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BMR Legal Comments on OECD Public Consultation on Proposed Changes to Commentaries in the OECD Model Tax Convention on Article 9 and on Related Articles

BMR Legal has been in approbation of a global tax policy focused on a simpler, more equitable and more transparent tax principles that will eventually foster cross-border trade and investment. BMR Legal values the opportunity to provide following inputs on the OECD public consultation document on proposed changes as carried out by Working Party 1 on commentaries on Article 9 and on related Articles.

In the following paragraphs, we have set out some suggestions which the Working Party may consider while updating the Commentary to Article 9.

1) Proposed update to Paragraph 2

The proposed paragraph 2 provides, *'In order to ensure the elimination of double taxation, the arm's length principle and the guidance on its interpretation in the OECD Transfer Pricing Guidelines* ***should*** *be followed in any re-writing of accounts.'*

Following a moderately liberal approach, especially for non-OECD member nations, we suggest amending the above statement by replacing the words 'arm's length principle and the guidance on its interpretation in the OECD Transfer Pricing Guidelines' with 'arm's length principle as per the domestic regulations or guidance on its interpretation in the OECD Transfer Pricing Guidelines.' The objective being that it should encompass scope under the domestic law.

We also wish to draw your attention to Para 17 of the Preface to the 2017 OECD Transfer pricing Guidelines which state that the Guidelines are also intended primarily to govern the resolution of MAP between (only) OECD member countries. Accordingly, cognizance of domestic legislation could be appropriate for non-OECD member countries.

Not recognizing domestic legislation may lead to increased controversy and uncertainty as taxpayers may seek to challenge transfer pricing adjustments under domestic law of non-OECD member countries, as being not in accordance with Article 9 treaty provisions, having recourse to the commentary.

Further, domestic practices and court procedures may prefer application of domestic law over international public law/ soft law.

2) Proposed Update – Para 3

Several countries such as India have heavily regulated financial markets with exchange controls particularly for offshore debt financing. Accordingly, characterisation of an amount into debt or equity cannot be considered independent of such regulations. It may thus be helpful if it is clarified that reference to domestic laws are not restricted to domestic tax laws. Accordingly, the OECD could consider adding the words "and the country's regulatory framework".

For ease of reference, the revised language could read as under, "The State making a determination as to the extent to which the purported loan is regarded as a loan will do so taking into account factors discussed in its domestic laws (including judicial doctrine) ***and its regulatory framework****, or in the OECD Transfer Pricing Guidelines*

3) Proposed update - Para 3.1 read with Para 6.1.

The update suggests that once a transaction between associated enterprises is determined to be at arm's length under Article 9, any limitation on deduction of expenses under domestic laws would not be considered to be economic double-taxation. There would be no obligation on a corresponding state to give credit under such situations.

While we recognize the practicality and simplicity of this approach, it also appears that an update of this nature seeks to undermine the role of double tax conventions in reducing the impact of double taxation.

As an example, Indian transfer pricing laws provide that there will be no corresponding adjustment to the income of the associated enterprise for arm's length price determined. Eg, if company A pays royalty @ 10% to group company B, and the arm's length price of such royalty is determined @7%, the royalty income of Group company B cannot be correspondingly reduced[1]. Additionally, the law also separately provides that if Company B (from this example), is undertaking an independent arm's length benchmarking analysis of its royalty income, and the arm's length rate is 7%, Company B cannot independently either reduce its taxable income in India from 10% to 7%, by virtue of restrictions under domestic laws, which restricts downward adjustment[2].

It appears that ordinarily Company B would have been entitled to seek MAP relief on the royalty that was not deductible in India, however, given this could be viewed as a specific domestic law limitation (*albeit* not directly an expense deduction limitation), it may be helpful if OECD clarifies and restricts the scope of domestic limitation of expenses.

Additionally, a fundamental principle of transfer pricing is that revised terms of a transaction even if they lead to lower profits, can still be arm's length, as long as it can be demonstrated that the revised terms meet the arm's length standard. However, domestic tax laws may seek to invoke domestic GAAR (General Anti Abuse Rules) on the ground that the same results in a tax benefit. Given that the revised commentary suggests MAP may not be a viable recourse in such situations, and the taxpayer will only have domestic law remedies, domestic regulations and audit practices may seek to aggressively pursue limiting deductions under GAAR.

Thus, given the wide ranging impact of the interpretation, it is recommended that the commentary provide specific deletes reference to other forms of tax deductions. Further, countries such as India do not have a domestic CFC legislation restricting interest deduction and hence implementation of Action Plan 4 by way of interest cap[3] is seen as a limiting factor, particularly given the large appetite for debt funding to lend thrust to mega-infrastructure projects.

We once again thank you for the opportunity to provide comments, and remain available for any clarification you may need from our end.

Seema Kejriwal Jariwala
BMR Legal Advocates .

BMR LEGAL ADVOCATES
13A–B Hansalaya Building
15 Barakhamba Road
New Delhi 110 001
India
Tel: +91 11 6678 3010
Seema.Kejriwal@bmrlegal.in

[1] Third proviso to Section 92C of the Income-tax Act, 1961
[2] Section 92(3) of the Income-tax Act, 1961
[3] section 94B of the Income-tax Act, 1961