



The Voice of OECD Business

**BIAC Comments on the
OECD Public Discussion Draft:
Draft Comments of the 2008 Update to the OECD Model Convention**

31 May 2008

BIAC appreciates this opportunity to provide comments on the OECD Draft 2008 Update to the OECD Model Convention dated 21 April 2008.

I. Preliminary Statements

BIAC supports regular updates to the Model:

The international business community appreciates the constant efforts of the OECD Fiscal Affairs Committee (CFA) to amend and improve the OECD Model Convention and its Commentary. We recognise that the CFA and its groups are dealing with many issues. Considerable efforts are often necessary to come to an agreement and the process can be time-consuming.

From a practical point of view, it is important to know at what moment an amendment has become final and can be used by treaty negotiators. While many countries properly do not accept that Commentary changes adopted after a treaty becomes effective should be used in interpreting that treaty, other countries take a different view. It is important for the business community to understand the principles that competent authorities might apply in resolving double taxation matters. Regular and frequent updates are helpful in this regard.

General remarks regarding BIAC's comments on the 2008 draft Update:

The 2008 Update consists of numerous amendments, many of which are of considerable practical importance. Some of the issues raised in the draft Update were discussed intensely between the OECD and the international business community, and as such BIAC has already commented on many of these issues. We appreciate that a considerable number of our comments were integrated into the proposed amendments.

In the following comments, we will not comment again where we think that the international business community can generally live with the conclusions reached in the 2008 Update. In these cases we simply express our agreement.

With respect to other amendments, and in particular to some conclusions we have difficulties to accept, we will comment and indicate why we cannot agree with the particular contents of the proposed Update. In those cases we will also refer to our previous comments regarding the earlier OECD Discussion Drafts. We would appreciate if our concerns and suggestions were taken into account before the draft Update will be formally approved by the OECD.

BIAC supports postponement of Commentary changes regarding Article 15 paragraph 2 (notion of the “economic” employer)

We would like to repeat again our concerns regarding the proposed changes to the Commentary on paragraph 2 of Article 15 released for public comments on 12 March 2007 (see BIAC comments of 30 June 2007). Due to the practical consequences of the envisaged changes we think that it is particularly important that a solution can be reached which will also be supported by the international business community.

II. Specific remarks of BIAC on the proposed changes

We will provide our comments following the order of the OECD draft comments in the 2008 Update.

Part I: Changes that have not already been released by the OECD before

See our comments below regarding the proposed changes to the Commentary (Part II, B).

Part II: Changes to be included in the 2008 Update of the Model Tax Convention

A. Changes to the Model

Article 25, new paragraph 5: Arbitration

BIAC supports the inclusion of the new paragraph 5 into the Model. This is an important step towards improving the resolution of tax treaty disputes under the bilateral conventions.

B. Changes to the Commentary

1. Changes to the Commentary on Article 1: New cross-references

BIAC agrees with the proposed Commentary changes.

2. Changes to the Commentary on Article 4;

a) Exclusion of companies without a comprehensive tax liability,

b) Place of effective management

a) *Commentary changes in paragraphs 8.2 and 8.3 regarding Article 4, paragraph 1, second sentence:*

BIAC strongly disagrees with the new interpretation which goes far beyond the wording of Article 4, paragraph 1, second sentence. In that sentence and in the existing Commentary (paragraph 8) it is clearly mentioned that a person is not to be considered a resident of a Contracting State in the sense of the Convention if, although not domiciled in that State, it is considered to be a resident according to domestic laws, but is subject only to a taxation limited to income from sources in that State or capital situated in that State.

The proposed new Commentary goes much further. The existing Commentary already assumed in paragraph 8 – under the wording and the so-called “spirit” of the Convention – that foreign-held companies exempt from tax on their foreign income by privileges tailored to attract conduit companies should be excluded. The existing Commentary then cautions, however: “The application of the second sentence has inherent difficulties and limitations.” And it continues: “Thus it has to be interpreted restrictively.” In the proposed draft commentary (paragraph 8.3) this sentence is simply deleted and replaced by the clear statement; “*It has to be interpreted in the light of its object and purpose, which is to exclude persons who are not subjected to the most comprehensive liability to tax generally imposed in that State.*”

This is an example where a provision in the Model Convention is given a new interpretation that is not covered by the wording of the article itself.

BIAC is of the clear opinion that this goes far beyond the role that the Commentary should play, namely to explain and interpret the provisions of the Model. The Commentary should therefore not be amended in this way.

b) *Place of effective management (paragraph 24 of the Commentary):*

BIAC is aware of the fact that the discussions conducted within the OECD and with third parties regarding the concept of the place of effective management have been long and controversial.

The modification proposed in paragraph 24 is in our view an improvement.

However, the optional wording proposed in paragraph 24.1 (for countries following a case-by-case approach) raises, on the one hand, the fundamental question of how far the OECD should go in proposing options to the agreed wording of an article. On the other hand, a case-by-case approach is certainly not a good choice from the perspective of the international business community. Contrary to what is said in the draft Commentary, dual residence of enterprises is an issue that could become even more important in future, due to new forms of doing business and new communication techniques. Since the competent authorities always have the possibility to go for a mutual agreement procedure in cases where they have doubts or do not agree with the decision made by the other authority, the proposed option is, in our understanding, not necessary. Furthermore, in situations where the two states follow different approaches, the option does not help. It can, on the contrary, have far reaching negative consequences for the business entities in case no agreement can be found, e.g. because there is a lack of criteria accepted by both states. No entitlement to treaty benefits or relief will be the consequence for the taxpayer.

The comments made in the last paragraph of the proposed new paragraph 24.1 are therefore of utmost importance in case two states choose the proposed new option. The criteria to be used in dual residence cases should in such situations always be discussed and agreed upon in the course of the bilateral negotiations.

However, BIAC suggests that the reference in paragraph 21.1 to “where its accounting records are kept” be deleted given the rapid increase of service centres causing such records to be kept outside country of operation. It no longer is a valid indicator.

3. Changes to the Commentary on Article 5: Alternative approach for a deemed service PE

BIAC has taken note of the (few) amendments made in the proposed new commentary on Article 5 as compared to the former discussion draft. We have also studied the Examples mentioned in paragraph 42.28 and the other clarifications.

BIAC continues to be strongly opposed to inserting the alternative approach into the Commentary (see BIAC comments of 16 February 2007). We therefore repeat here our main concerns made earlier.

- Under policy considerations BIAC fully supports the traditional approach to the attribution of taxation rights on business profits under the general rules of Article 5 of the OECD Model Tax Convention, which includes the provision of services. The permanent establishment threshold is well-known and accepted worldwide

and a point of reference to states and taxpayers in a global business environment.

- The proposed new Commentary defines a framework of rules and conditions that should govern states if they decide to deviate from the general permanent establishment standard under Article 5 and introduce a special deemed permanent establishment threshold for services taxation in their tax treaties. The business community sees the intention of OECD to provide more guidance to countries that intend to follow such an approach and understands that there is pressure from certain countries to at least go half-way by inserting the new approach in the Commentaries. BIAC is, however, of the clear opinion that these reasons do not justify a deviation from the fundamental principles governing the OECD PE approach, as laid down in paragraph 1 of Article 5.
- Major feasibility and policy issues regarding an alternative treaty provision on services are not addressed by the proposed Commentary and apparently left for states to resolve. These issues concern key elements inherent in the alternative approach, such as legislative and administrative application, attribution of profits, intermediate financing of refundable withholding tax, the threat of the creation of market barriers and possible unequal treatment of resident and non-resident service providers. These questions should rate high in importance for governments and business taxpayers alike. It seems almost impossible to fully appreciate the possible impact of the alternative approach to the taxation of services in the absence of any substantial and coherent information on these issues.
- Generally, BIAC is very concerned about OECD's plan to include fundamentally differing attribution rules like the proposal on deemed permanent establishments in the Commentary, which may create problems for future efforts to develop consensus positions on important issues. So far, states disagreeing could voice disagreement in the section called "Observations on the Commentary" or section "Reservations on the Article". For Article 5, there are many such observations and reservations. Those states wanting to adopt a deemed services permanent establishment approach ought to voice their observation or reservation in the specific sections.

BIAC therefore asks the Committee on Fiscal Affairs again to undertake further work on these policy and feasibility considerations, and proposes not to adopt this proposal.

4. Changes to the Commentary on Article 7: Attribution of profits to the PE

When comparing the amendments in Annex 2 (Changes made to the revised commentary on Article 7) with the BIAC comments of 31 July 2007 regarding the former OECD discussion draft, BIAC notes that only a few of its fundamental concerns

BIAC continues to support the move toward alignment with general transfer pricing principles, the preference for the separate entity approach, and the OECD's clear rejection of the Force of Attraction principle. Concern remains, however, about the level of work that may be required to properly document the profit attributable to a permanent establishment, especially given some permanent establishments may involve relatively small transactions which could lead to a disproportionate documentation effort for tax payers.

We continue to object strenuously to the following features of the revisions to the Article 7 Commentary:

a) We believe that Commentary which implements only a portion of the principles contained in the OECD reports on the attribution of income to permanent establishments is misguided. In particular, the adoption of KERTs principles (people's functions) to attribute some classes of assets (loans and financial assets) but not other classes of assets (intangibles) yields a completely incoherent system of attributing income. Even at this late date, we strongly urge the OECD to abandon this half-way implementation scheme.

b) We believe that the Commentary should be explicit about the intended legal effects of its changes and that individual countries should specifically indicate whether and to what extent they intend to follow this interim Commentary.

c) We believe the Commentary should unequivocally state that relief of double taxation within the meaning of the Model Convention requires that the home and host country agree as to the amount of income and expense attributable to a permanent establishment. While we do not object per se to the statements in new paragraph 15 of the Commentary, we are concerned that those statements not be read as a justification for competent authorities to avoid making the necessary compromises to reach a common understanding regarding the allocation of the tax base. For this reason BIAC requests OECD to reconsider this insertion.

d) We have grave doubts regarding the practical efficacy of a rule suggesting that the home country defer to the tax base determination of the host country but only provided the host country's determination is consistent with arm's length dealing.

BIAC continues to be deeply concerned whether the new OECD approach can be applied in practice under the existing wording of Article 7. Although the new draft categorically states in paragraph 48 that the OECD member countries agreed to accept, under certain conditions, for the purpose of relief of double taxation, the amount of interest deduction calculated under rules for capital attribution of the state of the PE, there are widespread fears that many states will in practice not be prepared to do so and that the end result of this long project will be to increase rather than reduce the instances of double taxation and extended controversy.

BIAC asks the OECD again to make sure that the position of each OECD country with respect to the application of this new Commentary to article 7 is made public at the moment the 2008 Update will become applicable. Furthermore it strongly urges the OECD to finalise as a priority matter and at the earliest possible time the revision of the provisions of article 7 and the new 'full implementation' Commentary regarding the authorized OECD approach.

**5- Changes to the Commentary on Article 9:
Replacement of cross-references**

BIAC agrees with the proposed Commentary changes.

**6. Changes to the Commentary on Article 10:
Distributions by Real Estate Investment Trusts**

BIAC agrees with the proposed Commentary changes.

**7. Changes to the Commentary on Article 12:
Clarification regarding software, services and know-how**

BIAC agrees with the majority of the proposed Commentary changes.

However, with regard to the proposed introduction to Paragraph 10.2 we would like to propose the insertion of the phrase "on a continuous or repetitive basis" after the phrase "any additional work" in the last sentence. We understand that it is possible for an engineering company to let its customer use a design (sometimes in the form of software) without modification by taking it from his so-called shelf or inventory of work products. It would require multiple instances of such use, not a single, isolated instance, for royalties category to apply.

Furthermore, within the new paragraph 11 to Article 12, the requirement to agree on a split between parties on services on transfer of information already available and to be obtained during the execution of the contract appears burdensome and not practical. BIAC requests OECD to reconsider this proposal.

On paragraph 11.4 of Article 12 BIAC suggests to change the proposed text to "payments for a list of existing or potential customers". To distinguish between various customers and origin is burdensome and does not appear necessary.

**8. Changes to the Commentary on Article 13:
Amendments regarding REITs**

BIAC agrees with the proposed Commentary changes.

**9. Changes to the Commentary on Article 15:
Clarification regarding the calculation of days of presence in the
source state**

BIAC agrees with the proposed Commentary changes.

**10 Changes to the Commentary on Article 17:
Option to be inserted in Article 17 - Right of taxpayer to ask for
taxation on a net basis in the source state**

BIAC agrees with the proposed Commentary changes.

**11. Changes to the Commentary on Article 21:
Clarification regarding persons not resident in a Contracting State**

BIAC agrees with the proposed Commentary changes.

**12. Changes to the Commentary on Articles 23 A and 23 B:
Clarification regarding the taxing right**

BIAC agrees with the proposed Commentary changes.

**13. Changes to the Commentary on Article 24:
Non-Discrimination**

Some of the proposed changes clearly restrict the application of the non discrimination clause (e.g. regarding indirect discrimination, the taxation of groups, the interpretation of the notion “in the same circumstances” or the application of thin-capitalisation rules). As mentioned in our earlier submissions, BIAC continues to believe that a restrictive approach goes in a wrong direction. The fundamental purposes of bilateral tax treaties is to remove double taxation and other tax obstacles. An effective protection from discrimination is important in practice, as foreign businesses and their employees are confronted with many and often subtle forms of unequal treatment.

BIAC sees the proposed changes as a first step and encourages the OECD to continue its efforts to further explore the subject of non-discrimination. We refer in

particular to the issues listed in the Annex to the OECD discussion draft of 3 May 2007.

**14. Changes to the Commentary on Article 25:
Improvement of the mutual agreement procedure,
arbitration supplementing the MAP**

BIAC welcomes the introduction of an arbitration mechanism that can be invoked in case the competent authorities do not come to an agreement within two years. We can also support the idea to provide for the arbitration procedure only within the context of the mutual agreement procedure of Article 25, as long as the competent authorities are bound by the decisions made by the arbitration panel (unless they find an agreement among themselves before the arbitration procedure is completed). Some questions, namely regarding the legal nature of the arbitral award (e.g. application of the UN Arbitration Convention in case of non-implementation), are in our understanding still open and should be clarified.

Annex: Sample Mutual Agreement on Arbitration:

BIAC agrees with most of the rules envisaged in the proposed Sample Agreement. We continue to think, however, that those rules are heavily biased in favour of the competent authorities instead of providing for a truly independent arbitration procedure. Some of the rules provided in the Sample Agreement seems to be overly complicated. They are difficult to understand and even more difficult to be followed in a practical case. We think that it would be wise to streamline the sample in order not to deter the tax authorities from adhering to the new paragraph 5 or to enter into a mutual agreement on the arbitration procedures to be followed before a conflict arises.