

MAISTO E ASSOCIATI

ASSOCIAZIONE PROFESSIONALE

Avv. Prof. GUGLIELMO MAISTO
Dott. PAOLO LUDOVICI*
Avv. RICCARDO MICHELUTTI*
Avv. MARCO CERRATO LL.M.
Dott. ANDREA PAROLINI* LL.M.
Dott. STEFANO M. CECCACCI*
Avv. PIETRO PICCONE FERRAROTTI
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Dott. ANDREA ANNONI*
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Dott. LUCA FORMICA*
Dott. GIORGIA ZANETTI
Dott. FRANCESCO MORRA
Dott. SILVIA BOIARDI

Milan, 25 January 2010

Mr Jeffrey Owens, Esq.
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris Cedex 16
FRANCE

Dear Mr Owens,

Re: Revised discussion draft on a new Article 7 of the OECD Model Tax Convention

* Dottore Commercialista

Maisto e Associati is pleased to provide its comments in response to the OECD Centre for Tax Policy and Administration's public invitation to comment on the "Revised discussion draft on a new Article 7 of the OECD Model Tax Convention", released on 24 November 2009 (the "Discussion Draft").

Firstly, we commend the OECD for its efforts to update Article 7 of the OECD Model Tax Convention, as the revisions proposed improve clarity and resolve a number of open issues.

The points below set out specific comments referring to one or more paragraphs of the Discussion Draft. We hope they may be useful in drafting the new Article 7 of the OECD Model Tax Convention and its Commentary.

Paragraph 10 of the Commentary to Article 7

Paragraph 10 clarifies that:

"[T]he right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general 'force of attraction' according to which income such as other business profits, dividends, interest and royalties arising from sources in their

PIAZZA F. MEDA, 5
20121 MILANO
TEL. +39.02.776931
FAX +39.02.77693300
email milano@maisto.it

PIAZZA D'ARACOELI, 1
00186 ROMA
TEL +39.06.45441410
FAX +39.06.45441411
email roma@maisto.it

2, THROGMORTON AVENUE
LONDON EC2N 2DG
TEL. +44.(0)20.73740299
FAX +44.(0)20.73740129
email london@maisto.it

territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment.... [T]he general force of attraction approach described above has now been rejected in international tax treaty practice.”

It is worth noting that in some countries the “force of attraction” operates at two different levels:

- for the application of *sourcing rules*, in order to determine whether a particular item of income is sourced in a State and therefore such State has the corresponding right to tax;
- for the application of *taxing rules*, in order to determine the method of assessment and collection of domestic taxes once the item of income is regarded as sourced in a particular State; for instance, in some OECD Member countries certain flows of income produced by non-residents are characterized for tax purposes as: (a) non-business income if the non-resident is not operating in the country through a permanent establishment; or (b) as business income if the non-resident carries on its activity in the State through a permanent establishment even though such item of income is not attributable to the permanent establishment itself.

The paragraph should refer to the first type of attraction only. If, pursuant to a treaty, an item of income is taxable in a Contracting State according to its taxing rules, such State should be free to tax such income as business income under the second type of force of attraction. This is also implied, *inter alia*, by paragraphs 28 and 72.

The Discussion Draft should therefore clarify that the force of attraction cannot be applied only as “sourcing rule”.

Paragraphs 18–20 of the Commentary to Article 7

Paragraphs 18 to 20 provide that:

“18. As explained in the Report, the attribution of profits to a permanent establishment under paragraph 2 will follow from the calculation of the profits (or losses) from all its activities, including transactions with independent enterprises, transactions with associated enterprises (with direct application of the 1995 Transfer Pricing Guidelines) and dealings with other parts of the enterprise. This analysis involves two steps which are described below.

“19. Under the first step, a functional and factual analysis is undertaken which will lead to:

- the attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
- the identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;
- the identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;

- the identification of other functions of the permanent establishment;
- the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test referred to in paragraph 24; and
- the attribution of capital based on the assets and risks attributed to the permanent establishment.

“20. Under the second step, any transactions with associated enterprises attributed to the permanent establishment are priced in accordance with the guidance of the 1995 Transfer Pricing Guidelines and these Guidelines are applied by analogy to dealings between the permanent establishment and the other parts of the enterprise of which it is a part.”

It is not clear if paragraph 19 refers only to the case where the enterprise enters into transactions that do not fall within the scope of Article 9, as the counterparties are independent enterprises. In this context it would be helpful to clarify that, only in such a case, the profits of the enterprise as a whole shall not be adjusted and the only issue is how to allocate such profits to the permanent establishment and to other parts of the same enterprise.

In dealing with associated enterprises, instead, one should first determine whether the profits of the whole enterprise are at arm's length or should be adjusted, and – in a second step – if and to what extent these profits should be allocated to the permanent establishment and to other parts of the same enterprise. It is our understanding that the primary transfer pricing adjustment should be between the States in which the enterprise is resident (State R) and the State in which the associated enterprise is resident (State T), on the basis of Article 9 of R–T Treaty; this primary adjustment should then lead to an adjustment in the allocation between the State of the permanent establishment (State S) and State R, based on the treaty between these two States.

This process is not entirely clear in the Commentary and may give rise to some conflicts: the residence State may have little or no interest in pursuing a transfer pricing dispute; however, this should not refrain the permanent establishment State from adjusting the profits realised by the permanent establishment in dealings with associated enterprises resident in a third State. The action undertaken by the permanent establishment State (State S) should force the residence State (State R) to enter into the transfer pricing dispute with the third State (State T). To this end, the Commentary should clarify that it would be worthwhile to introduce a mechanism that allows the permanent establishment State (State S) to be part of the consultation process or mutual agreement procedures between the residence State (State R) and the third State (State T), initiated on the basis of Article 9(2) or Article 25 of the treaty in force between State R and State T.

Paragraph 24 of the Commentary to Article 7

According to paragraph 24:

“[A]n accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the approach.”

The paragraph quotes “accounting record and contemporaneous documentation”.

With reference to the documentation it may be worthwhile to delete the term “contemporaneous” as it may be read in the sense that *only* contemporaneous documentation may be considered as “valid”. In reality, in countries where there are no statutory rules on contemporaneous documentation (particularly if such documentation refers to “internal dealings”), such documents may be formed and submitted even at a later stage, for instance, in the course of an audit.

With reference to the “accounting record” the paragraph should clarify when this should be prepared, namely if it has to be prepared at the moment of the dealing or at a subsequent time (e.g. before the filing of the tax return).

Paragraph 25 of the Commentary to Article 7

Paragraph 25 clarifies that Article 7(2):

“[A]pplies not only for the purposes of determining the profits that the Contracting State in which the permanent establishment is situated may tax in accordance with the last sentence of paragraph 1 but also for the application of Articles 23 A and 23 B by the other Contracting State. Where an enterprise of one State carries on business through a permanent establishment situated in the other State, the first-mentioned State must either exempt the profits that are attributable to the permanent establishment (Article 23 A) or give a credit for the tax levied by the other State on these profits (Article 23 B). Under both these Articles, that State must therefore determine the profits attributable to the permanent establishment in order to provide relief from double taxation and is required to follow the provisions of paragraph 2 for that purpose.”

It might be helpful to point out that Article 7(2) may be relevant for additional purposes – other than Articles 23 A and B – such as the allocation of taxing rights (sourcing rules), e.g. under Articles 15. For instance, the principles set forth by Article 7(2) could be relevant to determine whether the remuneration paid to an employee is “borne” by a permanent establishment on the basis of Article 15(2). With

reference to such issue, please see below our comments to paragraph 7.2 of the Commentary to Article 15.

Paragraph 26 of the Commentary to Article 7

According to paragraph 26:

“The separate and independent enterprise fiction that is mandated by paragraph 2 is restricted to the determination of the profits that are attributable to a permanent establishment. It does not extend to create notional income for the enterprise which a Contracting State could tax as such under its domestic law by arguing that such income is covered by another Article of the Convention which, in accordance with paragraph 4 of Article 7, allows taxation of that income notwithstanding paragraph 1 of Article 7.... [T]he fact that, under paragraph 2, a notional interest charge could be deducted in determining the profits attributable to a permanent establishment does not mean that any interest has been paid to the enterprise of which the permanent establishment is a part for the purposes of paragraphs 1 and 2 of Article 11. The separate and independent enterprise fiction does not extend to Article 11 and, for the purposes of that Article, one part of an enterprise cannot be considered to have made an interest payment to another part of the same enterprise.... Where, however, a transfer of assets between a permanent establishment and the rest of the enterprise is treated as a dealing for the purposes of paragraph 2 of Article 7, Article 13 does not prevent States from treating any gain from such a transfer as a capital gain to which the rules of that Article will apply (see paragraphs 4, 8 and 10 of the Commentary on Article 13).”

It is not clear why a “financing” between the head office and the permanent establishment generates a “notional interest” which falls within the scope of Article 7 instead of Article 11 not being a “real interest”, whilst a “transfer” of assets from the permanent establishment to the head office (or vice versa) generates a “notional capital gain” which falls within the scope of Article 13 being treated as a “real capital gain”. The taxing rules of a Contracting State may give the same recognition to “notional capital gains” and to “notional interest”, “notional rent”, etc., and therefore the comment of paragraph 10 of the Commentary on Article 13 may extend to these other notional items.

In our view a possible reason for such difference is that while Article 11 provides a treaty definition of the term “interest”, Article 13 does not provide a definition of “capital gains” but leaves to the domestic law of each Contracting State which capital gains should be taxed.

If this is the reason for the difference, it should clearly be stated.

Paragraph 31 of the Commentary to Article 7

According to paragraph 31:

“[I]n taxing the profits attributable to a permanent establishment situated on its territory, a Contracting State will, however, have to take account of the provisions of

paragraph 3 of Article 24. That paragraph requires, among other things, that expenses be deductible under the same conditions whether these are incurred for the purposes of the taxation of the profits of a permanent establishment situated in a Contracting State or the taxation of the profits of an enterprise of that State.”

The principle affirmed by the paragraph is that expenses incurred by the permanent establishment in “internal dealings” with other parts of the enterprise are deductible subject to the same requirements applicable to transactions with separate enterprises. It is possible that the domestic laws of the permanent establishment State provide special rules on deduction of costs incurred vis-à-vis blacklisted countries and that the costs incurred by the permanent establishment arise indeed from dealings with other parts of the enterprise established in any of such blacklisted countries. The Discussion Draft should clarify that in these situations such special domestic law rules should not be applicable or, alternatively, deemed to have been satisfied with regard to the deduction of the “notional expense” to the extent that the functional analysis test has been made at the level of the permanent establishment.

Paragraph 65 of the Commentary to Article 7

According to paragraph 65:

“[P]aragraph 3 does not apply to affect the computation of the exemption or credit under Article 23 A or 23 B except for the purposes of providing what would otherwise be unavailable double taxation relief for the tax paid to the Contracting State in which the permanent establishment is situated on the profits that have been attributed to the permanent establishment in that State. This paragraph will therefore not apply where these profits have been fully exempted by the other State or where the tax paid in the first-mentioned State has been fully credited against the other State’s tax under the domestic law of that other State and in accordance with Article 23 A or 23 B.”

There might be cases where items of income are fully exempted in the State of residence but such exemption is applied in such a manner that causes an increased tax burden on other types of income (e.g. exemption with progression). In such circumstances, it may be appropriate to enter into a mutual agreement procedure for the same reasons mentioned under paragraph 61 (the impact may be immediate rather than in future).

It might be desirable to include a reference to such a case in the Discussion Draft.

Paragraph 69 of the Commentary to Article 7

Paragraph 69 states that:

“[A]lthough it has not been found necessary in the Convention to define the term ‘profits’, it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries.”

Paragraph 69 seems to indicate that the term “profits” has the same meaning as the term “income” and is determined gross of expenses but this is not in line, for instance, with Article 7(3), which says that “*in determining the profits ... there shall be allowed as deductions expenses*”, which clearly indicates that profits are net of expenses.

The paragraph should be amended to clarify that point.

Commentary to Articles 10, 11, 12, 13, 15 and 21: “Effective connection”

We refer to paragraph 32 to the Commentary to Article 10 and to corresponding paragraphs of Articles 11, 12, 13, 15 and 21.

The Commentary clarifies that effective connection requires “economic ownership” which relates to “the attendant benefits and risks”.

We believe that in determining effective connection, and perhaps in evaluating the “attendant benefits and risks”, some reference should also be made to activities carried out by the enterprise. For instance, what if all benefits and risks for a shareholding can be allocated to a permanent establishment but all the activities related thereto (e.g. negotiation during acquisition, participation to shareholders’ meeting and board meetings, setting strategies and negotiation for the disposal) are carried out by other parts of the same enterprise?

Paragraph 7.2 of the Commentary to Article 15

According to paragraph 7.2:

“[F]or the purpose of determining the profits attributable to a permanent establishment pursuant to paragraph 2 of Article 7, the remuneration paid to an employee of an enterprise of a Contracting State for employment services rendered in the other State for the benefit of a permanent establishment of the enterprise situated in that other State may, given the circumstances, either give rise to a direct deduction or give rise to the deduction of a notional charge, e.g. for services rendered to the permanent establishment by another part of the enterprise. In the latter case, since the notional charge required by the legal fiction of the separate and independent enterprise that is applicable under paragraph 2 of Article 7 is merely a mechanism provided for by that paragraph for the sole purpose of determining the profits attributable to the permanent establishment, this fiction does not affect the determination of whether or not the remuneration is borne by the permanent establishment.”

A distinction should be made depending on the level of services that justify the notional charge.

If the services are broad and the cost of personnel is only a parameter to measure the value of the services, we agree that the cost is not borne by the user; otherwise, if the services merely consist in putting the employees at the disposal of the permanent establishment the outcome is more uncertain.

Other comments that do not suggest changes to the Discussion Draft – Paragraph 9 of the Commentary to Article 7

Paragraph 9, in illustrating the principle underlying Article 7(1), i.e. that the profit of an enterprises of one Contracting State shall not be taxed in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein, points out that it reflects “the international consensus” that, as a general rule of territoriality regarding taxation of non-residents, until an enterprise of one State sets up a permanent establishment in another State, “*it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profit.*”

This paragraph suggests that in order for a non-resident enterprise to “participate in the economic life” of a particular State it is sufficient to maintain a permanent establishment in that particular State.

The reference to the “participation in the economic life” can be found in the internal legislation of some OECD Member countries with reference to tax provisions different from tax treaties. For example, it is worth noting that Italy (and possibly other countries) interprets the “participation in the economic life” requirement in a different way. For instance, in ruling 10 October 2008 No. 427, the Italian tax authorities, in the context of the application of the Italian CFC rules (business test regarding the CFC company), concluded that a company participates in the economic life of a State only if it carries on activities for the “local market” of the State itself, i.e. the majority of clients and/or suppliers are located in such a State. Therefore, for instance, an enterprise (company or permanent establishment) with employees, offices and equipment in a particular State is not regarded as participating in the economic life of that State if its clients (and suppliers) are established outside that State.

Furthermore, in the EU context, the European Court of Justice in *Cadbury Schweppes* (C-196/04) pointed out that the freedom of establishment provided by the European Treaty intends to allow a

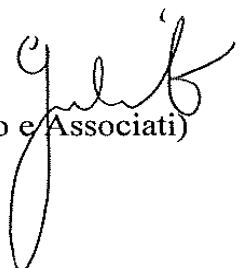
Community national to participate, on a stable and continuing basis, “in the economic life of a Member State”. Such a concept has been interpreted in a very wide manner in the decision itself, whereby the European Court of Justice concluded that the application of CFC legislation within Europe – that could restrict the freedom of establishment – should be limited to cases of “wholly artificial arrangements”, because only in such a case there is not a participation in the economic life of a Member State to be safeguarded.

The European Commission has reaffirmed such principle, for example, in its Communication on “The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries” [COM(2007) 785 Final].

We appreciate the opportunity to provide our comments on the Discussion Draft and thank you for your attention to this matter. We trust you will find these comments useful as you work towards producing a final revision of Article 7 and its Commentary.

Please feel free to contact us with any questions or comments concerning this letter.

Respectfully,


(Maisto e Associati)