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<u>**Subject**</u>: **Public Consultation Document – Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles.**

With respect to the issues raised in the "*Public Consultation Document – Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles*", published on 29 March 2021, Tremonti Romagnoli Piccardi e Associati appreciates the opportunity to submit the following observations and comments in relation to the proposed amendments to the Commentary on Article 9 and Article 25 of the OECD Model Tax Convention (the "Model Tax Convention").

* * *

I. <u>Proposed changes to the Commentary on Article 9.</u>

Replace paragraphs 2 to 4 of the Commentary on Article 9 with the following:

2. *This paragraph provides that the taxation authorities of a Contracting State may, for the purpose of calculating tax liabilities of associated enterprises, re-write the accounts of the enterprises if, as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that adjustment should be sanctioned in such circumstances. The provisions of this paragraph apply only if special conditions have been made or imposed between the* *two enterprises~~.~~* ***and, therefore, the provisions would not apply to the*** *~~No re-writing~~ of the accounts of associated enterprises ~~is authorised~~ if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis).* ***In order to ensure the elimination of double taxation, the arm's length principle and the guidance on its interpretation in the OECD Transfer Pricing Guidelines should be followed in any re-writing of accounts[1].***

[footnote: 1 See Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises [C (95)126/FINAL, as amended]. The Recommendation is reproduced in the Appendix to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations]

By way of introduction, we would like to outline that, in our view, this paragraph should not be perceived as an unconditional power of the tax authorities to re-write the associated enterprises' accounts.

In this context, as a preliminary note, it should be considered that the tax authorities should always follow the arm's length principle as the legal base for any tax assessment or re-characterization.

In these terms, only by analyzing the enterprise involved, its organizational/functional structure, and the market in which it operates it is possible to assess the correctness/congruity of the transfer pricing policy.

In other words, since transfer prices reflect the organization adopted for the business activity (and not *vice versa*), carrying out the correct functional analysis means identifying the various phases in which the value chain is articulated. This approach should lead to identifying the so-called "key value drivers", namely the functions that mainly contribute to the value creation of the business.

To conclude, we clearly agree that the re-writing of the accounts should be done following the arm's length principle, although it is also our opinion that this should be limited to well-justified circumstances. In any case, (***i***) the burden of proof regarding the legitimacy of the re-writing of the accounts should fall on the tax authorities, and (***ii***) the same tax authorities should carry out and document the most accurate functional analysis of the counterparties to give appropriate evidence that the re-writing of the (local) accounts is indeed inevitable.

All the above being said, besides the fact that the proposed amendment appears merely formal, we would encourage some additional intervention to better clarify the "<u>last resort</u>" feature of such power of re-characterization.

By way of example, the tax authorities of the first jurisdiction (***i***) should not deny the existence of a cost recorded in the counterparty's accounts, and (***ii***) redetermine its profitability accordingly, (***iii***) without carrying out a thorough functional analysis of said counterparty, and, in any case, (***iv***) <u>without counterchecking the main transaction by using direct methods</u>.

In conclusion, the amendment in question should be the occasion to more clearly emphasize the above interpretation and, in essence and again, limit the recourse to re-characterization of the accounts only to pathological contexts.

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. ~~*As discussed in the Committee on Fiscal Affairs' Report on "Thin Capitalisation", [footnote: Adopted by the Council of the OECD on 26 November 1986 and reproduced in Volume II of the full version of the OECD Model Tax Convention at page R (4)1.] there is an interplay between tax treaties and domestic rules on thin capitalisation relevant to the scope of the Article. The Committee considers that:*~~

> ~~*a) the Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;*~~
>
> ~~*b) the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also 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;*~~
>
> ~~*c) the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties.*~~

On 11 February 2020, the Organization for Economic Cooperation and Development (OECD) released the *Transfer Pricing Guidance on Financial Transactions* (the "TP Guidance on Financial Transactions" or the "Guidance").In particular, Sub-section B.1 of the said Guidance sheds light on the application of Article 9 of the 2017 Model Tax Convention (which relates to the taxation of the profits of associated enterprises), *inter alia*, to determine the fairer debt/equity *ratio* for an entity belonging to a multinational group. To this end, the main focus of the Guidance concerns the relationship with the accurate delineation of the transaction under Chapter I of the OECD Transfer Pricing Guidelines.

The Guidance also states that jurisdictions shall not be limited in introducing domestic provisions aimed at reducing the tax deductibility of certain items under specific circumstances. Room is also clearly left for countries to adopt strategies to limit interest deductions, such as rules that reflect Action 4 of the BEPS project.

It has however been noticed that these alternative approaches should anyway include a "*multi-factor analysis of the characteristics of the instrument*[1]".

With this in mind, the proposal to modify paragraph 3 of the Commentaries to Article 9 seems appropriate and coherent with the framework introduced by the Guidance.

However, in our opinion, it would be necessary to more precisely identify the hierarchy of the rules to be followed to achieve the proper qualification of the financial transactions – e.g., an intercompany loan - as a debt or equity.

In particular, the amendment in question should be seen as an opportunity to help in clarifying the priority of application among (**i**) the OECD TP Guidelines, (**ii**) the domestic transfer pricing rules (that most of the times mirror the OECD TP Guidelines) and/or (**iii**) other provisions of the tax law dealing with that matter (such as thin capitalization rule, *etc*.).

In very practical terms, one should be in the position to conclude that – under the same example above - the possibility to qualify a purported loan as a loan (or equity) should be made priorly referring to the OECD TP Guidelines, without considering the domestic legislations, which then

[1] see G. Condoleon, S. Perrella, F. Alfonso, Z. Held, M. Billings, and A. Cousins, "*INSIGHT: Debt Characterization and Application of OECD Accurate Delineation Analysis*", Bloomberg Tax, May 2020.

intervenes afterwards by providing the domestic features (e.g., the limitation of interest expenses deductibility rules including the thin capitalization one, if applicable).

* * *

II. Proposed change to the Commentary on Article 25 (mutual agreement procedure).

12.1 More generally, the economic double taxation that may result from a primary adjustment consisting of the inclusion of profits of associated enterprises in an amount not justified by reference to the arm's length standard would result in taxation not in accordance with one of the objects and purposes of the Convention to eliminate double taxation. A denial of access to the mutual agreement procedure in these circumstances, with a view to eliminating the economic double taxation that could follow from such an adjustment, would likely frustrate an objective of the Convention. States should therefore provide access to the mutual agreement procedure in transfer pricing cases.

In situations where the price applied for cross-border transactions is not in line with the arm's length principle, the tax authorities of State A may be entitled to perform the relevant adjustments (i.e., primary adjustments) to the transfer prices adopted by the associated enterprise to bring the price at par with the presumed arm's length principle. This may clearly give access to forms of economic double taxation, as the same profit may have already been subject to taxation in the hands of the associated enterprise in the other contracting State (i.e., State B).

In order to mitigate the economic double taxation caused by the application of Article 9, paragraph 1, the tax authority of State B is generally requested to carry out a corresponding adjustment (so-called "downward adjustment") if it is concluded that State A's remark is in line with fair market conditions.

Once the latter adjustment has been adopted, the re-allocation of profits between the two jurisdictions should be consistent with the arm's length principle without producing forms of double taxation. Therefore, the effective operation of corresponding adjustments as per Article 9, paragraph 2, of the OECD Model is the key to eliminating economic double taxation in a transfer pricing adjustment.

Since Article 9, paragraph 2, is not adopted by all Double Tax Treaties (DTT), it could happen that State B would not recognise a corresponding adjustment in relation to the primary adjustment that has been made by State A.

In such a case, the Commentary on Article 25 already highlights the importance for each jurisdiction to implement a domestic solution to eliminate/mitigate economic double taxation[2].

The proposed changes to Commentary on Articles 25, under analysis, further strengthen the importance of this concept by introducing a recommendation regarding the adoption of corresponding adjustments to the greatest possible extent.

Following the above reasoning, from our perspective, the possibility to benefit from the Mutual Agreement Procedure (MAP) according to Article 25 of the Model Tax Convention should indeed be extended to all cases of economic double taxation.

In other words, it should someway be granted not only in cases where no corresponding adjustment has been made, but

[2] It should be noted that, from an Italian point of view, Article 59, Paragraph 2 of Law Decree No. 50 of 24 April 2017 amended the national rules on corresponding adjustments (previously issued only in the context of a MAP) by introducing Article 31-quater of Presidential Decree No. 600 of 22 September 1973.
Within this legal framework, the taxpayer is entitled to benefit from a corresponding adjustment in the following cases: (**i**) in the execution of agreements signed between the Italian Tax Authority and the relevant foreign competent tax authority in the context of a MAP under any applicable Double Tax Treaty (i.e., art. 25 of OECD Model), or the Convention 90/436/EEC of 23 July 1990; (**ii**) as an outcome of an administrative tax assessment carried out within international cooperation activities if the contracting States have accepted the result of the tax assessment; or (**iii**) through the filing of a specific written request, in respect of a final primary adjustment at arm's length performed by a state that entered into a treaty with Italy and allowed an adequate exchange of information.

also in other cases which go beyond issues pertaining merely to transfer pricing.

To better clarify, this could be the case of a cost, such as – for instance - management fees, which are assessed as not deductible in the relevant jurisdiction due to their alleged lack of inherence to the business activity (rather than to the pure violation of the correct application of the arm’s length principle).

Based on the above, in our opinion, even if the tax assessment carried out by the tax authorities is therefore not (formally) grounded on the violation of the Transfer Pricing legislation, the taxpayer should, however, be given the possibility to pursue the MAP.

Otherwise, one would face the paradox that while – under the same example - the provider of the service would indeed subject the relating income to tax, the recipient of the service would not be allowed to deduct the cost, with the consequence that the denial to pursue the MAP would, in essence, procure forms of unjustified double taxation.

This said, although we are clearly aware that there are strict legal grounds which rule the access to MAPs, we also believe that the Commentary should to the maximum extent possible encourage tax administration to admit the recourse to MAPs in those cases for which, as noted above, a mere formal analysis of the circumstances could in principle imply the denial of the access to the procedure.

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If you have any questions or you would like further clarification regarding any of the points discussed above, please contact:

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Yours sincerely,

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