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

PwC International Ltd on behalf of its network of member firms (PwC) welcomes the opportunity to share its views in reaction to the consultation document on *Proposed changes to Commentaries in the OECD Model Tax Convention on Article 9 and on related articles*.

The clarification on corresponding adjustments for transfer pricing profit adjustments under Article 9 is helpful. This is also true in relation to adjustments for PE profit allocation changes. However, we feel that it would be useful to deal with some of the interpretational issues arising out of the 11 February 2020 report on Transfer Pricing Guidance on Financial Transactions.

As a broad and more general comment, one of the areas where we considered there may have been the opportunity to introduce more certainty (in particular in light of Chapter X of the OECD Guidelines) was around the interaction of risk-free/risk-adjusted returns and treaties. Where a loan has been accurately delineated such that the contractual lender (Territory A) is entitled to only a risk-free return and the residual element is due to the territory where treasury substance lies (Territory B), it is not clear what characterisation such payments/reallocations should take. In particular, is the intended mechanism to ensure that Territory B receives its risk adjusted return, a payment from Territory A to Territory B (and if so, what is the character of such payment; interest or a service payment)? Or in the alternative, is it instead a hypothesised payment from the borrower to Territory B directly? These questions (and the answers to these questions) are important from a withholding tax perspective, but also a beneficial ownership perspective and absent further guidance in these areas, we anticipate further bilateral disputes/contention.

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Some of the comments below relate strictly to the proposed changes in wording but we also hope it is constructive to point out views on the overall implications of the resulting text and associated Commentary.

Article 9

- The intended restatement of the Commentary seems to give a broader scope for matters to be taken into account in determining whether an amount of interest is at arm's length. For example, it specifically refers to all terms and conditions as well as transactions other than payments and whether a loan would have been made (not just on the grounds of thin cap). However, it seems to give more weight than previously to domestic legislation, of which thin cap and other factors determining whether a transaction is viewed as a loan, deductions and deductibility of interest (including restrictions recommended by BEPS Action 4) are merely illustrations. As a result there may be an increased danger of a mismatch of domestic rules in the jurisdictions that are parties to a bilateral treaty and if an overall AL result is not agreed there may still be double taxation if it cannot be resolved by MAP, an area which has proved difficult in our experience.
- There are helpful comments that domestic rules should not increase taxable profits above an ALP amount. The additional clarity that a jurisdiction will not be expected to provide a corresponding reduction to the extent that, in its opinion, profit in the counterparty jurisdiction is increased above ALP, may be intended to indicate that MAP should be the appropriate course for seeking a remedy. That would still depend on access to MAP and the statement that a transfer pricing dispute is eligible for MAP (see Art 25) may not be sufficient if the first jurisdiction doesn't accept that ALP is the issue.
- This Commentary reiterates that allocation of costs should take place before domestic rules are then applied to those costs. That does seem to leave the possibility that some costs which might be regarded as appropriate by many jurisdictions will be deductible in no territory.
- In relation to the recharacterisation of transactions, the Commentary would now state

  > "The provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises and, therefore, the provisions would not apply to the re-writing of the accounts of associated enterprises if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis).".

  It is not clear what the choice and ordering of the words sets out to achieve. The first sub-clause may be a restatement of the provisions although it talks here about 'special conditions' rather than 'special relations'. The second sub-clause, rather than referring to the aforementioned two enterprises, relates to 'associated enterprises' presumably not meaning enterprises associated with the earlier two enterprises; it also refers to transactions … on normal open market commercial terms' as being on an arm's length basis, but an abnormal term would not necessarily mean a transaction is not at arm's length.

Article 7

- The statement that a corresponding adjustment would have to be made only to the extent that a change in PE profits reflects ALP, is similar to that in relation to Art 9 above and we would make an equivalent point.
- The adjustment in the text only seems to apply to the newest version of Art 7 without guidance in relation to the former version(s) and in particular the application of AOA.

Article 24

- The move to Art 24 from Art 9 of the statement that it is not discriminatory to have additional information requirements for payments to non-residents including the reversal of the burden of proof seems logical.

Article 25

- The amplification that, in line with Action 14, a transfer pricing dispute would potentially involve taxation not in accordance with the objectives and purpose of a treaty so that it is eligible for MAP is helpful insofar as it goes but there should be maximum access to MAP (see also above). It is hoped that it may helpfully draw attention to the good faith application of the treaty by both parties.

Other matters

- There is a concern that the wording could be construed as another step in the direction of abolishing or diminishing the value of the ALP. Notwithstanding the discussions in relation to Pillar One which, if agreed on, will inevitably be scope-restricted, ALP will continue to apply to other groups and may play a significant role in relation to Amount B.
- Chapter X of the OECD Guidelines underscores that, besides interest rates, all terms and conditions of the financing transactions, including the volume of debt, should be tested against the arm's-length principle. Consequently, there should be flexibility regarding capital structure [or "balance of debt and equity," as per the wording of Chapter X], in line with what we see in the open market at arm's length, in order not to distort business decisions. Even independent enterprises which are generally similar to one another may make vastly different determinations regarding the appropriate level of debt vs. equity funding, and the Guidelines and the Article 9 Commentary should not be prescriptive.

We would be happy to discuss any element of this response with the OECD. Please do not hesitate to contact me or one of the people whose details are set out below.

Yours sincerely,

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