

# Recent Developments at the OECD

Presentation to BMA Conference  
Mumbai, India  
3 – 4 December 2004

David Partington  
OECD Secretariat  
Paris

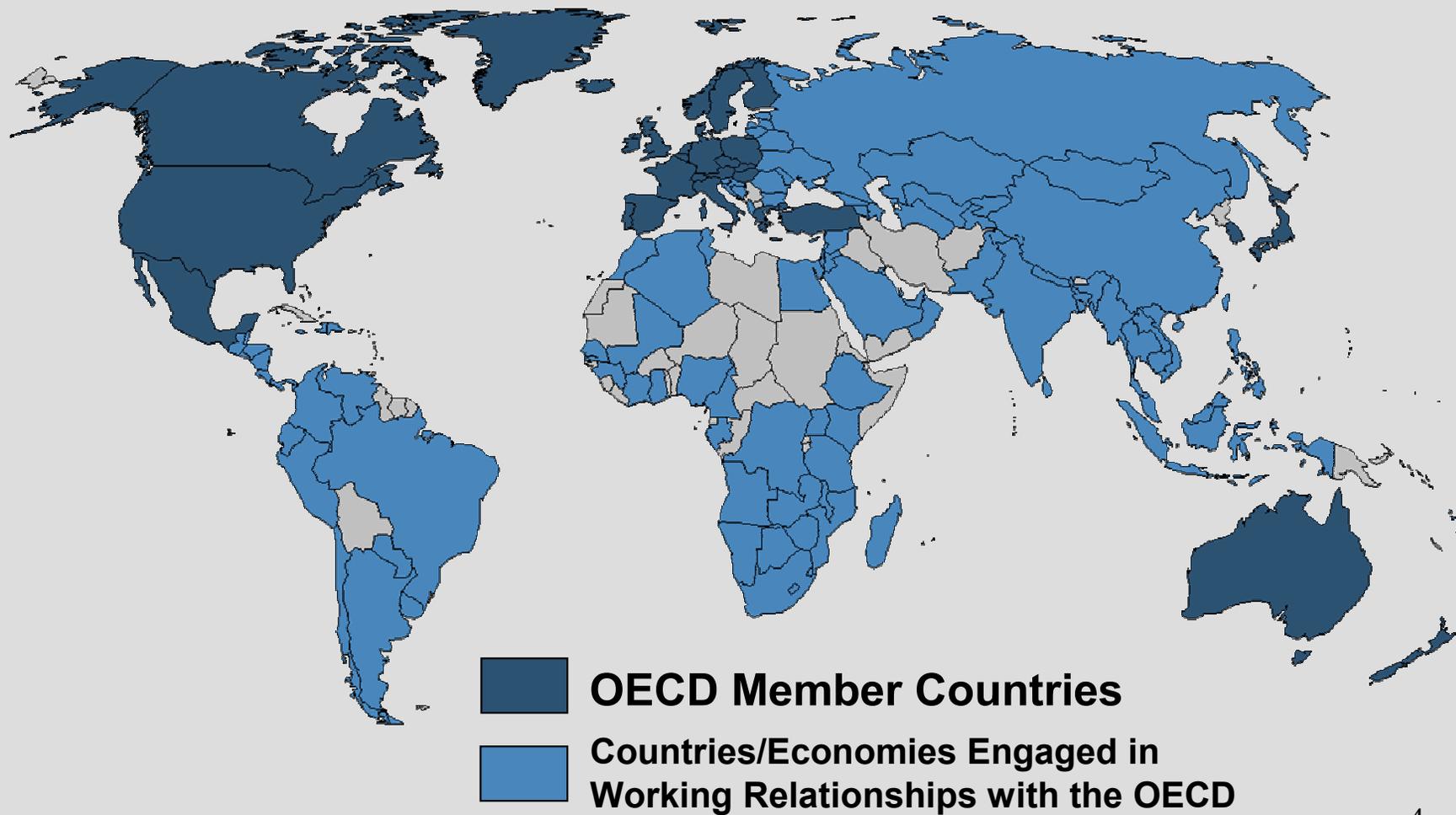
# Key International Tax Developments

- Tax Treaties Update
- Dispute Resolution
- Transfer Pricing Update

## What is the OECD

- Organisation for Economic Co-operation and Development
- A forum for economic and social challenges of interdependence and globalisation
- A provider of comparative data, analysis and forecasts to underpin multilateral co-operation
- Setter of “soft” and occasionally “hard” rules in which governments work together to address

# Limited membership but global reach



# OECD's Work in Taxation

- OECD sets the international taxation guidelines in areas where international co-ordination is desirable:
  - tax treaties (OECD Model Tax Convention)
  - transfer pricing
  - e-commerce
  - exchange of information
  - harmful tax practices
  - consumption tax
- Guidelines developed through expert committees and consensus approach
- Can't issue directives - need to develop an international consensus

## Working with Business and Non-Members

- Becoming more common and takes various forms:
  - BIAC (Business & Industry Advisory Committee)
  - Technical experts on working groups (e.g., e-com TAGs)
  - Open dialogue
  - Consultation on discussion drafts (<http://www.oecd.org>)
- Desired outcomes:
  - Consensus on rules
  - conventional application of existing rules
  - sound fiscal policy

# Part I Tax Treaty Update

## Treaty Work: Next Update to the Model

- Working assumption: Next update in Mid 2005
- Main contents:
  - Guidance on tax treaty issues arising from employee stock-option plans
  - Changes to the Commentary on Article 8
  - Changes resulting from our work on cross-border issues related to pensions
  - Changes to the Commentary on Article 5 to clarify generally agreed views
  - Changes to Article 26 of the Model Tax Convention and its Commentary
  - Changes to the Commentary on Article 11 to suggest no source taxation of interest (or certain categories thereof)

## 2005 Update: Issues Related to Stock-Options

- Final report adopted in June
- Posted on OECD web site in September
- Conclusions will be incorporated in 2005 update
- Basically follows the approaches put forward in the first discussion draft:
  - exercise is generally the dividing line between employment income and capital gains
  - vesting is generally the dividing line for determining to which employment services an option relates (bias towards future services but this is a case by case determination)
  - residence country must provide relief regardless of when the source country tax the employment benefit

## 2005 Update: Article 8 Commentary

- Clarification of the scope of Article 8 on Income from international air transport and shipping:
  - substantial rewriting of the Commentary on paragraph 1
  - clarifies that activities directly connected, primarily connected, and ancillary to international transport are covered
  - Includes some activities done for other operators
- Changes drafted in co-operation with representatives of the airline/shipping industry, were released for comments in April 2004
- Changes were slightly revised in September based on comments received
- Final version is about to be released

## 2005 Update: Cross-Border Pensions

- Clarification in the Commentary of technical issues and alternative provisions
- Draft released in November 2003
- Proposals for changes to the Commentary on Article 18 were revised based on comments; final version adopted at the September meeting
- Changes will be incorporated in the 2005 update

## 2005 Update: Article 5 Clarification

- As a result of a court decision, Working Party No. 1 was invited by business to expressly confirm in the Commentary some widely-accepted interpretations related to the permanent establishment concept
- Discussion draft released on 12 April 2004
- 3 Issues:
  - PE determination must be made for each company of a group
  - Providing management services to another company of the group does not mean that the company has a PE
  - Participation in meetings is not enough to conclude that one exercises an authority to conclude contracts

## Article 5 clarification cont.

- Comments received were very supportive
- Only a few small changes made as a result of the comments, including a new sentence to further clarify that deriving an economic benefit from the activities of another company taking place in another country does not mean that you have a PE in that country:
  - “... Indeed, the fact that a company’s own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced, or services supplied, by another company in a different country would not have a permanent establishment because of that even though it may benefit from the manufacturing of these parts or the supplying of these services.”

## 2005 Update: Revision of Article 26

- Existing paragraph 1 spit into 2 paragraphs. New paragraph 2 includes a rule permitting disclosure of information to oversight authorities
- Paragraph 3 is the renumbered paragraph 2 (information not obliged to disclose)
- new paragraph 4 addresses domestic tax interest in the information:
  - states the principle formerly acknowledged in the Commentary
  - subject to paragraph 3 limitations other than domestic tax interest
- new paragraph 5: states paragraph 3 cannot be used to decline to exchange information solely because it is held by banks, other financial institutions, nominees etc. or to exchange ownership information

## Other Treaty Work (not in the 2005 update)

- Background document on practical aspects of the negotiation and application of tax treaties
- Place of effective management as a tie-breaker rule (consideration of TAG report)
- Working Group on application of tax treaties to services:
  - Follow-up to Business Profits TAG report
  - Has only met once; longer-term project
  - Consultation with business will start in 2005

## Other Treaty Work (not in the 2005 update)

- Working Group on application of tax treaties to trusts, collective investment vehicles and other specific entities:
  - Follow-up to partnership report
  - Consultation with business in February 2005
- Scope of paragraph 2 of Article 15
  - Discussion draft released on 5 April 2004
  - “Hiring-out of labour” report revisited
  - It is a report of a small drafting group; has not yet been discussed by WP1
  - WP1 wanted input from business before starting its discussion of the report
  - Longer-term project: report will certainly be changed as a result of the comments received

## Part II – Dispute Resolution

## Dispute Resolution

Project launched on website in Spring 2003

- [www.oecd.org/ctp](http://www.oecd.org/ctp)
- Both Transfer Pricing and Treaty issues
- Joint Working Group – WP1 and WP6 Delegates (JWG)
- Country Profiles created on website March 2004
- Progress Report released on website July 2004
- Need continuing input from both business and non-OECD economies
- Aiming to complete project by end of 2006

## Scope of Project

- Focus on improving the Mutual Agreement Procedure (MAP) of Article 25 of OECD Model Tax Convention
- Aim is to ensure a fully effective MAP process that has the confidence of taxpayers:
  - Look at all aspects from initial access to implementation
  - Must not be a “black box” for taxpayers
- Identify possible additional dispute resolution mechanisms (arbitration, expert opinion, mediation etc)
- Possible use to *supplement* not replace the MAP

## Outcomes

- Main Outcomes expected by end of 2006
- Guidance on improving the effectiveness of MAP
- Production of Manual on Effective Mutual Agreement Procedures (MEMAP)
- Any necessary changes to Commentary on Article 25
- Possible Recommendations on the use of other dispute resolution mechanisms to supplement not replace the MAP (e.g. mediation, arbitration)

## Outline of July 2004 Progress Report

- Based on good faith application of the treaty
- Follows chronology of MAP
- Analyses problems and starts process of identifying solutions based on best features of MAP
- 3 sets of proposals:
  - Current proposals (which countries could adopt now)
  - Proposals for future work (need more work on developing potential solutions)
  - Proposals for future study (issues have been framed but need further study)

## Next Steps

- Comments invited on progress report by 15 October 2004
- Major consultation with business
- Work on MEMAP and Draft Changes to Model Commentary in 2005/6
- What other form of consultation would you like?
- Let us know your views and please comment!

# Part III – Transfer Pricing Update

## Attribution of profits to a PE

- Starting point : lack of consensus
  - no common interpretation or application
- Problems e.g. with global trading and e-commerce
- Development of Working Hypothesis (WH):
  - How far can be PE be treated as if it were a separate enterprise?
  - How far can guidance in TP Guidelines be applied, *by analogy*, to attribute profits under Article 7(2)?
- Test the application of WH in practice: does it make sense?
  - banks, insurance, global trading and server PEs

## Working Hypothesis

Profits to be attributed to a PE are the profits that the PE would have earned at arm's length as if it were a separate enterprise performing the same functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2)

## Working Hypothesis

- Functionally separate entity approach (not single entity)
- Two step approach to attribute profit:
  - (1) Use functional and factual analysis to hypothesise the PE as a distinct and separate enterprise
  - (2) Application of the arm's length principle to the hypothetical enterprise in accordance with the 1995 Guidelines (by analogy)
- Focus on first step – most difficult

## Attribution of Profits: Discussion Drafts

- Discussion Paper: 8th February 2001
  - Part I : PE in general
  - Part II: Special Considerations for banks
- April 2002 business consultation
- 4 March 2003 release
  - Revised Part II on banks
  - Part III on global trading
- Release of Revised Part I on 3 August 2004
  - Deadline for comments 28 September!
  - Discussion by WP6 on 25/26 October
- To come
  - Part IV on insurance
  - Changes in Model Commentary to Article 7
  - Chapter(s) in TP Guidelines

## Revision of Part I

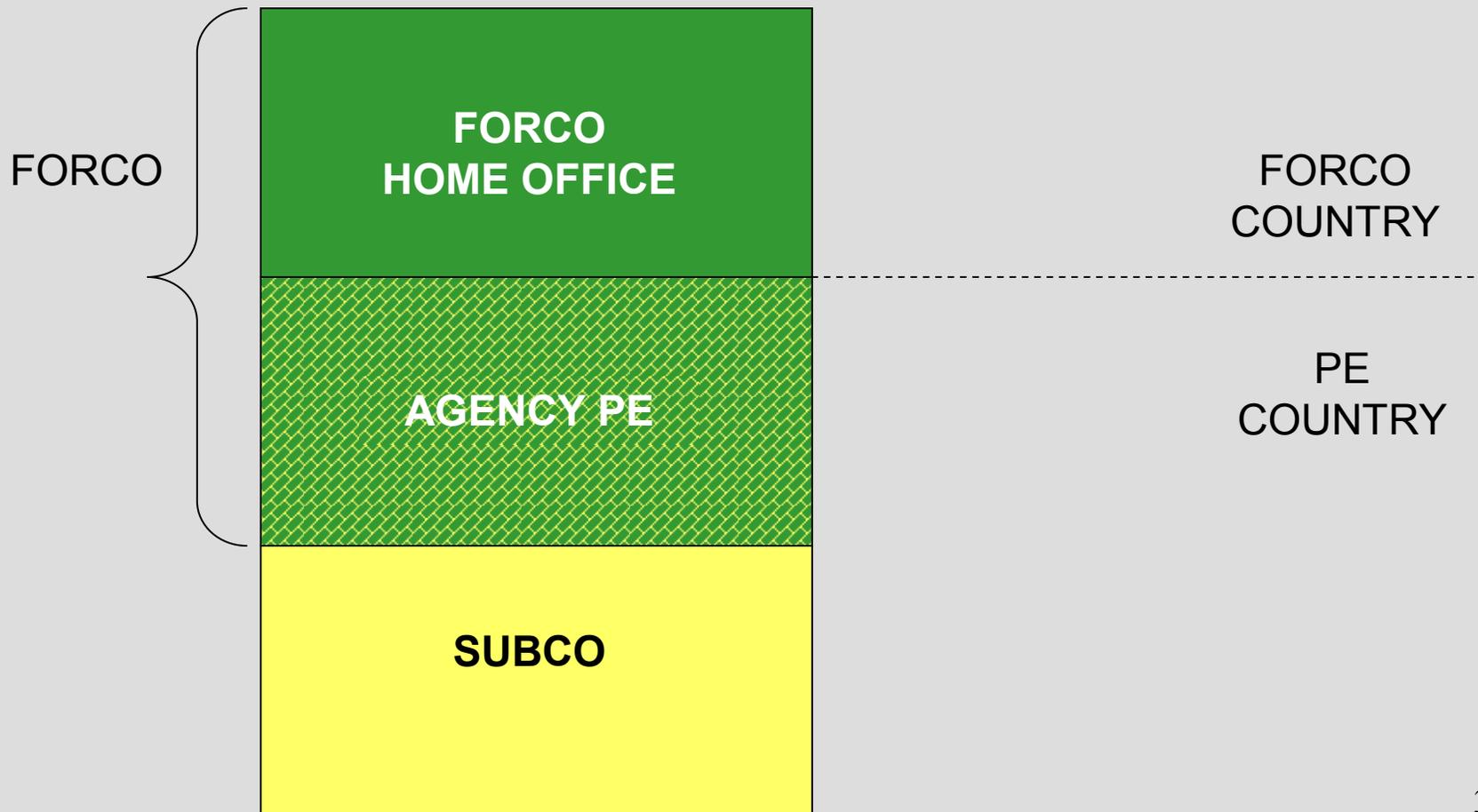
- Build on progress made during revision of Parts II and III
- Apply to non-financial businesses
- Number of issues require review
- Symmetrical approach
  - Same approach by both host and home country
  - Limits of DT relief as based on domestic law definitions, e.g. of profits
  - Interaction with flexibility given for capital attribution methods
- Dependent agent PE

## Key Issues in Revision of Parts I-III

- Dependent agent PEs) - General principle in Part I
- Report based on the assumption that PE has been created by virtue of Article 5(5)
- OECD may need to consider clarifying Article 5(5) threshold
- Aim is to replace current lack of guidance on attribution
- May be profit over and above reward to agent but be no profit where all agent's functions are already fully rewarded
- Need to recognise are 2 taxpayers in PE jurisdiction: the PE and the agent
- Administratively may collect tax off only one taxpayer

# Example: Dependent Sales Agent

Subco sells computer products on behalf of Forco



## Dependent sales example – PE of Forco

- Dependent agent (Subco) doesn't take title to the goods (inventory risk and reward belongs to Forco)
- Question is whether profits should be attributed to PE of Forco
- Depends on functional and factual analysis
  - Where are key entrepreneurial risk-taking (KERT) functions performed in respect of inventory risk?
  - Only attribute to PE of Forco if agent (Subco) performs the KERT on behalf of Forco

## Following and engaging in our work

- OECD web site: [www.oecd.org](http://www.oecd.org)