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Dear Matt,

Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles

Thank you for the opportunity to provide comments on the '*Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles – Public consultation document*' which was issued on 29 March 2021 (**Public consultation document**).

BACKGROUND

By way of background, I have specialised in the area of international transfer pricing and the attribution of profits to permanent establishments for more than 25 years, first at the Australian Taxation Office (ATO), then as a director with KPMG and since October 2015 through Damian Preshaw Consulting Pty Ltd.

While at the ATO, I was an Australian delegate to the OECD's Committee on Fiscal Affairs' Working Party No.6 (Taxation of Multinational Enterprises) (**WP6**) and to WP6's Steering Group on Transfer Pricing from September 1994 to June 2003. During this time, I was actively involved in the development of the 1995 OECD Transfer Pricing Guidelines and with the development of the Authorised OECD Approach for the attribution of profits to permanent establishments (AOA) which is now reflected in the new Business Profits Article and associated Commentary included in the OECD Model Tax Convention on Income and on Capital (**OECD MTC**) and Commentaries in 2010.

GENERAL COMMENTS

Introductory comments

The OECD's Committee on Fiscal Affairs (**CFA**) carried out a detailed examination of tax treaty issues arising in relation to thin capitalisation in its report on Thin Capitalisation published in 1987 (**1987 Thin Capitalisation report**). The 1987 Thin Capitalisation report led to a number of changes being made to the Commentaries to the OECD MTC including the Commentary to Article 9 where the relevant changes are now set out in paragraph 3 of the Commentary to Article 9.

Two additional points should be noted in relation to the 1987 Thin Capitalisation report. First, Part IV (Practical application of arm's length principle in relation to thin capitalisation) of the 1987 Thin Capitalisation report considered the practical application of the arm's length principle in paragraph 1 of Article 9 in relation to domestic thin capitalisation rules, however, recognised that it was difficult to provide precise guidelines to assist with the drafting of national legislation.[1] While some general guidance was provided in Part IV, none of this guidance found its way into Part V (Conclusions and suggestions) of the 1987 Thin Capitalisation report nor subsequently into the Commentary to paragraph 1 of Article 9.

Second, the 1987 Thin capitalisation report acknowledged that domestic rules might be introduced to counter abusive situations such as where a loan between ostensibly independent persons, and Article 9 therefore does not apply, was entered into in order to conceal the fact that the real parties to the transaction were associated enterprises.[2] However, it specifically made no comment on the point of whether or not the domestic law should require the authorities to ensure that taxation arising from the impact of such measures conforms with the arm's length principle in paragraph 1 of Article 9.[3]

Notwithstanding the issue of the 1987 Thin Capitalisation report, the interaction between domestic thin capitalisation rules and paragraph 1 of Article 9 has nevertheless continued to be something of a fraught issue. WP6 looked at the interaction between domestic thin capitalisation rules and paragraph 1 of Article 9 in the early 2000's when it established the Sub-Group on Cross-border Related Party Financial Dealings, however, nothing came of these efforts.

More recently, the issue of the interaction of domestic rules and tax treaties has been addressed as part of the OECD/G20's BEPs project, in particular in the report *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (**final report on Action 6 of the OECD/G20 BEPS Project**). The final report on Action 6 of the OECD/G20 BEPS Project specifically mentions paragraph 3 of the Commentary to Article 9 as an example where the Commentaries to the OECD MTC already address potential concerns about tax treaties preventing the application of specific domestic law provisions that would prevent abusive transactions.[4]

The final report on Action 6 of the OECD/G20 BEPS Project led to substantial changes being made to the Commentary to Article 1 to better articulate the relationship between domestic anti-abuse rules and tax treaties. Of particular relevance in the present context are paragraphs 66 to 80 and especially paragraph 70 of the Commentary to Article 1 which were introduced as

[1] Paragraph 70 of the 1987 Thin Capitalisation report.
[2] Paragraphs 73 and 80 of the 1987 Thin Capitalisation report.
[3] Paragraph 80 of the 1987 Thin Capitalisation report.
[4] Paragraph 55 of the final report on Action 6 of the OECD/G20 BEPS Project.

a result of final report on Action 6 of the OECD/G20 BEPS Project. Paragraph 70 of the Commentary to Article 1 is reproduced below: [5]

> "70. Generally, where the application of provisions of domestic law and of those of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of "*pacta sunt servanda*" which is incorporated in Article 26 of the *Vienna Convention on the Law of Treaties*. Thus, if the application of specific anti-abuse rules found in domestic law were to result in a tax treatment that is not in accordance with the provisions of a tax treaty, this would conflict with the provisions of that treaty and the provisions of the treaty should prevail under public international law."

While paragraphs 71-80 of the Commentary to Article 1 set out why such potential conflicts will often be avoided, they do not contradict the position set out in paragraph 70 of the Commentary to Article 1. Further, no OECD member country has expressed an observation disagreeing with any aspect of anything said in paragraphs 66 to 80 of the Commentary to Article 1.

While Contracting States are free to include specific provisions in their bilateral tax treaties to clarify that there is either no conflict or, even if there is a conflict, allowing the application of domestic laws (eg where a tax treaty expressly allows the application of a thin capitalisation rule in the domestic law of one or both of the Contracting States),[6] such bilateral arrangements do not change the general position set out in paragraph 70 of the Commentary to Article 1.

General comments on proposed changes to Commentaries

With the above introductory comments providing context, a number of significant concerns arise in relation to the proposed changes to the Commentaries set out in the Public consultation document. While the Detailed Comments section of this submission discusses these concerns in detail, they primarily relate to three things.

First, no argument, let alone a compelling argument, has been put forward as to why the position set out in paragraph 3 of the Commentary to Article 9, is either incorrect or should be deleted. On the contrary, and as mentioned above, the final report on Action 6 of the OECD/G20 BEPS Project specifically mentions paragraph 3 of the Commentary to Article 9 as an example where the Commentaries to the OECD MTC already address potential concerns about tax treaties preventing the application of specific domestic law provisions that would prevent abusive transactions.[7]

Further, if the proposed deletion of paragraph 3 of the Commentary to Article 9 is made, this would have the consequential effect that interpretative matters relating to the interaction between domestic rules on thin capitalisation and paragraph 1 of Article 9 would not be addressed in the Commentary to Article 9 but discussed in the Commentary to Article 1 (eg paragraph 72) and in the Commentary to Article 24 (eg paragraph 74). This would be a very unsatisfactory outcome.

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[5] Paragraph 34 of the Commentary to Article 1 of the United Nations Model Double Taxation Convention between Developed and Developing Countries is in identical terms to paragraph 70.

[6] Paragraph 72 of the Commentary to Article 1.

[7] Paragraph 55 of the final report on Action 6 of the OECD/G20 BEPS Project.

It is therefore recommended that paragraph 3 of the Commentary to Article 9 be retained and if any additional or supplementary guidance is needed that such guidance be included in a way that retains consistency with the guidance in paragraph 3 of the Commentary to Article 9.

Second, a number of the proposed changes set out in the Public consultation document have failed to have regard to paragraphs 66 to 80 of the Commentary to Article 1, and in particular to paragraph 70 and would if adopted result in inconsistencies arising between the Commentary to Article 9 and the Commentary to Article 1. Again, this would be a very unsatisfactory outcome.

Third, a number of the proposed changes to the Commentary to Article 9 are based on paragraphs drawn from the Commentary to Article 7. However, while consistency across the Commentaries with respect to the various articles is desirable, where it is appropriate, fundamental differences between paragraph 1 of Article 9 and paragraph 2 of Article 7 have not been taken into account. This is particularly evident in the first sentences of proposed new paragraphs 3.1 and 6.1 of the Commentary to Article 9. As such, changes are required so that the differences between paragraph 1 of Article 9 and paragraph 2 of Article 7 are appropriately reflected in their respective Commentaries.

The following section provides detailed comments in relation to the proposed changes to the Commentaries in the OECD MTC and includes recommendations in relation to changes that could be made to address the concerns raised.

DETAILED COMMENTS

Unless otherwise stated, all references to specific articles are to articles in the 2017 OECD MTC.

PROPOSED CHANGES TO THE COMMENTARY ON ARTICLE 9

Proposed changes to paragraph 2 of the Commentary to Article 9

Significant concerns arise in relation to the proposed new sentence to be added at the end of paragraph 2 of the Commentary to Article 9. These are set out in more detail below.

Is it intended to incorporate by reference the OECD Transfer Pricing Guidelines into the Commentary to Article 9?

Paragraph 28 of the Introduction to the OECD MTC and Commentary states "For each Article in the Convention, there is a detailed Commentary that is intended to illustrate or interpret its provisions." However, there is no detailed Commentary in relation to paragraph 1 of Article 9. Instead, paragraph 1 of the Commentary to Article 9 states that the OECD's report entitled *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (**OECD TP Guidelines**) represents internationally agreed principles and provides guidelines for the application of the arm's length principle of which the Article is the authoritative statement.

Nevertheless, the Commentary to paragraph 1 of Article 9 does not go so far as to state that the OECD TP Guidelines are "intended to illustrate or interpret" the provisions of paragraph 1 of Article 9 in the absence of a detailed Commentary. In these circumstances, questions have continued to arise about the legal status of the OECD TP guidelines, its relationship with the Commentary to Article 9, and in particular, whether the OECD TP Guidelines have been incorporated by reference into the Commentary to Article 9.[8]

As noted in paragraph 29.3 of the Introduction to the OECD MTC, courts are increasingly using the Commentaries on the provisions of the OECD MTC in reaching their decisions, the Commentaries have been cited in the published decisions of the courts of the great majority of OECD member countries, and in many decisions, the Commentaries have been extensively quoted and analysed, and have frequently played a key role in the judge's deliberations.

With the above by way of background, there are two aspects of the proposed new sentence to be added at the end of paragraph 2 which directly raises the question as to whether its effect, whether intended or not, is to incorporate by reference the OECD TP Guidelines into the Commentary to Article 9. These are firstly, the use of the word "*interpretation*", and secondly the statement that the OECD TP Guidelines "*should be followed*" in any re-writing of accounts.

While the same question arises in relation to the existing Commentary to Article 9, the better view at the present time would seem to be that the OECD TP Guidelines have not been incorporated by reference into the Commentary to Article 9. This view is based in part at least on the final sentence of paragraph 1 of the Commentary to Article 9 which states that the OECD TP Guidelines provide *"guidelines for the application",* as distinct from an interpretation of the arm's length principle as expressed in paragraph 1 of Article 9.

If it is intended that the OECD TP Guidelines be incorporated by reference into the Commentary to Article 9, then the following recommendations are made:

- Prior to making any changes to the Commentary to Article 9, the OECD should consult widely on potential issues that could arise if such a change were to be made;
- A statement to this effect should be explicitly included in the Commentary to Article 9;
- A conforming change would be required to the final sentence of paragraph 1 of the Commentary to Article 9 to replace the word "*application*" with the word "*interpretation*".

If, however, it is not intended that the OECD TP Guidelines be incorporated by reference into the Commentary to Article 9, then it is recommended that the following changes be made to the proposed new sentence to be added at the end of paragraph 2:

- The word "*interpretation*" be replaced by the word "*application*". Such a change would also maintain consistency with the last sentence of paragraph 1 of the Commentary to Article 9; and
- The words "*should be followed*" should be replaced by the words "*should be considered*".

[8] *The Status of the OECD Transfer Pricing Guidelines in the Post-BEPS Dynamic*', Michael Kobetsky, International Tax Studies, 2020 (Volume 3), No 2; *J Calderon, "The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalisation Reaching the Tax Law?",* 35 Intertax 4 (2007) at pp11-12.

Numerous inconsistencies will arise if the proposed new sentence is added at the end of paragraph 2

As currently drafted, the proposed new sentence to be added at the end of paragraph 2 would result in numerous inconsistencies arising.

First, the proposed new sentence to be added at the end of paragraph 2 states that "*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*". However, as discussed further below, the final sentence of proposed new paragraph 3 would give Contracting States a choice to use either domestic laws or the OECD TP Guidelines to determine whether a loan should be regarded as a loan or as something else (eg a contribution of equity capital). As such, there is an inconsistency between the proposed new sentence to be added at the end of paragraph 2 and the final sentence of proposed new paragraph 3.

Second, contrary to the proposed new sentence to be added at the end of paragraph 2, the OECD TP Guidelines do not need to be followed by Contracting States in all situations. In particular, paragraphs 10.8 to 10.10 of Chapter X (Financial transactions) of the OECD TP Guidelines[9] give Contracting States a choice whether to follow the OECD TP Guidelines or to apply domestic law for purposes of addressing the balance of debt and equity funding of an entity and interest deductibility. As such, an inconsistency would arise between the proposed new sentence to be added at the end of paragraph 2 and paragraphs 10.8 to 10.10 of Chapter X (Financial transactions) of the OECD TP Guidelines.

Third, and most significantly, the choices given to Contracting States referred to in the two preceding points are, at face value, inconsistent with various aspects of paragraphs 66 to 80 of the Commentary to Article 1, and in particular paragraph 70 (discussed above in the introductory comments section of the General Comments).

The above concerns could be addressed by first inserting a general statement of principle into the Commentary to paragraph 1 of Article 9 which addresses how paragraph 1 of Article 9 interacts with the domestic law of a Contracting State. And second, by modifying the proposed new sentence to be added at the end of paragraph 2 so that it is consistent with the general statement of principle.

With respect to a general statement of principle, the final two sentences of paragraph 9.34 of the 2017 OECD TP Guidelines (paragraph 9.163 in the 2010 OECD TP Guidelines) could be used as the basis for such a statement:

> "9.34 MNEs are free to organise their business operations as they see fit. Tax administrations do not have the right to dictate to an MNE how to design its structure or where to locate its business operations. In making commercial decisions, tax considerations may be a factor. Tax administrations, however, have the right to determine the tax consequences of the structure put in place by an MNE, subject to the application of treaties and in particular of Article 9 of the OECD Model Tax Convention. This means that tax administrations may make, where appropriate, adjustments to profits in accordance with Article 9 of the

[9] OECD (2020), *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10*, OECD, Paris.

OECD Model Tax Convention and other types of adjustments allowed by their domestic law (e.g. under general or specific anti-abuse rules), to the extent that such adjustments are compatible with their treaty obligations."

It is submitted that the final two sentences of paragraph 9.34 of the 2017 OECD TP Guidelines accurately reflect how paragraph 1 of Article 9 interacts with the domestic law of a Contacting State. Further and importantly, these two sentences are consistent with paragraphs 66 to 80 of the Commentary to Article 1.

It is therefore recommended that the following sentence be included in the Commentary to paragraph 1 of Article 9 immediately before the proposed new final sentence to be added to paragraph 2:

> ***"This means that a Contracting State may make, where appropriate, adjustments to profits in accordance with paragraph 1 of Article 9 and other types of adjustments allowed by its domestic law (e.g. under general or specific legislative anti-abuse rules), as long as there is conformity with the guidance in paragraphs 66 to 80 of the Commentary to Article 1, the requirements of paragraph 1 of Article 9 and the other provisions of the Convention."***

With respect to modifying the proposed new sentence to be added at the end of paragraph 2 so that it is consistent with the general statement of principle, it is recommended that the modifications indicated below be made. It has also been assumed that it is not intended to incorporate by reference the OECD TP Guidelines into the Commentary to Article 9:

> "In order to ensure the elimination of double taxation, the arm's length principle ***as expressed in paragraph 1 of Article 9 should be followed*** and the guidance on its ~~interpretation~~ ***application*** in the OECD Transfer Pricing Guidelines should be ~~followed~~ ***duly considered*** in any re-writing of accounts."

Further, if the above recommendations are accepted, conforming changes would be required to Chapter X of the OECD TP Guidelines.

The words "In order to ensure the elimination of double taxation" should be deleted

The words "*In order to ensure the elimination of double taxation*" at the beginning of the proposed new sentence to be inserted at the end of paragraph 2 should be deleted for the following reasons:

- Paragraph 1 of Article 9 does not address the elimination of double taxation, that is the domain of paragraph 2 of Article 9; and
- These words are not necessary in any event, as the remaining words of the proposed new sentence to be inserted at the end of paragraph 2 stand on their own (subject to the other concerns that have been raised).

This concern could be addressed by making the following change:

> "~~In order to ensure the elimination of double taxation,~~ ***Where the accounts do not show the true taxable profits arising in a Contracting State,*** 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."

Other comments

The term "*OECD Transfer Pricing Guidelines*" has not been defined. The full title of the guidelines is used in paragraph 1 of the Commentary to Article 9.

Summary of recommended changes

Based on the above comments, the following recommendations are made:

1. That the following sentence be added to paragraph 2 of the Commentary on Article 9 immediately before the proposed new final sentence to be added to paragraph 2:

> ***"This means that a Contracting State may make, where appropriate, adjustments to profits in accordance with paragraph 1 of Article 9 and other types of adjustments allowed by its domestic law (e.g. under general or specific legislative anti-abuse rules), as long as there is conformity with the requirements of paragraph 1 of Article 9 and the other provisions of the Convention.***"

2. That the proposed new sentence to be added at the end of paragraph 2 be redrafted as shown below. In doing so, it has been assumed that it is not intended to incorporate by reference the OECD TP Guidelines into the Commentary to Article 9:

> "~~In order to ensure the elimination of double taxation,~~ ***Where the accounts do not show the true taxable profits arising in a Contracting State,*** the arm's length principle ***as expressed in paragraph 1 of Article 9 should be followed*** and the guidance on its ~~interpretation~~ ***application*** in the OECD Transfer Pricing Guidelines ***for Multinational Enterprises and Tax Administrations*** should be ~~followed~~ ***duly considered*** in any re-writing of accounts."

3. That conforming changes be made to Chapter X of the OECD TP Guidelines to ensure that it is consistent with paragraphs 66 to 80 of the Commentary to Article 1 and also with paragraph 9.34 of the OECD TP Guidelines.

Proposed new paragraph 3 of the Commentary to Article 9

A number of concerns arise in relation to proposed new paragraph 3 of the Commentary to Article 9, in particular with the final sentence. These concerns are addressed below.

General statements of principle should precede examples of the application of such principles

As an initial comment and without in any way detracting from any subsequent comments, the order of proposed new paragraphs 3 and 3.1 should be reversed. Proposed new paragraph 3.1 sets out a statement of principle that is of general application. By contrast, proposed new paragraph 3 discusses how this general principle would apply to an interest payment and to whether a purported loan should be regarded as a loan.

The first sentence of proposed new paragraph 3

Contrary to the statement made in the first sentence of the proposed new paragraph 3, application of the arm's length principle in paragraph 1 of Article 9 does not normally consider "*whether an interest payment can be regarded as an arm's length amount*" but rather whether the interest rate applicable to a particular loan is an arm's length rate as is currently reflected in the first part of paragraph 3(b) of the Commentary to Article 9.

This concern could be addressed by making the following changes to the first sentence of proposed paragraph 3:

> "In considering whether ~~an interest payment can be regarded as an arm's length amount~~ ***the interest rate applicable to a particular loan is an arm's length rate***, a State will typically examine the terms and conditions of the loan such as the rate of interest."

Further, it is also too simplistic to state that a tax administration in a Contracting State "*will typically examine the terms and conditions of the loan such as the rate of interest*" as in loans between independent entities, the interest rate is only one of a number of factors that the parties will have regard to. Numerous factors can be relevant with respect to whether the terms and conditions of a loan are consistent with what independent parties would agree to, not just the rate of interest. In particular, the following are noted: the term and currency of the loan, whether security or covenants are provided by the borrower to the lender and whether the loan is senior or subordinated to other debt of the borrower.

This concern could be addressed by making the following changes to the first sentence of proposed paragraph 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***, the term and currency of the loan, whether security or covenants have been provided by the borrower and whether the loan is senior or subordinated to other debt issued by the borrower***."

The final sentence of proposed new paragraph 3

A number of significant concerns arise in relation to the final sentence of proposed new paragraph 3. In summary form, these are:

- The use of the word "or" in the final sentence inappropriately gives Contracting States a choice as to whether to use domestic law or the OECD TP Guidelines;
- The proposed sentence has failed to have regard to paragraphs 66 to 80 of the Commentary to Article 1; and
- The proposed sentence conflicts with the position stated in paragraph 3(a) of the Commentary to Article 9.

Each of these concerns is addressed below.

The use of the word "or" in the final sentence inappropriately gives Contracting States a choice as to whether to use domestic law or the OECD TP Guidelines

The use of the word "or" in the last sentence inappropriately gives Contracting States a choice as to whether to use domestic laws or the OECD TP Guidelines. In addition to the comments below in relation to the failure to have regard to paragraphs 66 to 80 of the Commentary to Article 1, and especially to paragraph 70, the provision of such a choice to Contracting States, which is not set out clearly in the terms of the relevant tax treaty article, provides no certainty to either other Contracting States or to MNE groups as to the approach that a particular Contracting State might take. Such uncertainty is not conducive to minimising potential tax disputes or to resolving such disputes when they arise.

Further, as mentioned in comments above, there is an inconsistency between the final sentence of proposed new paragraph 3 and the proposed new sentence to be added at the end of paragraph 2.

The proposed sentence has failed to have regard to paragraphs 66 to 80 of the Commentary to Article 1

Significantly, the final sentence of proposed new paragraph 3 is unconstrained by any considerations other than domestic law or the OECD TP Guidelines and as such has failed to have regard to paragraphs 66 to 80 of the Commentary to Article 1, and in particular to paragraph 70 which is reproduced in the General Comments section.

As mentioned in the General Comments section, while paragraphs 71-80 of the Commentary to Article 1 set out why such potential conflicts will often be avoided, they do not contradict the position set out in paragraph 70 of the Commentary to Article 1. Further, while Contracting States are also free to include specific provisions in their bilateral tax treaties to clarify that there is either no conflict or, even if there is a conflict, allowing the application of domestic laws (eg where a tax treaty expressly allows the application of a thin capitalisation rule in the domestic law of one or both of the Contracting States),[10] such bilateral arrangements do not change the general position set out in paragraph 70 of the Commentary to Article 1.

The proposed sentence conflicts with the position stated in paragraph 3(a) of the Commentary to Article 9

Equally significantly, the final sentence of proposed new paragraph 3 conflicts with the position stated in paragraph 3(a) of the Commentary to paragraph 1 of Article 9 which states that:

> "the Article does not prevent the application of national rules on thin capitalisation <u>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</u>." (emphasis added)

While the interaction between domestic thin capitalisation rules and paragraph 1 of Article 9 has been somewhat of a fraught issue for a long time, the position stated in paragraph 3(a) of

[10] Paragraph 72 of the Commentary to Article 1.

the Commentary to Article 9 is quite clear and has been reflected in the Commentary to Article 9 since 1992.

No argument, let alone a compelling argument, has been put forward as to why the position set out in paragraph 3 of the Commentary to Article 9, is either incorrect or should be deleted. It is therefore recommended that paragraph 3 of the Commentary to Article 9 be retained and if any additional or supplementary guidance is needed that such guidance be included in a way that is consistent with the guidance in paragraph 3 of the Commentary to Article 9.

Proposed changes to the final sentence to address the concerns raised

The above concerns could be addressed by making the following changes to the final sentence of proposed new paragraph 3:

> "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 ***general or specific legislative anti-abuse rules and*** judicial doctrine***s***)***, as long as there is conformity with the guidance in paragraphs 66 to 80 of the Commentary to Article 1, the requirements of paragraph 1 of Article 9 and the other provisions of the Convention***~~, or in the OECD Transfer Pricing Guidelines~~."

Summary of recommended changes

Based on the above comments, the following recommendations are made:

(1) That proposed new paragraph 3 of the Commentary to Article 9 not be included and instead paragraph 3 of the existing Commentary to Article 9 be retained.

(2) In the alternative, that the order of proposed new paragraphs 3 and 3.1 be reversed and that proposed new paragraph 3 of the Commentary to Article 9 be redrafted as shown below:

> "3. In considering whether ~~an interest payment can be regarded as an arm's length amount~~ ***the interest rate applicable to a particular loan is an arm's length rate***, a State will typically examine the terms and conditions of the loan such as the rate of interest***, the term and currency of the loan, whether security or covenants have been provided by the borrower and whether the loan is senior or subordinated to other debt issued by the borrower***. 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 ***general or specific legislative anti-abuse rules and*** judicial doctrine***s***)***, as long as there is conformity with the guidance in paragraphs 66 to 80 of the Commentary to Article 1, the requirements of paragraph 1 of Article 9 and the other provisions of the Convention***~~, or in the OECD Transfer Pricing Guidelines~~."

Proposed new paragraph 3.1 of the Commentary to Article 9

The first three sentences of proposed new paragraph 3.1 correspond with the second to fourth sentences of paragraph 30 of the Commentary to Article 7. However, while consistency across the Commentaries with respect to the various articles is desirable where it is appropriate, fundamental differences between paragraph 1 of Article 9 and paragraph 2 of Article 7 have not been taken into account in the proposed new paragraph 3.1. This is particularly evident in the first sentence of proposed new paragraph 3.1. Further, a number of the same concerns also arise in relation to the first sentence of proposed new paragraph 6.1 of the Commentary to Article 9.

The first sentence of proposed new paragraph 3.1

Fundamental differences between paragraph 1 of Article 9 and paragraph 2 of Article 7 have not been taken into account in the drafting of the first sentence of proposed new paragraph 3.1.

First, paragraph 1 of Article 9 does not require that the profits of *the enterprises in each Contracting State* be allocated. Unlike paragraph 2 of Article 7, under which the profits of *an enterprise of a Contracting State* are attributed to the relevant permanent establishment *by both* Contracting States,[11] paragraph 1 of Article 9 permits a Contracting State to increase the profits of *an enterprise of that Contracting State* by reference to the arm's length principle as it is expressed in paragraph 1 of Article 9 and to tax accordingly (where the conditions for the operation of the article are met).

Second, paragraph 1 of Article 9 does not require a Contracting State to allocate the profits of an enterprise *in accordance with the arm's length principle* per se, but rather is permissive, in the sense that it allows but does not require a Contracting State to subject to tax profits of an enterprise in an amount not exceeding the arm's length profits. In other words, paragraph 1 of Article 9 imposes a ceiling or an upper limit on the amount of profits of an enterprise of a Contracting State that a Contracting State can subject to tax with that ceiling or upper limit being set by reference to the arm's length principle as it is expressed in paragraph 1 of Article 9. The words "may be included" in paragraph 1 of Article 9 reflect this construction. By way of example, an increase in the amount of profits subject to tax in a Contracting State but to an amount less than an arm's length amount is nevertheless consistent with paragraph 1 of Article 9.

By contrast, paragraph 2 of Article 7 is prescriptive or mandatory, in the sense that it requires each Contracting State to attribute to the permanent establishment the profits it might be expected to make if it were a separate and independent enterprise (ie to attribute the arm's length profits).

Third, and unlike paragraph 2 of Article 7, in the context of paragraph 1 of Article 9, it is not correct to say that "it is for the domestic law *of each* Contracting State to determine whether and how such profits should be taxed". Paragraph 1 of Article 9 does not consider whether the profits subject to tax in the Contracting State making the primary adjustment have also been

[11] As explained in paragraph 27 of the Commentary to Article 7, the underlying rationale for doing so is primarily to facilitate providing relief from juridical double taxation under Article 23A or 23B.

subject to tax in the other Contracting State. That is the domain of paragraph 2 of Article 9, not paragraph 1.

The above concerns could be addressed by making the following changes to the first sentence of proposed new paragraph 3.1:

> Once ***a Contracting State has determined*** the profits ***of an enterprise that are subject to tax in its jurisdiction*** ~~of the two enterprises have been allocated in accordance with the arm's length principle~~, ***as long as there is conformity with the guidance in paragraphs 66 to 80 of the Commentary to Article 1, the requirements of paragraph 1 of Article 9 and the other provisions of the Convention,*** it is for the domestic law of ~~each~~ ***that*** 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~~.

The second sentence of proposed paragraph 3.1

The words "*of either enterprise*" should be replaced by the words "*of an enterprise*" because, as mentioned above, paragraph 1 of Article 9, unlike paragraph 2 of Article 7, only applies to an enterprise of *a* Contracting State.

Further, and consistently with the approach taken in paragraph 66 of the Commentary to Article 7, it would be both appropriate and desirable to broaden the scope of the second sentence so that it encompassed both revenues or gains and not just expenses. This could be achieved by replacing the words "the issue of whether expenses are deductible" with the words "the issue***s*** of ***which revenues or gains are taxable and which*** ~~whether~~ expenses are deductible" with changes being shown in marked text.

The third sentence of proposed paragraph 3.1

For reasons expressed elsewhere in these comments, the words "*paragraphs 66 to 80 of the Commentary to Article 1 and*" should be inserted before the words "*paragraph 4 of Article 24.*"

The fourth sentence of proposed paragraph 3.1

For the reasons given above in relation to why the operation of paragraph 1 of Article 9 is not the same as the operation of paragraph 2 of Article 7, the fourth sentence of proposed paragraph 3.1 should be modified by replacing the words "*makes an equivalent statement*" with "*makes a corresponding statement*".

Summary of recommended changes

Based on the above comments, it is recommended that the proposed new paragraph 3.1 be redrafted as follows:

> "Once ***a Contracting State has determined*** the profits ***of an enterprise that are subject to tax in its jurisdiction*** ~~of the two enterprises have been allocated in accordance with the arm's length principle~~, ***as long as there is conformity with the guidance in paragraphs 66 to 80 of the Commentary to Article 1, the requirements of paragraph 1 of Article 9 and the other provisions of the Convention,*** it is for the domestic law of ~~each~~ ***that*** 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~~. Article 9 does not deal with the issue***s*** of ***which revenues or gains are taxable and which*** ~~whether~~ expenses are deductible when computing the taxable income of ~~either~~ ***an*** enterprise. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, ***paragraphs 66 to 80 of the Commentary to Article 1 and*** paragraph 4 of Article 24. Paragraph 30 of the Commentary on Article 7 makes~~ an equivalent~~ ***a corresponding*** statement for the application of Article 7. 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."

Proposed changes to paragraph 4 of the Commentary to Article 9:

The proposed changes to paragraph 4 of the Commentary to Article 9 are agreed with.

Proposed changes to paragraph 6 of the Commentary to Article 9:

The broad thrust of the proposed changes to paragraph 6 are agreed with, however, some modifications are needed if, contrary to the recommendation provided below, the final sentence of proposed new paragraph 6.1 is added to the Commentary to Article 9. The need for modifications arises because it should be explicitly recognised in the Commentary to paragraph 2 of Article 9 that there are (now) two very different circumstances in which the Contracting State from whom an appropriate adjustment has been sought under paragraph 2 of Article 9 is not required to provide an appropriate adjustment or to only provide an appropriate adjustment up to a particular amount. These are:

- Where the Contracting State making the primary adjustment has adjusted profits to a level which exceeds what they would have been if they had been correctly computed in accordance with paragraph 1 of Article 9 (ie as stated in paragraph 6 of the Commentary to Article 9); and
- Where economic double taxation does not arise following a primary adjustment being made to the extent that the potential economic double taxation arises from mismatches in the domestic tax law treatment (ie as stated in the final sentence of proposed new paragraph 6.1 of the Commentary to Article 9).

Summary of recommended changes

Based on the above comments, it is recommended that the proposed changes to paragraph 6 be modified as follows:

(1) By inserting the words "*subject to the final sentence of paragraph 6.1 of the Commentary to Article 9,*" after the semi-colon and before the words "*the adjustment is due only*" in the first sentence of paragraph 6; and

(2) By adding the words "*and subject also to the final sentence of paragraph 6.1 of the Commentary to Article 9*" at the end of paragraph 6.

Proposed new paragraph 6.1 of the Commentary to Article 9

Significant concerns arise in relation to proposed new paragraph 6.1, in particular the first and final sentences. These concerns are addressed in more detail below.

The first sentence of proposed new paragraph 6.1

The concerns arising in relation to the first sentence of proposed new paragraph 6.1 are the same as a number of the concerns arising in relation to the first sentence of proposed new paragraph 3.1 which have been discussed above. Changes to the first sentence of proposed new paragraph 6.1 are shown in the ***Summary of recommended changes*** below, consistent with changes recommended in relation to the first sentence of proposed new paragraph 3.1.

The second sentence of proposed new paragraph 6.1

The second sentence omits the important words "*as long as there is conformity with the requirements of [paragraph 1 of Article 9 and the] other provisions of the Convention*" which are included as the final part of the first sentence of proposed new paragraph 3.1. These words should also be included at the end of the second sentence of proposed new paragraph 6.1.

The final sentence of proposed new paragraph 6.1

The final sentence of proposed new paragraph 6.1 should not be added to the Commentary to Article 9.

As noted in the introductory words in paragraph 2 of the Public consultation document, proposed new paragraph 6.1 derives from paragraph 66 of the Commentary to Article 7. However, the final sentence of proposed new paragraph 6.1 appears to have overlooked significant differences between Article 7 and Article 9. In this instance, the key difference relates to the distinction between juridical double taxation and economic double taxation.

Juridical double taxation is generally understood as relating to the same income or capital being subject to tax in the hands of the same legal entity in two or more States.[12] By contrast, under economic double taxation, the same income or capital is subject to tax in the hands of two different legal entities.[13]

Mismatches in domestic law treatment will not often arise under Article 9 because the relevant amount of profits relates to a revenue item or gain in the hands of an enterprise of the Contracting State making the primary adjustment while in the other Contracting State the relevant amount will relate to an expense or an outgoing in the hands of the associated enterprise and vice versa.

[12] Paragraph 1 of the Introduction to the OECD MTC; paragraph 1 of the Commentary to Articles 23A and 23B of the OECD MTC.

[13] Paragraph 5 of the Commentary to Article 9 of the OECD MTC; paragraph 2 of the Commentary to Articles 23A and 23B of the OECD MTC.

If nevertheless, the final sentence of proposed new paragraph 6.1 is to be added to the Commentary to Article 9, then it is recommended that an example also be included to illustrate when a mismatch in domestic law treatment might arise in the context of Article 9.

Summary of recommended changes

Based on the above comments, the following recommendations are made:

(1) That the proposed new paragraph 6.1 be redrafted as follows:

> "6.1 As noted in paragraph 3.1 above, ***paragraph 1 of*** Article 9 applies ~~only~~ for the purpose~~s~~ of ***determining the profits of an enterprise that are subject to tax in a Contracting State*** ~~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***, as long as there is conformity with the requirements of paragraph 1 of Article 9 and the other provisions of the Convention***. ~~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.~~"

(2) That if, notwithstanding the preceding recommendation, the final sentence of proposed new paragraph 6.1 is to be added to the Commentary to Article 9, then in the alternative, an example be included to illustrate when a mismatch in domestic law treatment might arise in the context of Article 9.

PROPOSED CHANGE TO THE COMMENTARY ON ARTICLE 7 (BUSINESS PROFITS)

While the broad thrust of the proposed changes to paragraph 59 of the Commentary to Article 7 are supported, for similar reasons to those expressed above in the comments on the proposed changes to paragraph 6 of the Commentary to Article 9, it is recommended that the following addition to the final sentence of paragraph 59 of the Commentary to Article 7 is made.

Insert the words "*and subject also to paragraph 66 of the Commentary to Article 7*" at the end of paragraph 59.

PROPOSED CHANGE TO THE COMMENTARY ON ARTICLE 24 (NON-DISCRIMINATION)

The proposed changes to paragraph 75 of the Commentary to Article 24 are agreed with.

PROPOSED CHANGES TO THE COMMENTARY ON ARTICLE 25 (MUTUAL AGREEMENT PROCEDURE)

The proposed new paragraph 12.1 of the Commentary to Article 25 is based on paragraph 11 of Section 1.A (Elements of a minimum standard to ensure the timely, effective and efficient resolution of treaty-related disputes) of the report *Making Dispute Resolution Mechanisms More Effective, Action 14 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project.

While the broad thrust of proposed new paragraph 12.1 is supported, some modifications to the first and final sentences of the proposed new paragraph are nevertheless needed. These are discussed in more detail below.

The first sentence of proposed new paragraph 12.1

Re: the words "the inclusion of profits of associated enterprises"

The first sentence of proposed new paragraph 12.1 refers to "*the inclusion of profits of associated enterprises*" that may result from a primary adjustment. For similar reasons to those given above in relation to the first sentence of proposed new paragraph 3.1, the making of a primary adjustment by a Contracting State does not result in the inclusion of profits of two associated enterprises.

As stated in paragraph 5 of the Commentary to Article 9:

> "*The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different persons), insofar as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B.*"
> (emphasis added)

This concern could be addressed by making the following change to the first sentence of proposed new paragraph 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 ***of profits*** 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."

The term "arm's length standard" is not used in the Commentary to Article 25

The first sentence of proposed new paragraph 12.1 proposes to introduce the term "arm's length standard" into the Commentary to Article 25. However, this term is not used in either the Commentary to Article 25 or the Commentary to Article 9 which both use the term "arm's length principle". The term "arm's length standard" should not be introduced into the Commentary to Article 25.

This concern could be addressed by making the following change to the first sentence of proposed new paragraph 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 ***principle in paragraph 1 of Article 9*** ~~standard~~ would result in taxation not in accordance with one of the objects and purposes of the Convention to eliminate double taxation."

The final sentence of proposed new paragraph 12.1

The final sentence of proposed new paragraph 12.1 provides that "*States should therefore provide access to the mutual agreement procedure in transfer pricing cases.*" However, as discussed earlier in this submission and as noted in paragraphs 3(a) and 3(b) of the Commentary to Article 9, paragraph 1 of Article 9 is not limited to transfer pricing cases and may also be relevant in other situations, for example, in the application of domestic thin capitalisation rules.

This concern could be addressed by adding the words "*and in other cases where the conditions in paragraph 1 of Article 9 are met*" at the end of the final sentence of proposed new paragraph 12.1.

Summary of recommended changes

Based on the above comments, it is recommended that the proposed new paragraph 12.1 be redrafted as follows:

> "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 ***of profits*** not justified by reference to the arm's length ***principle in paragraph 1 of Article 9*** ~~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 ***and in other cases where the conditions in paragraph 1 of Article 9 are met***."

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Please do not hesitate to contact me if you would like to discuss any aspect of this submission in further detail.

Damian Preshaw

Company Director