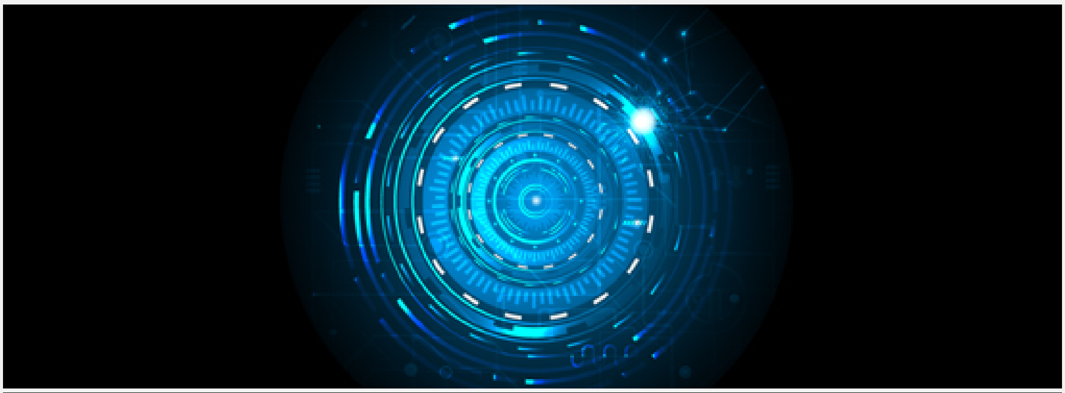

OECD updates Model Tax Convention

Global Transfer Pricing Alert 2018-001

The Organisation for Economic Co-operation and Development (OECD) on December 18 released a revised version of its model income tax convention (the 2017 OECD Model). The 2017 OECD Model provides the basis for negotiation and application of bilateral tax treaties between countries to prevent tax evasion and avoidance. Though not binding on any country, the 2017 OECD Model provides a means for settling common problems that arise in the field of international double taxation when bilateral tax treaties are negotiated.

The 2017 OECD Model primarily reflects a consolidation of the treaty-related measures resulting from the work on the base erosion and profit shifting (BEPS) project under action 2 (Neutralizing the Effects of Hybrid Mismatch Arrangements), action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status), and action 14 (Making Dispute Resolution More Effective).

Of particular note to transfer pricing practitioners are changes to the commentaries to Article 7 (Business Profits), the commentaries to Article 9 (Associated Enterprises), and both the text and commentaries to Article 25 (Mutual Agreement Procedure). A discussion of those changes is provided below.

Summary of changes to Articles 7 (Business Profits), 9 (Associated Enterprises), and 25 (Mutual Agreement Procedure)

The language and overall approach to each article generally has remained the same. The text of Articles 7 and 9 has not been changed, but as noted above, the commentaries have been modified. The most important modifications address certain issues such as taxpayer-initiated adjustments and time limits during which an adjustment may be made. In addition, certain conforming changes take into account the work on the BEPS project.

Article 25 has been subject to the most revisions. The text of Article 25.1 has been broadened so that now an application for competent authority relief may be made to either country, not just the country of which the person is a resident or national (as applicable). The rules in Article 25.5 related to arbitration have also been modified, and the commentaries to Article 25 have been substantially revised. Many of the revisions to the commentaries merely reflect the changes made to Articles 25.1 and 25.5. Other revisions, however, reflect changes resulting from the work on the BEPS project and the changes made to other articles, such as Articles 7 and 9.

Changes to Article 7 (Business Profits)

The language and overall approach of Article 7 has remained the same as the prior version of the OECD Model from 2014 (2014 OECD Model). That approach is referred to as the "Authorized OECD Approach" (AOA). Under the AOA, when an enterprise of one country carries on business in the other country through a permanent establishment (PE), the profits attributable to the PE are those that the PE might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used, and risks assumed. Any transactions with associated enterprises attributed to the PE are priced in accordance with the OECD transfer pricing guidelines, and those guidelines are applied by analogy to dealings between the PE and the other parts of the enterprise.

Even though the text of Article 7 has remained the same, the commentaries have been updated to take into account changes made by the BEPS project. For example, conforming changes have been made to take into account the restriction in scope to Article 5.4(d), which deals with the exception for fixed places of business of PEs.

In addition, new language has been added to the commentaries to Article 7 discussing (i) taxpayer-initiated adjustments; and (ii) a limitation on the length of time during which an adjustment may be made (*see* new paragraph 59.1 and the new language in paragraph 62 of the Article 7 commentaries). As discussed below, the same changes have been made to the commentaries to Article 9 (modified as appropriate in the context of each article).

Changes to Article 9 (Associated Enterprises)

As with Article 7, the language of Article 9 has remained the same. Nevertheless, two changes have been made to the commentaries – one concerning taxpayer-initiated adjustments and another including additional language to the paragraph concerning the length of time during which an adjustment may be made. The details of those changes are as follows.

New paragraph 6.1 of the commentaries to Article 9 includes a discussion regarding taxpayer-initiated adjustments. The new paragraph affirms that competent authorities are able to eliminate double taxation in situations whereby a taxpayer makes an adjustment to amend a previously filed return. The commentaries explain that such adjustments, when made in good faith, may facilitate the reporting of taxable income by taxpayers in accordance with the arm's length principle. In those situations, the competent authorities may meet to determine whether the taxpayer-initiated adjustment meets the conditions of the arm's length standard and, if so, the appropriate adjustment that should be made in the other country. This change is consistent with the new language concerning taxpayer-initiated positions under the US rules for competent authority procedures (*see* section 2.01(2) of Rev. Proc. 2015-40, 2015-35 I.R.B. 236).

The second change involves new language added to paragraph 10 of the commentaries to Article 9 concerning the length of time during which an adjustment may be made. As with the 2014 OECD Model, the 2017 OECD Model leaves open the question whether there should be a period of time after the expiration of which one country would not be obliged to make an appropriate corresponding adjustment following an upward revision of profits by the other state. Nevertheless, new language in paragraph 10 recommends a provision that should be included by countries that consider an open-ended commitment to be unreasonable. If a country wishes to impose such a time limit, the 2017 OECD Model now recommends that the following paragraph be added after Article 9.2:

> 3. A Contracting State shall not include in the profits of an enterprise, and tax accordingly, profits that would have accrued to the enterprise but by reason of the conditions referred to in paragraph 1 have not so accrued, after [bilaterally agreed period] from the end of the taxable year in which the profits would have accrued to the enterprise. The provisions of this paragraph shall not apply in the case of fraud, gross negligence or wilful default.

As discussed above, conforming changes have been made to the commentaries to Article 7 for this rule too.

Changes to Article 25 (Mutual Agreement Procedure)

Overall, Article 25 of the 2017 OECD Model maintains the same policies and procedures as the version of this article in the 2014 OECD Model. Nevertheless, as noted, the text of Article 25 of the 2017 OECD Model has been modified, as have the commentaries. The changes to the text of Article 25 generally expand on policies that were present in the 2014 OECD Model, as well as implement changes resulting from the work on the BEPS project. Similarly, the changes to the commentaries of Article 25 make conforming revisions based on changes to the text of Article 25, changes to the commentaries to other articles of the 2017 OECD Model, and on changes resulting from the other BEPS action items.

The first change to the text of Article 25 occurs in Article 25.1. It states that a person seeking competent authority relief may now present his or her case to the competent authority of either country. Under the 2014 OECD Model, the case had to be presented to the country of which the person was a resident (or, in the case of a nondiscrimination claim under Article 24.1, the country of which the person was a national). This change, as explained in new paragraph 17 of the Commentaries to Article 25, is intended to reinforce the general principle that access to the mutual agreement procedure should be as widely available as possible. In addition, this change is intended to ensure that the decision of whether a case should be discussed is open to consideration by both competent authorities.

The other changes to the text occur in Article 25.5, and they concern the rules relating to arbitration. Article 25.5 now specifies that the commencement date for arbitration should begin two years from the date when "all the information required by both competent authorities" has been presented to both competent authorities. In contrast, Article 25.5 of the 2014 OECD Model merely stated that the time frame would begin from the "presentation of the case" to the other competent authority. The new language provides a more precise way to determine the commencement date. In addition, Article 25.5 now specifies that a request for arbitration must be in writing.

Finally, the text of the 2017 OECD Model has deleted a footnote from Article 25.5 that was included in the 2014 OECD Model. That footnote discussed when it would be appropriate for a treaty to include an arbitration provision. As explained in new paragraph 65 of the commentaries to Article 25, the footnote was deleted in recognition of how important the OECD considers arbitration to be.

The commentaries on Article 25 have been revised as well. As discussed above, many of the changes are conforming revisions based on the changes to the text of Article 25. Other revisions conform the commentaries on Article 25 to changes that have been made to the commentaries on other articles. For example, new language has been added regarding taxpayer-initiated adjustments, and this parallels the changes made to the commentaries on Articles 7 and 9. Other revisions represent changes resulting from the work on BEPS. As explained in new paragraph 75 of the commentaries to Article 25, for instance, the sample mutual agreement on arbitration has been revised to reflect a process that is similar to the one used in Part VI of the BEPS Multilateral Instrument.

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