COMMISSION OF THE EUROPEAN COMMUNITIES

COM (76) 611 Final/2

Bruxelles, 2 December 1976

Explanatory Memorandum
concerning
PROPOSAL FOR A COUNCIL DIRECTIVE

on the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises (arbitration procedure)

(submitted by the Commission to the Council)

EXPLANATORY MEMORANDUM

I. GENERAL CONSIDERATIONS

1. Transactions between two associated enterprises situated in two different countries are sometimes carried out at prices which differ from those that would have been adopted by independent parties, without this necessarily meaning that any deceit has been intended. The result is a reduction of the taxable profits of one of the concerns and therefore also of its tax bill.

For this reason, tax authorities faced by such circumstances increase the profits of the enterprise in question to the figure that would have appeared if the same transactions had taken place between independent parties.

2. When one country's tax authority increases the profits of an enterprise but the profits of the associated concern that is its partner in the transaction are not correspondingly reduced in the other country, the group as a whole suffers double taxation.

Such double taxation may well give rise to distortions, both in the conditions of competition and in capital movements, of a kind that would otherwise not exist.

3. Such consequences are not acceptable within the Community, because they directly affect the operation of the common market. In its communication to the Council setting out its action programme for taxation (1), the Commission therefore undertook to submit proposals in this field in 1976.

4. There is all the more need to tackle this problem in that, as the Commission pointed out in the explanatory memorandum accompanying its proposal for a directive concerning mutual assistance by the competent authorities

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(1) COM(75)391 final of 23 July 1975

of Member States in the field of direct taxation (1), submitted to the Council on 5 April 1976, the introduction of a system for the exchange of information carries the risk of increasing the number of cases of double taxation, especially where transfer prices within groups of companies are concerned. For this reason the Commission on that occasion reaffirmed its undertaking to deal with the problem, stating that it would without delay present an appropriate proposal to the Council and furthermore expressing the wish that it might be adopted at the same time as the proposal for a directive on mutual assistance.

5. Certain conventions for the avoidance of double taxation concluded between Member States already contain a provision directed at ending double taxation through a mutual agreement procedure between the two tax authorities. But these conventions go no further than merely laying down an obligation to enter upon such a procedure, which clearly gives no guarantee that the double taxation will in fact be eliminated.

In order to be sure of suppressing such double taxation it is necessary to provide that where the tax authorities concerned do not reach agreement, the case will be submitted to a commission which will have to settle it. It is true that certain bilateral conventions provide for the setting up of commissions of this kind, but they consist only of representatives of the tax authorities. The Commission however thinks it essential to make certain that a decision will be taken definitely removing double taxation in every case. This will be achieved by adding an uneven number of independent persons of standing to the commission, which will then take its decisions by majority vote.

These commissions will by no means constitute supranational judicial bodies ; all that is being done is to expand the already existing provisions in such a way that they will in every case result in the suppression of double taxation.

6. There is no question of entrusting the arbitration commissioners with the task of establishing rules for the avoidance of the artificial transfer of profits between concerns in the same group by means of pricing arrangements. The Commission, as it stated in the above-mentioned Action Programme for Taxation, will continue its work in this latter area with a view to

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(1) COM(76)119 final of 31 March 1976

submitting proposals for common rules. The arbitration commissions, for their part, will examine and settle each case presented to them on its own merits.

II. COMMENTS ON CERTAINS ARTICLES

Article 1

Paragraph 1

7. This paragraph sets out the conditions under which the procedure provided in the directive for eliminating double taxation may be set in motion.

These conditions are as follows :

- the tax authority of a Member State must have increased the amount of the taxable profits derived by an enterprise from transactions which were carried out with an associated enterprise and which are considered to be lower than the profits that would have resulted from the same or similar transactions carried out between independent parties ("dealing at arm's length") ;
- the increase must give rise, or be likely to give rise, to double taxation for the group of which the enterprises form part.

8. The first phase of the procedure in question consists of a "mutual agreement procedure" with rules similar to those that already exist in bilateral taxation agreements. This means that where double taxation has arisen or there is a risk that it will arise, each of the two associated enterprises may apply to its national tax authority to obtain a satisfactory solution. Quite apart from this possibility, they still preserve their national rights of appeal. This meets the wich not to restrict the rights which taxpayers already enjoy under bilateral agreements.

9. To avoid both States seeking a solution at the same time, which might result in a double benefit to the group of enterprises, the third subparagraph of paragraph 1 provides that each authority to which a case is presented shall inform the other authority.

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Paragraph 2

10. This paragraph contains the definitions of certain terms used in the directive, which are adapted to its specific purpose.

The concept of "double taxation" supposes an increase of profits in one State without a corresponding adjustment taking place in the other. Such an adjustment would normally be made by reducing the profits of the associated enterprise by an appropriate amount. Nevertheless it is also permissible to make the adjustment through the "tax credit" method preferred by certain States (United Kingdom, Ireland).

Paragraph 3

11. This paragraph lays down that the preceding principles shall apply not only if the enterprises have made profits but also if they have made losses.

Article 2

12. The authority to which a case is presented has first of all to try on its own to find a satisfactory solution. If it cannot do so, it will make contact with the other authority, the two authorities being required to do everything possible to reach a mutual agreement that will eliminate the double taxation.

Article 3

Paragraph 1

13. The provisions of Article 3 and those which follow introduce a procedure which, because it goes beyond a mere effort by the national tax authorities to reach agreement (see Art. 2 and the mutual agreement procedures in double taxation conventions), results - and this is new - in the effective elimination of double taxation in each individual case. This procedure is based on the joint commission already provided in the OECD model convention. The composition of this commission, which under that convention consists only of representatives of the two national tax authorities concerned, is modified to enable it to make decisions which will completely remove double taxation.

14. This commission has to meet when the national tax authorities have failed to reach mutual agreement in a space of two years. This limit is

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necessary to give the authorities time to reach agreement but, on the other hand, it takes account of the legitimate right of the enterprises to obtain a settlement within a period that is not excessive from their point of view.

Paragraph 2

15. This paragraph lays down the conditions to be met by the two enterprises if the commission is to consider the case.

Firstly, they have to agree in advance to accept the commission's decision, since the two national tax authorities will also be bound by the decision.

The second subparagraph has regard to the domestic legislation of certain countries, which prevents their administrations from departing from the decision of a national court or tribunal even to give effect to a decision of an international joint commission and even if to do so would be in the taxpayer's favour. Where relations with such a State or between such States are concerned, and in order to avoid a decision by the Commission which might be in contradiction with the decision of a national court or tribunal, the two enterprises are therefore presented with the following choice :

- either they must opt for the decision of the commission, which will guarantee the elimination of the double taxation ; this involves giving up the right to appeal to a national appeal body or the withdrawal of such an appeal, or else presupposes that the time within which an appeal might have been made has expired ;
- or they must opt for the national appeal procedure, giving no guarantee that double taxation will be eliminated ; such a course excludes the possibility of applying to the commission.

Paragraph 4

16. This paragraph makes clear that enterprises which do not wish to avail themselves of the procedure before the commission suffer no loss of rights in the field of the traditional mutual agreement procedure.

Article 4

Paragraph 1

17. The purpose for which the commission referred to in Article 3 exists means that it must be constituted in such a way as to be able to make

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a decision that will eliminate double taxation. This requirement implies that an uneven number of independent persons of standing must be brought into the commission so as to avoid deadlock between the two tax authorities. The commission nevertheless continues to be a body derived from the two tax authorities which, in consequence, have the task of appointing the independent persons.

18. Since the cases submitted to the commission will have their own special features, the qualifications required of the independent persons may not always be the same. For this reason it is not laid down that the independent persons should be given a mandate for a minimum period ; the tax authorities are thus free to choose these persons for particular cases if need should arise.

The Member States are however required in all circumstances to ensure that the commission is constituted in good time, so that it can be summoned to meet by the deadline laid down in Article 3, paragraph 1, and can reach an immediate decision (see paragraph 8).

Paragraph 2

19. To facilitate selection, it is provided that it can be made from a list. The choice is nevertheless not restricted to this list, because of the special qualifications that might be needed for certain particular cases.

20. The drawing of lots is provided as a way of avoiding deadlock if the two tax authorities cannot reach agreement on the selection of one or more independent persons.

21. A tax authority may refuse to accept the appointment of any given independent person whose name is drawn by lot.

Paragraph 4

22. As regards professional secrecy, the independent persons are subject to the laws of both Member States concerned, and therefore in practice to whichever is the more strict.

Paragraph 7

23. In order that the commission may operate as flexibly as possible, the tax authorities are free to make further procedural rules for their bilateral relations.

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Article 6

24. Since it is not the purpose of the commission to bring back into question any point at issue on which the tax authorities have already reached agreement, the commission's decision bears only upon the amount in respect of which double taxation still exists.

Article 7

Paragraph 1

25. The aim of this provision is to prevent a State from escaping the obligation to initiate the mutual agreement procedure or proceedings before the commission on the grounds that the national decision concerning the increase of the profits of an enterprise (or the decision concerning the taxation of the associated enterprise) has already become final.

Paragraph 2

26. This paragraph deals with the circumstances arising when, after the conclusion of a mutual agreement procedure or of proceedings before the commission, the national decisions on which they were based are altered, for example as a result of a later special investigation into a particular case.

The paragraph provides that in such cases the results of such procedures or proceedings must be modified to take account of the alteration in the national taxation.

Article 8

Paragraph 1

27. This Article states that the preceding rules, which deal with transactions between two legally separate enterprises forming part of the same group, shall apply mutatis mutandis to similar relations between the headquarters and permanent establishments of an enterprise and between the different permanent establishments of an enterprise.

Paragraph 2

28. This paragraph deals with the situation in which, in the absence of a tax agreement, a State's domestic legislation does not completely avoid double taxation but brings only partial relief.

In such circumstances this relief must also be adjusted so as to take account of an increase applied in the other State by virtue of the preceding provisions.