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Tax Treaties,
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OECD/CTPA

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Comments on the public consultation document "*Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles*"

Dear Sirs,

We would like to thank you for the opportunity to submit our comments on the OECD public consultation document "*Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles*" released on 29 March 2021 (the "**Proposal**").

In this respect, please find hereinafter our observations, which also take into account our experience with particular regard to Italy.

Please note that our proposed changes to the text of the Proposal are reported in ***bold italics*** for additions and ~~strikethrough~~ for deletions.

1. Proposed changes to the Commentary on Article 9

1.1. Interest payments

With regard to new § 3 of the Commentary, it is our view that, in order to effectively eliminate instances of double taxation and ensure an allocation of taxing rights between the two Contracting States that is in line with the arm's length standard, it would be necessary to clarify that the determination to be made by the relevant State, under Article 9 of the Convention, on whether the purported loan should be recharacterized as equity capital must be primarily based on the OECD Transfer Pricing Guidelines (hereinafter "**TP Guidelines**") and only to a subordinate extent, and as long as that does not conflict with the TP Guidelines, on the basis of factors discussed in its domestic law (including judicial doctrine). In particular, for the purpose of applying Article 9 of the Convention to determine the balance of debt and equity funding of an entity within an MNE group, the Contracting States should have primary recourse to the accurate delineation of the transaction under Section

D.1 of Chapter I of the TP Guidelines, as elucidated in Section B.1 of Chapter X of the same Guidelines. Recourse to other approaches and factors, as employed under domestic legislation to establish the appropriate balance of debt and equity funding of an entity, while not precluded, should however be used under Article 9 only to support the accurate delineation of the transaction under the above-mentioned Sections of the TP Guidelines, and to the extent that they do not conflict with them. Any different approach that ignores an accurate delineation of the transaction as purported in the TP Guidelines would be in breach of the arm's length principle entailed in Article 9 and would constitute a violation of the treaty obligations of the relevant Contracting State.

Indeed, the approaches and factors used under the domestic laws of the Contracting States (including judicial doctrine) could differ significantly from each other, thus triggering a considerable risk of conflicts of recharacterizations of the loans. Conversely, a clear position taken in the Commentary on the decisive relevance of the TP Guidelines - for the purpose of establishing whether the purported loan should be recharacterized as equity capital - would contribute to (i) reducing the instances of double taxation, (ii) ensuring that the outcome of the determination is in line with the arm's length standard, and (iii) guiding the Competent Authorities of the Contracting States for the purpose of resolving the residual conflicts through the mutual agreement procedure.

For these reasons, we suggest amending proposed § 3 of the Commentary as follows:

> 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 ***primarily on the basis of the OECD Transfer Pricing Guidelines and only to a subordinate extent, and as long as that does not conflict with the those Guidelines, on the basis of factors discussed in its domestic law (including judicial doctrine)*** ~~taking into account factors discussed in its domestic laws (including judicial doctrine), or in the OECD Transfer Pricing Guidelines~~.

For the same purpose, it would be useful to amend Section B.1 of Chapter X of the TP Guidelines in order to clarify this view.[1]

[1] In this respect, footnote 1 to Section B of the report OECD (2020), *Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10*, OECD, Paris, explicitly provides that: "*The guidance contained in this subsection is consistent with the Commentary on Article 9 of the 2017 OECD Model Tax Convention and also with the Commentary as it would read with proposed changes that have been agreed by Working Party No. 1. The guidance might be revised in the event that those proposals are materially changed at any stage*" (emphasis added).

1.2. Domestic law rules on the computation of taxable profits

We favor the inclusion of "parallel statements" in Article 7 and Article 9 in order to ensure uniformity as far as the application of the arm's length principle is concerned.

In particular, we welcome new § 3.1., in which, for the sake of clarity, we would suggest including an explicit reference to the rules on the temporal allocation of (revenues and) expenses for tax purposes. These rules, in fact, should be seen as falling outside the scope of application of Article 9 of the Convention, while being within the domain of domestic law, although subject to the operation of other provisions of the Conventions, such as Article 24.

In this respect, we suggest amending proposed § 3.1 of the Commentary as follows:

> 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***, when*** 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 of whether ***and when*** expenses are deductible when computing the taxable income of either enterprise. The conditions ***and timing*** for the deductibility of expenses are a matter to be determined by domestic law, 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. 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.

In addition, for the sake of coordination, we would suggest amending proposed new § 6.1 to include (i) an express reference to the domestic rules on the temporal allocation of revenues and expenses for tax purposes, as well as (ii) a statement clarifying that domestic rules on the computation of taxable profits remain subject to the operation of other provisions of the Conventions, such as Article 24.

For these reasons, we suggest amending proposed § 6.1 of the Commentary as follows:

> 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, ***including the temporal allocation of revenues and expenses for tax purposes,*** which is a question of domestic law, ***subject to other provisions of the Convention and, in particular, paragraph 4 of Article 24***. 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.

1.3. Application of domestic law rules that partially overlap with Article 9 of the Convention

In some cases, certain domestic law provisions that formally deal with the computation of the taxable profits overlap with the application of Article 9 of the Convention. In our experience, this is predominantly the case with regard to domestic law rules denying the deduction, in whole or in part, of expenses for (intercompany) services (i) that are deemed not to have been rendered, or (ii) that are not clearly connected to the business of the recipient, or (iii) that a judicious entrepreneur would have probably not required, or (iv) whose amount is deemed to be unreasonable from an economic perspective.

Although those rules often do not apply exclusively to intercompany transactions and are not formally relying on the arm's length standard at the domestic level, their concrete application to the provision of intercompany services may, and often does, overlap with the operation of Article 9 of the Convention. In particular, those domestic rules not infrequently apply to cases that are covered by Section B.1 of Chapter VII of the TP Guidelines, which deals primarily with the analysis on whether intra-group services have been effectively rendered, an analysis that should be carried out before any estimation of the intercompany prices according to the arm's length principle (which should be made under Section B.2 of Chapter VII).

In this respect, we suggest adding to proposed new § 6.1 of the Commentary a sentence clarifying that the application of those domestic law rules to intercompany transactions occurred between enterprises of the two Contracting States should in any case comply with the Section B.1 and B.2 of Chapter VII of the TP Guidelines. For instance, the following paragraph could be added at the end of § 6.1:

> ***It is, however, intended that the application to intercompany transactions of domestic law rules denying, in whole or in part, the deduction of expenses for services that are regarded either as not having been rendered, or as not connected to the business of the recipient, or as services that a judicious entrepreneur would have not purchased, or as services whose amount is deemed to be unreasonable from an economic perspective, should comply in any case with the guidance provided in Section B, and in particular B.1, of Chapter VII of these guidelines.***

Similarly, the Commentary on Article 25 should clarify that the application of those domestic rules to intercompany transactions falling within the scope of Article 9 of the Convention, in particular if causing instances of double taxation, should be covered by the mutual agreement procedure in transfer pricing cases insofar as the result of their application is not compliant with Article 9, as interpreted by Section B.1 and B.2 of Chapter VII of the TP Guidelines.

2. PROPOSED CHANGES TO THE COMMENTARY ON ARTICLE 24

Based on the text of § 75 of the Commentary, as interpreted in the light of the general principle of proportionality,[2] we submit that, where the additional information requested in connection with cross-border payments and the connected audit procedures go beyond what is necessary in order to ensure "*similar levels of compliance and verification*", they result in a breach of paragraph 4 of Article 24 of the Convention. This is particularly the case where those additional requests and procedures lead to the burdensome duplication of administrative requirements and the obligation to provide documents and data already in possession of the tax authorities.

For the sake of clarity, we propose this interpretation to be spelled out within § 75. To this end, the following wording could be adopted:

> 75. Also, paragraph 4 does not prohibit additional information requirements with respect to payments made to non-residents since these requirements, including the reversal of the burden of proof, are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents. ***Conversely, paragraph 4 prohibits additional information requirements that go beyond the extent necessary to ensure similar levels of compliance and verification, triggering burdensome duplications of administrative requirements and obligations to provide documents and data already in possession of the tax authorities.***

In addition, it is our view that a distinction should be made between the mere reversal of the burden of proof and the existence of requirements for the deductibility of cross-border payments[3] that are more severe than those applicable to purely domestic payments. In the latter case, the domestic law provision entails a discrimination contrary to Article 24(4) of the Convention.

Therefore, we propose to add at the end of § 75 of the Commentary the following sentence:

> ***Moreover, where the domestic law of a Contracting State makes the deductibility of payments made by an enterprise of that State to a resident of the other Contracting State subject to more severe requirements, with regard to the burden of proof, than those applicable to purely domestic payments, such as those limiting the types of evidence that may be provided, or establishing that specific facts must be proved, those requirements entail a discrimination that is prohibited by paragraph 4.***

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[2] According to which "*paragraph 4 does not prohibit additional information requirements with respect to payments made to non-residents since these requirements […] are* <u>*intended to ensure similar levels of compliance and verification*</u>" (<u>emphasis</u> added).

[3] Reference is made, for example, to conditions limiting the types of evidence that may be provided or establishing that specific facts must be proved.

3. Proposed changes to the Commentary on Article 25

As already mentioned in previous section 1.3, we suggest including after proposed § 12.1 of the Commentary a provision aimed at clarifying that mutual agreement procedure under Article 25 should be available in cases of double taxation that may result from the application to intercompany transactions of domestic law rules denying, in whole or in part, the deduction of expenses for (i) services that are regarded either as not having been rendered, or (ii) as not connected to the business of the recipient, or (iii) as services that a judicious entrepreneur would have not purchased, or (iv) as services whose amount is deemed to be unreasonable from an economic perspective.

Indeed, although those rules often do not apply exclusively to intercompany transactions and are not formally relying on the arm's length standard, their concrete application to the provision of intercompany services may, and often does, overlap with the operation of Article 9 of the Convention. In particular, those domestic rules not infrequently apply to cases that are covered by Section B.1 of Chapter VII of the TP Guidelines, dealing with the analysis on whether intra-group services have been effectively rendered (and to lesser extent by Section B.2 thereof).

In this respect, 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 the application of those domestic rules, would frustrate the principal objective of the Convention and would run contrary to the principles highlighted in the BEPS final report on treaty-related disputes.[4] This denial, thus, would constitute a violation of the treaty obligations of the relevant Contracting State.

The Commentary on Article 25 should clarify that the application of domestic rules to intercompany transactions falling within the scope of Article 9 of the Convention, in particular if causing instances of double taxation, should be covered by the mutual agreement procedure in transfer pricing cases insofar the result of their application is not compliant with Article 9, as interpreted by Section B.1 and B.2 of Chapter VII of the TP Guidelines.

For these reasons, we recommend adding, after proposed § 12.1 of the Commentary, the following new § 12.2:

> ***12.2 Similarly, the application to intercompany transactions of domestic law rules denying, in whole or in part, the deduction of expenses for services that are regarded either as not having been rendered, or as not connected to the business of the recipient, or as services that a judicious entrepreneur would have not purchased, or as services whose amount is***

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[4] OECD, *Making Dispute Resolution Mechanisms More Effective, Action 14 - 2015 Final Report*, 5 October 2015.

> ***deemed to be unreasonable from an economic perspective, may cause instances of economic double taxation that fall within the scope of application of Article 9 of the Convention (see paragraph 6.1 of the Commentary on Article 9). Where this is the case, the resulting double taxation constitutes a taxation not in accordance with one of the objects and purposes of the Convention to eliminate double taxation. Therefore, a denial of access to the mutual agreement procedure in these circumstances, with a view to eliminating the economic double taxation resulting from the application of those domestic law provisions, would likely frustrate an objective of the Convention. States should therefore provide access to the mutual agreement procedure in these cases.***

In our experience, similar problems arise in the context of the attribution of profits to permanent establishments. Thus, the principle affirmed in § 12.2 with regard to intercompany transactions should also apply in the context of the internal dealings covered by Article 7. If it were concluded that a clarification in this respect would be useful, § 12.2 could be amended accordingly.

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Please do not hesitate to contact us, should you require any further information with regards to the content of this document.

Sincerely yours,

Pirola Pennuto Zei & Associati