ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

RESPONSE OF THE COMMITTEE ON FISCAL AFFAIRS TO THE COMMENTS RECEIVED ON THE APRIL DISCUSSION DRAFT ON THE 2008 UPDATE TO THE MODEL TAX CONVENTION

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CENTRE FOR TAX POLICY AND ADMINISTRATION

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On 17 July 2008, the OECD Council approved the contents of the 2008 Update to the OECD Model Tax Convention. This followed the earlier approval of the update by the Committee on Fiscal Affairs on 25 June 2008. The update will now be incorporated in a new version of the OECD Model Tax Convention that will be published at the beginning of September.

Whilst most of the changes included in the update had previously been released for public comments, the update itself was released as a discussion draft on 21 April 2008. The comments that were received have been posted on the OECD website. The Committee wishes to thank all the individuals and organisations that have sent comments. Whilst comments were specifically invited with respect to a number of technical changes to the Commentary on the Model Tax Convention that had not been previously released for comments, a large part of the comments that have been received dealt with parts of the update that had previously been released as separate discussion drafts.

The Committee carefully examined the comments received and after extensive review of these comments concluded that no major additional changes should be made to the update. It did, however, agree that a number of useful clarifying changes were proposed and that these should be included in the update. In addition, a few issues raised in the comments have been identified as requiring further work. The following provides a brief description of the comments received and the Committee's response to some of them.

Changes to the Commentary on Article 4

A few comments were received concerning the changes to the Commentary on paragraph 3 of Article 4, the residence tie-breaker rule related to legal persons. One commentator suggested redrafting paragraph 24 of the Commentary on Article 4 to provide greater clarity as to the meaning of the concept of place of effective management. As acknowledged by this commentator, however, his suggested draft was based on the approach put forward in the discussion draft "Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention" which had been released in 2003 by the Business Profits TAG. That approach has been rejected by the Committee because, for many countries, it gave undue deference to the place where a board of directors would meet, as opposed to the place where the most senior executives of the entity would make management decisions, which is the main reason for the change made to paragraph 24. In fact, in its comments, the OECD Business and Industry Advisory Committee (BIAC) has expressed the view that the change made to paragraph 24 was an improvement. Support for the change was also expressed by another commentator who also regretted, however, "that it has taken such a long time to reach a stated position."

BIAC has expressed concerns, however, about the new paragraph 24.1 that will be added to the Commentary on Article 4 and that will provide an alternative provision that countries that prefer a case-by-case approach to the concept of place of effective management may adopt in their bilateral treaties. That alternative, which is to leave the issue to be solved by the competent authorities, is now used in a large number of treaties and the Committee considered that it was important to discuss some of the issues that it raises and to provide criteria on which the competent authorities could base their decisions. Whilst BIAC suggested that one of these criteria, *i.e.* where the accounting records are kept, should be removed, the Committee considered that whilst this factor may not be appropriate in some cases, it would still be

relevant in many cases, for example, where corporate law specifically requires the main accounting records to be kept at a specific location.

BIAC also expressed concerns about the new paragraphs 8.2 and 8.3 of the Commentary on Article 4, which deals with the case of a person who is a resident of a State under that State's domestic law but is not a resident of that State for the purposes of one of its treaties. Whilst BIAC suggests that the interpretation given in paragraph 8.3 is not in accordance with the wording of the Article itself, the Committee believes that the statement according to which the last sentence of paragraph 1 of Article 4 "has to be interpreted in the light of its object and purpose, which is to exclude persons who are not subjected to the most comprehensive liability to tax generally imposed in a State" is a correct legal interpretation when read in the context of existing paragraph 8 of the Commentary. It decided, however, that the phrase "subjected to the most comprehensive liability to tax generally imposed in a State" in paragraph 8.3 of the Commentary should be replaced by "subjected to comprehensive taxation (full liability to tax) in a State" as this formulation is the one already used in paragraph 8 of the Commentary.

Changes to the Commentary on Article 5 (the tax treaty treatment of services)

Most of the comments received have focussed on the Commentary changes on the tax treaty treatment of services, which were released in December 2006 as a discussion draft. While some of these comments address technical issues, others reflect more general concerns about the inclusion in the Commentary of an alternative provision such as the one included in these changes.

As indicated in the changes, the Committee considers that the provision of services should, as a general rule subject to a few exceptions for some types of service (*e.g.* those covered by Articles 8 and 17), be treated the same way as other business activities and, therefore, the same permanent establishment threshold of taxation should apply to all business activities, including the provision of independent services. This conclusion is supported by various policy and administrative considerations described in the new paragraphs of the Commentary.

The Committee, however, has noted that some States (including some OECD countries) do not share that view. These States use various treaty approaches to preserve source taxation rights, in certain circumstances, with respect to the profits from such services. The Committee has considered that it was important to circumscribe the circumstances in which States could do so and has therefore decided to include in the Commentary an alternative provision that these States could use for that purpose and that would ensure that the additional taxation rights that would be granted to a State using the provision would not extend to services performed outside the territory of that State, would apply only to the profits from these services (as opposed to gross payments for them) and would not apply unless a certain threshold of physical presence in that State had been met.

The decision to include such a possible alternative in the Commentary was a difficult one for the Committee. The Committee as a whole does not support the use of such a provision and many member countries have clearly indicated that they would resist its inclusion in their bilateral treaties. The Committee, however, concluded for various reasons that it was better to acknowledge the existence of a minority treaty practice in this area.

In doing so, the Committee also recognised the validity of many of the concerns expressed in the comments that it has received from BIAC and other commentators, including concerns about compliance burden, legislative and administrative application and attribution of profits as well as more general concerns about the role of the Model Tax Convention and transparency of individual member countries' treaty practices. These more general concerns are currently being examined by the Committee with a

view to articulating a more consistent approach to the use of alternative provisions and the disclosure of each member country's treaty practices.

As already indicated, the Committee has also considered a number of technical issues raised with respect to these Commentary changes dealing with the tax treaty treatment of services.

One commentator recommended that the alternative provision should not apply to deem a permanent establishment to exist if services are rendered on a construction site for less than the period of time referred to in paragraph 3 of Article 5. This issue, however, was extensively discussed when the proposed changes were drafted and paragraphs 42.25 to 42.28 reflect the conclusions that were arrived at. As explained in these paragraphs, the relationship between the alternative provision and paragraph 3 of Article 5 involves a number of policy considerations. The Committee considered, however, that it would be useful to add a point made by this commentator, which is that if a shorter period is used in the alternative provision, this will significantly reduce the practical effect of paragraph 3 in the case of activities performed exclusively at a single site. Paragraph 42.27 has therefore been modified to read as follows (the proposed addition is in bold italics): "States that wish to use the alternative provision may therefore wish to consider referring to the same periods of time in that provision and in paragraph 3 of Article 5: ***if a shorter period is used in the alternative provision, this will reduce, in practice, the scope of application of paragraph 3.***"

Another commentator invited the Committee to provide that subparagraph *b*) of the alternative provision would not apply where work is performed through subcontractors. As already drafted, however, subparagraph *b*) would exclude most situations where an enterprise does work through a subcontractor since it only applies if an enterprise supervises, directs or controls the manner in which the relevant services are performed by an individual, which will typically not be the case where the individual is employed by a subcontractor. The same commentator asked, however, that the Committee clarify that this last rule would apply regardless of whether the subcontractor is associated to, or independent from, the enterprise. Since subparagraph *b*) does not make any distinction between associated and independent enterprises, the Committee agreed with that suggestion and decided to add the following sentence at the end of paragraph 42.43: "This rule applies regardless of whether the separate enterprise is associated with, or independent from, the company that entered into the contract."

A similar concern was expressed by another commentator who formulated detailed comments concerning the application of subparagraph *b*) of the alternative provision in the case of services provided by subcontractors. According to these comments, the phrase "under the supervision, direction or control", which is found in the subparagraph, is so broad that some could argue that any related party service provider should be considered to be under the supervision, direction, or control of its related principal. Even in the case of services performed by an unrelated service provider, some might argue that the principal could be considered to "supervise" or "direct" the performance of the service in some way. This led the commentator to suggest that this issue be addressed by providing a clear rule that "the activity of employees of a separate enterprise cannot be treated as the performance of services by a non-resident enterprise and, therefore, cannot create a PE for that enterprise." The commentator added, however, that countries preferring a different approach for services performed by self-employed individuals could retain the cross-reference in paragraph 42.32 to the "other persons" covered by paragraph 10 of the Commentary, as long as these were restricted to self-employed individuals. These comments also suggested clarifying example 3 in paragraph 42.44 and further indicated that, in cases where the non-resident enterprise engages a local enterprise to perform the services, the local enterprise (related or unrelated) would be compensated for its services and be fully liable for host country taxation on that compensation. The Committee noted, however, that the issue of the application of the alternative provision to subcontractors had been previously discussed extensively on the basis of comments received on the discussion draft. The changes to subparagraph *b*) reflected a difficult compromise intended to

reflect the view that the provision should only apply to an enterprise where that enterprise supervises, directs or controls the individual providing the services, a standard which characterizes a *de facto* employment relationship. While there may be some risk that this standard could be misinterpreted to apply to typical subcontractor arrangements, on balance the Committee believes that risk is not large enough to warrant re-opening the discussion at this time. If experience reveals that substantial uncertainty arises in practice in the application of this standard, the Committee will have the opportunity to review the Commentary in the course of its upcoming review of permanent establishment threshold issues.

The Committee agreed with the comments and suggestion of three commentators who considered that it was important to clarify that the explanations given on the alternative provision should not be used to interpret treaties that do not include a provision similar to the alternative provision; it therefore decided to add the following sentence to paragraph 42.25 of the Commentary: "The following paragraphs discuss various aspects of the alternative provision; clearly these paragraphs are not relevant in the case of treaties that do not include such a provision and do not, therefore, allow a permanent establishment to be found solely because the conditions described in this provision have been met."

The Committee did not agree, however, with a commentator's proposal to add to subparagraph *b)* of the alternative provision a *de minimis* exception applicable to all enterprises. According to that proposal, the provision would not apply unless the enterprise, during the relevant period, derived more than 10% of its gross service revenues from the services performed in the source State. Whilst such an exception would certainly reduce the administrative burden of applying the provision, it would considerably restrict the scope of the provision and would benefit large enterprises over smaller ones, which would make it unacceptable to the countries that are likely to use the provision.

Finally, one commentator raised the possibility that the alternative provision might be found to be contrary to the EC Treaty, in particular as regards the gross revenues test included in subparagraph *a)*. For the Committee, however, it is not clear why a tax treaty rule that would be based on a threshold of revenues would necessarily be in violation of the EC treaty; even if that were the case, that would not be a convincing argument for all the countries that are not part of the European Union. The same commentator also suggested that the alternative provision might conflict with the alternative provision on publicly-funded sport or artistic activities that is included in paragraph 14 of the Commentary on Article 17. The Committee, however, found that concern difficult to understand since the alternative provision on services does not allocate taxing rights (paragraph 7 of Article 7 ensures that Article 17 has priority over Article 7 and since the taxing rights on the profits attributable to a deemed permanent establishment would derive from Article 7, the last sentence of the provision found in paragraph 14 of the Commentary on Article 17 would ensure exemption from source taxation).

Revised Commentary on Article 7

BIAC and another commentator offered comments on the revised Commentary on Article 7, which was previously released in draft form in April 2007. These comments reiterated some of the concerns that had been expressed in 2007 about the two-step implementation process that the Committee adopted in June 2006 to implement the conclusions of its Report on Attribution of Profits to Permanent Establishments. The Committee wishes to note, however, that the main purpose of adopting that implementation process was precisely to provide more legal certainty as to how the conclusions of the Report will apply to existing and future treaties. As recent court decisions have shown, however, the interpretation of the current Article 7 is unclear and it would have been difficult to totally remove that uncertainty whilst keeping the existing wording of the Article.

BIAC and the other commentator also expressed surprise that very few changes had been made to the 2007 draft despite the comments received and the technical points raised in these comments. The

Committee regrets that the few changes made may have given the wrong impression that it did not take these comments into account; the comments received were in fact fully discussed at two meetings of the Group that had been mandated to draft the revised Commentary.

Finally, BIAC stressed the need for the OECD to finalise as a priority matter and at the earliest possible time the new Article 7 and its Commentary which will fully implement the Report on Attribution of Profits to Permanent Establishments. The Committee has now released a first draft of this new Article and its Commentary the Committee expects that the new Article, once revised to take account of comments, will be included in the next update to the Model Tax Convention, which is currently scheduled for 2010.

Changes to the Commentary on Article 12

BIAC expressed support for the majority of the changes made to the Commentary on Article 12 but suggested three drafting changes. The first was to add the words "on a continuous or repetitive basis" after the phrase "any additional work" in the last sentence of paragraph 10.2. The Committee, however, considered that, as drafted, this change could be problematic as it would suggest that a single instance of reproducing plans for commercial distribution would never trigger a royalty payment. The Committee agreed that the example provided by BIAC should, however, be examined as part of further work in this area. The second suggestion was to reconsider the last sentence of paragraph 11 according to which the definition of know-how relates to information concerning previous experience but does not apply to new information obtained as a result of performing services at the request of the payer, an interpretation that BIAC found to be "burdensome and not practical". The Committee, however, considered that the distinction between a payment for know-how and a payment for services is a crucial one and, whilst it agreed that it is sometimes difficult to make that distinction in practice, this must be done in order to avoid treating as royalties what are in fact payments for services. Finally, for similar practical reasons, BIAC suggested amending paragraph 11.4 to refer to payments for a list of existing or potential customers (as opposed to a list of potential customers only) as this would avoid the need to distinguish between the two types of lists. For the Committee, however, the suggested addition would be difficult to reconcile with the rest of the relevant sentence, which refers to a list such as one that would be developed specifically for a client by a marketing specialist out of generally available information.

Another set of comments dealt exclusively with the changes made to the Commentary on Article 12. These comments were generally supportive of the changes but suggested that further work may be needed in certain areas. The Committee welcomed that suggestion; Working Party No. 1, the sub-group of the Committee that deals with questions related to tax treaties, will therefore be invited to examine the following questions as part of its work on subsequent updates:

- as regards paragraphs 8.2, 15 and 16 of the Commentary on Article 12: to examine the possibility of clarifying when a set of rights would constitute "distinct and separate property" (looking, in particular, at the examples of patent and copyright right transfers described in the comments) and which transaction forms would result in a transfer "presented as an alienation" or "structured as a sale";

- as regards paragraph 10.1 of the Commentary on Article 12: to examine whether the types of payments to which the paragraph applies should be extended to cover certain payments referred to in the comments;

- as regards paragraph 10.2 of the Commentary on Article 12: to examine whether there is a need to deal specifically with payments made for the right to modify or reproduce existing plans in circumstances where there is no commercial exploitation right related to the modifications or reproductions (*i.e.* where the plans are modified or copied for personal use);

– as regards paragraph 11.4 of the Commentary on Article 12: to examine whether the treatment of customer lists should be further clarified as indicated in the comments.

These comments also included the wish that all OECD member states will now conform their treaty interpretations of payments with respect to software transactions to the guidance contained in the Commentary. The Committee noted that there has been a clear trend in that direction since the parts of the Commentary dealing with software payments were first adopted.

A third commentator also expressed support for the changes to the Commentary on Article 12.

Changes to the Commentary on Article 24

BIAC offered a general comment on the changes to the Commentary on Article 24 on non-discrimination, noting that some of the changes restricted the application of the Article, which BIAC considered as going in the wrong direction. BIAC added, however, that it saw that work as a first step and encouraged the OECD to continue its work in this area. As was indicated when the changes were released in draft form, the Committee will continue its work in this area and will look, among other things, at the various issues that were identified in the Annex to its discussion draft of 3 May 2007.

Another commentator expressed a general concern about the position of EU States as regards to the EC treaty. The Committee, however, finds that concern difficult to understand: whilst the EC treaty includes rules that are clearly different from those of bilateral tax treaties, it is not clear why these rules should affect the interpretation of Article 24. The same commentator also challenged some of the changes to the Commentary on Article 24 on the basis of two court decisions (the decision of the United Kingdom House of Lords in *Boake Allen* and the decision of the French Conseil d'Etat in *Andritz*). The Committee, however, is not convinced that these decisions necessarily support the conclusions reached by the commentator.

Changes to Article 25 and its Commentary

BIAC also offered comments on the changes to Article 25 made as a result of the work on dispute resolution. It expressed support for the addition of an arbitration mechanism in the OECD Model but raised a question about the legal nature of the arbitral award for the purposes of the possible application of the UN Arbitration Convention in case of non-application (indicating that this was still an open issue that needed to be clarified). It also suggested that the sample agreement included in the Commentary be streamlined. As explained in the Commentary on paragraph 5 as well as in the sample agreement, the arbitration process is part of the mutual agreement procedure and an arbitration decision rendered under that paragraph 5 will therefore be implemented through a mutual agreement. The nature of that process would not seem to allow for the application of the UN Arbitration Convention. As regards the sample agreement, the Committee wishes to note that the novelty of the arbitration provision made it necessary to provide as much guidance as possible to the States that will need to implement arbitration; clearly, as experience is gained in this area, there may be room for simplification.

Another commentator expressed support for the addition of the arbitration provision in Article 25 but suggested that the new paragraph be amended by adding "independent" before "administrative tribunal". The Committee, however, considers that such a change is not necessary given the normal usage of the word "tribunal".

Other comments

Finally, one set of comments dealt with issues specific to the airline industry that were not directly related to the contents of the 2008 update. These comments will be examined at a future meeting of Working Party No. 1.