

**PLACE OF EFFECTIVE MANAGEMENT CONCEPT:
SUGGESTIONS FOR CHANGES TO THE OECD MODEL TAX CONVENTION**

Introduction

1. In February 2001, the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (“TAG”) publicly released for comments its discussion draft entitled “The impact of the Communications Revolution on the Application of ‘Place of Effective Management’ as a Tie Breaker Rule”.

2. The TAG wishes to thank the individuals and organizations that have sent comments on the discussion draft. The TAG examined these comments and found that they supported the alternative options of providing clarification of the place of effective management concept as a tie-breaker rule and developing a hierarchy of different approaches (which could be based on factors similar to those used as a tie-breaker for individuals) that would constitute a new tie-breaker rule.

3. The TAG has accordingly developed the two alternative proposals which are included in this note. The first proposal (“Refinement of the place of effective management concept”) seeks to refine the concept of “place of effective management” by expanding the Commentary explanations as to how the concept should be interpreted. The second proposal (“Hierarchy of tests”) puts forward an alternative version of paragraph 3 of Article 4 of the Model Tax Convention (the tie-breaker rule for persons other than individuals), together with Commentary thereon. As will be seen, that proposal itself includes three different options as regards a possible second tie-breaker test.

4. The TAG invites interested parties to send their comments, before 1 September 2003, on these proposals and options. Comments on the note should be sent to:

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5. The TAG also recommends to Working Party No. 1 to examine the various alternative proposals discussed in this note in light of the comments that will be received on them with a view to decide whether and how the OECD Model Tax Convention should be amended.

A. Refinement of the place of effective management concept

6. The first proposal seeks to refine the concept of “place of effective management” by expanding the Commentary explanations as to how the test should be interpreted.

7. The following changes have been prepared for that purpose (proposed additions to the existing Commentary appear in ***bold italics***; deletions appear as ~~striketrough~~)

Replace paragraph 24 of the Commentary on Article 4 by the following:

“24. As a result of these considerations, the "place of effective management" has been adopted as the preference criterion for persons other than individuals. ~~[the rest of the existing paragraph has been incorporated in modified form in the following paragraphs]~~ ~~The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.~~

24.1 An entity may have more than one place of management, but it can have only one place of effective management at any one time. *[this corresponds to the last sentence of existing paragraph 24]*

24.2 The place of effective management is the place where ***the*** key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made ~~The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given.,~~ ***i.e.*** the place where the actions to be taken by the entity as a whole are, ***in fact***, determined ~~and all.~~ ***All the*** relevant facts and circumstances must be examined to determine the place of effective management. *[this corresponds to the second and third sentences of existing paragraph 24].*

24.3 The place of effective management ~~will~~ ***is*** ordinarily ~~be~~ the place where the most senior person or group of persons (for example a board of directors) makes its decisions, *[this corresponds to the third sentence of existing paragraph 24]* ***which normally corresponds to where it meets. There are cases, however, where the key management and commercial decisions necessary for the conduct of the entity's business are in substance made in one place somewhere by a person or group of persons but are formally finalized somewhere else by it or by another person or group of persons. In such cases, it will be necessary to consider other factors. Depending on the circumstances, these other factors could include:***

- ***Where a board of directors formally finalizes key management and commercial decisions necessary for the conduct of the entity's business at meetings held in one State but these decisions are in substance made in another State, the place of effective management will be in the latter State.***
- ***If there is a person such as a controlling interest holder (e.g. a parent company or associated enterprise) that effectively makes the key management and commercial decisions that are necessary for the conduct of the entity's business, the place of effective***

management will be where that person makes these key decisions. For that to be the case, however, the key decisions made by that person must go beyond decisions related to the normal management and policy formulation of a group's activities (e.g. the type of decisions that a parent company of a multinational group would be expected to take as regards the direction, co-ordination and supervision of the activities of each part of the group).

- *Where a board of directors routinely approves the commercial and strategic decisions made by the executive officers, the place where the executive officers perform their functions would be important in determining the place of effective management of the entity. In distinguishing between a place where a decision is made as opposed to where it is merely approved, one should consider the place where advice on recommendations or options relating to the decisions were considered and where the decisions were ultimately developed.”*

B. Hierarchy of tests

8. The second proposal is to adopt the following new version of paragraph 3 of Article 4 of the Model Tax Convention (the tie-breaker rule for persons other than individuals). That new version, which would replace the existing paragraph, follows the approach currently used in paragraph 2 (the tie-breaker rule for individuals) of using four different rules that apply in succession to resolve the dual-residence situation. Three different options have been offered as regards the second rule that would apply if the situation could not be solved through the place of effective management test. Comments are particularly invited on which of these three options should be preferred, on whether one of these options (e.g. option C, as was suggested by some members of the TAG) should be made the first rule after place of effective management with one of the other two options becoming the next rule in the hierarchy, and on whether the three options should rather be offered as three additional rules in the proposed hierarchy (and if yes, in which order).

“3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then its status shall be determined as follows:

- a) it shall be deemed to be a resident only of the State in which its place of effective management is situated;
- b) if the State in which its place of effective management is situated cannot be determined or if its place of effective management is in neither State, it shall be deemed to be a resident only of the State [OPTION A: with which its economic relations are closer] [OPTION B: in which its business activities are primarily carried on] [OPTION C: in which its senior executive decisions are primarily taken].
- c) if the State [with which its economic relations are closer] [in which its business activities are primarily carried on] [in which its senior executive decisions are primarily taken] cannot be determined, it shall be deemed to be a resident of the State from the laws of which it derives its legal status;
- d) if it derives its legal status from neither State or from both States, or if the State the State from the laws of which it derives its legal status cannot be determined, the competent authorities of the Contracting States shall settle the question by mutual agreement. “

9. The Commentary to that new paragraph could be drafted along the following lines (proposed additions to the existing Commentary appear in ***bold italics***; deletions appear as ~~strikethrough~~):

Replace paragraphs 21 to 24 of the Commentary to Article 4 by the following:

“21. This paragraph concerns companies and other bodies of persons, irrespective of whether they are or not legal persons. It may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State, but it is, of course, possible if, for instance, one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies, etc., also, special rules as to the preference must be established.

22. To solve such conflicts of residence, rules have been established which give the attachment to one State a preference over the attachment to the other State. As for individuals, the facts to which the rules will apply are those existing during the period when the residence of the taxpayer affects tax liability, which may be less than an entire taxable period.

~~22. — It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed.~~

~~23. — The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the "place of management" of the enterprise is situated; other conventions attach importance to its "place of effective management", others again to the "fiscal domicile of the operator".~~

23. The paragraph first gives preference to the Contracting State in which the "place of effective management" of the entity is situated. An entity may have more than one place of management, but it can have only one place of effective management at any one time. [*this sentence corresponds to the last sentence of existing paragraph 24*]

24. The place of effective management is the place where ***the*** key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. ~~The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given, i.e. the place where the actions to be taken by the entity as a whole are, ***in fact***, determined and all. ***All the*** relevant facts and circumstances must be examined to determine the place of effective management. [*this corresponds to the second and third sentences of existing paragraph 24*].~~

24.1 The place of effective management ~~will~~***is*** ordinarily ~~be~~ the place where the most senior person or group of persons (for example a board of directors) makes its decisions, [*this corresponds to the third sentence of existing paragraph 24*] ***which normally corresponds to where it meets. There are cases, however, where the key management and commercial decisions necessary for the conduct of the entity's business are in substance made in one place somewhere by a person or group of persons but are formally finalized somewhere else by it or by another person or group of persons. In such cases, it will be necessary to consider other factors. Depending on the circumstances, these other factors could include:***

- ***Where a board of directors formally finalizes key management and commercial decisions necessary for the conduct of the entity's business at meetings held in one State but these***

decisions are in substance made in ~~the other~~ another State, the place of effective management will be in the latter State.

- If there is a person such as a controlling interest holder (e.g. a parent company or associated enterprise) that effectively makes the key management and commercial decisions that are necessary for the conduct of the entity's business, the place of effective management will be where that person makes these key decisions. For that to be the case, however, the key decisions taken by that person must go beyond decisions related to the normal management and policy formulation of a group's activities (e.g. the type of decisions that a parent company of a multinational group would be expected to take as regards the direction, co-ordination and supervision of the activities of each part of the group).*
- Where a board of directors routinely approves the commercial and strategic decisions made by the executive officers, the place where the executive officers perform their functions would be important in determining the place of effective management of the entity. In distinguishing between a place where a decision is made as opposed to where it is merely approved, one should consider the place where advice on recommendations or options relating to the decisions were considered and where the decisions were ultimately developed.*

[OPTION A: 24.2 In some rare cases it may be impossible to make a clear determination of the State in which the place of effective management of the entity is situated or the facts may indicate that this place is situated in none of the Contracting States. For instance, it may be that the senior group of persons responsible for making key decisions for the entity regularly meets in different places so that the decisions are not primarily taken in any given State. Also, that group may carry its meetings through modern communication technology in such a way that it is impossible to identify a particular State where its decisions are made. In these cases subparagraph b) gives preference to the State with which the entity's economic relations are closer. The preference to the State with which the economic relations are closer is based on the conclusion that, in such cases, the entity should be considered a resident of the Contracting State in which it is making greater use of economic resources as well as the legal, financial, physical and social infrastructures. The application of that test will involve examining various factors, such as in which State the entity has most of its employees and assets, carries on most of its activities, derives most of its revenues, has its headquarters, carries on most of its senior management functions or from which State the entity derives its legal status. If an examination of these and other relevant factors taken as a whole clearly shows that the entity is more economically related to one State than to the other, then it will be considered to be a resident of only that State.]

[OPTION B: 24.2 In some rare cases it may be impossible to make a clear determination of the State in which the place of effective management of the entity is situated or the facts may indicate that this place is situated in none of the Contracting States. For instance, it may be that the senior group of persons responsible for making key decisions for the entity regularly meets in different places so that the decisions are not primarily taken in any given State. Also, that group may carry its meetings through modern communication technology in such a way that it is impossible to identify a particular State where its decisions are made. In these cases subparagraph b) gives preference to the State in which the entity's business activities are primarily carried on. This will require determining, on the basis of a functional analysis of the activities performed by the entity in the two Contracting States, in which of these two States the functions performed by the entity are clearly the most important.]

[OPTION C: 24.2 In some rare cases it may be impossible to make a clear determination of the State in which the place of effective management of the entity is situated or the facts may

indicate that this place is situated in none of the Contracting States. For instance, it may be that the senior group of persons responsible for making key decisions for the entity regularly meets in different places so that the decisions are not primarily taken in any given State. Also, that group may carry its meetings through modern communication technology in such a way that it is impossible to identify a particular State where its decisions are made. In these cases subparagraph b) gives preference to the State in which the entity's senior executive decisions are primarily taken. This will require determining from which country the clear majority of senior executive decisions (e.g. the decisions of executive officers such the president, vice-presidents, treasurer etc.) are taken. This will usually be the State in which the headquarters of the entity are located, to the extent that they are primarily located in one State. For that purpose, the headquarters would be where one would expect to find the senior executives in charge of the business of the entity. In some States, the laws applicable to an entity which derives its legal status from the laws of the State require that the headquarters of the entity be maintained in that State.]

24.3 Where, in the situation referred to in sub-paragraph b), the State [with which the entity's economic relations are closer] [in which the entity's business activities are primarily carried on] [in which the entity's senior executive decisions are primarily taken] cannot be determined, the entity will be deemed to be a resident of the State from the laws of which it derives its legal status. This will normally be the State under the laws of which the entity has been established but it may also be, for example, a State in which a company has been continued (where this is allowed under the relevant corporate law).

24.4 If the application of that last test reveals that the entity derives its status from the laws of both States or of neither of them, or if it cannot be determined (because of legal or factual uncertainty) from which State's laws the entity derives its legal status, the competent authorities of the Contracting States must settle the question by mutual agreement. As the practice long followed in the application of paragraph 2 (the rule applicable to individuals) has shown, the competent authorities may therefore address a case where an entity is a resident of the two Contracting States by examining each of the subparagraphs of paragraph 3. Pursuant to paragraph 3 of Article 25, they will do that in order to resolve any doubt as to the interpretation or application of subparagraphs a) to c); if they then conclude that these subparagraphs do not solve the case, they will reach a decision as to the residence of the entity for purposes of the Convention pursuant to subparagraph d)."