Comments on revised discussion draft of a new Article 7 of the OECD Model Tax Convention

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1. Introduction

Ernst & Young is grateful for the opportunity to comment on the revised discussion draft of a new Article 7 of the OECD Model Tax Convention (hereinafter referred to as: the “Revised Draft”).

The major change proposed in the Revised Draft is the replacement of paragraph 3 of the new Article 7, as it appeared in the discussion draft on a new Article 7 (Business Profits) of the OECD Tax Convention, published 7 July 2008 (hereinafter referred to as: the “July 2008 Draft”). Now a broader provision has been introduced that provides a corresponding adjustment mechanism similar the one of paragraph 2 of Article 9 OECD Model Tax Convention. For that reason our comments mainly concerns the revised paragraph 3 of the new Article 7 and its Commentary.

Ernst & Young welcomes the revised text of paragraph 3 of the new Article 7. As mentioned, it introduces a corresponding adjustment mechanism (hereinafter referred to as: “CAM”). The commentary also introduces an alternative CAM version in paragraphs 66 to 68 inclusive of the Commentary. We explicitly note when our comments regard the alternative CAM version.
2. Comments on the Revised Draft

2.1 Relationship between the paragraph 2 and 3 of the new Article 7 and Article 25

The intent of paragraph 3 of the new Article 7 is to relieve double taxation from different, albeit acceptable, interpretations of paragraph 2 of the new Article 7 by the two Contracting States. Such a case would not be covered by the mutual agreement procedure under paragraph 1 of Article 25 (hereinafter referred to as “MAP”), including the arbitration process under paragraph 5 of Article 25 (hereinafter referred to as “Arbitration”) as both Contracting States act in accordance with paragraph 2 of the new Article 7. Therefore, the CAM under paragraph 3 of the new Article 7 concerns “in accordance with paragraph 2 of the new Article 7 cases.” That being said, the revised text of paragraph 3 and its revised Commentary give rise to the following concerns.

First, the scope of the application of CAM needs to be clarified. As mentioned above, we conclude that the introduction of CAM goes back to the non-applicability of MAP concerning “in accordance with paragraph 2 of the new Article 7 cases”. According to the paragraphs 46 and 63 of the Commentary these cases only regard different, albeit acceptable, interpretations of paragraph 2 of the new Article 7 by the two Contracting States. However, according to the text of paragraph 3 of the new Article 7 and the paragraphs 51 and 52 and the example in paragraphs 53 and 54 of the Commentary its scope seems to be much wider than only interpretation cases. These refer to a common transfer pricing adjustment.

Recommendation 1: we recommend that the scope of application of CAM cases is clarified, i.e. is it limited to acceptable interpretation differences of paragraph 2 of the new Article 7 by the two Contracting States only or does it also include common transfer pricing adjustments. If it is limited to interpretation differences it becomes important to define what should be considered interpretation differences. For example, the question arises how a different appreciation of the facts by the Contracting States resulting in the application of different transfer pricing methods should be considered. State R may consider that the application of the resale price method is only appropriate, while State S may feel that the cost plus method should be applied. The taxpayer applies the cost plus method. Now State R makes an adjustment based on the resale price method. Is this an interpretation case that is covered by paragraph 3 of Article 7?

Secondly, from paragraph 50 we conclude that paragraph 2 of the new Article 7 gives direct access to MAP and Arbitration if it can be established that State S has taxed the taxpayer not in accordance with said paragraph 2. Also, Article 23A or 23 B gives direct access to MAP/Arbitration if it can be concluded that state R for the purposes of said Article 23A or 23B did not determine the profits attributable to the permanent establishment in accordance with paragraph 2 of the new Article 7. Finally, from paragraph 54 of the Commentary we conclude that paragraph 3 of the new Article 7 also provides direct access to MAP and Arbitration regarding the corresponding adjustment obligation of the other State if the initial adjustment is justified both in principle and as regards the amount.

Recommendation 2: if our understanding is correct we recommend the Commentary clarifies that paragraph 3 of the new Article 7 provides direct and additional access to MAP and Arbitration next to paragraph 2 of the new Article 7 and Article 23A or 23B. In this respect the Commentary should also clarify whether the direct access to MAP and Arbitration regarding the corresponding adjustment obligation under paragraph 3 of the new Article 7 only regards interpretation cases or also common transfer pricing adjustments.
2.2 Access to CAM

According to the text of paragraph 3 of the new Article 7 and paragraph 56 of the Commentary CAM only applies if, amongst others, there is an adjustment by one of the Contracting States. As a rule one would expect that a taxpayer will determine the profits attributable to a permanent establishment in the same manner in each of the Contracting States and in accordance with paragraph 2 of the new Article 7. However, the taxpayer may be obliged by the local rules of the Contracting States to apply different, albeit paragraph 2 of the new Article 7 proof, approaches. For example, State R may require the application of the capital allocation approach, while State S requires the application of the thin capitalization approach. If the tax payer files the returns in both Contracting States accordingly and both Contracting States agree, double taxation may occur for which CAM is not applicable since there has not been an adjustment by either Contracting State. MAP/Arbitration seems also not applicable either since both Contracting States act in accordance with paragraph 2 of the new Article 7.

The question therefore is how to address these kind of cases. The taxpayer may file both returns in accordance with the approach of State R but this may lead to, for example, penalties or criminal charges in State S. An APA may be another solution. But the access to CAM or MAP/Arbitration seems not possible.

Recommendation 3: we recommend opening CAM for these kind of cases too. In the July 2008 Discussion Draft the issue was addressed in paragraph 53 of the Commentary by the concept of a deemed adjustment. We are in favor of re-introducing the deemed adjustment concept for the case addressed.

2.3 Transitional issues

CAM cases may also apply to cases under the current version of Article 7 and its Commentary. Currently, there seems to be no solution for CAM cases and, therefore, the risk of double taxation remains. The implementation of CAM in a bilateral tax treaty can be time consuming. We have no specific solution for the interim period, but one may review whether, for example, paragraph 3 of Article 25 and its commentary provide some leeway here in case of interpretation differences. In addition, countries could be urged to implement CAM processes and/or to conclude protocols to existing bilateral tax treaties.

2.4 Implications for the application of the Articles 9 and 25

Referring to our comments under section 2.1 above, the question arises if the same issue can arise for purposes of Article 9. For example, the OECD Transfer Pricing Guidelines acknowledge that various countries take different approaches, but at the same time allow these as at arm’s length. For example, the arm’s length principle allows CCAs based on contributions at cost and contributions at market prices (paragraph 8.15 Transfer Pricing Guidelines). If the CAM line of reasoning would be applied, this would mean that also in the case of Article 9 the access to MAP may be questionable in cases like paragraph 8.15 since it regards an interpretation issue. Then how to define “in accordance with paragraph 1 of Article 9 cases” versus “not in accordance with paragraph 1 of Article 9 cases” becomes important for Article 9 too.

Recommendation 4: we recommend that the Commentary addresses the implications of CAM for the application of the Articles 9 and 25 too along the lines of our comments under section 2.1.
2.5 The most appropriate arm’s length conditions, price and method

Paragraph 45 of the Commentary introduces the concept of: “the most appropriate arm’s length conditions,” while paragraph 66 introduces the concept of “the (most) appropriate arm’s length price or method.” From the Commentary we conclude that these concepts do not apply to the regular CAM version, but only to the alternative CAM version. Unfortunately, these concepts have not been clarified. These concepts may raise various questions, like whether they affect the use of an arm’s length range (paragraphs 1.45 – 1.48 OECD Transfer Pricing Guidelines) and how they relate to the concept of “the most appropriate transfer pricing method”, which has been introduced in paragraph 2.1 of the proposed revision of the chapters I-III of the OECD Transfer Pricing Guidelines.

Recommendation 5: We recommend that the Commentary clarifies the concept of most appropriate arm’s length conditions, price and method. It should neither change the application of the arm’s length principle under the Articles 7 and 9 nor impose additional obligations to the taxpayer. As a rule, no adjustment should be made if the taxpayer’s price is in accordance with the arm’s length principle, which includes the use of the arm’s length range.

2.6 Consequential changes to other parts of the OECD Model Tax Convention

Paragraph 7.2 of the Commentary to Article 15 now distinguishes between the allocation of expenses under paragraph 2 of the new Article 7 and the determination of whether or not the remuneration is borne by the permanent establishment. We understand that a notional charge under paragraph 2 of the new Article 7 is not decisive in determining whether or not the permanent establishment bears the expenses. The Commentary does not clarify how the “borne by the permanent establishment” requirement should then be applied.

Recommendation 6: we recommend that the Commentary provide guidance on how to comply with the “borne by the permanent establishment” requirement in the case of a notional charge.
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