



Council of the  
European Union

Brussels, 17 November 2016  
(OR. en)

14566/16

FISC 198  
ECOFIN 1057

## COVER NOTE

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From:	General Secretariat of the Council
To:	Delegations
Subject:	Report to the Code of Conduct Group (Business Taxation) on the work of the Subgroup during the Slovak Presidency – Clarification of the 3rd and 4th criteria of the Code

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Delegations will find attached the report to the Code of Conduct Group (Business Taxation) on the work of the Subgroup during the Slovak Presidency – Clarification of the 3rd and 4th criteria of the Code, as endorsed by the Code of Conduct Group (Business Taxation) on 19 October 2016.

**Report to the Code of Conduct Group on the work of the Subgroup  
during the Slovak Presidency:  
Clarification of the 3rd and 4th criteria of the Code**

**Introduction**

1. This paper reports to the Code of Conduct Group on the work done by the Subgroup on the clarification of the 3rd and 4th criteria of the Code during the Slovak Presidency.
2. The subgroup recommends to reflect the outcome of this work in the next 6-month report of the Code of Conduct Group to the ECOFIN Council and in the draft Council conclusions that will accompany that report, rather than through a separate set of Council conclusions.
3. The attached Annex contain the proposed draft Council conclusions as agreed by the Subgroup.

**Current mandate of the Subgroup**

4. The Council conclusions of March 2016 (doc. 6900/16, point 10) supported the creation of the new subgroup to deal with the clarification of the interpretation of Code's criteria 3 and 4: "*The Council (...) DECIDES that a subgroup will deal with the clarification of the third and the fourth criteria of the Code*".
5. The Council conclusions of December 2015 on the future of the Code of Conduct (doc. 15148/15, points 12-13) had previously agreed that the CoC Group "*should clarify the third criterion by developing guidance on the basis of OECD BEPS conclusions on Action 5*" and "*the fourth criterion by developing guidance in the light of the OECD Transfer Pricing Guidelines, as amended by OECD BEPS conclusions on Actions 8-9-10*".
6. The new Work Package which was endorsed by the ECOFIN Council in December 2015 also underlined that "*The Group will develop guidelines covering (...) the interpretation of criterion 3, focussing on the application of a nexus approach to preferential regimes other than patent boxes (...) [and] the interpretation of criterion 4, focussing on which internationally agreed standards are relevant and the role of the arm's length principle in identifying potentially harmful measures*".

7. The Code of Conduct Group meeting of 20 July 2016 confirmed this mandate and requested the new subgroup formation to prepare Council conclusions on this issue.

### **The Subgroup's work under the Slovak Presidency**

8. The Subgroup met on 30 September and 13 October 2016.
9. The Subgroup took as basis for its work the initial interpretations of criteria 3 and 4 is set out in a document on "*Definition of the criteria in paragraph B of the Code of Conduct*" tabled by the Commission services on 11 December 1998 (doc. 14039/98) and reviewed these interpretations on the basis of recent developments, notably OECD BEPS conclusions on Actions 5 and 8-9-10, as well as Action 13.
10. The first meeting of the Subgroup discussed the draft Council conclusions featured in Annex 1, which were finalised through a silence procedure.
11. The second meeting of the Subgroup was devoted to discussing a room document on other internationally accepted principles than the arms length principle, as developed by the OECD, that could be relevant for interpreting criterion 4. The Subgroup also discussed and agreed that further work will be required during upcoming presidencies.

## Further work

12. The Subgroup having agreed to substantiate the principles of the modified nexus approach<sup>1</sup>, as described in the OECD BEPS report on Action 5, on a case-by-case basis, the following types of regimes will need to be looked at, by order of priority, as appropriate:
  - i. holding company regimes;
  - ii. banking and insurance regimes;
  - iii. fund management regimes;
  - iv. financing and leasing regimes;
  - v. headquarter regimes;
  - vi. distribution and service centre regimes; and
  - vii. other regimes that may be identified by the group.
  
13. The Group should consider whether old CoC guidance on "special economic zones" should also be reviewed and updated in the light of the new interpretation of criterion 3, taking into account the provisions of paragraph G of the Code of Conduct.
  
14. With regard to the fourth criterion and its reference to the arm's length principle, as developed by the OECD, the Subgroup invites the European Commission, making use of its JTPF expert group, to consider reviewing and submitting proposals for updates of the EU Code of Conduct on transfer pricing documentation and other relevant EU guidelines by the end of 2019.
  
15. The Subgroup has agreed to develop guidelines with regard to the use of other internationally accepted principles for interpreting criterion 4, in addition to those enshrined in OECD Transfer Pricing Guidelines, in particular and where relevant:
  - a. Commentary to the OECD Model Tax Convention;
  - b. OECD principles for profit attribution to permanent establishments;
  - c. OECD BEPS minimum standards.

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<sup>1</sup> For example, it should be clarified how the modified nexus approach could be applied to these regimes in respect to the attribution of costs and revenues.

16. When developing these guidelines, the subgroup will also consider exploring principles such as matching costs with revenues.
  17. The subgroup agreed that the above-mentioned internationally agreed principles are not set at a particular point in time and that their evolving nature should be reflected in the relevant guidelines.
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"With regard to the Code of Conduct (Business Taxation), the Council:

- welcomes the progress achieved by the Code of Conduct Group during the Slovak Presidency as set out in its report (doc. XXX/16 FISC XX ECOFIN XX);
- welcomes in particular the work performed on the clarification of the third and fourth criteria of the Code in the context of OECD BEPS reports on Actions 5-8-9-10;
- agrees to consider the principles of the modified nexus approach, as described in the OECD BEPS report on Action 5, as a starting point for the work of the Code of Conduct Group on preferential regimes other than patent boxes when interpreting the third criterion of the Code and to substantiate these principles on a case-by-case basis depending on the type of regime in a manner consistent with the OECD;
- endorses the OECD BEPS report on *Aligning Transfer Pricing Outcomes with Value Creation* (Actions 8-9-10);
- invites the European Commission, making use of its EU Joint Transfer Pricing Forum (JTPF) expert group, to investigate the need to revise past EU guidelines on transfer pricing issues in the light of this OECD BEPS report and to report to and advise the Code of Conduct Group as appropriate;
- asks the Code of Conduct Group to continue its work with a view to facilitating, through the third and fourth criteria, an effective, swift and coordinated implementation at EU level of the principles of the modified nexus approach and other internationally accepted principles such as the arms' length principle as developed by the OECD;
- agrees to take into account the changes to the OECD Transfer Pricing Guidelines for interpreting the internationally accepted arm's length principle as a key reference for the fourth criterion of the Code;
- supports also further work by the OECD on transfer pricing issues, amongst others the transactional profit split method."