PUBLIC CONSULTATION DOCUMENT

PROPOSED CHANGES TO COMMENTARIES IN THE OECD MODEL TAX CONVENTION ON ARTICLE 9 AND ON RELATED ARTICLES

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Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles

Public consultation document

Public Consultation Instructions

Article 9 of the OECD Model Tax Convention deals with the taxation of transactions between associated enterprises.

Working Party 1 on Tax Conventions and Related Questions (which is the subgroup of the OECD Committee on Fiscal Affairs in charge of the Model Tax Convention), in consultation with Working Party 6 and the Forum on Tax Administration's MAP Forum, has recently undertaken work on the Commentary on Article 9 to clarify its application, especially as it relates to domestic laws on interest deductibility, where some commentators have questioned its interaction with those rules. This work is closely linked to the report Transfer Pricing Guidance on Financial Transactions published on 11 February 2020.

This public discussion draft includes proposals for changes to the Commentary on Article 9 and other related articles. The changes put forward in this discussion draft are expected to be included in the next update to the OECD Model Tax Convention.

The Committee invites interested parties to send their comments on this discussion draft before **28 May 2021**. These comments will be examined at the following meeting of Working Party 1.

Comments on this discussion draft should be sent electronically (in Word format) by email to taxtreaties@oecd.org and may be addressed to:

Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA

Unless otherwise requested at the time of submission, comments submitted in response to this invitation will be posted on the OECD website. Comments submitted in the name of a collective "grouping" or "coalition", or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

This document is a discussion draft released for the purpose of inviting comments from interested parties. It does not necessarily reflect the final views of the OECD and its member countries.

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1 Background

Working Party 1 on Tax Conventions and Related Questions (the subsidiary body of the OECD Committee on Fiscal Affairs in charge of the Model Tax Convention) has recently undertaken work to amend the Commentary on Article 9 to clarify its application, especially as it relates to domestic laws on interest deductibility, such as those recommended in the final report on BEPS Action 4, where some commentators have questioned the interaction of Article 9 with those rules.

The following are the changes that are proposed to the Commentaries on the Model Tax Convention as a result of the work of the Working Party on these issues. Changes to the existing text of the Model Tax Convention appear in ***bold italics*** for additions and ~~strikethrough~~ for deletions.

2 Proposed changes to the Commentary on Article 9

1. Replace paragraphs 2 to 4 of the Commentary on Article 9 with the following:

2. This paragraph provides that the taxation authorities of a Contracting State may, for the purpose of calculating tax liabilities of associated enterprises, re-write the accounts of the enterprises if, as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that adjustment should be sanctioned in such circumstances. The provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises~~.~~ ***and, therefore, the provisions would not apply to the*** ~~No~~ re-writing of the accounts of associated enterprises ~~is authorised~~ if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis). ***In order to ensure the elimination of double taxation, the arm's length principle and the guidance on its interpretation in the OECD Transfer Pricing Guidelines should be followed in any re-writing of accounts[1].***

[footnote: [1] See Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises [C(95)126/FINAL, as amended]. The Recommendation is reproduced in the Appendix to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.]

3. In considering whether an interest payment can be regarded as an arm's length amount, a State will typically examine the terms and conditions of the loan such as the rate of interest. It may also need to examine, based on the facts and circumstances, whether a purported loan should be regarded as a loan or as another kind of transaction, in particular a contribution to equity capital. The State making a determination as to the extent to which the purported loan is regarded as a loan will do so taking into account factors discussed in its domestic laws (including judicial doctrine), or in the OECD Transfer Pricing Guidelines. ~~As discussed in the Committee on Fiscal Affairs' Report on "Thin Capitalisation", [footnote: Adopted by the Council of the OECD on 26 November 1986 and reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(4)1.] there is an interplay between tax treaties and domestic rules on thin capitalisation relevant to the scope of the Article. The Committee considers that:~~

~~a) the Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;~~

~~b) the Article is relevant not only in determining whether the rate of~~

~~interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital.;~~

~~c) the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties.~~

3.1 Once the profits of the two enterprises have been allocated in accordance with the arm's length principle, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed, as long as there is conformity with the requirements of other provisions of the Convention. Article 9 does not deal with the issue of whether expenses are deductible when computing the taxable income of either enterprise. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 4 of Article 24. Paragraph 30 of the Commentary on Article 7 makes an equivalent statement for the application of Article 7. Examples of domestic rules that can deny a deduction for expenses include certain rules on entertainment expenses and on interest such as those recommended in the final report on Action 4 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project.[1]

[footnote: 1 OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241176-en.]

4. The question ***may*** arise~~s as to~~ whether special procedural rules which some countries have adopted for dealing with transactions between related parties are consistent with the Convention. For instance, ***is*** ~~it may be asked whether~~ the reversal of the burden of proof or presumptions of any kind which are sometimes found in domestic laws ~~are~~ consistent with the arm's length principle~~.~~***? These questions are not answered in Article 9, but should be considered under Article 24 (see paragraphs 75 and 80 of the Commentary on Article 24).*** ~~A number of countries interpret the Article in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of the Article and that it has the function of raising the arm's length principle at treaty level. Also, almost all member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of Article 24. However, in some cases the application of the national law of some countries may result in adjustments to profits at variance with the principles of the Article. Contracting States are enabled by the Article to deal with such situations by means of corresponding adjustments (see below) and under mutual agreement procedures.~~

2. The following change to paragraph 6 of the Commentary on Article 9 and the next additional paragraph (which derives from a parallel statement in paragraph 66 of the Commentary on paragraph 3 of Article 7) are proposed to clarify the obligations of the State making a corresponding adjustment.

6. It should be noted, however, that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is

due only ~~if~~ ***to the extent that*** State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, ~~the paragraph may not be invoked and should not be applied~~ where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's length basis~~,~~ State B is ~~therefore~~ committed to make an adjustment of the profits of the affiliated company if it considers that the adjustment made in State A is justified ~~both~~ in principle ***but only to the extent of the amount that reflects profits computed on an arm's length basis***. ~~and as regards the amount.~~

6.1 As noted in paragraph 3.1 above, Article 9 applies only for the purposes of allocating profits to the two enterprises in accordance with the arm's length principle. It does not deal with the subsequent computation of taxable income, which is a question of domestic law. Any mismatch in this domestic law treatment does not in itself result in economic double taxation for the purposes of paragraph 2 and there is thus no obligation on State B to make a corresponding adjustment in these circumstances.

[Current paragraph 6.1 of the Commentary on Article 9 would be renumbered as paragraph 6.2.]

3 Proposed change to the Commentary on Article 7 (business profits)

3. The following proposed changes to paragraph 59 of the Commentary on Article 7 reflect the proposed changes in paragraph 6 of the Commentary on Article 9, set out in paragraph 2 above.

> 59. As is the case for paragraph 2 of Article 9, a corresponding adjustment is not automatically to be made under paragraph 3 simply because the profits attributed to the permanent establishment have been adjusted by one of the Contracting States. The corresponding adjustment is required only ~~if~~ ***to the extent that*** the other State considers that the adjusted profits conform with paragraph 2. In other words, ***regardless of which State makes the initial adjustment,*** ~~paragraph 3 may not be invoked and should not be applied~~ where ***that State adjusts*** the profits attributable to the permanent establishment ~~are adjusted~~ to a level that is different from what they would have been if they had been correctly computed in accordance with the principles of paragraph 2. ~~Regardless of which State makes the initial adjustment~~, the other State is obliged to make an appropriate corresponding adjustment ***but only to the extent that*** ~~if~~ it considers that the adjusted profits correctly reflect what the profits would have been ***if they had been correctly computed in accordance with these principles*** ~~if the permanent establishment's dealings had been transactions at arm's length. The other State is therefore committed to make such a corresponding adjustment only if it considers that the initial adjustment is justified both in principle and as regards the amount~~

4 Proposed change to the Commentary on Article 24 (non-discrimination)

4. The following changes to the commentary on Article 24 arise as a consequence of the proposed changes to paragraph 4 of the Commentary on Article 9.

> 75. Also, paragraph 4 does not prohibit additional information requirements with respect to payments made to non-residents since these requirements***, including the reversal of the burden of proof,*** are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents.

5 Proposed change to the Commentary on Article 25 (mutual agreement procedure)

5. The following proposed new paragraph in the Commentary on Article 25 is designed to confirm the practices of OECD member States in admitting cases into the mutual agreement procedure and to reinforce one of the conclusions of the BEPS Action 14 Final Report.

> ***12.1 More generally, the economic double taxation that may result from a primary adjustment consisting of the inclusion of profits of associated enterprises in an amount not justified by reference to the arm's length standard would result in taxation not in accordance with one of the objects and purposes of the Convention to eliminate double taxation. A denial of access to the mutual agreement procedure in these circumstances, with a view to eliminating the economic double taxation that could follow from such an adjustment, would likely frustrate an objective of the Convention. States should therefore provide access to the mutual agreement procedure in transfer pricing cases.***