FOGLIA & PARTNERS
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To: Tax Treaties, Transfer Pricing and Financial Transactions Division OECD/CTPA

By e-mail: taxtreaties@oecd.org

From: Foglia & Partners

Re: Comments on proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles

Date: 27 May 2021

Ladies and Gentlemen,

We welcome the opportunity to submit our comments on behalf of Foglia & Partners on the public consultation documents "*Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles*" ("**Discussion Draft**") released by the Committee of Fiscal Affairs of the Organisation for Economic Cooperation and Development ("**OECD**") on 29 March 2021 and to contribute to the discussion on relevant matters.

We appreciate efforts made so far to align the principles included in the 2017 edition of the OECD Transfer Pricing Guidelines ("**TP Guidelines**") - and in the recent "*Transfer Pricing Guidance on Financial Transactions*", published on 11 February 2020 ("**TP Guidance on Financial Transactions**") - with the Commentary of the OECD Model Tax Convention ("**OECD Model**"). In particular, we commend the Committee's steady efforts in looking for a consistent pragmatic application of the arm's length principle among countries in order to allow multinational enterprises ("**MNEs**") to correctly structure their group finance activities.

In these comments, we first provide general comments and observations on the Discussion Draft in the context of the current international tax framework, then turn to certain selected specific substantive topics relative to some particular aspects of the proposed changes to the Commentaries of the OECD Model.

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A. FOREWORD AND GENERAL COMMENTS

As first, we note that the ongoing works on the Discussion Draft are mainly aimed at clarifying the application of Article 9 of the OECD Model, especially with respect to its interaction with domestic laws on interest deductibility. In doing so, the Discussion Draft specifies that the work at stake is "closely linked" to the TP Guidance on Financial Transactions[1].

In this respect, as a preliminary remark, we highlight how this connection drags into the Discussion Draft several critical issues and uncertainties that certain stakeholders have already expressed in the context of the public consultations on the draft of the TP Guidance on Financial Transactions[2], including with respect to issues arising from the actual determination of whether a purported loan should be regarded as a loan or as some other kind of payment (i.e., equity contribution).

Indeed, also based on the different interpretation of certain factors/indicators stemming from the principles set out in Actions 8-10 of the BEPS and ultimately outlined in the TP Guidance on Financial Transactions, the European (including Italian) tax environment has experienced an increase in challenges on this matter, with an enhanced focus of tax administrations on financial transactions carried out by MNEs.

Therefore, as a guiding principle for the running works, we recommend that, in line with other types of transactions, the changes to the Commentary and potential further works on these topic should provide taxpayers with an higher degree of "certainty" with respect to the principles underlying the transfer pricing of financial transactions (either from a legislative or from a more general practical perspective), so that taxpayers can effectively and concretely benefit from these principles in line with the internationally accepted tax framework; this will aid in preventing (or at least minimizing) disputes on the interpretation of the relevant applicable rules.

In our view, if the OECD recommends, and countries implement, clear, straightforward parameters under which financial transactions could be analyzed and assessed in a consistent manner for arm's length purposes, with limited discretion and subjectivity on the part of both taxpayers and tax administrations, it would mitigate potential mismatch in the interpretations that could result in significant tax uncertainty for taxpayers and potential challenges against MNEs.

In addition, as to the well-known (among academics and practitioners) historical debate about the interaction between tax treaty rules and domestic legislation, covered in the Discussion Draft with particular regard to the interplay among Article 9 of the OECD

[1] As noted in the "*Public Consultation Instructions*" (page 2) of the Discussion Draft.

[2] We are referring to public comments provided by some stakeholders with respect to the "discussion draft" of transfer pricing guidance financial transactions released in 2018, following which the TP Guidance on Financial Transaction have been officially released.

Model and the domestic interest deduction regulations, we recommend particular attention in addressing this issue, since the proper elaboration of these principles may somehow trigger transversal effects also with respect to future works/projects, as the one on the Pillar Two Blueprint[3], in which can be found the debated and controversial statement according to which there would be a "*general principle (…) with limited exceptions*" under which "*tax treaties are not intended to restrict a jurisdiction's right to tax its own residents*"[4]; a principle that – according to the Pillar Two Blueprint – would have already been codified in Article 1, paragraph 3, of the OECD Model (the so-called "saving clause").

Given the above, we note that - whilst trying to clarify the application of Article 9 and interaction with domestic laws on interest deductibility (such as those recommended and designed in the final report on BEPS Action 4, implemented in European countries in line with the ATAD Directive 2016/1164) - the Discussion Draft *inter alia* specifies that[5]:

- in assessing "*whether an interest payment reflects the arm's length amount, State will typically examine the terms and conditions of the loan such as the rate of interest*";

- the contracting State making a determination on the extent to which a financing transaction is regarded as a loan or an equity contribution would do so taking into account factors discussed (i) in its domestic laws (including judicial doctrine) "or" (ii) in the TP Guidelines;

- once the profits of the associated enterprises have been allocated in accordance with the arm's length principle (and thus with Article 9 of the OECD Model), domestic law determines whether and how those profits are taxed (subject to the provisions of the OECD Model and, in particular, paragraph 4 of Article 24). Therefore, according to the Discussion Draft, Article 9 does not address the deductibility of expenses or computation of taxable income under domestic law, but only allocation of profits;

- as a result, any mismatch arising from the subsequent computation of tax under domestic laws would not yield "double taxation" for purposes of paragraph 2 of Article 9 of the OECD Model and therefore a corresponding adjustment would not have to be made by the involved States.

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[3] We are referring to the report entitled "*Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint*", released by the OECD on 14 October 2020.

[4] Please refer to para. 679-680 of the Pillar Two Blueprint.

[5] Please refer to the changes proposed in the Chapter 2 of Discussion Draft (page 5-7) with respect to Commentary on Article 9 of the Model Tax Convention.

With respect to this latter point and in particular to the "double taxation that may result from a primary adjustment", the Discussion Draft also includes[6] a proposal to add a new paragraph to the Commentary on Article 25 of the OECD Model that seems to be designed to confirm the practices of OECD member countries regarding the admission of cases into mutual agreement procedures ("**MAP**") and to reinforce one of the conclusions of the final report on BEPS Action 14 (i.e., ensure that taxpayers can access MAP when eligible).

Finally, the Discussion Draft also includes[7] proposed changes with respect to the Commentary on Article 7 and 24 of the OECD Model; these were applied in order to respectively (i) reflect the proposed changes to corresponding adjustments also in relation to permanent establishment and (ii) include the "reversal of the burden of proof" as an example of the information requirement that can be made with respect to payments to non-residents.

With regard to the above, we anticipate that, in our view, some proposed changes in the Discussion Draft – as currently formulated – would in some cases increase the potential for disagreement with tax authorities. Therefore, we stress the need that the Commentary to the OECD Model and any related further guidance to be developed on these relevant matters should provide clear rules and approaches to obtain consistent implementation and application of the underlying principles among the countries and minimize uncertainties.

Given the above, please find below our comments in respect of some specific aspects related to the proposed changes to the Commentaries of the OECD Model.

B. COMMENTS ON SPECIFIC ISSUES OF THE DISCUSSION DRAFT

I. The interaction between the domestic legislations and Article 9 of the OECD Model for loan characterization purposes

It's worth underlining that while the current Commentary on Article 9 includes (in paragraph 3) references to "thin capitalisation" domestic rules related to and 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), the Discussion Draft includes a

[6] Please refer to Chapter 5 (pages 10) of the Discussion Draft.

[7] Please refer to Chapters 3 and 4 (pages 8-9) of the Discussion Draft.

broader reference in this respect.

In particular, in proposing a new paragraph 3 to the Commentary of Article 9 of OECD Model, the Discussion Draft provides that:

> "*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*."

In other terms, under the Discussion Draft, it seems to be provided that a State, in addition to assessing the terms and conditions of the loan (such as the interest rate), 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 an equity contribution). In this regard, it's worth noting as the Discussion Draft specifies that in order to determine the extent to which the purported loan is regarded as a loan, the relevant State will have to take into account factors discussed in (i) its domestic laws (including judicial doctrine) **"or"** (ii) in the TP Guidelines.

The above generic and broad formulation proposed in the Discussion Draft risks creating additional "uncertainty" (along with the practical concerns already outlined by some stakeholders with respect to the TP Guidance on Financial Transactions) regarding the actual characterization of a financial transaction given that it does not specifically address the interaction (e.g., optionality?) of the two sources of law (i.e., domestic laws and TP Guidelines) that are not necessarily consistent with each other.

As to the interaction between the domestic laws and TP Guidelines for these purposes, having regard to the aforementioned "close link" between the proposed Commentary in the Discussion Draft and the TP Guidance on Financial Transactions, we note that paragraphs 10.8 and 10.9 of the TP Guidance on Financial Transactions apparently allowed each jurisdiction to decide whether to adopt the guidance in Chapter I of the TP Guidelines to qualify the financial instruments or, instead, allow domestic legislation take precedence.

Indeed, on the point, the TP Guidance on Financial Transactions states that: "*10.8. Although this guidance reflects an approach of accurate delineation of the actual transaction in accordance with Chapter I to determine the amount of debt to be priced, it is acknowledged that other approaches may be taken to address the issue of the balance of debt and equity funding of an entity under domestic legislation* *before pricing the interest on the debt so determined. These approaches may include a multi-factor analysis of the characteristics of the instrument and the issuer.*

10.9. Accordingly, <u>this guidance is not intended to prevent countries from implementing approaches to address the balance of debt and equity funding of an entity and interest deductibility under domestic legislation, nor does it seek to mandate accurate delineation under Chapter I as the only approach for determining whether purported debt should be respected as debt</u>".

Given the above, we recommend the following:

(i) revise the proposed Commentary *inter alia* clarifying whether (or not) the aforementioned approach (i.e., precedence of the domestic legislation over the TP Guidelines) should be adopted according to the OECD, or, alternatively, clarifying any different applicable approach; in this respect, also

(ii) propose consistent solutions/best practices to avoid and/or solve situations in which each jurisdiction involved in a transaction exploits a difference in interpretation of the applicable principles (e.g., for cases of "double taxation" arising where one jurisdiction – State A – recharacterizes a financial transaction in order to deny the deduction of interest payments but, in the view of the other contracting State – State B – there is no issue with the loan challenged in State A); and

(iii) specifically delineate the role of the "loan characterization approach" proposed under Article 9 of the OECD Model and its applicability for countries, such as Italy[8], which have not implemented an *ad hoc* provision allowing for the requalification of a loan as equity, but have merely implemented the arm's length principle in their domestic legislation. This having in mind also that, in such cases: (a) in most jurisdictions (including Italy), tax treaties can only limit domestic legislation and never expand on it; (b) in principle, as also argued by some scholars, for countries not having an *ad hoc* rule, an eventual recharacterization of a loan could be challenged only under the domestic anti-abusive rules (for cases meeting the relevant requirements).

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[8] The peculiarity of the Italian tax environment is that, notwithstanding the lack of any specific domestic provision allowing for the recharacterization of a loan as equity contribution, the Italian tax authority – in an official (debated) position (Italian Revenue Agency Circular Letter No. 6/2016) – has however made explicit reference to the principles outlined in the TP Guidelines in order to eventually support – in the context of shareholder loan transactions – challenge with respect to the outbound interest deductibility and to eventually recharacterize the relevant flows in dividends (with consequent related withholding tax treatment).

II. The consequences stemming from the eventual recharacterization of a transaction also for MAP purposes

In addition to that which has been outlined above in paragraph I., we note that the Discussion Draft and the relevant proposed changes to the Commentary of Article 9 do not expressly clarify the specific ramifications arising from the eventual recharacterization – under Article 9 of the OECD Model – of a loan as equity contribution, and do not address the actual resolution of the consequent "double taxation", neither through a direct reference to MAPs.

This is an important matter: not only for countries that have already implemented rules allowing the recharacterization at hand but also for other countries that, as anticipated, could challenge the actual characterization of a loan through domestic anti-abusive rules, for instance because of (i) the lack of a specific domestic provision allowing for the requalification of a loan as equity, and (ii) in light of the fact that the TP Guidance on Financial Transactions seems to suggest the possibility for jurisdictions to choose between the application of a domestic legislation or the TP Guidelines.

The issue for MNEs located in these latter countries is self-evident, merely considering how the same OECD, in the Manual on Effective Mutual Agreement Procedures ("**MEMAP**"), has already acknowledged that[9]: "*Some competent authorities have had a tendency not to discuss a case where an adjustment is based upon anti-avoidance provisions of their country's domestic laws. This means, generally, that if a competent authority were to consider a request for assistance in such a case, it would limit itself to forwarding the case to the other competent authority for any relief that the foreign competent authority may provide at the latter's discretion*".

Given the above, we suggest to revise/supplement the proposed Commentary considering these specific issues, also taking into account the principles already developed in the current Commentary to Article 25 of the OECD Model, according to which, *inter alia,* it is specified that *"(…) In the absence of a special provision, there is no general rule denying perceived abusive situations going to the mutual agreement procedure, however. The simple fact that a charge of tax is made under an avoidance provision of domestic law should not be a reason to deny access to mutual agreement (…)*"[10].

[9] Please refer to paragraph 3.2.3 of the MEMAP.

[10] Please refer to paragraph 26 of the Commentary to Article 25 (MAP).

3. The domestic rules on expenses deductibility and the related risk of unresolved "double taxation"

An additional concern that we would like to highlight is the issue concerning the exact demarcation of the boundary between (i) the domestic deductibility rules of the relevant jurisdictions and (ii) the arm's length principle under Article 9 of the OECD Model; this should in particular be evaluated when considering the potential consequences of "double taxation".

Indeed, in trying to address the interplay among domestic law and Article 9, the new proposed paragraphs 3.1 and 6.1 of the Commentary to Article 9 specify that:

> "*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. <u>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</u>, 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. <u>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</u>.*
> *(…)*
> *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. <u>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</u>.*"

In other words, according to the approach that seems to have been formulated in the Discussion Draft, once the profits of the associated enterprises have been allocated in accordance with the arm's length principle, is the domestic law that determines whether and how those profits are taxed and so whether and how the relevant expenses are deductible.

On this basis, according to the Discussion Draft, any mismatch arising from this domestic law treatment would <u>not</u> yield to the "double taxation" under paragraph 2 of Article 9, which generally fall within the scope of the MAP under Article 25 of the OECD Model[11].

Such a "broad" and generic approach - adopted in the Discussion Draft, which completely relies on domestic law to identify the rules that do not allow MNEs to the deduct expenses - generates concerns as it implies a risk of a "double taxation" undermining access to the MAP for MNEs (because of a "double taxation" not covered by Article 9 of the OCED Model); this in the event a jurisdiction may deem certain intercompany transactions to be non-deductible on the basis of domestic rules and not the arm's length principle.

As a result, we suggest investigating and further developing some guiding principles aimed – *inter alia* – at identifying the features of domestic rules and/or when they are able to address the domestic treatment of the expenses and not to distort the arm's length principle. Such further works may follow the same path already traced by paragraph 74 of the Commentary on paragraph 4 of Article 24 of the OECD Model, under which it is stated that "*Paragraph 4 does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation <u>insofar as these are compatible with paragraph 1 of Article 9</u> or paragraph 6 of Article 11. However, <u>if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4</u>*".

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We hope that you will find our comments useful and please do not hesitate to contact us if you require any clarification.

We welcome the opportunity to discuss these comments in greater detail and to continue to participate in the dialogue as the OECD advance the work on this important project.

Yours sincerely,

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[11] Indeed, as expressly provided by paragraph 10 of the Commentary to Article 25 of the OECD Model "*(…) the corresponding adjustments to be made in pursuance of paragraph 2 of the same Article thus fall within the scope of the mutual agreement procedure, both as concerns assessing whether they are well-founded and for determining their amount*".