International Association of Tax Judges

The increasing impact of soft law on (international) tax law :

Introduction

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The increasing impact of soft law on (international) tax law

- The trigger: the continuous update of the OECD TP Guidelines;

  - On 23 May 2016, the OECD Council approved the amendments to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as set out in the 2015 BEPS Report on Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) and the 2015 BEPS Report on Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting). **These amendments provide** further clarity and **legal certainty** about the status of the BEPS changes to the Transfer Pricing Guidelines, which were endorsed by the Council on 1 October 2015, by the G20 Finance Ministers on 8 October 2015, and by the G20 Leaders on 15-16 November 2015.

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- Example
- *"Para. 6.42: "While determining legal ownership and contractual arrangements is an important first step in the analysis, these determinations are separate and distinct from the question of remuneration under the arm's length principle.* ***For transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible, even though such returns may initially accrue to the legal owner as a result of its legal or contractual right to exploit the intangible****. The return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members through their functions performed, assets used, and risks assumed. "*
- OECD TP Guidelines generally considered as so called *soft law* (as opposed to hard law);

What is soft law?

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- Definition of soft law : *"Rules of conduct that are laid down in instruments which have not been attributed legally binding force as such, but nevertheless may have certain – indirect – legal effects, and that are aimed at and may produce practical effects"* *L. SENDEN, "Soft law, Self-regulation and Co-regulation in European Law: where do they meet?", 9, Electronic Journal of Comparative Law*
- The criticisms: lack of transparency, public debate and democratic legitimacy :
  - In relation to the making process, it could be said that these 'regulations' of soft law are elaborated without direct or indirect intervention of the competent national parliaments;
  - soft law is adopted through a making process that does not entail the possibilities of public discussion, official publicity and transparency with which the domestic law is made in all democratic countries;

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- *"In relation to the making process, it could be said that these 'regulations' of soft law are elaborated without direct or indirect intervention of the competent national parliaments. On the contrary, the soft law regulations (and rule making process) are carried out by representatives of the OECD Member States (generally civil servants of the different national tax administrations) and therefor they do not possess the necessary democratic legitimacy to adopt 'regulations' in a strict sense. Also, soft law is adopted through a making process that does not entail the possibilities of public discussion, official publicity and transparency with which the domestic law is made in all democratic countries (...).On the other hand, the States and other persons directly affected by these soft law rules generally have few means to participate in the making of these regulations, as they also have few mechanisms that allow them to exert a legal review on the legality of the soft law adopted or on the measures of enforcement of such soft law"* *(R. ROSE and E.C. PAGE, Lawmaking through the Backdoor, (European Policy Forum, London, 2001), p. 20.*

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- The impact of soft law on international tax law is not based exclusively, but to a large extent, on the work of the OECD.

- As far as soft law in international tax matters is concerned, reference is mostly made to :

  - OECD and UN Model Conventions and Commentaries
  - OECD Transfer Pricing Guidelines
  - OECD Standards for Transparency and Effective Exchange of Information
  - And BEPS-reports?

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- ***Article 5 of the Convention on the Organisation of the OECD (December 14, 1990)***
- *"In order to achieve its aims, the Organisation may:*
  - *(a) take decisions which, except as otherwise provided, shall be binding on all the Members;*
  - *(b) make* ***recommendations*** *to Members; and*
  - *(c) enter into agreements with Members, non-member States and international organisations. "*

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- In international tax matters, we see that the OECD issues mostly ***recommendations*** rather than binding decisions, since the latter could affect the national sovereignty of the Member States.
- Those recommendations are prepared by the Committee on Fiscal Affairs (CFA) and are endorsed by the OECD Council.
- This has also been the case for the OECD Transfer Pricing Guidelines:
  - they were approved by the Committee on Fiscal Affairs on 27 June 1995 and are the object of the Recommendation of the OECD Council C(95)126/FINAL, of 13 July 1995.
  - they are based on art. 5 (b) of the Convention on the Oecd and therefore, the tax administrations of the OECD member states are simply encouraged to follow the Guidelines;
  - but the recommendation instructs the CFA to monitor the implementation of the Guidelines, showing that Member States are somewhere expected to comply with them;

The EU Commission and soft law

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- *"The use of non-legislative or soft law approaches could be particularly effective in cases where they have a firm legal foundation, based on the Treaty and the case law of the Court of Justice. In such cases, instruments such as Communications, recommendations, guidelines and interpretative notices can provide guidance to Member States on the application of the Treaty principles and promote the rapid removal of obstacles to the Internal Market." EU Commission, 2001)*
  - The best-known example of EC soft law in the tax field is the Code of Conduct on Business Taxation, in which Member States agreed not to engage in specified techniques of harmful tax competition and to eliminate existing tax practices identified as harmful.

The OECD Transfer Pricing Guidelines

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- The Transfer Pricing Guidelines as an example.
- First reference to the arm's length principle in international tax law is seen in the model of the League of Nations.
- Initially, the concept remained rather vague and in practice it often led to difficulties of interpretation. For example, the OECD commentary on article 9 of the 1963 or even 1977 model did not even mention the term *'arm's length'* as opposed to the current OECD commentary.

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- It was in 1979 that the OECD published its first report on transfer pricing, namely *'Transfer Pricing and Multinational Enterprises*'. The report was largely based on the US Treasury Regulations of 1968 on Section 482, which is still the central transfer pricing article in US tax law today.
- It was during the revision of the OECD Model Convention and the commentary in 1992 that the OECD commentary referred for the first time to the above-mentioned OECD report of 1979 and indiacted that the report had to be regarded as *'internationally agreed principles and providing valid guidelines for the interpretation of the arm's length principle*'.

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- June 27, 1995 : OECD Transfer Pricing Guidelines as a recommendation approved by the CFA (OECD);
- Endorsed by the OECD Council on July 13, 1995;
- One of the aims of these guidelines was to revise and update the 1979 report referred to above.
- Those TP Guidelines are since 2010 updated on a regular basis.
- So what is currently the legal value of the OECD Transfer Pricing Guidelines?

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- It is commonly accepted that those TP Guidelines are not legally binding. That follows also from artikel 18 b van de *Rules of Procedure of the (OECD) Organisation* that mentions with respect to the OECD Recommendations the following *: "Recommendations of the Organisation, made by the Council in accordance with art. 5, 6 and 7 of the Convention, shall be submitted to the Members for consideration in order that they may,* ***if they consider it opportune****, provide for their implementation".*
- But that does not mean that those TP Guidelines have no legal value at all;

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- When concluding a double taxation convention, States may refer explicitly in a Protocol to these Guidelines or indicate that some provisions of the Convention should be interpreted in line with those Guidelines. For example, in article 1 of the Protocol to the **Belgian-US treaty** of 27.11.2006, we read the following :

- *"It is understood that the business profits to be attributed to a permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment. **The principles of the OECD Transfer Pricing Guidelines will apply for purposes of determining the profits attributable to a permanent establishment**, taking into account the different economic and legal circumstances of a single entity. Accordingly, any of the methods described therein as acceptable methods for determining an arm's length result may be used to determine the income of a permanent establishment so long as those methods are applied in accordance with the Guidelines."*

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- And art. 6 i) of the same Protocol with respect to the Arbitration procedure :

  "i) In making its determination, the arbitration board will apply, as necessary and in descending order of priority:

  - *i) the provisions of the Convention;*
  - *ii) any agreed commentaries or explanations of the Contracting States concerning the Convention;*
    iii) the laws of the Contracting States to the extent they are not inconsistent with each other; and
    iv) ***any OECD Commentary, Guidelines or Reports regarding relevant analogous portions of the OECD Model Tax Convention. "***

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- In the case of **the treaty between Japan and the United States** of 2003, both countries agreed through diplomatic notes that the treaty should be interpreted according to *the latest available version of the Guidelines*, which is criticized by several authors for allowing an informal modification of the original meaning of the treaty;
- The treaty between **Japan and the Netherlands** of 2010 allows, in certain cases, to submit the differences arising from its application to arbitration and the complementary agreement which develops this possibility expressly states that issues related to the application of the arm's length standard should be decided ***having regard to the Guidelines, as amended from time to time.***

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- And also in case the domestic tax legislation explicitly refers to the OECD TP Guidelines, it can be assumed that these Guidelines are legally binding at least for the application of domestic tax law. (*Ireland, Mexico, Spain, United Kingdom,…*);
- The Netherlands : The Introduction of the Dutch Decree, of 30 March 2001, on the application of the arm's length principle :
  - *'With regard to cross-border transaactions, there is agreement amongst the OECD Member countries regarding the "arm's length principle", as is included in Article 9 of the OECD Model Tax Convention. The OECD's Commentary on Article 9 of the OECD Model Tax Convention and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (henceforth the OECD Guidelines) provide for further guidance on the arm's length principle. The policy of the Netherlands on the arm's length principle in the field of international tax law is that this principle forms an integral part of the Netherlandes system of tax law as a result*

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- *of its incorporation in the broad definition recorded in Section 3.8 of the Income Tax Act 2001.* ***In principle, this means that the OECD Guidelines apply directly to the Netherlands under Section 3.8 of thè Income Tax Act 2001."***

- But what about future changes?

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- **The OECD-Commentary** referred for the first time in 1992 to the TP-Guidelines. Nowadays we read in § 1 of the OECD-commentary on art. 9 : *"Its conclusions are set out in the report entitled Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations,1 which is periodically updated to reflect the progress of the work of the Committee in this area. That report represents internationally agreed principles and provides guidelines for the application of the arm's length principle of which the Article is the authoritative statement."*
- So are the TP Guidelines since then part of the OECD Commentaries and is the legal value of the OECD TP Guidelines therefore determined by the legal value of the OECD-commentaries?

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- Reference to the OECD Transfer Pricing Guidelines is most frequently made in administrative circulars or other analogous documents issued by the Tax Administrations (Australia, Belgium, Canada, ...) and which, in general, are only binding to them but not to taxpayers or the judiciary.

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- To begin with, in **Canada**, the Federal Court of Appeal in the case *Smithkline Beecham Animal Health Inc. v. Canada*, of 31 May 2002 ([2002] F.C.A. 229) justified the use of the OECD Guidelines as an interpretative tool with the following arguments:
  - *"It appears to be common ground that the OECD Guidelines inform or should inform the interpretation and application of subsection 69(2) of the Income Tax Act. The OECD Guidelines state the principles for determining international transfer prices and, where possible, the agreement among OECD members with respect to the practices to be followed" (paragraph 8).*

- **source : Vega A.*, "International governance through soft law: The case of the OECD transfer pricing guidelines", TranState Working Papers, No. 163 (2012)

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- In **Germany**, the Federal Fiscal Court (*Bundesfinanzhof*) took the OECD Guidelines into account and cited them to reinforce its position in its judgement of 17 October 2001 (I R 103/00).
- Similarly, in **Austria** the Administrative Court (*Verwaltungsgerichtshof*) also referred to the OECD Guidelines in its judgement of 13 September 2006 (reference no. 2002/13/0190) to justify the method which was more adequate for the determination of transfer prices among related firms.
- In **Italy**, the judgement of the *Corte Suprema di Cassazione* of 13 October 2006 (no. 22023) also considered the 1995 Guidelines to confirm the initial position of the Court, even though the facts of the case took place before their publication.

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- Another country where the Courts have paid attention to the OECD Guidelines is **Spain**. For instance, the judgement of the Supreme Court (*Tribunal Supremo*) of 6 February 2008 (RJ 2008/1357) considers that the position of the Tax Administration was in accordance not only with the domestic legislation but also with the 1979 OECD Report on Transfer Pricing. Similarly, the *Audiencia Nacional* also referred to the OECD Guidelines to justify the use of certain methods to compute transfer prices under the arm's length standard, since they were more explicit than the Spanish legislation (judgements of 27 September 2007 (JUR 2007/306677) and 11 December 2008 (JUR 2009/3142)).

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- In **Switzerland**, the relevance of the Guidelines can be observed in the judgement of the Federal Administrative Court (*Bundesverwaltungsgericht / Tribunal administratif fédéral*) of 24 September 2009 (A-710/2007).
- **Hungary** : Decision no. 14.K.32.030/2016/30 of Budapest-Metropolitan Administration and Labour Court : On the basis of an expert opinion the Court concluded that neither the company's method nor that of the Hungarian Tax Authority were appropriate to determine the arm's length price of the transaction *because their methods did not comply with the standards of OECD Transfer Pricing Guidelines.*

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- However, in a few other countries the courts have expressly rejected the OECD Guidelines or they mention them only in very exceptional cases.
- In particular, in **Australia** the Federal Court stated in the judgement *SNF (Australia) Pty Ltd v. Commissioner of Taxation* [2010] FCA 635, of 25 June 2010, that the OECD Guidelines were not legally binding and that it would deviate from them: *"Both the 1979 and the 1995 guidelines have a role in assisting the Court in considering the appropriate methodology and the way in which methodologies are to be applied. I refer to the 1995 guidelines as a convenient reference to the various methods that have been adopted or referred to in determining arm's length consideration.*

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- *However, the 1995 guidelines do not dictate to the Court any one or more appropriate methods, and are just what they purport to be, guidelines. I treat them effectively as part of the submissions of Counsel as referring to a number of methods by which an arm's length consideration might be calculated. I have not relied upon any of the guidelines for the purposes of interpreting Div 13" (paragraphs 58 and 59)."*
- In other countries such as **the United States** and **France**, references to the OECD Guidelines in the case-law are almost non-existent.

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- High Court of **Malawi** : July 27, 2018 : *"It does not matter that these local pieces of legislation are modelled on OECD Guidelines as to warrant use of the OECD Guidelines at the expense of the Taxation Act and the Transfer Pricing Regulations, 2009. The respondent was at liberty to cite and use these OECD Guidelines only as an interpretation aid. As a tax administrator, the respondent is to strictly follow the dictates of the law as enacted by the Legislature. Any slight departure from the law is not allowed. Having said that, it is my finding that the respondent used the OECD Guidelines and not the Transfer Pricing Regulations 2009.* ***The use of these Guidelines at the expense of the Transfer Pricing Regulations, 2009 is illegal."***

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- So : the TP Guidelines as a genuine source of law or only as a confirmation of the autonomous interpretation of the judge?

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<table>
<tr><td rowspan="5">Countries with references to the OECD Guidelines</td><td>With references in legislation</td><td colspan="2">Hungary, Latvia, Mexico, Norway, Peru, Romania, Spain and the United Kingdom.</td></tr>
<tr><td rowspan="3">With references in circulars and other publications of the Tax Administration</td><td>Frequent references</td><td>Australia, Belgium, Canada, Germany, Namibia, New Zealand, South Africa, Switzerland and the United Kingdom.</td></tr>
<tr><td>Translation and publication of the Guidelines by the Tax Authorities</td><td>Austria, Czech Republic, Italy and Slovak Republic.</td></tr>
<tr><td>References in particular cases</td><td>United States.</td></tr>
<tr><td>With references in case-law</td><td colspan="2">Canada, Germany, Italy, Kenya, Spain and Switzerland.
In very exceptional cases: United States and France.
References denying the relevance of the Guidelines: Australia.</td></tr>
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The OECD Commentaries

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- The introduction to the OECD Commentaries :

  - *As the Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of member countries, they are of special importance in the development of international fiscal law. Although the commentaries are not designed to be annexed in any matter to the conventions signed by member countries,* ***which unlike the Model are legally binding international instruments****, they can nevertheless be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes." (...).*

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- And with respect to later changes :

  - *"Needless to say, amendments to the Articles of the Model Convention and changes to the Commentaries that are a direct result of these amendments are not relevant to the interpretation or application of previously concluded conventions where the provisions of those conventions are different in substance from the amended Articles.* ***However, other changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations."***

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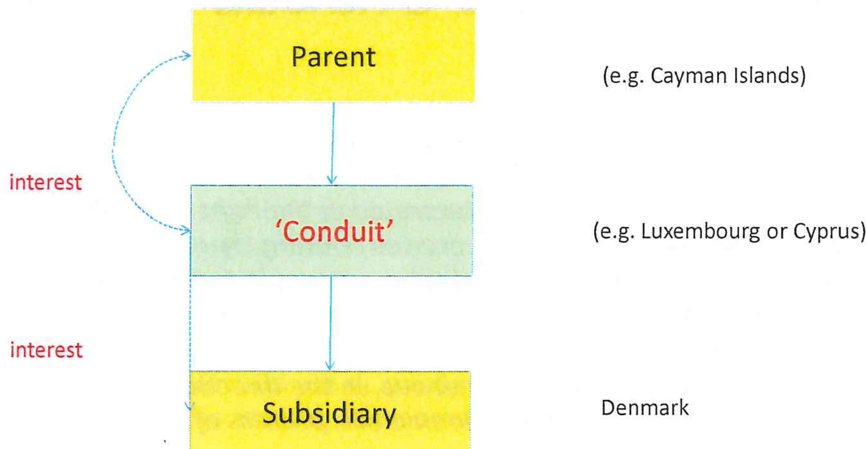
- Heavily debated by commentators :

  - Art. 31 or 32 of the Vienna Convention applicable? (see annex 2)
  - Presumption of applicability of the OECD Commentaries at the time the treaty was negotiated if no observations have been made in the OECD commentary?
    - but what if the other State is a non-OECD country?
  - What about the ambulatory character of the OECD-commentary?

The ECJ and the OECD Commentaries

The increasing impact of soft law on (international) tax law - ECJ cases C-115/16, C-118/16, C-119/16 and C-299/16 of February 26, 2019 :



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- Art. 1 of the EU Interest-Royalty Directive COU2003/49/EC of 3 June 2003

- *"1. Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that **the beneficial owner** of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State. "*

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- ECJ cases C-115/16, C-118/16, C-119/16 and C-299/16 of February 26, 2019 :

  - *"The applicants in the main proceedings submit that, if the concept of 'beneficial owner of the interest or royalties', within the meaning of Article 1(1) of Directive 2003/49,* ***were interpreted in the light of the OECD Model Tax Convention and of the commentaries relating thereto, that interpretation would not be acceptable as it would lack any democratic legitimacy whatsoever. That argument cannot, however, be upheld as such an interpretation, even if it draws on the OECD's documents, has its basis, as is clear from paragraphs 85 to 90 above, in the directive itself and in its legislative history reflecting the democratic process of the European Union."***

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- ECJ Case C-324/00 - September 26, 2002 : Lankhorst-Hohorst - Opinion AG Mischo

- *"80. Indeed, assuming that such compliance were established, it must still be 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. "*

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- ECJ case C-265/04 - January 19, 2006 - Bouanich
- OECD commentaries can not restrict EU law :
- *"The answer to the second question must therefore be that Articles 56 EC and 58 EC must be interpreted as precluding national legislation which derives from a double taxation agreement, such as the Franco-Swedish agreement, which fixes a lower ceiling on the taxation of dividends for non-resident shareholders than for resident shareholders, **and, by interpreting that agreement in the light of the OECD's commentaries** on its applicable model convention, permits the nominal value of such shares to be deducted from the share repurchase payment, except where, under such national legislation, non-resident shareholders are not treated less favourably than resident shareholders. It is for the national court to determine whether that is the case in the specific circumstances of the main proceedings. "*

Annex 1 : all updates OECD TP Guidelines

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- Since their original version the TP Guidelines have been *supplemented*:
  - By the report on intangible property and services, adopted by the Committee on Fiscal Affairs on 23 January 1996 [DAFFE/CFA(96)2] and noted by the Council on 11 April 1996 [C(96)46], incorporated in Chapters VI and VII;
  - By the report on cost contribution arrangements, adopted by the Committee on Fiscal Affairs on 25 June 1997 [DAFFE/CFA(97)27] and noted by the Council on 24 July 1997 [C(97)144], incorporated in Chapter VIII;
  - By the report on the guidelines for monitoring procedures on the OECD Transfer Pricing Guidelines and the involvement of the business community,], adopted by the Committee on Fiscal Affairs on 24 June 1997 and noted by the Council on 23 October 1997 [C(97)196], incorporated in the annexes;

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- By the report on the guidelines for conducting advance pricing arrangements under the mutual agreement procedure, adopted by the Committee on Fiscal Affairs on 30 June 1999 [DAFFE/CFA(99)31] and noted by the Council on 28 October 1999 [C(99)138], incorporated in the annexes;
- By the report on the transfer pricing aspects of business restructurings, adopted by the Committee on Fiscal Affairs on 22 June 2010 [CTPA/CFA(2010)46] and approved by the Council on 22 July 2010 [Annex I to C(2010)99], incorporated in Chapter IX.

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- And the TP Guidelines have been *modified* :
  - By an update of Chapter IV, adopted by the Committee on Fiscal Affairs on 6 June 2008 [CTPA/CFA(2008)30/REV1] and an update of the Foreword and of the Preface, adopted by the Committee on Fiscal Affairs on 22 June 2009 [CTPA/CFA(2009)51/REV1], approved by the Council on 16 July 2009 [C(2009)88];
  - By a revision of Chapters I-III, adopted by the Committee on Fiscal Affairs on 22 June 2010 [CTPA/CFA(2010)55] and approved by the Council on 22 July 2010 [Annex I to C(2010)99]; and
  - By an update of the Foreword, of the Preface, of the Glossary, of Chapters IV-VIII and of the annexes, adopted by the Committee on Fiscal Affairs on 22 June 2010 [CTPA/CFA(2010)47] and approved by the Council on 22 July 2010 [Annex I to C(2010)99].

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- By a revision of Section E on safe harbours in Chapter IV, and the addition of another Annex to this Chapter including three sample Memoranda of Understanding to establish bilateral safe harbours, adopted by the Committee on Fiscal Affairs on 26 April 2013 [CTPA/CFA(2013)23] and approved by the Council on 16 May 2013 [C(2013)69].
- By a revision of Chapters I, II, V-VIII by the Report on BEPS Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation and the Report on BEPS Action 13, Transfer Pricing Documentation and Country-by-Country Reporting, endorsed by the Council on 1 October 2015
- By a revision of Chapter IX adopted by the Committee on Fiscal Affairs on 31 December 2016 [CTPA/CFA/NOE2(2016)76] and approved by the Council on 3 April 2017 [C(2017)37].

Annex 2 : art. 31 & 32 Vienna Convention

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- Vienna Convention on the Law of Treaties 1969
- Art. 31 :
  - *§ 1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty* ***in their context*** *and in the light of its object and purpos*
  - *§ 2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:*
    - *(a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;*
    - *(b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty. "*

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- *§ 3. There shall be taken into account, together with the context:*
- *(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;*
- *(b) any subsequent practice in the applica- tion of the treaty which establishes the agreement of the parties regarding its interpretation;*
- *(c) any relevant rules of international law applicable in the relations between the parties.*
- *§ 4. A special meaning shall be given to a term if it is established that the parties so intended.*

Art. 32 :

- *Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpret- ation according to article 31:*
- *(a) leaves the meaning ambiguous or obscure; or*
- *(b) leads to a result which is manifestly absurd or unreasonable.*

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