

OECD Update

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OECD Tax Agenda Overview

- Major Recent Releases
- Status of PE Profit Attribution Work
- Major Issues on Treaty Agenda
- Major Issues on Transfer Pricing Agenda
- Enlargement/Enhanced Engagement

Major Recent Releases



- 2008 Update to the Model Tax Convention
- Final Four-Part Report on the Attribution of Profits to Permanent Establishments
- Discussion Draft on Transactional Profit Methods
- Discussion Draft on a New Article 7
- Discussion Draft on Transfer Pricing Aspects of Business Restructurings

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2008 Update to Model Tax Convention

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The 2008 Update: Overview



- Updates the July 2005 Model
- Many years' work on several projects
- Consultation, joint working and discussion drafts
- Most of the changes are to the Commentary, including several alternative provisions

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Highlights of 2008 Model Update



- Arbitration (Article 25(5))
- Non-discrimination (Article 24)
- Attribution of profits to PEs (Article 7)
- REITs (Article 10)
- Alternative PE threshold for services (Article 5)
- Definition of royalties (Article 12)
- Tie-breaker rule (Article 4(3))
- Non-member country positions

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Arbitration (Article 25)



- *Improving the Resolution of Tax Treaty Disputes* (February 2007)
- No CA agreement after two years - mandatory arbitration:
 - Binding on both countries
 - A supplement to the CA process
 - Mode of arbitration not specified
 - Change to the Model itself (Paragraph 5)

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Non-discrimination (Article 24)



- *Application and Interpretation of Article 24* (May 2007)
- Changes to the Commentary to clarify the intended scope of the Article

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REITS (Article 10)



- *Tax Treaty Issues Related to REITs (Oct 2007)*
- Joint working group with the REIT industry
- Optional provision in the Commentary regarding cross-border distributions from a REIT:
 - Small investors treated as portfolio investors (15%)
 - Large investors subject to full source state tax

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Alternative PE threshold for services



- OECD Model has no special PE threshold for services
- UN Model triggers PE if enterprise furnishes services through employees or other personnel if activities continue for same or connected project within host State for period(s) of >6 months in any 12-month period
- WP1 developed a similar (but modified) version of such a provision for inclusion in 2008 OECD Commentary as alternative to OECD Model

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Alternative PE threshold for services



- New paragraphs added to Commentary on Article 5
 - Services similar to other business
 - Existing PE threshold appropriate – NO CHANGE to Model itself
 - But some OECD States prefer policy of source taxation of services even in absence of fixed place of business or dependent agent PE

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Alternative PE threshold for services



- Compromise – services PE alternative provision added to 2008 Commentary on Article 5
- But *all* OECD States agree:
 - No source State taxation of services performed by non-resident outside source State
 - Taxation of services income should be only on a net basis
 - Services should be taxed only once a threshold is passed

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Minor Changes (All Commentary)



- Residence definition (Article 4) is clarified to exclude persons who are not subject to comprehensive liability because they are treaty residents of a third country
- Place of effective management “is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a *whole* are in substance made”
 - Based on all relevant facts and circumstances
 - Entity can only have one place of “effective management”
- Alternative “competent authority” tie-breaker

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Minor Changes (cont.)



- Meaning of royalties (Article 12)
- Taking days of residence into account in the 183-day rule (Article 15)
- Allowing net taxation of sportsmen and artistes (Article 17)
- Emphasis that “Other Income” Article (Article 21) applies to third country income
- Taxpayer-friendly approach to MAP (Article 25)

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Reservations, etc.



- Changes to observations and reservations on 18 Articles
- Addition of positions of Armenia, Chile, Democratic Republic of the Congo, Kazakhstan and India – now a total of 30 non-OECD countries have set out their positions

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Status of PE Profit Attribution Project

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Status of PE Profit Attribution Work



- Council Recommendation on final Report
- Partial implementation through revised Article 7 Commentary in 2008 Update to Model
 - Relevant to existing treaties
- Full implementation contemplated through new Article 7
 - Discussion Draft with text of *new* Article 7 and accompany Commentary released in July 2008 – comments welcome!
 - Relevant to future treaties
 - Aim is to include in next (2010?) Update to OECD Model
 - Issues under discussion include consequential changes on other provisions of Model, treatment of notional payments, double tax relief, impact of Part IV (Insurance) conclusions

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Major Issues on Treaty Agenda

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Major Issues on Treaty Agenda



- Conference on 50th Anniversary of the Model, held September 8-9, 2008
- New Article 7
- Non-discrimination – Phase 2
- Collective investment vehicles
- Permanent establishment definition clarification
- Beneficial owner concept
- Short-term assignments
- Reservations/observations policy

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New Article 7



- Discussion Draft released July 2008
- Comments welcome until December 31, 2008
- Explicitly references “functions performed, assets used and risks assumed” as well as “dealings”
- Eliminates former paragraphs 3 (expense allocation), 4 (apportionment), 5 (no profits from purchasing function) and 6 (year to year consistency)
- Includes “symmetry” provision to avoid double tax due to conflicting capital attribution rules
- Commentary has optional alternative or additional double tax relief paragraphs

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Nondiscrimination



- Status of Phase 2 of project:
 - Launched by an invitational seminar in Leiden in April 2008
 - Also was a major topic at IFA Congress in Brussels in September 2008
 - Examples of policy issues to be reviewed in Phase 2:
 - Should cross-border reorganizations be protected?
 - Should trade/investment agreement concepts be adopted (e.g., prohibiting discrimination against foreign production or foreign investment)?
 - Should ECJ jurisprudence be used in interpretation?

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Collective investment vehicles



- 2006 Roundtable covered:
 - Questions of treaty entitlement of funds themselves
 - Questions of availability of treaty benefits to investors
 - Compliance and administrative difficulties posed by large and fluctuating numbers of investors, involvement of intermediaries
 - Specific issues relating to increasingly common REIT vehicles through which collective investment in immovable property is structured
- Resulted in projects on CIVs and REITs

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Collective investment vehicles



- CIV Project involves:
 - Informal Consultative Group (industry specialists, as well as OECD and non-OECD government representatives dealing with tax policy and tax administration)
 - Mandate to make concrete and detailed proposals to CFA by late 2008 for improving the application of tax treaties to income from collective investment
 - Informal coordination ongoing with EU FISCO group
 - Future work to depend on renewal of funding

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New Treaty Work for 2009-2010



- Article 5 PE threshold issues – likely to address a series of interpretative issues, including the meaning of:
 - Contracting “in the name of”
 - “Preparatory or auxiliary” exceptions
 - Fixed place of business, meaning of “at the disposal of”
- Meaning of the “beneficial owner” concept
 - Likely to include examination of recent jurisprudence from various countries

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Major Issues on Transfer Pricing Agenda

Major Issues on Transfer Pricing Agenda

- Business restructurings
- Comparability
- Profit methods

Tax Issues in Business Restructurings



- What is seen in practice:
 - Cross-border redeployment by MNEs of functions, assets and risks; cross-border reallocation of profits
 - Conversion of “full-fledged distributors” into limited risk distributors or “commissionnaires”
 - Conversion of “full-fledged manufacturers” into “contract manufacturers” or “toll manufacturers”
 - Rationalization and/or specialization of operations
 - Migration of intangible assets and of risks, together with associated profit potential, often to low-tax jurisdictions

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Tax Issues in Business Restructurings



- Business restructurings often result in the reallocation of profits from the entity or entities that are restructured to the principal because of the redeployment of functions, assets and risks
- Significance of the issue:
 - Tax base erosion concern for certain countries
 - Uncoordinated reactions by governments
 - Huge stakes and uncertainties for business and for governments

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Tax Issues in Business Restructurings



- Mandate given by the CFA -- a call for balance:
 - To tackle those restructurings which lack substance or are “abusive”
 - AND
 - To provide clearer guidance for restructurings that have sound commercial reasons, to provide more certainty

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Status of Project



- Project began in 2005, to look at treaty and transfer pricing aspects of business restructurings -- Articles 5 (PE), 7 (Business Profits) and 9 (Associated Enterprises)
- Discussion draft on Article 9 transfer pricing issues published on September 19, 2008 (“BR TP Report”)
- Article 5 issues to be dealt with by WP1 as part of general review of PE issues in 2009-2010
- Article 7 issues already largely addressed by PE Profit Attribution Report

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BR TP Report



- The analysis is based on existing transfer pricing rules
- The discussion starts from the premise that the arm's length principle and the OECD *Transfer Pricing Guidelines* ("TP Guidelines") do not and should not apply differently to post-restructuring transactions than to transactions that were structured as such from the beginning
- The discussion is composed of four Issues Notes

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The Four Issues Notes



- Special considerations for risks
- Arm's length compensation for the restructuring itself
- The application of the arm's length principle and the TP Guidelines to post-restructuring arrangements
- The exceptional circumstances when a tax administration may consider not recognizing a transaction or structure adopted by a taxpayer

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Special Considerations for Risks



- Analysis starts with contractual terms
- Must also take into account:
 - Whether parties' conduct conforms to contract
 - Whether contractual allocation of risk is arm's length – based on comparables or an analysis of who has control over the risk
 - Whether the risk is economically significant
 - What the transfer pricing consequences of the risk allocation are

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Arm's Length Compensation for the Restructuring Itself



- Analysis of whether compensation required must rest on a full understanding of the restructuring
- No compensation required for transfer of profit/loss potential *per se* – only for transfer of rights or assets carrying profit/loss potential
- Whether transfer of profit/loss potential is arm's length depends on options realistically available to the parties

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Arm's Length Compensation for the Restructuring Itself (cont)



- Common BR issues in valuing transfers of tangible and intangible assets, ongoing concerns
- Often a need to consider whether restructured entity is entitled to indemnification for termination or substantial renegotiation of prior arrangement
 - No presumption that indemnification required
 - Depends on analysis of rights and obligations, what independent parties would have agreed

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Remuneration of Post-Restructuring Transactions



- Arm's length principle doesn't apply differently to post-restructuring transactions versus those structured as such from beginning
- But factual differences may affect comparability analysis
- Selection and application of TP method must derive from comparability analysis taking into account functions, assets and risks of both parties

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Remuneration of Post-Restructuring Transactions (cont)



- There may be inter-relationship between compensation for restructuring itself and for post-restructuring transactions
- Before-and-after profit comparisons not enough to support a TP adjustment, but may inform comparability analysis
- How any locations savings should be allocated depends on what independent parties would have agreed, how competitive the relocated activity is

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Recognition of Actual Transactions Undertaken



- TP Guidelines don't address country's ability to characterize transactions under its domestic non-TP rules
- TP analysis starts with transactions actually undertaken – contracts play a major role
- Not all TP adjustments amount to non-recognition of taxpayer's transactions
- Non-recognition is an exception to the general principle of basing the TP analysis on the transactions actually undertaken

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Recognition of Actual Transactions Undertaken (cont)



- Non-arm's length arrangements should be dealt with as much as possible on the basis of pricing adjustments, rather than non-recognition
- Mere fact that a related party arrangement is not found between independent parties does not make it non-arm's length
- Assessment of commercial rationality requires assessment of realistically available options
- Existence of group-level rationale does not eliminate need for arm's length treatment of each member

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Business Restructuring - Next Steps



- Comments welcome before 19 February 2009!
- Public consultation likely to be held June 2009
- PE definitional issues to be addressed by Working Party 1 during 2009-2010

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Comparability



- WP6 project related to monitoring of 1995 Transfer Pricing Guidelines
- Closely linked with WP6 review of profit methods — this is the beginning of the revision of the Guidelines
- Discussion draft released in May 2006
- Public consultation to be held November 2008
- Ultimate goal to update Chapter I of Transfer Pricing Guidelines

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Comparability



- Issues being considered:
 - Timing issues in comparability
 - Internal comparables
 - Determination of available sources of information and of their reliability
 - Uncontrolled transactions
 - Examining the five comparability factors

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Comparability



- Issues being considered (cont'd):
 - Comparability adjustments
 - Multiple year data
 - Aggregation of transactions
 - Definition of the arm's length range, extreme results, methods to enhance reliability, loss-making comparables
 - Documenting a search for comparables

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Profit Methods



- Profit methods (TNMM and Profit Split methods) currently have a last resort status in the OECD Guidelines, but are more widely used than would be expected from their last resort method status
- Goal of project is to:
 - Re-discuss the status of the methods
 - Develop further guidance on how to apply these methods in practice

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Profit Methods



- Issues being considered:
 - Status of transactional profit methods as last resort methods
 - Use of a transactional profit method either in conjunction with a traditional transaction method or as a sanity check to test the plausibility of the outcome of a traditional transaction method
 - Application of transactional profit methods and intangibles

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Profit Methods



- Issues being considered (cont'd):
 - Application of transactional profit methods and consideration of risks
 - Access to information needed to apply or review the application of a transactional profit method:
 - Management accounts?
 - Cost accounting?
 - Foreign party?

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Profit Methods



- Issues being considered (cont'd):
 - Application of a profit split method:
 - Determination of the profit to be split
 - Reliability of a residual analysis and of a contribution analysis
 - How to split the profit
 - Application of the TNMM method:
 - Standard of comparability
 - Determination of the net margin
 - Other Methods

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Profit Methods



- Status and next steps:
 - Discussion draft released January 2008
 - Public consultation to be held November 2008
 - Ultimate goal is to update Chapter III of Transfer Pricing Guidelines

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Enlargement and Enhanced Engagement

Enlargement/Enhanced Engagement

- Council decision in 2007 to enlarge membership, deepen dialogue with other non-member jurisdictions
- Membership dialogue underway with *Chile, Estonia, Israel, Russia and Slovenia*
- More intense engagement underway with *Brazil, China, India, Indonesia and South Africa*
- Also closer relations with ASEAN countries
- Goal by 2020: for OECD to have 40+ members, to represent 80% of world GDP

Following and Engaging in Our Work

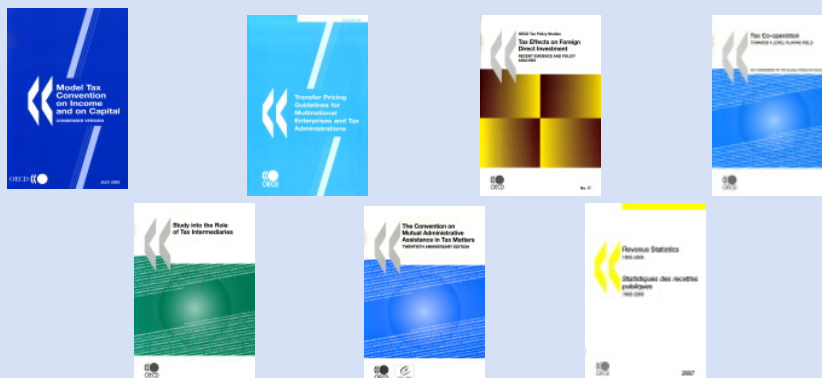


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