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WU Transfer Pricing Center

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Vienna, May 15, 2021

Subject: Comments to the Public consultation document – Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles

Dear Ladies and Gentlemen,

The WU Transfer Pricing Center at the Institute for Austrian and International Tax Law at WU (Vienna University of Economics and Business) would like to thank the OECD for the opportunity to provide comments to the "*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 Consultation Document"). We are pleased to elaborate our comments on the issues raised. First and foremost, we would like to congratulate the OECD for the work on the Consultation Document and we highly appreciate the ongoing work of the OECD in the area of transfer pricing and the related aspects.

1. General Comments

From a general perspective we would like to highlight that the proposed changes to the OECD Commentary, especially regarding Article 9, seemingly aim to differentiate between the levels of **profit allocation (which is subject to international tax law) and profit determination[1] (which is subject to domestic tax law)**. We certainly welcome these changes. However, in order to more precisely highlight this differentiation in the Commentary to Article 9, we would suggest using the wording "profit allocation" and "profit determination" throughout the entire Consultation Document.[2] Additionally, it should also be highlighted that Article 9 OECD Model should only focus on the sphere of "profit allocation", whereas "profit determination" (including the allowance or disallowance of the tax deductibility of certain expenses) should still be subject to domestic tax law. Finally, the Consultation Document in some parts seem to imply that profit allocation (based on double tax treaties) could/should be applied before profit determination (based on domestic legislation). This rationale might not always occur.

Moreover, we observe that the **interplay between profit allocation rules** (derived from the double tax treaties) **and profit determination rules** (derived from domestic tax

[1] The term "profit determination" used in this document intends to address domestic "tax base determination".
[2] Of course, for consistency purposes, this might need to be changed in the entire Commentary to Article 9 and, eventually, in the Commentaries to the other articles.

provision, including general and specific anti-avoidance rules) is a matter that is broader than Article 9 and concerns, more generally, the entire OECD Model Convention. Therefore, it might not be beneficial to address this issue specifically in the Commentary to Article 9, unless otherwise explicitly and sufficiently linked to all relevant Articles of the OECD Model Convention. To this end, in order to ensure a smooth and relatively similar application of domestic profit determination provisions, the OECD might consider providing some general guidance on how domestic profit determination rules (*inter alia*, general anti-avoidance rules, specific anti-avoidance rules and/or other related domestic tax provisions – including domestic transfer pricing rules) can be applied harmoniously with profit allocation rules. Such harmonizing guidance might be included in the OECD Commentary, not necessarily related to Article 9. However, we are conscious of the fact that this might require considerable efforts in order to be developed and agreed by numerous countries.

Furthermore, it is preliminary worth highlighting that, when referring to the issue of "whether a purported loan should be regarded as a loan or as another kind of transaction, in particular a contribution to equity capital",[3] a clear **differentiation should be made between the "accurate delineation" and the "recognition" of intra-group loans**.[4] Indeed, from a transfer pricing perspective, an arm's length analysis starts with the "accurate delineation" of the actual transaction (i.e., the underlying intra-group loan). Based on this analysis, the economically relevant characteristics of the intra-group loan (i.e., contractual term, functional analysis, characteristics of property and services, economic circumstances, and business strategies) should be analysed in light of the actual conduct of the related parties. The starting point should be the contractual terms. However, in case there are certain terms of the underlying loan agreement, which tend – from a prima vista perspective – not to be in line with the actual conduct of the related parties, this does not automatically lead to a non-recognition of the loan as such; rather, one should aim to properly analyse all the economically relevant characteristics of the intra-group loan and, eventually, delineate the loan in light of the actual conducts of the parties. In other words, in order to ensure that "conducts are aligned with contracts", from a transfer pricing perspective, the economically relevant characteristics to be considered should be the ones derived by the conducts of the parties. Once the loan transaction is accurately delineated, the "recognition" step should be applied. In this second step, "the transaction as accurately delineated may be disregarded, and if appropriate, replaced by an alternative transaction" in case "arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction".[5] Importantly, this step is characterized by an

[3] See Consultation Document and the suggested changes to para 3 of the Commentary to Article 9; for the underlying rationale please also see paras 10.4 et seq. OECD (2020), Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10, OECD, Paris, www.oecd.org.
[4] It seems that both, the (i) OECD Transfer Pricing Guidance on Financial Transactions as well as (ii) the current Consultation Document, tend to be unclear on this differentiation. For further clarifications, see Petruzzi R. /Holzinger R., Accurate Delineation vs Recognition of Intra-group Loans, Tax Notes International 2020, 6 et seq.
[5] See para 1.122 OECD TPG 2017.

exceptional nature. The said non-recognition mechanism laid down in Chapter 1 of the OECD Transfer Pricing Guidelines should eventually be cautiously applied as a mean of last resort from a transfer pricing perspective (i.e., with a limited scope to transactions that are not based upon a valid economic rationale). Therefore, to this end, a better alignment with the wording of Chapter 1 of the OECD Transfer Pricing Guidelines would be ideal.[6]

2. Specific Comments

2.1. Comments on the proposed changes to the Commentary on Article 9

Comments regarding the suggested amendments to paragraph 2 of the OECD Commentary on Article 9:

- In general, the insertion of the highlighted phrases in the suggested paragraph 2 are **important and fully supported** from an (international tax law based) understanding of the arm's length principle. In case of a "re-writing" of the accounts of associated enterprises, we find the proposed reference to the OECD Transfer Pricing Guidelines appropriate and technically sound.

- However, we would suggest replacing the wording "true taxable profits" with "**arm's length taxable profits**", in order to avoid any potential mismatches between "true taxable profits" and the "arm's length profits", if the two terminologies could be inferred divergently.

- Moreover, we would suggest replacing the wording "sanctioned" with "**applied**".

- Additionally, we would suggest replacing the wording "normal open market commercial terms (on an arm's length basis)" with the wording "**on an arm's length basis**". Indeed, the arm's length principle does not always correspond to the "normal open market commercial terms".[7]

Comments regarding the suggested amendments to paragraph 3 of the OECD Commentary on Article 9:

- As a general comment, we understand the historical reasons underlying the decision by the OECD to focus on issues related to loans. However, the same or similar questions (i.e., the interaction between "profit allocation" and "profit determination") are **also equally relevant for other intra-group transactions** (e.g., other types of financing transactions, transactions involving services, transactions involving intangibles) and the related **interplay between "profit allocation" and "profit determination"** (i.e., the interplay between transfer

[6] See para 1.119 et seq. OECD TPG 2017.
[7] See Petruzzi R., The Arm's Length Principle: Between Legal Fiction and Economic Reality, in Lang, M., Storck, A., Petruzzi, R. (Eds.), Transfer Pricing in a Post-BEPS World (Amsterdam: Wolters Kluwer, 2016).

pricing and general or specific anti-avoidance rules as well as other relevant domestic tax provisions). Therefore, the application of paragraph 3 exclusively to loans (new chapter X of the OECD Guidelines) could lead to inconsistencies with other special transaction types addressed in Chapter VI, Chapter VII, Chapter VIII or Chapter IX in the existing OECD Guidelines.

- Moreover, it is to be understood that domestic tax provision (i.e., targeting the sphere of "profit determination") like general anti-avoidance rules, specific anti-avoidance rules and/or other related domestic tax provision, often have a **wider scope**, meaning that they, for example, even deny a (partial) tax deductibility (i.e., regarding the sphere of "profit determination") also in cases in which Article 9 OECD Model would not yet argue for a "non-recognition" (i.e., regarding the sphere of "profit allocation"). From our point of view, this general understanding is properly in line with States' tax sovereignty (i.e., they are free to design their domestic tax law provisions). However – as already briefly addressed above – a **harmonizing guidance by the OECD** on how to design such domestic provisions might be welcomed.

- Additionally, in the case of loans, the interaction between "profit allocation" and "profit determination" (already discussed by the previous wording of paragraph 3) might generate numerous issues highlighted below. Therefore, in order to reduce the issues below, we would suggest **deleting entirely** the wording of paragraph 3 (including paragraph 3.1). Deleting the paragraph would eliminate the perception of exclusivity provided to financial transactions as opposed to other transaction types.

- Alternatively, the wording of paragraph 3 may require a **significant rewording**, in order to a) reduce the issues mentioned below and b) extending its scope in order to deal with all different types of intra-group transactions.

- In case the OECD still intends to retain the wording of paragraph 3 (and 3.1) and continuing focusing only on issues related to loan transactions, we would suggest the following amendments:

    - The sentence "*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*" could be amended as follows:

        - Replacing the wording "interest payment" with "**interest expense or income**"

        - Replacing the wording "terms and conditions of the loan" with "**all the economically relevant characteristics of the loan (i.e., contractual terms, functional analysis, characteristics of the loan, economic circumstances, business strategies)**"

  - Deleting reference to "**the rate of interest**", considering that this is only one of the contractual terms and characteristics of a loan. Alternatively, reference to the rate of interest can be completed by reference to other common terms and conditions of a loan (e.g., maturity, payment terms, securitisation, etc.). To this end, it would be worth listing some (or all) the elements highlighted in the OECD Transfer Pricing Guidance on Financial Transactions.[8]

  - Adding at the end a reference to "**leading to the accurate delineation of the loan**".

- As for the remaining part of the suggested wording of paragraph 3, we would suggest clarifying the issue of the differentiation between **delineation and recognition** as mentioned above in our "General comments". Indeed, the international understanding of "non-recognition" (based upon the rationale laid down in the OECD Transfer Pricing Guidelines) should be the last resort in the sphere of "profit allocation" and only applicable if the underlying intra-group transaction does not have any economic rationale. Moreover, domestic tax provision (i.e., targeting the sphere of "profit determination") like general anti-avoidance rules, specific anti-avoidance rules and/or other related domestic tax provisions, often have a wider scope, meaning that they, for example, even (partially) deny a tax deductibility (i.e., regarding the sphere of "profit determination") in cases in which Article 9 OECD Model would not yet argue for a "non-recognition" (i.e., regarding the sphere of "profit allocation").

- Consequently, we would suggest amending the sentence "*do so taking into account factors discussed in its domestic law (…) or in the OECD Transfer Pricing Guidelines*", as follows: "*do so taking into account factors discussed in its domestic law (…) or in ~~the~~* ***light of the rationale for recognition of accurately delineated transactions laid down in the*** *OECD Transfer Pricing Guidelines.*" From our point of view, the explicit reference to the recognition rationale of the OECD Transfer Pricing Guidelines makes clear that the question of "whether a purported loan should be regarded as a loan or as another kind of transaction, in particular a contribution to equity capital"[9] should be carefully analysed (after the loan being accurately delineated) and applied only in exceptional circumstances. To this end, indeed, a reference to the **exceptionality** of the non-recognition would be beneficial.

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[8] Para 10.51. - 10.61, OECD (2020), Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS Actions 4, 8-10, OECD, Paris.

[9] *Supra,* Paragraph 10.10, "Although countries may have different views on the application of Article 9 to determine the balance of debt and equity funding of an entity within an MNE group, the purpose of this section is to provide guidance for countries that use the accurate delineation under Chapter I to determine whether a purported loan should be regarded as a loan for tax purposes (or should be regarded as some other kind of payment, in particular a contribution to equity capital)."

- Separately, the structuring of the text "taking into account factors discussed in its domestic laws (including judicial doctrine), '**or**' in the OECD Transfer Pricing Guidelines" might indicate that different sources of law/guidance (i.e., the domestic law and the OECD Transfer Pricing Guidelines) are equated with each other. The use of the word "or" might induce ambiguity since the two instruments do not enjoy the same legal status. For this purpose, we suggest replacing the word "or" with "**and**". Alternatively, the words "**and/or**" may also be used, if appropriate.

Comments regarding the suggested paragraph 3.1 of the OECD Commentary on Article 9:

- In general, we are of the opinion that the differentiation between "profit allocation" and "profit determination" foreseen in the suggested paragraph 3.1 of the OECD Model is **dogmatically sound and to be welcomed**.

- However, we would suggest including a sentence referencing the fact that domestic legislation might consider whether transfer pricing rules or other anti-avoidance rules limiting the deductibility of interest expenses should be **coordinated or not** (to this end, an important question would be whether there is a hierarchy in application of the different types of rules). The above clarification would be beneficial also in light of the fact that the deletion of the old paragraph 3 might be interpreted as a general non-coordination between transfer pricing rules and other anti-avoidance rules limiting the deductibility of interest expenses.

- Finally, the sentence "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" might seem to indicate a **hierarchy of application** between tax treaties and domestic transfer pricing (or other anti-avoidance) rules. This issue might need to be further investigated, since it might be possible under certain circumstances that the profit allocation (based on double tax treaties) might be applied after the profit determination (based on domestic legislation).

- In conclusion, in order to avoid the issues mentioned above, the OECD could alternatively consider **deleting entirely** the paragraph 3.1.

Comments regarding the suggested amendments to paragraph 4 of the OECD Commentary on Article 9:

- We **share the view** that Article 9 OECD Model – as a "mere" profit allocation rule in international tax law – does not and should not deal with questions, whether for example specific procedural rules in domestic tax law like a reversal of the burden of proof or presumptions of any kind are consistent with the arm's length principle. Such rules like the reversal of the burden of proof should rather be analysed regarding their conformity with the OECD Model based upon Article 24 (i.e., do such domestic rules constitute a discrimination or not).

Comments regarding the suggested paragraph 6 of the OECD Commentary on Article 9:

- From our point of view, the foreseen changes in the wording of the paragraph are **very important** to ensure that the concept of corresponding adjustment cannot be integrated as "automatic" adjustment.

Comments regarding the suggested paragraph 6.1 of the OECD Commentary on Article 9:

- From our point of view, the foreseen changes in the wording of the paragraph are, in general, dogmatically sound. However, the interplay between profit allocation and profit determination, as described in our comments above, might generate numerous issues that would need to be further clarified. Additionally, also paragraph 6.1 seems to refer to an order of application between tax treaties and domestic law that might not always occur. Therefore, also in this case, we would suggest **deleting entirely** or **significantly amending** paragraph 6.1.

2.2. Comments on the proposed changes to the Commentary on Article 7

Comments regarding the suggested paragraph 59 of the OECD Commentary on Article 7:

- From our point of view, the foreseen changes in the wording of the paragraph are **extremely important** to ensure proper application of a corresponding adjustment.

- Some **changes in the terminology** could include the following, in order to maintain the consistency between the OECD Transfer Pricing Guidelines and the intent of the changes in wording:

  - The term "initial adjustment" can be replaced by "**primary adjustment**" for consistency with other paragraphs in the Commentaries and the OECD Transfer Pricing Guidelines.

  - The terms "principles of Paragraph 2" and the terms "these principles" could be replaced with "**the arm's length principle**" to avoid ambiguities on what the term "principles" refers to, despite the general impression that the pluralistic reference is made to the text in Paragraph 2 which states, "the arm's length principle and the guidance on its interpretation in the OECD Transfer Pricing Guidelines".

2.3. Comments on the proposed changes to the Commentary on Article 24

Comments regarding the suggested paragraph 75 of the OECD Commentary on Article 24:

- From our point of view, **the foreseen inclusion of "the reversal of the burden of proof" in the wording is to be critically assessed**. Even though it is perfectly understandable that, in certain situations, a reversal of the burden of proof is appropriate in specific cases of transactions with foreign associated enterprises (e.g., when taxpayers do not provide any kind of proof for the arm's length nature of the transactions), the insertion of the phrase "including the reversal of the burden of proof" might encourage some tax authorities to imply a reversal of the burden of proof in international cases. In other words, the insertion of the phrase "including the reversal of the burden of proof" could be understood to almost incentivize tax authorities to apply the reversal of the burden of proof in every cross-border situation.

- However, especially in light of the constantly increasing international collaboration of tax authorities and the different means for the exchange of information, the above mentioned general acceptance of a reversal of the burden of proof might be in conflict with the **principle of equal treatment** (i.e., if one compares a mere domestic case, where there is no reversal of the burden of proof and an international case, where there might be an unfounded reversal of the burden of proof).

- As already addressed above, there might of course also be cases in which a reversal of the burden of proof seems to be acceptable on the merits, thus not being in conflict with the general non-discrimination rationale laid down in Article 24 OECD Model Convention. However, from our point of view, it is already clear in light of the current interpretational guidance, that such cases might not be in conflict with Article 24 OECD Model Convention, meaning that **we do not see any need for the inclusion of the phrase "including the reversal of the burden of proof"** in paragraph 75 of the OECD Commentary on Article 24. Something which is already "clear" should rather not be tried to be "clarified", since otherwise the inclusion of the phrase could even rather result in interpretational difficulties, since one might then argue that the reversal of the burden of proof has only ceased to be a violation of the prohibition of non-discrimination since the inclusion of the phrase "including the reversal of the burden of proof" in the wording of the OECD Commentary.

- We therefore suggest **deleting the intended inclusion** of the phrase "**including the reversal of the burden of proof**" and to **keep paragraph 75** of the OECD Commentary on Article 24 **unchanged**.

2.4. Comments on the proposed changes to the Commentary on Article 25

Comments regarding the suggested paragraph 12.1 of the OECD Commentary on Article 25:

- On the one hand, it seems to be understandable from a holistic perspective that access to MAPs should be provided in case of economic double taxation. Therefore, the **inclusion of paragraph 12.1 might be welcomed**.

- However, in order to avoid any misunderstanding, it would be ideal to replace "not justified by reference to the arm's length standard" with "**not in line with the arm's length principle**".

3. Additional Policy Considerations

The overall outcome of the intended changes may not completely resolve the ambiguities resulting from the interactive application of domestic laws and tax treaties for determining the deductibility of certain expenses (or taxation of certain income). The resulting situation might lead to inconsistencies in the tax and transfer pricing treatment of certain expenses (or income). The proposed changes might not necessarily address economic double taxation consequences that the OECD Model Convention may otherwise seek to eliminate, particularly since there is no basis for the second Contracting State to make corresponding adjustments for certain expenses (or income). In this context, on one hand, the limitations on deductibility of certain expenses such as interests would be restrictively applied to controlled transactions between associated enterprises, while on the other hand no equivalent rules or limitations on deductibility may exist for interest expenses (or income) that occur between independent enterprises in their normal commercial and financial relations. If controlled transactions (or conditions) are admissible in a manner inconsistent with comparable uncontrolled transactions (or conditions), the very objective of Article 9 of the OECD Model Convention stands undermined. In this regard, we suggest that the OECD could consider a **more intensive policy exercise to systematically address the sequence of interplay between, on the one hand, the various Articles of the OECD Model and their Commentaries, and, on the other, the domestic tax rules (including anti-avoidance rules and transfer pricing rules)**. In the absence of targeted clarifications, addressed through the OECD Model and Commentaries, States might take the position to formally agree on the proposed changes laid down within the scope of Article 9, but may simultaneously make suitable modifications to domestic profit determination rules, undermining the object and purpose of Article 9. Such "back door" changes may not entirely reflect the OECD policy intent to preserve fiscal sovereignty in tax design, but may instead only reflect a dilution of the OECD objective to enhance tax harmonisation.

In this context, the policy intent of Pillar Two Blueprint[10] based on the GloBE (Global Anti-Base Erosion) indicates in various parts that the rules on deductibility of certain payments, including interest payments, operates in a stand-alone manner, and does not conflict with the existing tax treaty obligations. For instance, the proposal on the scope of deductible payments for allocations as part of the Undertaxed Payment Rule (UTPR) excludes application of interest limitations. Further, the Subject to Tax Rule (STTR) is not intended to be applied through changes to the Articles of the OECD Model Tax Convention and

[10] Para 494 and Para 571, OECD (2020), Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

explicitly makes references to Article 7 (business profits), Article 11 (interest) and Article 12 (royalties) as exclusions. This potentially increases the conflicts regarding the role of existing Articles in the tax treaties to govern a jurisdiction's sovereign right to determine the tax base by permitting or prohibiting certain deductions such as interest payments. Therefore, the broader interplay between the expected consensus on Pillar Two, and the proposed changes to Article 9 may have to be viewed in conjunction, in order to avoid ambiguities that may arise from different dimensions.

We remain available for any further clarification.

Yours faithfully,

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