S-LENGTH PRINCIPLE IN THE OECD MODEL TREATY AND EC TAX LAW (PART 2)

In many instances, the interplay between Directives will effectively rule out the possibility of member states levying withholding taxes on (purported) interest payments from a qualifying subsidiary to its EU parent company. But even if transfer pricing and thin capitalization rules were in compliance with EC tax law, there would still be broad areas that give rise to cross-border disputes detrimental to the smooth functioning of the internal market and that create additional costs for both business and national tax administrations

Part 1

of this article[1] began 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. The article covered 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 ("OECD Model"), and Article 4 of the EC Arbitration Convention,[2] and began 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 below, the final installment, picks up with conclusions from Lankhorst-Hohorst regarding arm's-length adjustments; analyzes the potential application of the EU Parent-Subsidiary Directive to the facts of the case; and wraps up with some remarks on the interplay between the Parent-Subsidiary Directive and the Interest and Royalties Directive.

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Relevance of *Lankhorst-Hohorst* for Arm's-Length Adjustments

The implications of the arguments put forward by the AG in *Lankhorst-Hohorst*[3]—and their acceptance by the European Court of Justice (ECJ)—seem clear. Article 9 OECD Model, and thus the arm's-length principle, may neither immunize national tax provisions from the verdict of discrimination nor justify purported discrimination. Thus, any thin capitalization rules that apply only to cross-border situations must be reconsidered, even if they are based on the arm's-length principle,[4] since the German thin capitalization rule that the ECJ rejected allowed such an arm's-length test in section 8a(1)(2) *Korperschaftsteuergesetz* (KStG) (Corporate Income Tax Act) as a defense to the thin capitalization rules in section 8a KStG.[5] Although the arm's-length principle was not applied as a positive criterion, but only negatively as a standardized safe harbor with the burden of proof on the corporation, it was nevertheless an integral part of section 8a(1)(2) KStG.

Lankhorst-Hohorst therefore highlights, probably more than any previous case, that EC law prevails over OECD rules, such as Article 9 OECD Model, which, in principle, allows for application of national thin capitalization rules. The AG could not have made this clearer. The German government's position in *Lankhorst-Hohorst* did not address the classical arm's-length adjustment of interest rates under Article 9 OECD Model, since section 8a KStG led to a complete reclassification of all interest payments into hidden profit distributions. However, the loan from the Dutch parent to the German subsidiary was cheaper than the bank loan that it replaced and thus seemingly not intended to extract excess interest from the subsidiary. Thus, if the arm's-length principle under Article 9 OECD Model were applied to the interest rate charged by the Dutch parent, Germany (step 1) would have had to tax the subsidiary on the difference between an arm's-length interest rate and the cheaper intercompany interest rate, and (step 2) grant the subsidiary a deduction for the deemed-paid full arm's-length interest rate.

It can easily be derived from *Lankhorst-Hohorst* that all unfavorable transfer pricing adjustments that apply only to transactions with nonresident related persons constitute a restriction on the freedom of establishment or the freedom of capital movement, as relevant.[6] However, it seems that the ECJ did not care much for dealing with the more general transfer pricing issues or with recharacterizing interest payments beyond the specific issues raised by the German thin capitalization rules in *Lankhorst-Hohorst*.[7] This may explain why the court did not consider the impact and breadth of the EC issue on Article 9 OECD Model.[8] The following discussion therefore aims to reconcile the holding in regard to Article 9 OECD Model in *Lankhorst-Hohorst* with *Gilly*,[9] in which the ECJ basically found that the allocation of taxing rights in a tax treaty is neutral and thus not discriminatory. Further, the relationship between primary adjustments and corresponding adjustments under Article 9 OECD Model must be considered against the background of the recent *De Groot* case,[10] which explicitly grants member states the authority to shift obligations under EC law in their bilateral tax treaties.

Article 9 OECD Model: Tension Between *Lankhorst-Hohorst* and *Gilly?*

The arm's-length principle under Article 9 OECD Model is an internationally accepted method for countries to stake their tax claims.[11] Thus, the issue arises whether Article 9(1) OECD Model can be seen as a provision that allocates taxing rights between two contracting states.[12] This question is important since, in *Gilly*, the ECJ considered that "Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation—by means, *inter alia*, of international agreements—and have concluded many bilateral conventions based, in particular, on the model conventions on income and wealth tax drawn up by the [OECD]."[13] Differentiations with regard to the allocation of taxing rights, even when based on nationality, therefore do not amount to forbidden discrimination, which flows, absent any unifying or harmonizing measures adopted in the Community context, "from the contracting parties' competence to define the criteria for allocating their powers of taxation as between themselves, with a view to eliminating double taxation."[14]

Although the ECJ gives much weight to the OECD Model, it seems that Article 9(1) OECD Model does not fit under the *Gilly* criteria for two reasons. First, Article 9(1) contains a rule that transcends the mere allocation of taxing rights, since it addresses only one contracting state at a time and thus has no "view to eliminating double taxation." Second, as the Advocate General in *Lankhorst-Hohorst* made clear, the exercise of taxing rights must be nondiscriminatory "irrespective of anything which the provisions of the OECD model convention may permit." Thus, even though Article 9 OECD Model permits arm's-length adjustments, the ECJ's case law clearly forbids such adjustments if they are applied only in cross-border settings and thereby lead to disadvantageous treatment of cross-border transactions, as opposed to domestic transactions.[15]

DeGroot: Possible Relevance of Corresponding Adjustments

As already mentioned, the Commission considered in *Lankhorst-Hohorst* that section 8a KStG might be justified by its purpose, but it referred to the risk of double taxation in this case and submitted that Article 9(2) of the OECD Model may afford the outline of a solution.[16] The ECJ also recognized the argument that application of the German thin capitalization rules may lead to economic double taxation in Germany and the country of the interest recipient if that country does not recognize the German reclassification of interest as a dividend. Conversely, would application of cross-border adjustments be acceptable under the EC Treaty if this double taxation were effectively avoided by way of corresponding adjustments? Even if this were true, with regard to thin capitalization reclassifications, the practical aspect of the question barely exists. Most countries are not willing to make corresponding adjustments under Article 9(2) OECD Model with respect to thin capitalization reclassifications by the subsidiary's country of residence.[17] And there is some doubt whether the Arbitration Convention, which provides for a mandatory settlement mechanism for transfer pricing disputes between EU member states, would cover such a case.

As a general matter, however, the question arises whether cross-border adjustments under Article 9 OECD Model can be either justified or even

rendered nondiscriminatory if the parent's country of residence makes corresponding adjustments to avoid economic double taxation. It can be argued that, if this were true, such adjustments do not lead to disadvantageous treatment of cross-border financing as opposed to domestic financing.

The prevailing opinion in legal scholarship holds that the treatment in the parent's country of residence is not relevant to a justification of a discriminatory tax provision in the subsidiary's country of residence. Nevertheless, the issue should be considered in a broader framework, raising the general question whether discrimination may be carved out, or justified, by taking into consideration the overall tax burden that the taxpayer must bear; thus, the focus may shift to taxation in another country to wipe out the verdict of discrimination in one country.

The case law on this general issue is not completely clear[18] and legal scholarship is split down the middle. Some argue that the treatment in the residence country must be considered in evaluating whether there is discrimination in the source country,[19] while others support the view that the overall tax burden is irrelevant in determining such discrimination, or justifying it.[20] In the abstract, the latter view seems preferable. First, ECJ case law seems to proceed in this direction.[21] Second, if discrimination must be evaluated from the perspective of one country,[22] it would be asymmetrical to consider taxation in another state to potentially justify this discrimination. Third, if the tax situation in the other country is taken into account without reservation, conformity with EC law would depend on legislation and administrative acts in the other country, which would not be compatible with the sovereign status of national tax legislation still existing in the EU.

This said, the issue nevertheless seems different when a member state takes a restricting measure, but makes sure, in a bilateral or multilateral agreement, that the discrimination is cured in another member state. It seems that this possibility was introduced by *De Groot*,[23] which involved whether the state of residence must take into account its residents' general personal and family circumstances in the full amount, as opposed to an amount proportional to the percentage of income earned in the residence state if some of the income is earned in another country. The ECJ basically held that it must do so when less than 90% of the income is derived in the source state, but also stated:

> Member States are of course free, in the absence of unifying or harmonising measures adopted in the Community, to alter, by way of bilateral or multilateral agreements for the avoidance of double taxation, that correlation between the total income of residents and residents' general personal and family circumstances to be taken into account by the State of residence. The State of residence can therefore be released by way of an international agreement from its obligation to take into account in full the personal and family situation of taxpayers residing in its territory who work partially abroad.[24]

The method considered in *De Groot* is that member states would agree in a bilateral agreement and in deviation from the ECJ's case law to allocate personal deductions in the same proportion as the taxpayer's earnings in the state of residence and the state of employment. Thus, for instance, 30% income in the state of residence and 70% in the state of employment would lead to the same ratio of personal deductions.[25] In principle, the ECJ rejects a pro rata allocation under EC law,[26] but it does allow member states to agree to such an allocation by way of a bilateral or multilateral treaty.

If this idea was transferred to the issue of corresponding adjustments, it would mean that a discriminatory measure of one member state might be accepted, as long as another member state is obligated to, and in fact does, make an appropriate corresponding adjustment. It seems that member states have a strong argument in favor of applying arm's-length adjustments in cross-border settings if economic double taxation is avoided by a corresponding adjustment in the other country. It is unclear whether this situation is already achieved by existing mandatory arbitration procedures, under either double taxation conventions or the EC Arbitration Convention.[27] In any event, *De Groot* suggests that member states have the means to agree on appropriate rules in their tax treaties.

This aspect of *De Groot* may gain additional relevance in another setting. Although the prevailing opinion holds that arm's-length adjustments or thin capitalization rules are in compliance with EC law if they apply in domestic as well as cross-border settings, there are good reasons to question this view. This is because the mere extension of arm's-length adjustments to domestic settings changes nothing with regard to a possible economic double taxation in cross-border settings—one form of discrimination is merely replaced by a new restriction. Thus, the possibility cannot be rules out that the ECJ's case law will enter into its next stage, which will aim at the removal of such double taxation. If this development of the case law takes place, the implications of *De Groot* would be, for example, that the denial of a deduction would be in line with EC law only if it were conditioned on a corresponding profit adjustment by the state of the recipient company.

Reclassification and the Parent-Subsidiary Directive—Did the AG Overstep?

As noted above, the Advocate General (AG) also suggested in *Lankhorst-Hohorst* that if interest payments were reclassified as profit distributions under national thin capitalization rules, the EU Parent-Subsidiary Directive[28] should apply, prohibiting the imposition of tax on the resulting constructive distributions. Although the ECJ ruled that the German thin capitalization rules are a breach of the freedom

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1 Kofler, "The Relationship Between the Arm's-Length Principle in the OECD Model Treaty and EC Tax Law (Part 1)," 16 JOIT 32 (January 2005).

2 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"). The last two member states to ratify the Prolongation Protocol and deposit instruments of ratification did so (Italy on July 29, 2004, and Portugal on August 8, 2004). Thus, the EC Arbitration Convention re-entered into force, with retroactive effect from January 1, 2000, on November 1, 2004.

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

4 For additional references, see Part 1 of this article, note 1, *supra*.

5 Section 8a KStG provides a limitation of the debt financing of a German corporation by non-German shareholders, i.e., thin capitalization rules.

6 Even before Lankhorst-Hohorst, the prevailing opinion was that transfer pricing rules are not compatible with EC law.

7 It even seems unclear whether the application of section 8a KStG in the particular case was discriminatory, since the letter of support (*Patronatserklarung*) in Lankhorst-Hohorst would also have led to a reclassification in a purely domestic setting.

8 See Confederation Fiscale Europeenne, "Comments on ECJ, *Lankhorst-Hohorst GmbH*, Case C-324/00, 12 December 2002," 43 European Taxation 171 (IBFD, 2003).

9 ECJ, May 12, 1998, C-336/96, ECR 1998, I-2793.

10 ECJ, December 12, 2002, C-385/00, ECR 2002, I-11819.

11 Article 9 (Associated Enterprises) provides that "(1) where (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then 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."

12 This question is also relevant in regard of Article 7(2) OECD Model, which embodies the arm's-length principle for permanent establishments.

13 See Opinion of AG Colomer, November 20, 1997, C-336/96, ECR 1998, I-2793, para. 44; *cf.* Lehner, "Annotations on the Judgment of the European Court of Justice, Case 336/96—The *Gilly* Case—of 12 May 1988," 52 Bulletin for Int'l Fiscal Documentation 334 (IBFD, 1998). Although the ECJ gives much weight to the OECD Model Convention, it can be derived from the decision in Saint-Gobain that any allocation of taxing rights is considered neutral; see ECJ, September 21, 1999, C-307/97, ECR 1999, I-6161, para. 56; *cf.* Van den Hurk, "The European Court of Justice Knows Its Limits—A Discussion Inspired by the *Gilly* and *ICI* Cases," EC Tax Rev. (1999), page 216.

14 For further arguments of the ECJ on this point, see Vanistendael, "Case C-336/96, Mr. and Mrs. Robert Gilly," Common Mkt. L. Rev. (2000), page 171.

15 But see discussion in the text below on whether adjustments applied in cross-border as well as domestic settings may amount to a forbidden restriction if they result in economic double taxation.

16 Article Article 9(2) provides: "Where a Contracting State includes in the profits of an enterprise of that State and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. 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."

17 For the relationship between Germany and the Netherlands, see, e.g., Cordewener, "Company Taxation, Cross-Border Financing and Thin Capitalization in the EU Internal Market: Some Comments on *Lankhorst-Hohorst GmbH*," 43 European Taxation 108 (IBFD, 2003).

18 Although the judgments in Schumacker, ECJ, February 14, 1995, C-279/93, ECR 1995, I-225, and Wielockx, ECJ, August 11, 1995, C-80/94, ECR 1995, I-2493, consider the treatment of a taxpayer in his country of residence to evaluate whether an unjustified discrimination occurred in the source country, the relevance of these inquiries is limited to an overall assessment of the taxpayer's ability to pay and specifically concerns whether the source country is factually able to grant certain benefits or whether this obligation "switches over" to the source country. Further, other cases, e.g., Commerzbank, ECJ, July 13, 1993, C-330/91, ECR 1993, I-4017, clearly point to an isolated evaluation of an allegedly discriminatory provision; see, e.g., Toifl, "Can a Discrimination in the State of Residence Be Justified by the Taxable Situation in the State of Source?," EC Tax Rev. (1996), page 165; Jann, "How Does Community Law Affect Benefits Available to Non-Resident Taxpayers under Tax Treaties?," *id.*, page 171.

19 See, e.g., Hughes, "Withholding Taxes and the Most Favoured Nation Clause," 51 Bulletin for Int'l Fiscal Documentation 126 (IBFD, 1997).

20 See, e.g., Schuch, "'Most Favoured Nation Clause' in Tax Treaty Law," EC Tax Rev. (1996), page 164.

21 Although not completely on point, the ECJ has repeatedly rejected a "compensatory" taxation without considering an overall treatment of the taxpayer in both countries; see Case C-294/97 Eurowings Luftverkehrs [1999] ECR I-7447, para. 43 *et seq.*; Danner, ECJ, October 3, 2002, C-136/00, ECR 2002, I-8147, para. 56; De Groot, *supra* note 10, para. 97.

22 See, e.g., Lyons, "Discrimination Against Individuals and Enterprises on Grounds of Nationality: Direct Taxation and the European Court of Justice," EC Tax J. (1995/96), page 35.

23 Note 10, *supra*.

of establishment, and saw no need to examine the point raised by the AG with respect to the Parent-Subsidiary Directive, the AG's arguments are of general breadth and may indicate some significant future developments.

The Parent-Subsidiary Directive states in its preamble that it aims to eliminate tax disadvantages of cross-border cooperation between parent companies and subsidiaries of different member states to facilitate the grouping together of companies "to allow enterprises to adapt to the requirements of the common market, to increase their productivity and to improve their competitive strength at the international level." Thus, it is clear (particularly from the third recital in the preamble) that the Directive seeks, by the introduction of a common tax system, to ensure that cooperation between companies of different member states is not penalized compared with cooperation between companies in the same member state.[29] If certain requirements are met, the measures are twofold. First, the residence country of a parent company that receives a cross-border distribution from its subsidiary must either exempt the distributions from corporate tax or grant an indirect credit for the corporate tax that the subsidiary paid. Second, to ensure fiscal neutrality, the profits that a subsidiary distributes to its parent company are exempt from withholding tax in the subsidiary's country of residence.[30]

Withholding tax exemption. The latter rule, as laid down in Article 5 of the Directive, is as simple as it can be: "Profits which a subsidiary distributes to its parent company shall be exempt from withholding tax." Article 7(1), however, raises a complication by providing that "withholding tax" "shall not cover an advance payment or prepayment (*precompte*) of corporation tax to the Member State of the subsidiary which is made in connection with a distribution of profits to its parent company."

ECJ case law. The ECJ's case law has given some guidance on how to understand "distribution of profits" and "withholding tax" in Article 5 of the Directive. In *Epson*, the ECJ clearly stated that the "term withholding tax contained in it is not limited to certain specific types of national taxation."[31] Further, the nature of a tax, duty, or charge must be determined under Community law, according to objective characteristics, irrespective of its classification under national law. The *Epson* and *Athinaïki Zythopiia* cases clarified that any tax on income received in the state in which dividends are distributed is a withholding tax on distributed profits for purposes of Article 5 of the Directive where the chargeable event for the tax is the payment of dividends or any other income from shares, the taxable amount is the income from those shares, and the taxable person is the holder of the shares.[32] These guidelines can be considered settled case law.

German imputation system. Since the argument of the AG dealt with the German *Ausschüttungsbelastung* ("distribution burden"), which qualifies as a corporate tax under German domestic tax law, it is worthwhile to take a brief look at the German imputation system as it was in force during the relevant years in *Lankhorst-Hohorst*.[33] Under that system, undistributed income of a corporation generally was subject to a tax of 45% (section 23(1) KStG) or a lower or zero rate under special provisions or exemptions (*Tarifbelastung*), but the corporate tax was decreased or increased to 30% when profits were distributed (section 27(1) KStG (*Ausschüttungsbelastung*)).

Thus, the *Ausschüttungsbelastung* had two forms. If corporate income was subject to full corporation tax, the 45% rate was *decreased* to 30% when income was distributed to the shareholders; in other words, only a 30% corporate tax was levied on distributed income. On the other hand, if the corporate income was taxed at a low or a zero rate (for example, because of tax exemptions), the corporation tax was *increased* to 30% through the *Ausschüttungsbelastung*, which equalized the German tax burden on every domestic profit distribution to neutralize the imputation credit.[34] Also, a 25% withholding tax was imposed on the distribution (*Einkommensteuergesetz* (EstG) (Income Tax Act), sections 43, 43a). At the shareholder level, income consisted of the distribution (section 20(1)(1) EStG), not reduced by the tax withheld by the corporation (section 12(3) EStG), grossed up by the 30% creditable corporation tax (section 20(1)(3) EStG), and was taxed at the shareholder's individual tax rate. Conversely, the withholding tax and the 30% corporation tax were credited against such tax liability (sections 36(2)(2) and (3) EStG), which could also result in a tax refund. Before assessing the situation in *Lankhorst-Hohorst*, see Exhibit 1 for a simple example of the German system (distribution to a domestic, individual shareholder).

EXHIBIT 1
Distribution to a Domestic, Individual Shareholder

<table>
<tr><th></th><th>Decrease under § 27(1) KStG</th><th>Increase under § 27(1) KStG</th></tr>
<tr><td>CORPORATE LEVEL</td><td></td><td></td></tr>
<tr><td>Income</td><td>100</td><td>100</td></tr>
<tr><td>"Tarifbelastung" (for example, 45% general corporate tax (§ 23(1) KStG) or 0% corporate tax (e.g., because of tax exemptions))</td><td>(45)</td><td>(0)</td></tr>
<tr><td>Distributable income</td><td>55</td><td>100</td></tr>
<tr><td>Ausschüttungsbelastung: decrease or increase of corporate tax in event of a full distribution (§ 27(1) KStG)</td><td>15</td><td>(30)</td></tr>
<tr><td>Distribution</td><td>70</td><td>70</td></tr>
<tr><td>Withholding tax of 25% (§§ 43, 43a EStG)</td><td>(17.5)</td><td>(17.5)</td></tr>
<tr><td>Cash-flow to shareholder</td><td>52.5</td><td>52.5</td></tr>
<tr><td>SHAREHOLDER LEVEL</td><td colspan="2"></td></tr>
<tr><td>Cash-flow to shareholder</td><td colspan="2">52.5</td></tr>
<tr><td>Withholding tax (§ 12(3) EStG)</td><td colspan="2">17.5</td></tr>
<tr><td>Distribution (§ 20(1)(1) EStG)</td><td colspan="2">70</td></tr>
<tr><td>Gross-up by creditable corporate tax (§ 20(1)(3) EStG)</td><td colspan="2">30</td></tr>
<tr><td>Income</td><td colspan="2">100</td></tr>
<tr><td>Individual income tax, e.g., at 40%</td><td colspan="2">(40)</td></tr>
<tr><td>Credit for withholding tax (§ 36(2)(2) EStG)</td><td colspan="2">17.5</td></tr>
<tr><td>Credit for corporate tax (§ 36(2)(3) EStG)</td><td colspan="2">30</td></tr>
<tr><td>Tax liability (refund)</td><td colspan="2">(7.5)</td></tr>
</table>

Application in *Lankhorst-Hohorst*. In *Lankhorst-Hohorst*, the German tax authorities reclassified the interest payments as hidden profit distributions under section 8a KStG, increased the income of *Lankhorst-Hohorst GmbH* by the amount of the disallowed interest deductions, and levied the 30% *Ausschüttungsbelastung* on the hidden profit distributions. However, the Advocate General suggested that the *Ausschüttungsbelastung* should be considered "withholding tax" within the meaning of Article 5 of the Directive and thus may not be imposed. He relied on *Athinaïki Zythopoiia*,[35] stating that the German legislation's provision of a corporation tax on profits of the subsidiary does not preclude application of the Parent-Subsidiary Directive. Also, that classification of the tax at issue as a withholding tax within the meaning of Article 5 of the Directive would, as the Commission claimed, have the effect of completely prohibiting any thin capitalization rules does not preclude such a classification, since the Directive does not include any exceptions allowing non-application of that provision to protect the thin capitalization rules.

The AG then maintained that the considerations that led the ECJ in *Athinaïki Zythopoiia* to classify the tax at issue in the main proceedings as a withholding tax were also present in *Lankhorst-Hohorst*. The chargeable event for the *Ausschüttungsbelastung* was the payment of (covert) dividends; in addition, the amount of tax was directly related to the amount of the distribution. Further, Lankhorst-Hohorst GmbH was not able to offset, against losses from previous years, the increase in its basic taxable amount resulting from the application of section 8a(1)(2) KStG, a situation that the ECJ found decisive in *Athinaïki Zythopoiia*. Thus, the AG found that the Directive would have to be applied,[36] which meant a prohibition of the *Ausschüttungsbelastung*.

Given this argument, two major questions arise. First, do interest payments, reclassified as hidden profit distributions under domestic law, qualify as "distributions" within the meaning of Article 5 of the Directive? Second, can the *Ausschüttungsbelastung* be

24 *Id.* para. 99. The ECJ also held (para. 101) that "the mechanisms used to eliminate double taxation or the national tax systems which have the effect of eliminating or alleviating double taxation must permit the taxpayers in the States concerned to be certain that, as the end result, all their personal and family circumstances will be duly taken into account, irrespective of how those member states have allocated that obligation amongst themselves, in order not to give rise to inequality of treatment which is incompatible with the Treaty provisions on the freedom of movement for workers and in no way results from the disparities between the national tax laws."

25 The ECJ's comment in De Groot was in response to the Netherlands' argument that a fair division of the personal deductions is a pro rata division.

26 For this line of case law, its problems, and the alternative approach of "fractional taxation," see, e.g., Wattel, "Progressive Taxation of Non-Residents and Intra-EC Allocation of Personal Allowances: Why *Schumacker*, *Asscher*, *Gilly* and *Gschwind* Do Not Suffice," 40 European Taxation 210 (IBFD, 2000).

27 Although such procedures provide for a result, they still are time-consuming and cumbersome and thus could be considered a further obstacle to the internal market; see Commission Staff Working Paper, "Company Taxation in the Internal Market," SEC(2001)1681, 255 *et seq.*, available at http://europa.eu.int/comm/taxation_customs/resources/documents/company_tax_study_en.pdf

28 Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of 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).

29 See, e.g., Epson, ECJ, June 8, 2000, C-375/98, 2000, I-04243, para. 20; Athinaiki Zythopiia, ECJ, October 4, 2001, C-294/99, ECR 2001, I-6797, para. 25; Océ van der Grinten, ECJ, September 25, 2003, C-58/01, para. 45.

30 See also Denkavit, ECJ, October 17, 1996, C-283/94, C-291/94 and C-292/94, ECR 1996, I-5063, para. 22; Oce van der Grinten, *id.* para. 45.

31 See Epson, *supra* note 29; for an analysis of this case, see De Sousa de Camara, "Parent-Subsidiary Directive: The Epson Case," 41 European Taxation 307 (IBFD, 2001).

32 See Epson, *supra* note 29, para. 23; Athinaiki Zythopiia, *supra* note 29, para. 28.

33 KStG 1996 and EStG 1997. However, Germany repealed its imputation system as of January 1, 2001.

34 Conversely, the imputation credit for corporation tax granted to the shareholders was 30/70 of the distributed dividend.

35 Note 29, *supra*.

36 The AG also rejected the argument that section 8a(1)(2) KStG could fall within the anti-abuse exception in Article 1(2) of the Directive, according to which that Directive "shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse."

37 Helminen, "Dividend Equivalent Benefits and the Concept of Profit Distribution of the EC Parent-Subsidiary Directive," EC Tax Rev. (2000), page 167; Terra and Wattel, *European Tax Law* (3d ed., Kluwer Law Int'l, 2001), page 354.

excluded from "withholding tax" by means of Article 7(1) of the Directive?

As to the first issue, it seems clear that the source state, which reclassifies interest payments as hidden distributions, must grant the benefits provided by the Parent-Subsidiary Directive;[37] this conclusion implicitly underlies the reasoning of the AG in *Lankhorst-Hohorst*. Indeed, it would be cynical if a member state was allowed not only to treat interest payments as profit distributions, but to argue that the interest is not the kind of profit distribution covered by the Directive, since that position would lead to the double taxation that the Directive aims to eliminate.

As to the second issue, the AG's finding is somewhat surprising. The German government had argued that the *Ausschuttüngsbelastung* "is not a withholding tax but normal taxation of the profits of the subsidiary, in the form of corporation tax."[38] This statement has merit. If the AG's argument in the event of a reclassification of interest payments under domestic thin capitalization rules were correct, it would equally apply when a corporation simply makes profits and immediately distributes them to its EU shareholders. However, the 30% *Ausschüttungsbelastung* is usually achieved by a reduction of the 45% *Tarifbelastung*.

Directive Article 5. Modifying the facts in *Lankhorst-Hohorst* and assuming that Lankhorst-Hohorst GmbH was in a profit situation and had no available losses, the tax on the income increase due to the disallowance of interest deductions would be subject to taxation at a 45% rate, which would be reduced to 30% at the moment of distribution. It is hard to see where in this situation a "withholding tax" within the meaning of Article 5 of the Directive is levied, since a decrease of tax is quite the opposite of an imposition of tax. From a legal and economic perspective, it should not matter for the application of the Parent-Subsidiary Directive at what moment a *corporate* tax is imposed. However, the point that the AG seems to have made is that Lankhorst-Hohorst GmbH was really in a loss situation; thus, the denial of interest deductions would not have led to 45% taxation of profits, but merely to a reduction of losses. Therefore, the AG probably considered the 30% *Ausschüttungsbelastung* a withholding tax, which is imposed irrespective of a loss situation of the distributing corporation.

Directive Article 7(1). Even assuming, however, that the German *Auschüttungsbelastung* constitutes a withholding tax under Article 5(1), the AG's argument could be questioned with regard to Article 7(1) of the Directive, which the AG did not even mention. This provision states that the "term 'withholding tax' as used in this Directive shall not cover an advance payment or prepayment (*précompte*) of corporation tax to the Member State of the subsidiary which is made in connection with a distribution of profits to its parent company."

Until *Athinaïki Zythopiia*,[39] the objective of Article 7(1) of the Directive seemed clear. Some countries with imputation systems collect corporate tax when distributions are made to equalize the corporate tax burden and finance the tax credit for the recipient. These corporate tax payments should not constitute a "withholding tax" whose prohibition prevents the source country from levying a single layer of tax, that is, corporate tax on the profits of the subsidiary. For example, French companies distributing profits that have not borne corporate tax or that have been taxed at a reduced rate must pay an equalization tax, the *précompte*, which is equal to the difference between the ordinary corporate income tax and the tax to which the distributed profits had effectively been subjected.[40] Thus, taxes such as the French *précompte*, the Italian *maggiorazione di conguaglio*,[41] the British ACT,[42] the Finish compensatory tax,[43] and the German *Ausschüttungsbelastung* are or were[44] intended to equalize the domestic tax burden on every domestic profit distribution to neutralize the imputation credit. Against this background—and despite the requirement of an "advance payment or prepayment"—it was argued that Article 7(1) "makes it clear that imputation-system States may continue levying their equalization taxes,"[45] thus excluding, for example, the French *précompte*, as well as the German *Ausschüttungsbelastung*, from the definition of a "withholding tax" under Article 5.

Greece vs. imputation-system countries. However, the issue is not as clear as it may seem, since the ECJ has shuffled matters in *Athinaïki Zythopiia*.[46] The issue was whether there is a withholding tax within the meaning of Article 5(1) of the Directive when Greek legislation provides (1) that where a subsidiary distributes profits to its parent company, (2) account is to be taken, in determining the subsidiary's taxable profits, of its total net profits, including income that has been subject to special taxation entailing extinction of tax liability and also nontaxable income, (3) when those two categories of income would not be taxable based on the national legislation if they remained with the subsidiary and were not distributed to the parent company.

Although Greece did not apply an imputation system, but rather exempted distributions at the shareholder level, there seemed to be a similarity between the Greek taxation of distributions and equalization taxes in imputation-system countries.[47] Nevertheless, the ECJ held that the tax at issue constituted a withholding tax within the meaning of Article 5 of the Directive and that the taxation could not be treated like an advance payment or prepayment (*précompte*) of corporation tax to the member state of the subsidiary within the meaning of Article 7(1) of the Directive.[48]

The reasoning of the ECJ in *Athinaïki Zythopiia* seems to overhaul the prevailing opinion toward the meaning of Article 7(1) of the Directive. The court stated that the "taxation relates to income which is taxed only in the event of a distribution of dividends and up to the limit of the dividends paid"—the increase in the basic taxable amount generated by the distribution of profits cannot be offset by the subsidiary using negative income from previous tax years, contrary to the fiscal principle enabling losses to be carried forward in Greek law.

This reasoning raises the question of the relationship between Article 7(1) and equalization taxes in imputation-system countries, since the inability to offset losses against the tax base of an equalization tax also holds true, for example, with regard to the British ACT, the French *précompte*, and the German *Ausschüttungsbelastung*. To resolve this issue, it could be argued, as the AG suggested in *Athinaïki Zythopiia*, that "the exception in Article 7(1) of the Directive is not applicable" if an equalization tax "is not an advance payment or prepayment but definitive taxation." Under this reading of Article 7(1), British ACT would have qualified, in many instances, as prepayment,[49] while the French *précompte*,[50] the Finish compensatory tax, or the German *Ausschüttungsbelastung* usually do not qualify as prepayment.

Précompte. While the AG's reasoning in *Lankhorst-Hohorst* clearly reflects the language of the Directive and is in line with the ECJ's decision in *Athinaïki Zythopiia*, it still could be questioned why Article 7(1) of the Directive explicitly uses the term "*précompte*." If it was intended to extend the exception to the French *précompte* in general and thus beyond an "advance payment or prepayment," there are good reasons why the German *Ausschüttungsbelastung* should have been covered by Article 7(1) as well.

However, the issue is of declining relevance since many countries have repealed their equalization taxes or abandoned their imputation systems entirely.[51] For example, Italy repealed its *maggiorazione di conguaglio* effective January 1, 1998; the U.K. abolished the ACT with effect from April 1999; Germany switched from an imputation system to a shareholder-relief system and thereby gave up the *Ausschüttungsbelastung* effective from 2001; the French *(Continued on page 62)*

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38 The Finnish Central Board of Taxation recently took a similar position with regard to the Finnish equalization tax; see, with critical comments, Hintsanen and Pettersson, "Finland: Supreme Administrative Court Rules on Taxation of Dual Resident Companies," 44 European Taxation 194 *et seq.* (IBFD, 2004).

39 Note 29, *supra*.

40 Before the French tax reform of 2004 took effect from January 1, 2005, every dividend paid by a French company subject to corporation tax carried an avoir fiscal tax credit, aimed at avoiding double economic taxation of dividends at the shareholder level. See "French Parliament Votes on 2004 Finance Bill, 2003 Amended Finance Bill," E&Y Foreign Desk, 15 JOIT 8 (May 2004). If a dividend is paid out of profits on which full corporation tax has not been imposed (i.e., from profits taxed at a reduced rate, exempted, or on which taxation has been deferred), the avoir fiscal remains in principle available to the shareholder. However, the purpose of the avoir fiscal would be biased in this situation, since no double economic taxation would have occurred. Hence, the precompte is levied, which broadly matches the advantage of the avoir fiscal. As an incentive to distribute dividends, the *precompte* also applies to dividends paid out of after-tax profits made more than five years before the distribution.

41 See Tredicine, "Italy: Withholding Tax on the Equalization Tax Refund in Breach of EC Law," 42 European Taxation 259 *et seq.* (IBFD, 2002).

42 See Tardivy, Schiessl, Haelterman, Sunderman, and Berner, "Parent Subsidiary Directive: The Long Reach of Athinaiki," 13 Int'l Tax Rev. 11 (March 2002).

43 See Hintsanen and Pettersson, *supra* note 38.

44 In the last few years, many European countries have repealed their equalization taxes unilaterally; see discussion in the text below.

45 See Hintsanen and Pettersson, *supra* note 38, page 196.

46 Note 29, *supra*; for a discussion of this case, see Stavropoulos, "ECJ: Greek Income Tax Provision Is a Withholding Within the Meaning of the Parent-Subsidiary Directive," 42 European Taxation 94 (IBFD, 2002).

47 The Greek tax system, as it stood in Athinaiki Zythopiia, can be described as a shareholder relief system. Profits were fully taxed with corporate income tax at either 35% or 40% at the company level, and distributed profits were not taxable in the hands of the private individual shareholder. However, as in Athinaiki Zythopiia, if profits were distributed as a dividend, the taxable profit had to be increased by the portion of distributed profits corresponding to tax-exempt income and the portion of distributed profits corresponding to income taxed based on special regulations after being increased by the applicable tax.

48 See para. 29 of the decision. For Greece's reaction to this judgment, see Stavropoulos, "Greece: Income, Inheritance and Incentive Tax Legislation Reform," 43 European Taxation 134 (IBFD, 2003).

49 See e.g., Vanistendael, "Tax Policy Reform: The Implementation of the Parent/Subsidiary Directive in the EC—Comments on Some Unresolved Questions," 5 Tax Notes Int'l 599 (September 21, 1992); see also Metallgesellschaft and Hoechst, ECJ, March 8, 2001, C-397/98, C-410/98, ECR 2001, I-1727. However, it was very common that the ACT was not a "true advance payment of corporation tax" where U.K. companies did not have mainstream corporation tax liabilities, e.g., due to losses, against which they could offset their ACT payments; see decision of the British High Court (Chancery Division), January 22, 2003, Pirelli Cable Holding v. Commissioners of Inland Revenue [2003] EWHC 32 (Ch), EuLR 2003, 166, para. 60.

50 Except when the precompte was payable because of a distribution paid out of the special reserve for long-term capital gains.

51 See generally European Team of the IBFD, "The *Oce van der Grinten* Case: Implications for Other EU Member States," 43 European Taxation 402 (IBFD, 2003).

Economic Substance

(Continued from page 56) above, the DGT considers the following:

- To evaluate the existence of valid economic motives, all circumstances of the transaction must be analyzed, including the practical result obtained. If a negative result is produced, i.e., a failed business project, the taxpayer must justify this fact, and if the tax administration feels that the failure of the project has not been sufficiently explained, it has the burden of proving the non-existence of a valid motive.
- If a case falls within the rule that disallows application of the special system when the transaction is not carried out for valid economic motives but rather for the sole purpose of obtaining a tax benefit, the tax administration need not prove the existence of tax avoidance. Therefore, the system will not apply when (1) the primary purpose of the transaction is tax avoidance; and (2) valid economic motives do not exist and the sole purpose of the transaction is to obtain tax savings. In conclusion, it is not sufficient for there to be *any* type of restructuring or rationalization—only those carried out for valid economic motives are eligible for deferred tax treatment, even where there is no tax savings. This is where we find the contradiction, however. A transaction may have no economic motive and still not have tax avoidance as its primary purpose, yet the tax administration refuses eligibility for the special system.
- Not only the main transaction but also preparatory transactions and those carried out subsequently must be analyzed, as they may constitute proof of a valid business restructuring or that a tax advantage is primarily sought.
- Finally, and for the purpose of evaluating whether the objective of the transaction is to obtain a tax advantage, the taxation of the parties before and after the transaction must be analyzed to evaluate the tax savings, if any.

Consequently, to evaluate the main economic reason for the transaction, it appears that the tax burden of each of the companies involved, both before and after the transaction, must be compared to determine whether this tax burden has decreased significantly as a result of the transaction. Subsequently, the economic advantages (e.g., volume of activity and resources) that the transaction has produced must be identified and it must be determined whether these advantages are proportional to the decrease in the tax burden.

If the economic motive is more relevant than the tax savings obtained, the tax administration should not dispute application of the special system. In contrast, if the tax savings is recognizable and of greater importance than the underlying economic motives, it appears that the special regime may not apply.

Possible sanctions for violation of the anti-abuse provisions. For instances involving "statutory fraud," the law prohibits sanctions because the conflict is based on a "different interpretation of the law" (tax administration vs. the taxpayer). On the other hand, in situations involving simulation, sanctions can be applied if the administration can prove that the taxpayer is at fault. In that instance, the conflict focuses on the act or transaction executed by the taxpayer (rather than an interpretation of the law) to reduce or avoid tax. Sanctions can be imposed by the tax administration following a separate procedure to prove taxpayer fault. ●

Arm's Length Principle

(Continued from page 43) Finance Bill for 2004 will repeal the imputation system and the *précompte* as of January 1, 2005; and Finland intends to abolish its imputation system and the compensatory tax by January 1, 2005.[52]

Implications for Reclassified Interest Payments Under Thin Cap Rules and "Secondary Adjustments"

Despite the uncertainty with regard to the scope of Article 7(1) of the Directive, ECJ case law and the arguments of the AG in *Lankhorst-Hohorst* clearly show that reclassified interest payments may not be subjected to withholding tax if the requirements of the Parent-Subsidiary Directive are fulfilled. Putting aside the question of equalization taxes, the residence country of a qualifying subsidiary may not levy withholding tax on any deemed profit distributions.[53] The submitted facts in *Lankhorst-Hohorst* do not indicate whether and, if so, at what rate[54] a withholding tax under sections 20(1)(1), 43, and 43a EStG was imposed—a question that was generally disputed in German legal writing.[55] With regard to this issue, the German Federal Ministry of Finance[56] and the prevailing opinion held that withholding tax must be imposed but may be reduced to the applicable rate under a double taxation convention.[57] However, if the AG's reasoning were applied to this situation, the withholding tax clearly would not be allowed.

Further, the AG's reasoning that a corporate income tax adjustment at the thinly capitalized subsidiary level is barred by the prohibition on the assessment of withholding tax on dividend payments under the Parent-Subsidiary Directive seems to be valid for all types of cross-border income tax adjustments, including adjustments in transfer pricing cases in a parent-subsidiary situation. Thus, the field of application of the AG's reasoning in *Lankhorst-Hohorst* concerns all "secondary adjustments" that take the form of a constructive distribution from a subsidiary to an EU parent. Such "secondary adjustments" may arise when a country makes a primary adjustment to the income of a subsidiary of a foreign parent—for example, a downward adjustment of expenses. In these instances, the excess profits in the hands of the foreign parent may be treated as having been transferred as a dividend, applying the rules of domestic law to the distribution.[58] It seems clear that, if the prerequisites of the Parent-Subsidiary Directive are met, the subsidiary's country of residence may not levy a withholding tax on the distribution. Thus, Article 5 of the Directive may play an important role in transfer pricing cases and may thereby even resolve the disputed issue of whether the parent's country of residence must grant a tax credit for withholding taxes levied on "secondary transactions" by the source country.

Interplay Between Parent-Subsidiary and the Interest and Royalties Directives

The AG's arguments in *Lankhorst-Hohorst* also raise the question of whether the Parent-Subsidiary Directive and the recently issued Interest and Royalties Directive[59] supplement each other with regard to thin capitalization reclassifications and transfer pricing adjustments of interest rates. Article 1 of the Interest and Royalties Directive requires member states, under certain prerequisites, to exempt interest and royalties from any tax imposed on interest and royalties in that state, whether by deduction at source or by assessment, where the beneficial owner of the interest or royalty is a company of another member state or a permanent establishment in another member state of a company of a member state.[60] Article 2(a) of the Directive reflects Article 11(3) OECD Model, defining interest as "income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures."

The Interest and Royalties Directive seems to address thin capitalization rules and transfer pricing issues in two, partly overlapping, provisions. First, under Article 4(1)(a), the source state is not obliged to ensure the benefits of the Directive for "payments which are treated as a distribution of profits or as a repayment of capital under the law of the source State." This provision seems to permit the application of domestic thin capitalization rules, but only when the law of the source state is not itself rendered ineffective under the EC Treaty pursuant to the decision in *Lankhorst-Hohorst*.

Second, Article 4(2) adopts the approach taken in Article 11(6) OECD Model, i.e., that where, "by reason of a special relationship between the payer and the beneficial owner of interest or royalties, or between one of them and some other person, the amount of the interest or royalties exceeds the amount which would have been agreed by the payer and the beneficial owner in the absence of such a relationship, the provisions of the Directive shall apply only to the latter amount, if any."

However, the breadth of the latter provision is unclear. The proposal for the Directive[61] stipulated in the second sentence of Article 5 that "in the case of interest, where by reason of such a relationship between the payer and the beneficial owner of the interest, or between one of them and some other person, the amount of the debt claim in respect of which the interest is paid exceeds the amount which would have been agreed by the payer and beneficial owner in the absence of such relationship, the provisions of the Directive shall only apply to the latter amount, if any." Although this proposed version made explicit reference to thin capitalization rules, the final wording of the "special relationships" paragraph now clearly refers only to situations where the interest rate agreed exceeds the interest rate that would have been agreed by unrelated parties. Thus, it may be questioned whether current Article 4(2) of the Directive also covers thin capitalization rules based on reclassification of a loan as equity irrespective of an arm's-length inquiry. However, Article 4(2) clearly applies to an adjustment of charged interest rates and renders the Directive inapplicable to the amount that exceeds the arm's-length rate.

Articles 4(1)(a) and 4(2) of the Interest and Royalties Directive thus raise the question of whether the Parent-Subsidiary Directive comes into play at that point where the Interest and Royalties Directive stops. The proposed Interest and Royalties Directive explicitly addressed this issue in Article 4 (now Article 4(1)) by stating that

52 See Hintsanen and Pettersson, *supra* note 38, page 196; *cf.* Raitasuo "Working Group Recommends Tax Cuts, Revocation of Dividend Imputation," 29 Tax Notes Int'l 831 (March 3, 2003).

53 This approach seems broadly consistent with the treatment of reclassified interest payments under double taxation treaties. Article 10(2) OECD Model, which provides for a reduction of withholding tax on dividends, applies as long as the source state taxes benefits, such as "disguised distributions of profits," as dividends. See OECD, Commentaries to the Model Tax Convention on Income and on Capital 2003 (2003), Article 10(28). In *Issues in International Taxation No. 2: Thin Capitalization* (Paris, 1987), the OECD Committee on Fiscal Affairs concluded that "it would in certain cases be appropriate to regard as a dividend a payment which had been treated as a dividend under national rules dealing with thin or hidden capitalisation" (para. 56). The last sentence of Article 10(3) of the OECD Model, which provides for a reference to national law in determining the meaning of "dividends" that is usually also found in bilateral treaties, is considered to cover reclassified interest payments.

54 The possibilities include the 25% withholding tax rate under German domestic law (sections 43, 43a EStG) and the reduced treaty rate for dividends under the German-Dutch income tax treaty.

55 The question boils down to whether the reclassification under section 8a KStG also has effect for the classification of such payments for purposes of the EStG, since section 20(1)(1) EStG covers "covert profit distributions," on which a 25% withholding tax is imposed by sections 43 and 43a EStG, which formally refer to the items of income covered by section 20(1)(1) EStG.

56 German Federal Ministry of Finance December 15, 1994, concerning "*Gesellschafter-Fremdfinanzierung* (section 8a KStG)," Bundessteuerblatt 1995 I 25 et seq., para. 76.

57 The German Tax Courts are divided on this issue. While the FG (Finanzgericht) (tax trial court) Berlin, February 16, 2001, 3 B 3280/00, FR 2001, 891, accepted the imposition of withholding tax under sections 20(1)(1), 43, and 43a EStG on such hidden distributions, the FG Dusseldorf, September 5, 2000, 6 K 2821/97 KE, EFG 2001, 84, rejected this result based on the argument that a specific provision in section 20 EStG would be necessary to subject deemed distributions under section 8a KStG to withholding tax. Because both appeals were withdrawn, neither case reached the Highest Tax Court, the German Bundesfinanzhof (BFH).

58 See OECD Transfer Pricing Guidelines, para. 4.67.

59 Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states. The Directive entered into force on January 1, 2004.

60 According to Article 1(7) of the Directive, the exemption applies only if the payor and payee are associated companies. Companies are associated when one has a direct minimum holding of 25% in the capital of another or when a third company has a direct minimum holding of 25% in both the payor and payee companies.

61 Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states, 98/C 123/07, as submitted by the Commission on March 6, 1998 (COM(1998) 67 final, OJ C 123/9, April 22, 1998).

interest "that has been recharacterised as a distribution of profits shall accordingly be subject instead to the provisions" of the Parent-Subsidiary Directive "where it is paid between companies to which the present Directive applies." During the legislative process, a suggestion was made to insert an identical provision into the proposed Article 5 (now Article 4(2)), since the issues are the same as under proposed Article 4.[62] However, neither reference is found in the current text of the Directive. Nevertheless, if the Interest and Royalties Directive does not apply to payments that qualify as profit distributions under Article 4(1)(a) or 4(2), such transactions are covered by the Parent-Subsidiary Directive if the relevant conditions are met.

Conclusion

Nondiscrimination under the fundamental freedoms of the EC Treaty trumps the internationally accepted arm's-length principle. Thus, member states must not apply disadvantageous thin capitalization rules or transfer pricing adjustments only in cross-border settings, "irrespective of anything which the provisions of the OECD model convention may permit," and regardless of whether the adjustments are based on the arm's-length principle. Even if these rules were written for and applied in domestic as well as cross-border settings, and thus would be nondiscriminatory, the possibility that ECJ case law will enter into its next stage and require the removal of this potential double taxation cannot be ruled out, since the mere extension of arm's-length adjustments to domestic settings, as carried out by several member states in reaction to *Lankhorst-Hohorst*, changes nothing with regard to a possible economic double taxation in cross-border settings. However, under *De Groot*, member states seem to have the means to agree on appropriate rules to avoid the judgment of discrimination in their tax treaties by obligating the other contracting state to perform corresponding adjustments. There may even be strong arguments that such a result has already been achieved by existing mandatory arbitration procedures, under either double taxation conventions or the EC Arbitration Convention.[63]

Further, the Parent-Subsidiary and Interest and Royalties Directives may play a major role with regard to thin capitalization rules and secondary adjustments in transfer pricing cases. The AG's reasoning in *Lankhorst-Hohorst* and existing case law make it clear that member states must not levy withholding taxes on deemed profit distributions in a qualifying subsidiary-parent relationship when those distributions result either from a reclassification of interest payments under thin capitalization rules or secondary adjustments in the form of dividends under transfer pricing rules. Application of the arm's-length principle may also lead to situations where payments are split between an accepted amount of interest and a deemed profit distribution in the amount exceeding the arm's-length interest rate. If the respective prerequisites are met, the Parent-Subsidiary Directive takes over where the Interest and Royalties Directive stops. Although the latter arguably does not apply to the reclassified interest payments according to Articles 4(1)(a) and 4(2), the former will. Thus, in many instances the interplay between these Directives will effectively rule out the possibility of member states levying withholding taxes on (purported) interest payments from a qualifying subsidiary to its EU parent company.

But even if transfer pricing and thin capitalization rules were in compliance with EC tax law, there would still be broad areas that give rise to cross-border disputes detrimental to the smooth functioning of the internal market and that create additional costs both for business and national tax administrations. Thus, the harmonization attempts by the Commission and the establishment of an "EU Joint Transfer Pricing Forum" with member states and business representatives raise hopes for a taxpayer friendly solution of many issues revolving around transfer pricing, such as documentation requirements and possible preventative measures to avoid double taxation (e.g., advance pricing agreements). The accession of the new member states to the EU on May 1, 2004,[64] should also put additional focus on the future of the EC Arbitration Convention. ●

62 See Opinion of the Economic and Social Committee on the "Proposal for a Council Directive on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Associated Companies of Different Member States" (98/C 284/09, OJ C 284/50, September 14, 1998).

63 However, the application of the De Groot approach to these issues has not been tested before the ECJ, so little guidance exists. It seems clear that the rules in member states' treaties must in fact provide for relief from double taxation. This can be derived from the ECJ's holding in De Groot that taxpayers must be certain that "as the end result, all their personal and family circumstances will be duly taken into account, irrespective of how those member states have allocated that obligation amongst themselves, in order not to give rise to inequality of treatment which is incompatible with the Treaty provisions on the freedom of movement for workers and in no way results from the disparities between the national tax laws." However, it is open whether only the "end result" is relevant or whether it must be considered that these procedures can be time consuming and cumbersome for the taxpayer.

64 See Lebovitz, MacLachlan, and Scheer, " EU Enlargement: Issues and Opportunities for Multinationals," 15 JOIT 18 (October 2003).