Ernst & Young, LLP
1101 New York Avenue, NW
Washington, DC 20005-4213

Tel: +202-327-6000
ey.com

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Organisation for Economic Co-operation and Development
Centre for Tax Policy and Administration
Tax Treaties, Transfer Pricing and Financial Transactions Division

Sent via email: taxtreaties@oecd.org

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

Ladies and Gentlemen:

We appreciate the opportunity to submit these comments on behalf of EY on the OECD's public consultation document, *Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles* (the Consultation Document), and to engage with the OECD on this important topic.

We would also welcome the opportunity for further engagement through the consultation process as the Consultation Document provides very limited background regarding the proposed changes to the Commentaries in the OECD Model Tax Convention 2017 (the Commentaries) and the underlying policy concerns that the changes seek to address. Without more context, it is difficult to understand the intentions behind the proposed changes or fully evaluate the effects such changes could have.

In this submission, we first provide some overall comments on our policy concerns about the potential impact of the proposed changes as drafted. We then discuss high-level technical considerations with a view to clarifying the proposals contained in the Consultation Document and provide specific suggestions with respect to the proposed changes to the Commentaries.

Overall comments

The introduction to the Consultation Document describes the proposed changes to the Commentaries as closely linked to the 2020 OECD report on Transfer Pricing Guidance on Financial Transactions. However, the proposals as drafted seem to have potential implications that go well beyond the subject matter of that report.

We are concerned that the proposed language can be read as stating that the conditions for the deductibility of expenses are a matter to be determined by domestic law and that if domestic law rules would result in a lower amount of expenses being deductible than the arm's length amount, this would not be considered to cause economic double taxation of the type that the provisions of the OECD Model Tax Convention (the Model) seek to eliminate. Under this reading, in a case of denial of a deduction by a Contracting State, there would be no obligation on the other State to make corresponding adjustments

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under Article 9 of the Model and the taxpayer would have no access to the Mutual Agreement Procedure (MAP). Accordingly, the proposed changes would mean that domestic law limitations on deductibility of expenses, even if such limitations were applicable exclusively to controlled transactions that are commercial in nature and priced at arm's length (and not to similar uncontrolled transactions), would not be considered to lead to economic double taxation that would be subject to relief under Article 9 of the Model.

As we will discuss in more detail below, this reading of the proposed changes to the Commentaries raises serious concerns. Firstly and most importantly, the proposed changes would undermine the arm's-length principle because measures that limit the deductibility of payments between associated enterprises could effectively undercut the profit allocation framework that is embodied in the Model and the OECD Transfer Pricing Guidelines (the Guidelines). In addition, it is not clear what the rationale would be for drawing a distinction between the inclusion of revenues and the deduction of costs in transactions between associated enterprises. In both cases, domestic law deviations from the arm's length principle would result in taxable profits that differ from the taxable profits of third parties in similar circumstances, with both deviations causing similar forms of economic double taxation.

Finally, it is important to reiterate that the Commentaries can only clarify the intent of the provisions of the Model but cannot alter the Model. Any deviation from the arm's length principle, including through deduction denials, such as seems to be the aim of the proposals in the Consultation Document could be accomplished only through changes to Article 9 itself or the incorporation of additional provisions in Model that modify the effect of Article 9 in specified circumstances.

Technical considerations

Context

The principles laid out in Article 9 of the Model and in the Guidelines form a cornerstone of the international tax framework. On this basis, profits are allocated between associated enterprises in a cross-border context, and taxing rights are allocated between Contracting States, as the main means of addressing competing jurisdictional tax claims on corporate profits. As a result, taxing rights are allocated in a way that prevents economic double taxation and that is supported by the MAP mechanism the OECD has worked to strengthen significantly over the last several years.

By aligning the cross-border tax treatment of profits generated by associated enterprises with profits generated by third parties, the arm's length principle only functions appropriately in resolving economic double taxation if it requires that payments between associated enterprises are not to be treated less favorably than payments between third parties (effectively requiring non-discriminatory treatment for associated and non-associated transactions).

Analysis of underlying issues

Several of the proposed changes in the Consultation Document seem to explain where the boundaries lie for Article 9 and other relevant articles of the Model. We agree it is helpful to reflect in the Commentaries the OECD's common understanding of the scope of the obligations attached to the application the arm's length principle. In this context, it is important to be specific in identifying which types of domestic law provisions and practices resulting in taxable profits that differ from the arm's

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length amount are in scope of Article 9 and which are not. In our view, the relevant consideration is whether the same level of taxable profits result for similar transactions between associated and non-associated enterprises. If so, the arm's length principle is not implicated even if the deduction of certain types of costs is disallowed under domestic law. However, if domestic legislation leads to differences in taxable profits when comparing associated transactions with similar non-associated transactions, the domestic law provision is at odds with the arm's length principle and a corresponding adjustment should then be made, and countries should thus provide access to MAP in such cases.

The arm's length principle provides the tools to delineate the conditions of a transaction between associated enterprises. For example, in the context of financial transactions, it provides tools for delineating whether the provision of funding is long or short term and whether it is high or low risk, who assumes that risk, and whether the conditions warrant a fixed or variable return. The Guidelines then provide guidance on the pricing of that transaction.

Separate from analyzing the appropriate delineation and pricing of the transaction, domestic law determines how the income is treated for tax purposes. For example, in the case of capital funding, domestic law determines its characterization as debt or equity and different tax treatment of the income may result based on this characterization. Because countries are sovereign in the determination of the characterization criteria for tax treatment, characterization differences may occur which lead to mismatches in the tax treatment of the income. Such mismatches are independent of whether the transaction is between associated or non-associated enterprises. Therefore, such a disallowance of deduction based on characterization is not within the scope of Article 9.

The profit allocation rules based on the arm's length principle and agreed between Contracting States only require these States to agree on the delineation and pricing of the transaction, but not on the domestic law consequences of the delineation of the transaction. Consequently, the arm's length principle does not create the obligation for one Contracting State to follow the income characterization of the other Contracting State and make a corresponding adjustment. There are other tools to address characterization mismatches, such for example the OECD's recommendation on BEPS Action 2 on hybrids. The below example may be helpful in illustrating the point on Article 9 of the Model and characterization mismatches:

Example

- Group AB decides to invest in a new R&D project. Two associated enterprises, Companies A (resident of Country X) and B (resident of Country Y) conclude a contract R&D contract, under which Company A will be paying Company B for the R&D activities performed. The contract indicates that Company A will become the owner of any intellectual property resulting from the R&D activities.
- The actual transactions relating to the R&D activities are delineated and analyzed in accordance with the Guidelines. Following the application of the control over risk guidance of the Guidelines, the R&D risk is re-allocated from Company A (which had contractually assumed the risk) to Company B. It is concluded that Company A only conducts funding activity and takes on funding risk.

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- This means that Company A is entitled to a risk-adjusted (or potentially a risk-free) financial return.
- The fact that Company A is entitled to such a financial return in some countries may lead to domestic interest deduction limitation rules in country Y that are based on the BEPS Action 4 recommendations being applicable.
- This illustrates how domestic legislation can determine the availability of deductions of certain types of payments without implicating Article 9.
- In this example, where BEPS Action 4 based rules may result in (partial) economic double taxation, this would not be double taxation of a type that tax treaties seek to eliminate.

A key question regarding the application of the provisions of Article 9 and other relevant articles of the Model to payments between associated enterprises is to what extent a State is free to limit the deductibility of certain payments, which would result in higher taxable profits. For example, can domestic law treatment go as far as allowing greater deductions for payments between third parties as compared to similar payments between associated enterprises? Similarly, do the relevant provisions of the Model allow States to include more in taxable income in relation to associated party transactions as compared to similar third-party transactions? The example below may be helpful in illustrating the issue of transfer pricing adjustments disguised as domestic deduction limitation rules:

Example

- Countries A and B each incorporate Article 9 of the Model into their treaties.
- Assume that the arm's length intercompany price for transaction X is exactly $100.
- Country A has a domestic law stating that, for inbound transactions X, the price between associated enterprises to be included as revenue is $150.
- Country B has a domestic law stating that, for outbound transactions X, there is a 50% denial of deductions for payments of the $100 price solely when the transaction occurs between associated enterprises. The payments are fully deductible when the transaction occurs between independent enterprises.
- Analysis:
    - Under the Model, Country A's inbound transaction policy would clearly constitute a violation of the arm's length principle under Article 9 – it results in an outcome between associated enterprises ($150) that differs from the outcome between independent enterprises ($100), inappropriately providing Country A with additional taxing rights of $50.

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- Country B's outbound policy achieves the same economic result as Country A's inbound policy, resulting in additional taxing rights of $50 for Country B.

- Effect: the inbound and outbound policies are both discriminatory as between associated enterprises and independent enterprises.
- Potential remedy:
  - Article 9 is concerned with "conditions made or imposed between the two enterprises in their commercial or financial relations that differ from those which would be made between independent enterprises." Accordingly, Article 9 inherently includes a non-discrimination element and is relevant to Country B's outbound policy.
- Conclusions:
  - The 'conditions made between independent enterprises' encompass the full deductibility of the outbound payment. This differs from the 'conditions between two associated enterprises' where full deductibility is not allowed for the exact same payment under Country B's policy.
  - Country B's policy constitutes economic double taxation, which tax treaties seek to eliminate.

It is important to reiterate the object and purpose of Article 9 and the other relevant provisions of the Model, which is to allocate profits between associated enterprises in a cross-border situation on the basis of the arm's length principle, resulting in equal levels of profit for similar associated and non-associated transactions.

Specific suggestions

When contemplating changes to the Commentaries, it is important to be precise in describing the type of income characterization mismatches that Article 9 and the other relevant provisions of the Model do not remedy, while also being explicit about the Contracting States' obligations to implement the arm's length principle. Care should be taken to ensure that any change cannot be read as opening the door to transfer pricing adjustments that are disguised as domestic law rules. We encourage the OECD to review the proposed changes to the Commentaries included in the Consultation Document in light of the concerns expressed above.

Similarly, it would be valuable to clarify that whenever there are overlapping domestic law tax claims that affect the level of taxable profits from a transaction between associated enterprises in a way that deviates from similar transactions between non-associated enterprises, including by delineating the transaction undertaken, countries should apply transfer pricing rules in their claims, which would be subject to the provisions of Article 9 and related Articles. In this regard, domestic law rules that implicitly or explicitly result in higher taxable profits for transactions between associated enterprises, compared to similar transactions between third parties, are also subject to Article 9 and related Articles. Examples are provisions that condition the deductibility of payments between associated enterprises by reference to

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quantum, benefit or purpose. It would furthermore be important to clarify that all cases that relate to *de jure* or *de facto* transfer pricing adjustments should be eligible for MAP.

In addition, we encourage the OECD to include in the Commentaries on Article 9 a more general statement that the object and purpose of Article 9 and other relevant provisions of the Model require equal treatment of related party transactions and third party transactions in order to discourage the introduction of domestic law measures that would discriminate between these two types of transactions.

Finally, we have significant concerns about the proposed change to paragraph 75 in the Commentary to Article 24, Paragraph 4, which seems to expand the scope of cases in which applying reversal of the burden of proof rules would be considered not to be discriminatory. The language previously contained in paragraph 4 of the Commentary to Article 9 stated that "almost all member states" considered measures, such as more stringent information requirements or even reversal of the burden of proof, to not constitute discrimination under Article 24. This seems to have been a reference to paragraph 80 in the Commentary to Article 24, Paragraph 5, which states the same in the context of transfer pricing inquiries specifically. Article 9 deals exclusively with the relationship between associated enterprises and paragraph 80 refers to the non-discriminatory nature of the burden of proof rules in the context of transfer pricing only. Making the proposed amendment to paragraph 75 would change the position previously taken in at least two ways: 1) it would expand the scope of the language beyond transfer pricing matters to encompass all cross-border matters; and 2) it would suggest that all member states are in agreement with this language. In our view, such a change should not be made without careful consideration of the policy issues and potential legal implications. We are concerned that the proposed change is too broad in its consequences, with the potential to undermine the purpose of Article 24, Paragraph 4.

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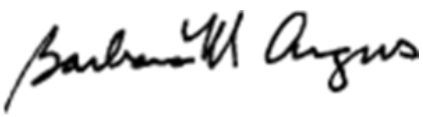
The global EY team that prepared this submission welcomes the opportunity to discuss these comments in greater detail and to continue to participate in the dialogue as the OECD and member countries advance the work on this important project.

If there are questions regarding this submission or if further information would be useful, please contact Marlies de Ruiter (marlies.de.ruiter@nl.ey.com), Maikel Evers (maikel.evers@nl.ey.com), Mike McDonald (Michael.McDonald4@ey.com), Michael Jenkins (michael.jenkins@au.ey.com), or me (barbara.angus@ey.com).

Yours sincerely, on behalf of EY,



Barbara M. Angus
EY Global Tax Policy Leader