LC Paper No. CB(1)44/05-06(20)
(English version only)

David Gunson

13 September 2005

Clerk to Bills Committee (Attention Debbie Yau)
Legislative Council
8 Jackson Road
Central
Hong Kong
By email to mleung@legco.gov.hk

Dear Madam,

BILLS COMMITTEE ON
REVENUE (PROFITS TAX EXEMPTION FOR OFFSHORE FUNDS) BILL 2005

PROBLEMS WITH "RESIDENCY" AND "CONTROL"

Referring to your letter of 13th September 2005, I am happy to learn that the Chairman of the Bills Committee has, if I may say so, correctly identified concerns in the business community about these entirely new concepts of measuring liability to tax, viz: "residency" and "control".

I did wonder how long it would take before the Administration realised that there are serious practical and tax law problems with introducing these concepts to the Inland Revenue Ordinance.

In other words, serious problems of policy principles remain which the draft legislation ignores. There are serious problems of definition alone. Then there is the fundamental question of the strange policy concept that a particular legal form of a particular sector of economic activity is subject to specialist rules of tax assessment that all other forms of economic activity are not.

For instance, the Administration has not adequately explained why, if

(a) (as I do) I administer in Hong Kong a registered occupational retirement scheme for residents and non-residents; it invests in Hong Kong and outside Hong Kong; and makes a fat return happily enough; and
(b) (as I do) I administer in Hong Kong an investment trust for resident and non-residents that is not registered as an occupational retirement scheme; it invests in Hong Kong and outside Hong Kong; and makes a fat return happily enough; furthermore, it fulfills exactly the same economic function as does (a) viz., long-term accumulation of gain;

(a) will remain exempt from tax but (b) will become assessable whereas before it was not.

I alluded to these problems 8 months ago in January 2005 when commenting on the Consultation paper, thus:

Why change from source-based to residency-based taxation? See para 5 of the Consultation paper

- *Summary of Government. tax policy can be found here:*

- *http://www.business.gov.hk/bep/opencms/release/eng/start/knowmkt/tax/index.html*
- *The famous source principle can be found here:*
- *http://www.ird.gov.hk/eng/paf/bus_pft_tsp.htm*
- *Keeping business tax simple as policy can be found here:*
- *http://www.business.gov.hk/bep/opencms/release/eng/start/knowmkt/tax/buztaxinfo.html*

EXISTING RULES ARE ADEQUATE

I can only also repeat my earlier submission that at present under the Inland Revenue Ordinance, the only occasion on which "residency" is at all important is in Rule 5 of the Inland Revenue Rules (Cap 112A). Rule 5 concerns itself with

METHOD OF ASCERTAINMENT AND DETERMINATION OF THE PROFITS OF
THE HONG KONG BRANCH OF A PERSON WHOSE HEAD OFFICE
IS ELSEWHERE THAN IN HONG KONG

And I can only repeat and hopefully be listened to that the Inland Revenue Rules are adequate to cover the present position of investment trusts.

THE INFLUENCE OF FOREIGN LAWS ON THE BILL

May I also draw the Bills Committee's attention to the New Zealand Inland Revenue Department's publication "Taxation of Investment Income" which could be perused at **Appendix A** (http://www.taxpolicy.ird.govt.nz/publications/files/html/invincome/). The New Zealand government is dealing with identical issues on structural problems of taxation of collective investment schemes.

It ought be pointed out that the policy of the Hong Kong government is to enter into Double Taxation Agreements with other jurisdictions' governments to allocate rights of taxation and to grant relief from double taxation. For instance Hong Kong and China are to begin tax treaty talks on September 5, which Frederick Ma Si-hang, Hong Kong's Secretary for Financial Services and the Treasury, said on July 14.

The Bills Committee ought take careful note of the model treaty used by Hong Kong namely, that of the Organisation For Economic Cooperation and Development. The OECD also announced on 8 September 2005 that its model Double Taxation Agreement would be upgraded – see the announcement at **Appendix B** (http://www.oecd.org/dataoecd/54/24/34576874.pdf) and related OECD papers at **Appendices C and D** (http://www.oecd.org/dataoecd/28/4/33614065.pdf) and (http://www.oecd.org/dataoecd/22/51/33637685.pdf). It specifically deals with the issue of multiple permanent establishments amongst other matters.

CONCLUSION

Overall, my submission is that this Bill is premature, inadequate and ought be shelved until further study of how other jurisdictions handle taxation of collective investment schemes is done, preferably this time with input from the private sector that actually operates them.

Yours faithfully,

David Gunson

Appendix A

Taxation of investment income

The treatment of collective investment vehicles and offshore portfolio investments in shares

A government discussion document

Hon Dr Michael Cullen
Minister of Finance
Minister of Revenue

First published in June 2005 by the Policy Advice Division of the Inland Revenue Department,
P O Box 2198, Wellington.

Taxation of investment income; the treatment of collective investment vehicles
and offshore portfolio investments in shares – a government discussion document.
ISBN 0-478-27127-1

CONTENTS

Chapter 1

INTRODUCTION

1.1 The financial system is an important contributor to growth in New Zealand and has a role in allocating scarce capital to productive use.

1.2 For this reason it is important that the tax rules for investment income operate efficiently and that investors' decisions are not distorted by different tax treatments for income from investments that are similar in nature. Under the current tax rules, for example, an investor who buys shares directly is taxed differently from an individual who buys them indirectly through an investment manager, such as a unit trust. Similarly, income from investments made in New Zealand are treated differently from those made offshore.

1.3 The proposals outlined in this discussion document aim to resolve these inconsistencies and the distorting effect they have on investor decision-making. The proposals are the culmination of a series of reviews of the tax rules for investment income, specifically focusing on the rules for investment via collective investment vehicles (CIVs), and for offshore portfolio investment in shares.[1] The most recent of these reviews, completed in 2004 by Craig Stobo, identified several significant tax problems and put forward recommendations for reform. The proposals in this discussion document build on the valuable work undertaken by Mr Stobo.

1.4 The key tax problems identified in the Stobo review were that different tax outcomes can arise depending on:

- whether an investor invests directly or through a collective vehicle; and
- whether the investment is in a New Zealand company or a foreign one.

1.5 When New Zealanders invest directly in a company, they are generally taxed only on dividends received from that company. When they pool together to make investments or have their monies managed by a professional, they will usually pay more tax. This is because dividends and capital gains are taxable for those in the business of investing, with most professional funds managers falling into this category.

1.6 In a pooled or collective fund, the tax treatment is based on the character of the fund and not on the nature of the individual investing into that fund. From the perspective of individual investors, this often results in over-taxation, because if they were to make similar investments directly, they would typically not pay tax on those capital gains.

[1] The term Collective Investment Vehicle (CIV) is used to refer generically to vehicles that pool the capital of different investors. The term Qualifying Collective Investment Vehicle (QCIV) is used to refer to entities that will qualify for the new tax rules.

1.7 The government proposes to adopt rules so that the tax treatment of pooled funds better reflects the treatment of individuals who invest in those funds.

1.8 Problems also arise in relation to different tax rules applying to different types of pooled vehicles, such as unit trusts or superannuation schemes. The government proposes to provide rules allowing these different structures to be treated similarly.

1.9 For offshore investments, special tax rules, known as the "grey list" exemption, apply to investments in entities resident in Australia, Canada, Germany, Japan, Norway, the United Kingdom and the United States. Investments in those countries can be taxed more favourably than comparable investment in New Zealand or countries that are not on the grey list.

1.10 The unintended effect is that incentives are created to invest directly and in offshore assets for tax purposes. This can disproportionately affect lower and middle-income savers because they are unlikely to have sufficient funds to invest directly and get diversified returns.

1.11 Balancing onshore and offshore taxation of investment is complicated. One reason is that New Zealanders pay tax on their domestic investments through the tax payments of companies that they invest in (though, often, people do not think about the tax paid by companies in this way). The company tax system levies tax on the earnings of companies even if they do not pay dividends, which provides a measure of tax on investments, even though rises in share price may not be directly taxable. In other countries, some companies pay a similar level of tax, while others pay little to no tax. Further, some offshore investments pay regular dividends, as most New Zealand companies do, while others rarely if ever do so. As a result, finding one tax treatment that suits all offshore investments and does not leave some offshore investments significantly under-taxed is a challenge.

1.12 The proposals outlined here are aimed at better aligning the tax treatment of direct and indirect investment in New Zealand shares, and ensuring that a reasonable level of tax is payable on offshore portfolio share investments.

1.13 The proposals also have wider links with other government initiatives being undertaken in the area of savings and investment. The main link is with the KiwiSaver proposal announced in the 2005 Budget, which aims to encourage employees to save through work-based savings schemes. It is important that if employees are encouraged to save through work-based savings, that the earnings from such investments are taxed consistently and fairly.

1.14 The proposals contained in this document are designed to achieve this, and have been developed in consultation with a number of stakeholders, including the Investment Savings and Insurance Association of New Zealand, the Association of Superannuation Funds of New Zealand, the Institute of Chartered Accountants of New Zealand, and various other financial industry and tax experts. This consultation has been very constructive and the government welcomes further input from these and other interested groups.

SUMMARY OF PROPOSALS

New tax rules for collective investment vehicles

- From 1 April 2007, a pooled fund that qualifies as a qualifying collective investment vehicle (QCIV) would be able to elect a new set of tax rules.
- Under the new tax rules for QCIVs, assessable income would generally exclude realised domestic share gains, although certain domestic share gains that are close debt substitutes would continue to be taxable.
- To qualify as a QCIV, a pooled vehicle would need to meet a number of criteria. These include that the vehicle's principal activities are in the nature of savings and investment; it is sufficiently widely held; investors in the vehicle are "portfolio" investors; and the vehicle is itself a "portfolio" investor.
- Under the new tax rules for QCIVs, assessable income would be required to be "flowed through" to investors, with the QCIV deducting tax at investors' elected tax rates.
- Under the flow-through model, to the extent possible, investors' income would need to be attributed and taxed on a regular basis.
- Investors in QCIVs would generally need to elect a tax rate for QCIV income, based on the previous year's total assessable income from all sources. For individuals, the rate elected would generally be a final withholding tax and would not affect family assistance or child support and student loan obligations. Companies and other non-individual investors would elect their statutory rate. The tax deducted on behalf of these entities would not be a final withholding tax.
- If the QCIV incurs a tax loss, the loss can be carried forward and used by the QCIV to offset assessable income in future years, or can be allocated to investors' accounts.
- Tax credits received by the QCIV, such as imputation credits, will be available to offset assessable income derived via the QCIV.

Proposals to change the tax rules for offshore portfolio investment in shares

- Tax rules for offshore investment in shares where the investor owns 10% or less of the foreign entity invested into ("portfolio" investment) will change.

- The grey list, which allows for concessionary tax treatment of investments into seven countries, will be removed for portfolio investments.
- QCIVs and other non-individual investors will, broadly, use the change in an offshore asset's value over the tax year to calculate their assessable income for that asset. This method will apply to assets for which there is a readily verifiable market value.
- Individuals will also base their assessable income on an offshore asset's change in value over the tax year. However, the tax paid will generally be spread over a number of years to reflect the investor's cashflow. This method will apply to assets for which there is a readily verifiable market value.
- Assessable income on assets that do not have a readily verifiable market value will be calculated under a simplified deemed rate of return approach.
- The new rules would not apply to individuals' investments below $50,000 (total cost of investments) into companies listed on a recognised stock exchange in a country with which New Zealand has a double tax agreement.

1.15 Submissions on any aspect of this discussion document are welcome and can be mailed to:

Taxation of Investment Income
C/- The Deputy Commissioner
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

1.16 Alternatively, submissions may be made in electronic form to:

policy.webmaster@ird.govt.nz

Please put "Taxation of Investment Income" in the subject line for electronic submissions.

1.17 Submissions should be made by 30 September 2005 and should contain a brief summary of the main points and recommendations. Submissions received by the due date will be acknowledged.

1.18 Please note that submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that there is any part of your submission that could be properly withheld under the Act, please indicate this clearly in your submission.

Chapter 2

BACKGROUND

2.1 New Zealand is a small, open economy that relies heavily on capital imports. Like all economically valuable inputs, capital is scarce relative to the uses it could be put to, so it is important that this capital is allocated to its most productive use.

2.2 The current tax rules for investment distort the productive allocation of capital and can generate widely varying tax results for similar types of investment. They also provide an incentive for New Zealanders to invest offshore to seek after-tax returns in just a few countries, when better overall returns may be available in New Zealand or in countries that do not receive concessionary tax treatments.

2.3 The taxation of investment income is a long-standing, complex and controversial issue. It has been the subject of many reviews, the most recent being:

- The Tax Review 2001, which looked at the structure of New Zealand's tax system, including those for investment, and recommended the government consider changes to the tax rules for portfolio offshore investment in shares. The proposal put forward for taxing offshore investment was a risk-free return method (RFRM) which would tax deemed income.
- A review of the tax rules for offshore investment in shares by tax policy officials, which culminated in an issues paper released in late 2003. This document outlined two options for reform – a method based on a deemed rate and a method based on taxing actual changes in value. Submissions on this document overwhelmingly favoured considering tax problems relating to domestic savings vehicles at the same time as any changes to the offshore rules.
- A review of the tax rules for investment income by Craig Stobo, the former CEO of BT Funds Management, in late 2004. It looked at both the vexatious issue of offshore investment, and the tax issues facing investment in New Zealand shares undertaken via a savings vehicle such as a managed fund.

2.4 These reviews and, most notably, the Stobo review have clearly revealed the extent of tax problems in this sector and put forward different options for mitigating various distortions that arise. These distortions are discussed in more detail later, together with the recommendations made for reform in the Stobo report.

Scope of the problem

2.5 Under the current tax rules for investment income, different tax outcomes can arise depending on whether an investor invests directly or through a savings vehicle such as a unit trust or superannuation fund. Equally, different tax outcomes can arise depending on whether the investment is in a New Zealand-based company or a foreign one, with different tax rules also applying to different investments offshore depending on whether the investment is in a grey list country. The grey list exemption applies to investments in entities resident in Australia, Canada, Germany, Japan, Norway, the United Kingdom and the United States. Finally, problems arise owing to the lack of integration, in certain cases, between an individual's marginal tax rate and the tax rate applying to the savings vehicle being invested into.

2.6 In light of these concerns, Craig Stobo was appointed by the government last year to look at the structure of the tax rules for investment income. His role was to consult with the various stakeholders in the New Zealand savings industry, and make recommendations for reform that were consistent with industry consensus.

2.7 The scope of the review included the taxation treatment of New Zealand-resident savings vehicles on their domestic investments in shares and the tax rules for offshore portfolio investment in shares by both savings vehicles and other investors. Direct investment by New Zealanders in domestic shares was not part of the terms of reference for the review. This was to ensure that the review of the taxation rules for investment income was feasible within the review's timeframe, from July to October 2004. It was also recognised that encompassing all aspects of the taxation of investment income, including investment in debt and other non-equity investments, would not have been possible without significantly delaying consideration of key areas such as the tax rules for savings vehicles and offshore investment.

2.8 The review provided a detailed summary of the existing tax boundaries for investment. One of the main distortions identified for domestic investment was the inequity in tax treatment depending on whether an investor acquires an ownership interest in a New Zealand company directly or via an investment vehicle. In most cases, a direct investment in a New Zealand company will be treated as being held, for tax purposes, on capital account. This means that only dividends, not increases in share value, are taxable. On the other hand, if the investment were made via an investment manager, most investment vehicles would hold investments on revenue account, with tax payable on realised gains as well as on dividends. This is because such vehicles are usually in the business of dealing in shares, which requires trustees or fund managers to maintain equity amongst current and future investors. This revenue account treatment occurs despite the fact that the investor may hold the investment in the CIV on capital account. The fact that the investor's capital account status is generally not reflected when he or she invests through a fund manager creates a disincentive for individuals to invest domestically using financial intermediaries.

2.9 A secondary issue considered was the non-alignment of investors' marginal tax rates and the tax rate applying to the savings vehicle invested into. Under the company tax model, imputation allows alignment of company and shareholder tax rates on payment of dividends and other distributions. However, for other entities, alignment of tax rates is either inefficient or absent altogether. An example of this is the tax treatment of superannuation funds where income is taxed to the fund at the rate of 33% but distributions are tax exempt. This creates alignment problems for taxpayers on marginal tax rates of 21% and 39% because the latter are under-taxed in a superannuation fund and the former are over-taxed. The tax treatment of income from unit trusts, superannuation funds and life insurance also varies.

2.10 The other major tax problem identified in the Stobo report was the different tax treatment that applies to investments made in New Zealand or offshore.

2.11 Under the current grey list exemption, non-controlled investment on capital account in companies resident in grey list countries is taxable only on distributions. While similar investment in domestic companies is also taxable on distributions, the company invested into is required to pay tax at 33% each year on its assessable income. Clearly, New Zealand does not have the power to tax offshore companies that New Zealanders invest into. The grey list effectively deems the tax paid by the foreign company in the foreign jurisdiction to be equivalent to New Zealand tax. It operates on the assumption that the entity resident in the grey list pays a similar level of tax to what would have been paid if the investment was made into a New Zealand company. When this level of tax is not paid offshore, the grey list creates an investment distortion in favour of investing offshore.

2.12 Finally, even with the grey list exemption, a different treatment applies depending on whether the offshore investment into a grey list country is made directly or via a New Zealand-resident CIV. That is because the domestic capital/revenue boundary applies on grey list investments. This means that a direct investor will generally hold grey list investments on capital account, whereas active investment managers will typically be deemed to hold an equivalent investment on revenue account, in the same way that domestic shares are treated as being held on revenue account. As with non-controlled investment in New Zealand shares, this creates a disadvantage for an investor when using savings vehicles to hold offshore investments.

Intermediation

2.13 The government is concerned about the tax distortions to investment identified by the Stobo review for several reasons.

2.14 One is the unintended inequity resulting from the current rules. The tax barrier to investing via savings vehicles may disproportionately affect lower and middle-income savers as these groups are unlikely to have sufficient funds and expertise to invest directly in a diversified portfolio of assets. For them, savings and investment vehicles may be an important source of portfolio diversification, but one that is currently tax-disadvantaged.

2.15 Another cause for concern is the effect of tax distortions on the financial system. The pooling of investment and its reallocation generates a broader range of investments than individuals would generally be able to undertake on their own, providing benefits both to investors and to the economy. Work carried out by the Treasury has highlighted the economic importance of the system of financial intermediation, including its role as a key source of finance for certain types of firms. The existing tax distortions impede the productive use of capital and misallocate investment by discouraging intermediation.

2.16 The tax distortion favouring direct investment may naturally lead to investment into larger, more established firms at the cost of investment in financial intermediaries, which affects the investments those intermediaries would make. This is because investors are likely to have incentives to invest directly in established companies. These companies are likely to pay a reasonable level of dividend, providing a greater level of comfort to an individual investor that the investment would be treated on capital account. That could limit access to external finance for some firms or investment types that are better serviced by the pooling of investment through financial intermediaries. Those more likely to be affected include newer firms, those with novel business plans or for whom intellectual property is a large portion of assets, smaller firms or those entering the export sector.

2.17 Discouraging the use of financial intermediaries can have broader costs on the financial system as well. Institutional investors may also play an important role in the efficient functioning of financial markets because investors rely on them, to some degree, to evaluate the governance of firms.

Taxation of offshore investments

2.18 The viability of the grey list as the basis for New Zealand's tax rules for offshore non-controlled investment in shares is increasingly under strain because of various investment entities that result in little or no tax paid in the grey list jurisdiction. Examples include Australian unit trusts (AUTs) and United Kingdom open-ended investment companies (OEICs).

2.19 In relation to Australian unit trusts, when the investment income is non-Australian sourced and derived immediately by non-residents, the AUT is not subject to tax on that income in Australia. Until recently, AUTs were able to pass through tax-free gains to New Zealand resident investors. Open-ended investment companies are slightly different in that they pay tax in the United Kingdom on dividends and other income, but not on capital gains.

2.20 The grey list also assumes that investments into grey list countries actually represent investments into "bricks and mortar" in those countries. The experience with AUTs and OEICs demonstrates that investments into grey list countries often flow through into other countries, where the assumption of adequate taxation is even less likely to hold. The popularity of AUTs and OEICs suggests strongly that the grey list will be unsustainable in the long-term.

2.21 By taxing grey list investments only on their distributions, the tax rules encourage New Zealanders to make overseas investments that do not distribute much of their income. Even when the grey list investment actually pays little or no tax overseas, the New Zealand tax rules deem them to have paid sufficient overseas tax. In effect, this exposes the New Zealand tax base to loopholes in the tax bases of the world's largest economies.

2.22 The assumptions underpinning the grey list increasingly no longer hold credibility, particularly for portfolio investment. Retention of these concessionary tax rules results in an increasingly significant incentive to invest offshore, and in a small number of countries, at the expense of investment in New Zealand or non-grey list countries which would offer diversification and growth opportunities for investors.

2.23 While direct portfolio investment by an individual in a company that is resident in a grey list country is typically taxable only on distributions from the company, investments in non-grey list companies can be taxed on an accrued basis. This typically occurs on unrealised changes in value, under the foreign investment fund (FIF) rules. The difference in tax treatment has created a real incentive for individuals directly investing offshore to invest in the grey list rather than lower-tax jurisdictions and certain high-growth non-grey list countries. That does not make sound economic sense.

2.24 Finally, the grey list retains the same distortion between direct and indirect investment for offshore investment that occurs domestically. New Zealanders are discouraged from using domestic investment vehicles in favour of overseas vehicles, which undermines the viability of investment vehicles based in New Zealand. If New Zealand-based investment vehicles are important economically for domestic investment, or for effectively managing overseas investments of New Zealanders, this is an undesirable outcome.

Stobo report's options for dealing with tax boundary concerns

2.25 The Stobo report proposed a number of options for resolving the identified concerns with the tax treatment of investment income:

- To resolve the non-alignment of personal and entity tax rates when investing via a managed fund and the different tax treatment across entities, it was recommended that qualifying savings vehicles, known as "qualifying collective investment vehicles" (QCIVs), be given flow-through treatment. Under a flow-through model, the vehicle would be transparent for tax purposes. The underlying income would be treated as being derived directly by the investors, with tax withheld at investors' marginal tax rates. QCIVs would simply operate as a withholding agent for tax purposes.

- To resolve concerns in relation to the inequity in tax treatment depending on whether an investor invests in domestic shares directly or via a QCIV, two options were provided:
  - Option (1): exempting from taxation realised gains on domestic shares made via a QCIV.
  - Option (2): taxing domestic shares held through a QCIV using a deemed rate approach (an investment and savings tax, a variant of the risk-free return method or RFRM).
- To resolve concerns in relation to the current tax rules for offshore portfolio investment in shares (the grey list and non-grey list distinction), the report recommended replacement of the grey list and FIF rules with an investment and savings tax.

2.26 In consulting on the tax boundaries and options to mitigate the impact of these on investment decisions, about 70 parties were consulted with as part of the review. They included individual fund managers, financial planners, tax advisors, consumer advocates and industry associations such as the Investment, Savings and Insurance Association, the Institute of Chartered Accountants of New Zealand, the Association of Superannuation Funds of New Zealand, the New Zealand Law Society and the Corporate Taxpayers Group.

2.27 The Stobo report necessarily evaluated any options for the resolution of the identified tax distortions at a high level, noting that the options needed to be developed in more detail, with relevant stakeholders. The report provides a sound basis for discussions with key stakeholders on detailed design issues around the options identified. These discussions have framed the proposals for change that are outlined in this document. Some proposals are different from those recommended by the Stobo report. Reasons for these differences are outlined later in this chapter, with greater detail included in the next few chapters.

Evaluation of options from the Stobo report

2.28 The options for changing the tax rules for savings vehicles put forward in the Stobo report were aimed at providing greater neutrality between the tax treatment of direct and indirect investment in onshore and offshore investment in shares. According to stakeholders consulted during the review, the distortion between direct and indirect investment (both offshore and onshore) was the key issue.

Domestic investment

2.29 As noted earlier, realised profits on New Zealand shares that are held directly are not taxed, while those made via a CIV generally are taxed. The current treatment therefore creates a distortion in favour of holding domestic shares directly, rather than through managed funds.

2.30 The Stobo report suggested that an investment and savings tax should replace the current rules that tax managed funds on their realised profits from shares held in New Zealand companies. Under this approach, assessable income would be calculated by deeming the value of a fund's share portfolio to have a return equivalent to the government stock rate. While such an approach is arguably better than the status quo, it would not provide sufficiently similar treatment to direct investment.

2.31 Of the two domestic reform options identified in the report, the option to exempt from tax most realised equity gains derived via a QCIV would bring the taxation of this income into alignment with that of direct investment better than an investment and savings tax would. As this was a key objective of the review, the option to exempt most domestic share gains would seem to be desirable from both an equity and efficiency perspective and is therefore the government's preferred option for reform. This was also the preferred option of most stakeholders consulted and is discussed in more detail in chapter 4.

2.32 Stakeholders consulted during the review also broadly supported a flow-through of assessable income to investors via QCIVs on the basis that this would allow for better alignment with investor tax rates and reduce the tax risks for QCIVs. While some concern was expressed over the cost required to change systems to accommodate the new approach, most stakeholders accepted that there were benefits in such an approach.

2.33 A flow-through model for QCIVs should result in taxpayers' personal tax rates applying to their investment income derived via a QCIV and should better align with the treatment of direct investment. The government therefore supports this option, which is discussed in greater detail in chapter 4.

Offshore investment

2.34 For the taxation of offshore investments, the option put forward by the Stobo report would remove the current grey/non-grey list distinction for portfolio investments, resulting in investment decisions being less influenced by the tax system. The government supports the removal of the grey/non-grey list distinction as this should remove tax biases in favour of investment in some countries and should encourage New Zealanders to invest in other countries based on after-foreign tax returns.

2.35 The report also recommended that an investment and savings tax replace the current tax rules on share gains derived via a QCIV, largely because it would remove the onshore/offshore boundary for QCIVs. However, the boundary would remain for non-QCIV investors, because the investment and savings tax would apply to their offshore direct holdings, whereas the current rules would apply to domestic shares. Under the Stobo recommendation, the onshore/offshore tax boundary would remain for direct portfolio investment in shares.

2.36 An investment and savings tax, although conceptually simple, is also relatively complex to apply. The complexity arises when investors make adjustments to their portfolio of offshore assets during a year – in other words, buys certain shares and sells others.

2.37 Under an investment and savings tax, if these "part-year" adjustments are not accounted for, a situation could arise where a taxpayer could be under-taxed or over-taxed. Investors would be under-taxed when they did not hold any assets at, say, the beginning of the year and they acquired assets during the year, because the investment and savings tax would calculate tax on an opening value of zero. They would be over-taxed when they held some offshore shares at the start of a year, but sold a portion of their holding during the year. If no adjustment were made to account for the fact that the holding at the beginning of the year was not retained for the entire year, tax would be paid as if none of the shares had been sold. Likewise, calculating tax on a full year's worth of income would occur on shares that were held for as little as one day.

2.38 Mechanisms exist for accounting for such portfolio adjustments. Officials developed such a method for shares held in a non-business context. (See the issues paper, *Taxation of non-controlled offshore investment in equity*, released in December 2003.) Funds could manage such adjustments relatively easily by simply calculating investment and savings tax on daily unit prices. However, the method developed for non-business investors is much more difficult.

2.39 While it would be possible to further simplify the investment and savings tax income calculation mechanism for smaller investors, the government does not consider that the simplification benefits are likely to be significant. Such a measure would still result in high compliance costs for investors, and any simplicity would come at the cost of greater inaccuracy in the income calculation measure. The potential for abuse of such a measure could easily outweigh the benefits.

2.40 The government is also concerned that an investment and savings tax would result in New Zealanders having to pay tax even when the value of their investment declined. While the assumptions underlying an investment and savings tax would support such a proposition, in practical terms, this could result in tax having to be paid on an offshore share, even when there is no cashflow, such as a dividend to meet the tax liability.

2.41 Finally, it is not clear that an investment and savings tax (or an RFRM) is the appropriate mechanism for taxing offshore portfolio investment in shares. Other options appear to be more suitable for dealing with the tax boundaries raised in the Stobo report. One such alternative, developed in consultation with stakeholders and which the government considers addresses many of the boundary issues identified in the Stobo report more comprehensively than an investment and savings tax/RFRM, is discussed in more detail in chapter 5.

Chapter 3

NEW TAX RULES FOR COLLECTIVE INVESTMENT VEHICLES

3.1 This chapter and chapter 4 outline a new set of tax rules for the calculation of assessable income derived through qualifying savings vehicles (termed qualifying collective investment vehicles or QCIVs) on their investments in domestic shares. It is envisaged that savings vehicles that meet the definition of QCIV will be able to elect into the rules from 1 April 2007. This will allow those vehicles that meet the QCIV definitional requirements to remain under the existing tax rules until they are able to make the transition. Whether the new rules remain elective will be reviewed in the future.

3.2 The aim of the proposals outlined in this chapter is to create a set of tax rules that allow investment vehicles to overcome the tax distortions discussed in the previous chapter. The proposals must therefore ensure that investors in QCIVs have their investment income taxed appropriately. The starting point for this is articulating which entities are eligible to use the new rules.

3.3 The current company tax rules generally tax distributions from companies even when the distributions were not taxed at the company level. While this treatment is being relaxed for QCIVs (on the basis that they are effectively operating as an investment decision-maker for their investors) it is important to note that these proposals do not aim to relax the rules outside this limited area.

Definition of a collective investment vehicle

3.4 To achieve the policy objectives described in chapter 2, it is necessary to define the nature of the vehicles that will qualify for the relaxation of income tax on certain share gains derived. Accordingly, the term "QCIV" needs to be defined, and difficult boundary issues will need to be resolved. The government aims to ensure that the boundary is appropriately defined to enable valid savings and investment vehicles to access the rules, while maintaining the tax base and preventing abuse of the rules. It is envisaged that the rules will be elective to prevent other entities from inadvertently falling within them and being subject to the associated QCIV tax obligations.

Features of a qualifying collective investment vehicle

3.5 Given the main policy objectives of the review, it is the government's view that an entity seeking QCIV status should have these key features to qualify for the proposed special tax treatment:

- Its principal activities should be in the nature of savings and investment.
- It should be sufficiently widely held.
- It does not issue units of different classes to its investors.
- Its investors should be "portfolio" investors.
- It should itself be a "portfolio" investor.
- It should be resident in New Zealand for tax purposes.

Principal activity of savings and investment

3.6 One of the key aims of the proposed rules is to remove a significant tax barrier to diversified portfolio investment faced by those investing via savings and investment vehicles. The government therefore considers that a QCIV should be a vehicle whose principal activity is the pooling and allocation of capital for the purposes of diversified saving and investment, and from which investors will be provided with investment returns. It is envisaged that this would involve the provision of facilities by the entity to enable many non-associated investors (such as subscribers, purchasers, or contributors) to come together and pool monetary capital, invest the pooled capital in a diversified manner, and share in the investment income and gains.

3.7 This requirement would aim to ensure that only genuinely diversified savings and investment vehicles were eligible to access the special tax QCIV rules. Entities with principal activities that are other than that of savings and investment, such as manufacturing firms, would therefore not be eligible. The meaning of "principal" should reflect the underlying objective that virtually all of the activities of the entity should be of a savings and investment nature.

3.8 The government welcomes submissions on this proposal.

Sufficiently widely held by portfolio investors

3.9 The government considers that a QCIV should be a sufficiently "widely held" savings and investment vehicle. This leads to the conclusion that the definition of QCIV should require that:

- The entity has a reasonable minimum number of non-associated persons investing into it.
- The entity's investors are "portfolio" investors only.

Minimum number of investors

3.10 The absence of a formal capital gains tax in New Zealand is driven by practical considerations rather than the application of theoretical economic principles in defining the appropriate tax base. However, in a country without a capital gains tax, there are sound reasons why a government would still seek to tax certain forms of capital gains – for example, when there is a significant degree of substitutability between non-taxable gains and gains that would otherwise form part of assessable income. With respect to the definition of a QCIV, substitutability with the taxable labour income of individuals is a key concern. Not taxing genuine labour income could undermine the tax system and reduce the tax base that provides the revenue necessary to fund critical public services.

3.11 To be consistent with the policy objectives of the special tax QCIV rules, a critical requirement of the definition of QCIV would be that the savings and investment entity has a reasonable number of non-associated investors holding an ownership (or equivalent) interest in that entity. The rationale for this requirement is to reduce the potential for abuse by ensuring that the rules are not accessed by "closely held" entities, or the widespread use of entities by individuals seeking to shelter their investment-trading labour income from tax.

3.12 The government seeks to determine a minimum number of investors that will ensure QCIVs are sufficiently widely held, while allowing genuine savings and investment vehicles to access the new rules. It is also important to ensure that vehicles specialising in greenfields investments and investments in unlisted companies are able to access the new rules where practical. This is considered important because there is the potential for these investments to significantly contribute to a sustainable increase in New Zealand's long-term economic growth, as well as lead to a greater diversification of investment portfolios. What constitutes a "sufficient number" of investors to be generally regarded as "widely held" is clearly a subjective issue, and it is acknowledged that any number used will ultimately be a question of judgement.

3.13 In seeking guidance for an appropriate minimum number of investors, current income tax legislation defines "widely held company" for certain purposes as essentially being a company that has at least 25 non-associated shareholders. In addition, the definition of "qualifying unit trust" in the income tax legislation requires a unit trust to have at least 100 non-associated unit holders (investors) in order to be treated as the same notional single person and prevent breaches of the shareholder continuity rules. Accordingly, there is some range in the current income tax legislation concerning the minimum number of investors typically required in a widely held context. When considering the minimum number of investors required for an entity to access the special tax QCIV rules, the government considers that the need to ensure that a QCIV is genuinely widely held should be balanced against not excluding funds that invest in unlisted New Zealand companies. Requirements on minimum investor numbers are relevant for greenfields investments and investments in unlisted companies, as often these funds have a limited number of investors.

3.14 Given the policy objectives of the proposals, the concern over abuse and tax avoidance in a "closely held" context, and the importance of facilitating access to the special tax QCIV rules for greenfields investments and investments in unlisted companies, the government considers at this stage that the minimum number of non-associated investors required for an entity to qualify as a QCIV should be 20. While this requirement would not accommodate all greenfields investments and investments in unlisted companies, it would facilitate access to the rules for those that are genuinely widely held.

3.15 If a QCIV invests into another QCIV, the minimum number of investors would automatically be met, although non-QCIV investors would still be limited to a portfolio interest. The rationale behind this exception would be to accommodate the common commercial situation in the funds management industry whereby retail investment funds achieve efficiencies and diversification through the use of diversified wholesale investment funds.

3.16 Submissions are welcomed on these issues.

Owners are portfolio investors

3.17 Given that the new rules are designed to apply to widely held entities that pool capital for many investors, the government considers that it is appropriate for there to be a requirement that the owners of the entity seeking QCIV status should be portfolio investors. This requirement supplements the constraint outlined earlier in relation to the minimum number of investors. However, this requirement raises boundary concerns about the precise meaning of the term "portfolio investor". The current taxation of offshore investment income rules – for example, the underlying foreign tax credit rules – and international norms on the taxation of portfolio investment, suggest that a "portfolio investor" is typically one holding equal to or less than a 10% actual ownership interest in any given asset or investment, taking into account any situation where there is a "market value circumstance".[2] While the government considers that this is a reasonable and generally accepted concept of portfolio investment, submissions are welcome on this point.

3.18 As QCIVs are themselves widely held, however, an exception to the "portfolio investor" rule is proposed to allow a QCIV to have a greater than 10% interest in another QCIV.

[2] A "market value circumstance" exists when a person's actual ownership interest in an entity does not accurately reflect the person's economic interest in that entity.

3.19 It is also proposed that exceptions to the "portfolio investor" rule be allowed in "unusual or temporary breaches" such as the insertion of seed capital or when a fund is winding down. Such rules are a feature of the current definition of "qualifying unit trust".

3.20 Submissions are welcome on developing workable "unusual or temporary breach" rules that do not give rise to significant tax base maintenance concerns and administration difficulties.

Entity seeking QCIV status must be a portfolio investor

3.21 To reduce tax barriers to portfolio investors accessing diversified investment portfolios, the government considers that the definition of QCIV should require the savings and investment vehicle seeking QCIV status to itself be a portfolio investor. The aim of this requirement would be to restrict access to the rules to those widely held entities that have pooled investors' resources and invested into a diversified range of investments.

3.22 In principle, the 10% portfolio requirement would seem an appropriate starting point for determining the maximum actual ownership interest a QCIV could have in any given asset or investment. However, when considering the maximum actual ownership interest a QCIV should be allowed to have in a particular investment under the new rules, the ability to access greenfields investments and investments in unlisted companies is an important consideration.

3.23 By their nature, these investments are typically owned by a small number of investors in the early-growth stages of investment. Consequently, maximum actual ownership interest rules that are too restrictive may exclude such investments. Further, the government understands that it is common and prudent practice in the funds management industry for certain diversified investment portfolios to contain investments in which the fund has a 100% interest – such as commercial property investments, for example. While this would not generally be consistent with a "portfolio investor" principle, the government considers it may be appropriate to accommodate these situations by modifying the maximum actual ownership interest tests as they would apply to a QCIV's outward investment.

3.24 To deal with these considerations, the government proposes two options in relation to the maximum actual ownership interest restrictions.

Option 1

3.25 Under this option, entities seeking QCIV status would generally be restricted to a maximum actual ownership interest of 10% in any given non-QCIV investment. That is consistent with international norms of what constitutes portfolio investment. However, the government acknowledges that the 10% portfolio investment requirement may significantly restrict access by investment funds designed to facilitate access to greenfields investments and investments in unlisted companies.

Option 2

3.26 Under option two, entities seeking QCIV status would generally be restricted to a maximum actual ownership interest of 25% in any given non-QCIV investment. Although that represents a departure from international norms in terms of the meaning of portfolio investment, it reflects a balance in order to ensure flexibility is provided to access certain types of investments, while ensuring QCIVs maintain diversified investment portfolios.

3.27 An additional requirement may be appropriate under this option to combat abuse of the rules. Specifically, an entity seeking QCIV status, that is not a registered superannuation scheme, would have a mechanism to ensure that investors could access their investments at an estimated market value (a "buy-back" mechanism).

3.28 The rationale for requiring a buy-back mechanism is to ensure that an investor in a QCIV is effectively in the same position as a direct investor – that is, the investor is able to redeem the investment at an estimated market value. While it is not proposed that such access would be available to investors on a daily basis (as this would preclude legitimate situations where investment lock-in was required by investors), the buy-back mechanism would need to be available to investors at a minimum of every five years.

Non-portfolio investment

3.29 Whether a portfolio interest is deemed to be 10% or 25% for a particular CIV, an exception could be provided for some non-portfolio investments. A QCIV could hold up to a 100% actual ownership interest in any particular non-QCIV investment, with the proviso that the aggregate value of all QCIV investments in which the QCIV has a non-portfolio interest do not represent more than 10% of the value of the entity's total investment portfolio during the entire period that the particular investment is held.

3.30 The rationale behind this requirement is to ensure that there is sufficient flexibility within the rules to allow a QCIV to hold a significant interest in investments that are part of a genuine diversified investment portfolio. This would accommodate diversified investments that are both passive – such as investments that derive rental, interest, dividend, and royalty income – and those that are active in nature, such as income derived from manufacturing activities, while ensuring that the vehicle is still in itself a portfolio investor.

3.31 It is acknowledged that these rules may preclude certain property trusts from accessing the new QCIV rules (as they may breach the suggested maximum 10% non-QCIV investment threshold). The government seeks submissions on this point

3.32 The government appreciates that each option has its merits and drawbacks. It also acknowledges that these maximum actual ownership interest restrictions may involve some compliance costs for taxpayers in terms of investment-level monitoring activities, notwithstanding the extra flexibility being proposed. Accordingly, submissions on ways to minimise compliance costs while guarding against potential abuse and circumvention of the rules are welcomed.

3.33 Under both options a QCIV can hold real property directly, provided the property is not more than 10% of the value of the QCIV's total underlying assets. To the extent that real property is held on revenue account, that could pose problems for QCIVs in flowing through unrealised taxable amounts to underlying investors. This would suggest that QCIVs holding real property on revenue account should have the option of accounting for tax on the change in value of that property.

3.34 Submissions are invited on how difficult it would be to require flow-through of unrealised taxable amounts to underlying investors.

One class of unit on issue

3.35 A key aim of the proposals is to ensure that the correct amount of income is taxed at the correct rate. To achieve this it is necessary to be able to calculate each investor's share of the underlying assets. If an entity issued different classes of unit – for example, Class A units which entitled investors to income and Class B units which entitled investors to capital appreciation – it would not be feasible to calculate each investor's share. In addition, allowing different classes of units to be issued could give rise to tax integrity concerns. For example, it could be possible for a class of unit to be issued that would provide investors on high marginal tax rates with an entitlement to non-taxable capital gains, while a different class of units, giving an entitlement to assessable income, could be provided to low marginal tax rate investors.

3.36 The government therefore proposes a requirement that to meet the QCIV definition, the entity issues only one class of unit for each fund it operates. This measure is not intended to stop QCIVs that consist of several different funds, such as a balanced fund, conservative fund or growth fund, from offering different units for the different funds. This is current commercial practice. Rather, it is meant to stop the development of products designed to stream different classes of income to different investors, depending on the tax benefits involved. QCIVs that do not offer units such as defined benefit superannuation schemes would not be subject to the requirement as they do not operate on a unit basis.

QCIV must be New Zealand-resident for tax purposes

3.37 An entity granted QCIV status will be required to discharge certain tax obligations, as outlined in the next chapter. Among these obligations is the requirement to calculate, deduct and forward tax payments to Inland Revenue on behalf of investors for the taxable investment income they derive.

3.38 To ensure that these obligations can be adequately monitored and enforced, QCIVs should have a fixed New Zealand presence. It is envisaged that this presence would take the form of a New Zealand-resident entity through which tax calculation and tax payment activities are performed. In principle, it is an appropriate tax policy result to allow non-resident portfolio investors access to the rules as well as resident investors, thereby allowing non-resident investors the same exemption from income tax for domestic share gains as that provided to resident investors. The proposed withholding tax rate that would be applicable to distributions by the QCIV to non-resident investors is discussed in the next chapter.

3.39 Submissions are welcome on the issue of whether there should be a requirement that an entity seeking QCIV status should be resident in New Zealand for tax purposes.

Breach of QCIV criteria

3.40 Only entities meeting and continuing to meet the QCIV definitional requirements should have access to, and continue to have access to, the special tax QCIV rules. Rules will need to be developed to address situations where breaches occur that are not of an unusual or temporary nature.

3.41 Given that existing tax rules would continue to apply to non-QCIV entities after the implementation date of the new rules, it follows that those breaching the QCIV definitional requirements would generally revert back to the tax treatment applying under those existing rules. However, there is a concern that this approach would allow some entities with QCIV status to change between the two sets of rules when it suited them, in clear conflict with the policy intent of the new rules. To prevent this kind of activity, the following consequences are proposed when an entity breaches the QCIV definitional requirements as a result of a situation that is not regarded as unusual or temporary:

- The flow-through status of investment income would be lost.
- The entity would revert to taxation under the tax rules existing for non-QCIVs from the beginning of the income year of breach. This may result in provisional tax liabilities arising and the imposition of tax penalties and use-of-money interest.
- There would be a deemed disposition and acquisition of all investments at market value at the time the breach first occurred.

- Domestic share gains would become taxable.
- Losses arising in relation to domestic shares would be available to offset against gains from domestic shares in the year of the breach. Any residual losses would be extinguished.
- The entity would forfeit its ability to become a QCIV in future.

3.42 The aim of these restrictions is to provide a significant disincentive for taxpayers to be in permanent breach, defeating the policy intent of the new rules. Submissions are welcomed on the nature and details of rules that should apply to permanent breaches of QCIV definitional requirements.

3.43 A question arises in respect of how to treat tax previously deducted and paid to Inland Revenue by the QCIV on behalf of investors before the time of breach. It is also relevant to the issue of how this tax would factor into any provisional tax payable by the entity in breach. Submissions on any problematic aspects of the proposed rules are invited.

QCIV a taxable entity

3.44 To ensure that the investment management fees derived by QCIVs from investors are declared and appropriately taxed, QCIVs would be taxable entities in relation to their investment management-fee income. The income subject to tax would be the net income derived by the QCIV from its investment management activities, which would generally consist of its fee income less any deductible expenses. QCIVs would therefore be required to file annual income tax returns.

3.45 A key exception to the portfolio investment rules would enable QCIVs to acquire a 100% ownership interest in business assets necessary to provide their investment management services. This would enable them to wholly own business assets such as a business premises from which investment management and administration activities are carried out; furniture and fittings; information technology and communications equipment. QCIVs would also be able to employ personnel to carry out and provide investment management services.

3.46 The government recognises that the proposal may not be a perfect fit with how CIVs are currently structured. Submissions on practical problems the proposal may give rise to are welcomed.

Application

3.47 The special QCIV tax rules would be elective to prevent savings and investment entities from inadvertently falling within the rules and being unknowingly exposed to the associated QCIV tax obligations. Accordingly, the current taxation of investment income rules would apply unless an entity specifically elected into the rules. While it is appreciated that this proposal would involve the operation of two sets of rules concurrently and therefore result in greater complexity, it would preserve the special status of the new rules by ensuring that only those meeting the definition of QCIV are exempt from income tax on domestic share gains. However, it is expected that the voluntary nature of the rules would be reviewed in future.

3.48 To combat possible abuse of the new rules by entities electing into the rules one year and out the next, the government considers it is necessary for elections into the new rules to be irrevocable. The new rules would cease to apply only on cessation and winding up of the particular entity, or in the case of a breach of the QCIV definitional requirements.

Points for submission

The government welcomes submissions on any points raised in this discussion document, with specific comment welcomed on the following:

- Whether the entity's principal activities should be in the nature of savings and investment, and the meaning of "principal".
- The appropriate minimum number of investors a QCIV should have in order to be sufficiently widely held.
- The concept that QCIV investors should be portfolio investors and the maximum investment that any one investor should be allowed to have in the QCIV.
- Whether workable "unusual or temporary breach" rules can be developed, and the nature of these rules.
- Whether the QCIV should itself be a portfolio investor and the maximum actual ownership interest a QCIV should be allowed to have in any given asset or investment.
- Whether there should be a requirement that an entity seeking QCIV status should be resident in New Zealand for tax purposes.
- The consequences of breaches of the QCIV definitional requirements when the breaches are not "unusual or temporary", and the nature and detail of any rules to deal with such situations.
- The practical problems associated with the QCIV being able to have 100% ownership in business assets necessary to conduct investment management and administrative functions.

Chapter 4

PROPOSALS TO ACHIEVE NEUTRALITY AND ALIGN MARGINAL TAX RATES

Proposal 1: A new definition of assessable income for QCIVs

4.1 To achieve broad neutrality between direct investment in New Zealand shares and investment via a QCIV, the definition of "assessable income" for QCIVs should be the same as under the current rules, except that realised gains on domestic shares will generally no longer be taxed.

4.2 The realised gains on most direct investments by individuals in shares are not taxed. The reason is the difficulty in demonstrating that the taxing provisions have been met for many individual direct investments in shares. These tests rely on factors such as the presence of a business, which can be hard to show for individuals, or a demonstration that the investor had a subjective dominant purpose of resale when the investment was purchased.

4.3 In contrast, the tests can be met more easily by a managed fund, because the fund will often, unambiguously, be in the business of trading in equities, and conservative trustees often err on the side of caution when deciding whether share gains should be returned for tax purposes. This difference in treatments creates clear disincentives, both anecdotally and practically, to use a managed fund to invest in shares.

Changes to the capital/revenue boundary for domestic share gains derived via QCIVs

4.4 Most savings vehicles that would qualify as QCIVs pay tax on domestic share gains – largely because they are treated as a separate entity from their underlying investors and because of uncertainty over the application of the capital/revenue boundary.

4.5 One effect of this uncertainty is that trustees of QCIVs do not know during the life of the investment whether the investment is taxable on realisation. They must treat it as if it were taxable to ensure that investors present at the time of realisation are not treated less favourably (by having to pay the tax) than investors who have already departed.

4.6 In terms of the capital/revenue boundary, sections CA 1(2), CB 1, CB 2, CB 3 and 4 of the Income Tax Act 2004 (sections CD 3, 4 and 5 of the Income Tax Act 1994) apply in determining whether share gains are taxable on realisation.

4.7 Section CB 1 of the 2004 Act (section CD 3 of the 1994 Act) deems the gross income of any person to include any amount derived from any business. For savings vehicles, it is very likely that section CB 1 will apply as such a vehicle is in the business of making investments – that is, buying and selling shares in order to make share gains. This provision, combined with the conservative nature of fund trustees, means that it is very likely that it would apply to tax share profits derived through QCIVs.

4.8 One option considered was removing the application of the "business" test for QCIVs. However, this alone would not deal with the issue of domestic share gains derived via QCIVs being taxable, as sections CB 2, 3 and 4 of the 2004 Act (sections CD 4 and 5 of the 1994 Act) could also apply to tax them.

4.9 Section CB 3 (the second limb of section CD 4 of the 1994 Act) taxes any gains from the sale of personal property such as shares if the property was acquired for the purpose of selling or otherwise disposing of it. This is what is known as the "purpose" test.

4.10 The "purpose" test is subjective, requiring consideration of the state of mind of the purchaser at the time of acquisition. If there is more than one purpose, then, typically, the test is whether the dominant purpose at the time of acquisition is one of sale or other disposition. There is a significant risk that even if domestic share gains derived via a QCIV are not taxable under the "business" test they would be taxed, in most instances, under the "purpose" test. Depending on the QCIV's pattern of investment, conservative trustees of funds are likely to want to avoid situations where Inland Revenue could challenge (perhaps in later years) that an investment had not been purchased with a dominant purpose of resale. This risk may well result in trustees returning such profits for tax purposes. Consequently, an amendment is proposed to ensure that section CB 3 does not apply to tax realised gains on domestic equity derived via a QCIV.

4.11 Sections CB 2 and CB 4 (the first and third limbs of CD 4 of the 1994 Act) tax the profits from shares if the person's business comprises dealing in shares, and when the profits of shares relate to the carrying on of an undertaking or scheme devised for the purpose of making a profit. Section CA 1(2) (CD 5 of the 1994 Act) taxes share gains if those gains are "income under ordinary concepts".

4.12 For similar reasons to those described earlier, there is a risk that trustees of funds could return, for tax purposes, gains on domestic shares as a result of the application of these provisions. Therefore these provisions should not apply to domestic equity gains derived via a QCIV.

4.13 This does not mean that certain domestic equity gains derived via QCIVs would not be subject to tax. It is proposed to continue to tax certain equity gains derived via QCIVs, that are akin to debt.

Gains on equity investment that would still be taxable

4.14 While the government proposes to exempt gains from equity investment from taxation the current debt treatment for such funds would be maintained. That is because the QCIV model is designed to proxy the tax treatment of individuals. With debt, there is currently no difference in the tax treatment between individuals and managed funds, as all taxpayers are subject to the financial arrangement rules relating to debt instruments.[3]

4.15 The capital gains exemption is also intended to apply only when the QCIV has full equity risk associated with the investment. The nature of equity risk is that the return is uncertain. While there may be a capital gain over time, there is also a real possibility of capital loss.

4.16 The government is concerned that in exempting capital gains for equity to proxy the tax outcomes for direct individual investors, this exemption becomes effectively extended to debt substitutes or to situations where the equity risk is removed through the use of derivatives.

4.17 One option is to broaden the dividend rules to include situations where a taxable return such as a dividend is converted into a non-taxable return – a capital gain. Examples include situations where dividends are deferred until redemption or a share is sold before a dividend is paid.

4.18 To ensure that any rules in this area are as clear and certain as possible, fixed rate shares, and shares that provide no dividend and are redeemable for a set price – provided that the price is equal to or greater than the cost to the QCIV of acquiring the share – would be treated as revenue account property by the QCIV. Strengthening the dividend rules to deal with debt substitutes held through QCIVs would not appear to give the necessary certainty to QCIVs or the government. However, submissions on this point are welcomed.

4.19 To ensure that capital gains are exempted only to the extent the QCIV was subject to the underlying equity risk, all costs relating to derivatives that would reduce equity risk generally would not be deductible. This ensures that only the portion of the return that reflects the equity risk is not subject to tax and reflects the tax treatment of an individual who holds shares on revenue account buying an equity option.

[3] It is accepted, however, that there is a timing difference and individuals may be cash-basis holders and so not return any discounts or deduct any premiums until the instrument matures or is sold.

Other assessable income and treatment of tax credits and deductibility of expenses

4.20 The new definition of "assessable income" for QCIVs would continue to include dividends, interest, and other returns, which are currently taxable. The only changes will be to the taxation of domestic share gains and the definition of "assessable income" in relation to portfolio investment in offshore shares by QCIVs. The latter is discussed in more detail in the next chapter. Tax credits such as imputation credits attached to dividends and resident withholding tax deducted on interest would continue to be available for use. The use of these credits is discussed further in the following section, on the proposed flow-through tax treatment for QCIVs.

4.21 Fees incurred by investors in investing via a QCIV will be able to be deducted against assessable income derived via a QCIV. Fees incurred that relate to the purchase of domestic shares will be deductible in the same way as if they had been incurred directly by an individual passive investor. Inland Revenue's Interpretation Statement IS0044 – *Financial planning fees: income tax deductibility* is helpful in providing guidance on the circumstances when such fees are deductible. The statement categorises financial planning fees and indicates that administration, monitoring, evaluation, re-planning and switching fees will be deductible for tax purposes.

Key question: would direct active investment in New Zealand shares be tax-disadvantaged relative to investment via a QCIV under the proposed changes?

One of the questions that arises from not taxing domestic share gains made via a QCIV is whether it would create a tax disadvantage for direct investment in New Zealand. That is because the "business" and "purpose" tests would continue to apply to individual investors on their direct holdings. Taxpayers who are share traders, for example, would continue to be taxed on realised share gains, whereas if the investments were via a QCIV, the activities of the QCIV would not render taxable the domestic share gains.

Individual investors would still be subject to tax on any share gains from trading as this is the correct tax base for these taxpayers. Not taxing these gains would create an incentive for taxpayers to substitute other employment activities (when income in the form of salary and wages is taxed) to this type of activity (when what is effectively the income from labour would not be taxed). This would create tax integrity concerns, because a form of labour income – exerted in trading in capital assets – would not be in the tax base.

It should be noted that under the new rules, if investors actively trade their interest in a QCIV, any gains from this activity will be subject to the capital/revenue boundary, as it exists currently. In other words, if an investor owns an interest in a QCIV and actively trades this interest, so that the "purpose" (or "business") test is met, any gains will continue to be taxable. In this context, the interest in the QCIV will be treated as any other share investment held directly by the individual investor.

The question of the appropriate tax base when a taxpayer invests through a QCIV is different. While the QCIV may actively trade shares on behalf of the taxpayer, under the proposed definition of a QCIV, the taxpayer will effectively give up control over the management of the investment. One of the key principles for qualifying as a QCIV is that the investor has a non-controlled or portfolio investment in the QCIV and the QCIV is itself a portfolio investor. When an investor has given up investment decision-making control, one concern about the substitutability of taxable labour activity with non-taxable activity no longer applies – the substitutability between QCIV income and labour income.

As the investor should not be able to influence the investment strategy of the QCIV, the question is then whether the gains made by the QCIV on the investor's behalf should be taxable as a proxy for the investor. It can be argued that they should not, because the investor pays a fee to the QCIV to undertake investments on his or her behalf. When a QCIV appropriates a higher fee for generating higher return – for example, with certain foreign hedge funds, taxing the fee would be the appropriate tax policy response rather than separately taxing the gain. This should capture the extra value added by the QCIV. In theory, the fee should proxy the implicit salary or wage income an individual share trader would receive from undertaking this activity.

In summary, the key difference between an individual making active direct investments or making them through a QCIV is that in the latter case the individual cedes control over investment decisions to the QCIV. Investing through a QCIV will also result in a fee being paid by the investor, which is taxable to the QCIV. In theory, this should reflect the value added by the QCIV.

Key question: what would occur in relation to passive funds?

"Passive" is the term given to investment funds with a ruling from Inland Revenue that they are not in the "business" of actively trading investments. These funds typically track the movements of foreign indices, such as the Morgan Stanley Capital Index, with buy-sell decisions contingent on these movements and changes to the composition of the index. The effect of the Inland Revenue ruling is to deem these investments to be held on capital account, and they are marketed as such. Anecdotally, it has been suggested that most passive funds track offshore indices, although there is evidence that some track New Zealand indices.

Under the proposed changes, savings vehicles that qualify as QCIVs and actively undertake domestic share investments would not be disadvantaged relative to passive funds that track domestic indices. The rulings that currently give passive funds a more favourable tax treatment are a tax distortion and influence investment behaviour in a particular way. The removal of this distortion for domestic investment should ensure that investment decisions are undertaken for commercial rather than tax reasons and are based on the returns and fees of the QCIV concerned.

Proposal 2: Flowing through assessable income to investors with tax deducted at marginal tax rates

4.22 While the definition of income is important, of equal importance is how this income will be taxed. As noted earlier, there is a significant non-alignment between personal and entity tax rates, depending on the savings vehicle being invested into. Changes are proposed to better align the tax treatment of investment via a QCIV with that of a direct investor.

4.23 It is proposed that QCIVs electing into the new rules must allocate to investors any assessable income derived in a year that relates to each investor's share of the underlying assets. The allocated income would be deemed to be derived by the investors, and QCIVs will withhold tax at investors' marginal tax rates. The tax would be deducted by the QCIV and remitted to Inland Revenue each year. The obligations on QCIVs would be similar to the current resident withholding tax requirements for banks and other large interest payers.

4.24 A key change for QCIVs is that they would act as a tax calculation and withholding tax agent on behalf of their investors. This has been broadly termed as the flow-through tax treatment for QCIVs.

Why is the government allowing QCIVs to flow through income?

4.25 Alignment of tax rates is important to ensure that the correct amount of tax is paid by an investor. Under current rules, alignment is limited to those entities that are subject to the company tax rules, such as unit trusts, or the qualifying trust rules, which include, for example, certain group investment funds. Even in these instances alignment can be partial.

4.26 One of the key distortions is the myriad of tax results that can arise depending on the entity structure of the QCIV, even though the product on offer may be identical. This can result in investor behaviour being driven by tax considerations. This occurs because there would be an incentive for taxpayers on a marginal tax rate of 39% to invest in superannuation schemes (with the final tax being 33%). Conversely, taxpayers on marginal rates of less than 33% might be discouraged from investing in these vehicles.

4.27 The proposed flow-through method is designed to remove many of the tax distinctions between the entities. Some distinctions will still remain, however, as there are certain QCIVs for whom flow-through is not possible for practical reasons. The tax rules will need to make allowances for these products and providers. These entities are likely to be a minority. The flow-through tax rules are designed to ensure that, as far as possible, tax rates do not disadvantage investors from investing via a QCIV rather than on their own account or in different QCIVs.

4.28 One of the key issues noted in the Stobo report on applying flow-through tax treatment for QCIVs was the potential cost to New Zealand QCIVs of updating their systems. One of the options considered by the report, was retaining the current entity tax rules for QCIVs but with a mechanism for aligning the QCIV tax rate with investors' marginal tax rates using a tax credit system. This option was later discarded because it would result in significant complexity for QCIVs.

4.29 The New Zealand savings industry is broadly supportive of the flow-through option. It also generally recognises that whatever changes are made will involve some cost to the industry resulting from the transition to a system that acts as a proxy for direct investors.

Background

4.30 The concept of mechanisms to align entity and investor tax rates is not new. In the context of managed funds, it was considered by the Taxation of Life Insurance and Superannuation (TOLIS) Review in the late 1990s. TOLIS recommended a tax-credit system for managed funds, a proposal that was not implemented because of technology and cost concerns at the time.

4.31 The current tax rules also contain various alignment mechanisms, most notably imputation rules applying to companies which allow a wash-up at investors' marginal tax rates on distributions from companies. Another is the tax treatment of qualifying trusts, where distributions of income within six months of the end of the tax year in which the income is derived are taxed at the marginal tax rates of beneficiaries.

4.32 As part of his consultation process, Craig Stobo considered a tax treatment for QCIVs that would remove the entity tax model and would push income derived via a QCIV into the hands of the ultimate beneficiaries – investors, to be taxed at their marginal tax rates. This flow-through approach was considered to have several benefits. They included a closer tax rate alignment than would happen under a tax-credit system and reduced risks for QCIVs because they would no longer be a taxpayer in respect of income derived on behalf of their investors. It was also considered that the issues that affected TOLIS were not as significant in the current environment because of advances in technology.

4.33 A flow-through model would generally apply to investment vehicles that elect to be QCIVs. There will be certain exceptions, which are discussed later.

4.34 It is recognised that not all QCIVs will be in a position to flow through income to their investors on 1 April 2007. Those entities will still be able to use the existing entity tax treatment until they are in a position to make the transition to the new rules. It should be noted, however, that the new definition of "assessable income" for a QCIV would (with the exception of defined benefit superannuation schemes) be tied to its ability to administer the flow-through model. In other words, if the existing rules apply for tax being paid at the entity level, the current definition of "income" for a QCIV would also apply.

How the flow-through model would work in practice

4.35 It is envisaged that the flow-through model would be feasible for a majority of vehicles that qualify as QCIVs. Vehicles such as widely held unit trusts (for example, qualifying unit trusts) and defined contribution superannuation schemes or other vehicles where the underlying investments can be allocated to investors in proportion to their contributions should be in a position to consider flow-through. The treatment for situations where it is not possible for investment income to be allocated to individual investors (for example, defined benefit superannuation schemes) is discussed later.

4.36 For the flow-through model to work, QCIVs would generally need to operate a system of accounts for each investor whereby the investor's share of assessable income is recorded and updated regularly. The account would also record the investor's share of any tax credits and tax deductible investment-management fees. Unit trusts will have unit registry systems for recording investor-specific information, although modifications are likely to be needed. For superannuation schemes that are defined contribution schemes, it is also likely that some system of investor accounts will exist. Again, modifications to these systems may be needed.

4.37 How a flow-through model would operate in practice would depend on the commercial arrangements surrounding the relevant QCIV. For example, a QCIV may wish to allocate income to investors' accounts on a regular basis or less frequently depending on how its systems operate. Allocations of income from which tax is deducted (attributions) may be less frequent.

4.38 An attribution would not require a physical distribution of income to investors, but rather just a record that the income is derived by a particular investor. Instead, investment income would typically be reinvested in the QCIV to generate further returns for investors. Under such an attribution event, there would be a requirement for tax to be withheld from assessable income and remitted to Inland Revenue. The post-tax return would be available to be re-invested by the QCIV, if that was desired by individual investors. The aim of this exercise is that the investors will continue to be largely unaffected by what occurs within an investment vehicle, subject to the election of correct withholding tax rates, which is discussed later in this document.

4.39 The payment of tax by the QCIV on behalf of investors may require the cancellation of some of an investor's interest in a QCIV – such as units in a unit trust. Such a cancellation may be contrary to the current trust deeds of funds. If this is the case, it may be necessary to introduce legislation that would validate certain cancellations that are inconsistent with trust deeds. The government invites submissions on whether such legislative enablement is necessary.

4.40 The key for the new tax rules is that there is at least one attribution of income each year to investors' accounts (an allocation from which tax is deducted), as well as an attribution when an investor exits a fund.

4.41 An attribution on exit will include instances where only part of an investment in a QCIV is realised – for example, when a few units in a unit trust are redeemed. The attribution would be for the exiting investor's share of the income derived by the QCIV up to the date of exit, and would include all forms of assessable income, including dividends, interest, income from offshore investments and any gains that may still be taxable. This may also necessitate the QCIV having to deduct the exiting investor's share of the tax on any unrealised gains that, on realisation, would be taxable.

4.42 Example 1 outlines how the flow-through process would work in a situation where a QCIV does an annual attribution to all investors with separate attributions on exit.

Example 1: Flow-through on annual and exit attributions

John and Emma invest in a widely held unit trust that is a QCIV. They contribute $10,000 each, with John electing a 19.5% tax rate and Emma a 39% tax rate. The QCIV has 98 other investors who have each contributed $10,000. The total funds under management is $1,000,000 and John and Emma's interest in the QCIV is 1% each. They enter the QCIV on 1 April 2007. John leaves the QCIV on 1 October 2007 while Emma stays for the duration of the year. On John's exit, a new investor enters the QCIV, so the existing investors' ownership levels are unaffected. The general attribution date is 31 March 2008.

During the year the investment gains derived via the QCIV comprise dividends of $50,000 (no imputation credits) paid on 1 June 2007, interest of $40,000 (no resident withholding tax deducted) paid on 1 November 2007 and a gain on the sale of New Zealand shares of $10,000 on 1 January 2008.

If the QCIV were to attribute income annually to all investors with separate attributions on exit, John's share of the income would be 1% of $50,000 = $500. On his exit, he would pay tax on $500 at 19.5% = $97.50, which would be deducted by the QCIV on his behalf.

Emma's share of the income would be 1% of $100,000 = $1,000, as she remains for the duration of the year. However, her assessable income would be only $900 (her share of the $50,000 dividend + $40,000 interest). She would pay tax on $900 at 39% = $351 at the yearly attribution date, which again would be deducted by the QCIV on her behalf.

4.43 From a tax administration viewpoint, an attribution on exit is required to prevent incorrect taxation (including over-taxation) and abuse of the rules. In other words, if a general attribution occurs only yearly, and there are no specific attributions when an investor cashes-out, there will be incentives for investors to leave the QCIV just before to the general attribution date to avoid paying tax altogether. Alternatively, QCIVs could be structured in such a way that the only investors on the attribution date are tax-exempt entities such as charities or other low-tax rate investors. While it is unlikely that such abuse would occur in practice, the exit of investors before attribution date would, without an attribution on exit, result in investor-equity concerns.

4.44 While an attribution on exit would assist in minimising opportunities for avoidance and would ensure a level of investor equity, alternatively, if there were regular enough attributions during the year to all investors, this too would address the concerns raised. If a QCIV were unable to attribute income to investors on exit (or partial exit) from the QCIV, quarterly attributions of income to all investors would be required. Under this approach, income allocated to investors' accounts in a quarter would be cleared out on the attribution date for that quarter.

4.45 This option would be less precise than having an attribution on exit, particularly as it could result in taxpayers other than those who have derived the assessable income having to pay the tax (for example, if an investor leaves between attribution dates). Example 2 outlines how the flow-through model would work when a QCIV makes quarterly attributions to all investors, although there are several ways that funds could do this in practice.

Example 2: Flow-through on quarterly attributions

Gary and Jane invest in a widely held unit trust that is a QCIV. They contribute $20,000 each, with Gary electing a 19.5% tax rate and Jane a 39% tax rate. The QCIV has 98 other investors who have contributed $20,000 each. The total funds under management are $2,000,000, and Gary and Jane's interest in the QCIV is 1% each. They enter the QCIV on 1 April 2007. Gary sells his entire interest in the QCIV on 5 September 2007, while Jane stays for the duration of the year. On Gary's exit, a new investor enters the QCIV, so the existing investors' ownership levels are unaffected. The quarterly attribution dates are 30 June, 30 September, 31 December and 31 March.

During the year the investment gains derived via the QCIV are dividends of $25,000 (no imputation credits) paid on 1 June 2007, interest of $60,000 (no resident withholding tax deducted) paid on 1 September 2007, further dividends of $35,000 (no credits) paid on 1 February 2008 and a gain on the sale of New Zealand shares of $25,000 on 1 March 2008.

If the QCIV were to attribute income quarterly to all investors, the attributions at the end of each quarter would be:

Period	*Gary*	*Jane*
1 April – 30 June	1% x $25,000 = $250	1% x $25,000 = $250
1 July – 30 Sept	-	1% x $60,000 = $600
1 Oct – 31 Dec	-	1% x $35,000 = $350
1 Jan – 31 March	-	1% x $25,000 = $250

As Gary is only present on the first attribution date, his assessable income would be only $250. Tax on this ($250 at 19.5% = $48.75) would be deducted on the first attribution date (30 June). However, Gary would still receive his share of the $60,000 of interest when he exits the QCIV (by way of a higher unit price) even though he will not end up paying any tax on it. That is because Gary would not be present on the next attribution date of 30 September. Consequently, if no adjustment is made to the price Gary receives on exit from the QCIV, to reflect the share of the tax owing on the income derived in the period, investors who will be present on the next attribution date will be required to make up the shortfall. Should Gary continue to enter and exit the fund, however, his interest in the fund may be on revenue account.

For Jane, who remains in the fund for the duration of the year, tax of $97.50 ($250 at 39%) would be deducted at the first attribution date; tax of $234 ($600 at 39%) at the second date; tax of $136.50 ($350 at 39%) at the third date; and no tax would be deducted on the last attribution date because the income is a tax free gain.

4.46 QCIVs that chose to do quarterly (or more regular) attributions would need to manage investor equity concerns. In principle, quarterly attributions to all investors would seem to reduce incentives for taxpayers to exit an investment in a QCIV just before to a general attribution date and enter after the attribution.

4.47 The government therefore considers that QCIVs should have the choice of making:

- a single attribution to all investors at the end of an income year, together with attributions when investors sell their interest, or part of their interest, in a QCIV; or
- an attribution to all investors each quarter – for example, at the end of June, September, December and March.

Who can invest in a QCIV?

4.48 The government considers that the opportunity to invest in a QCIV should not be limited to individuals. Therefore entities such as companies and other types of taxpayers such as partnerships and trusts should be allowed to invest in a QCIV. If a company invests in a QCIV and the QCIV derives tax-free capital gains on the company's behalf, these gains would, like other capital gains, be available to the company to be distributed tax-free on liquidation, as under the current rules.

Payment of tax withheld by QCIVs to Inland Revenue

4.49 Depending on the frequency of attributions – whether a yearly attribution to all investors in the QCIV and attributions on exit, or quarterly attributions to all investors – the profile of tax payments to Inland Revenue will change.

4.50 When a QCIV chooses to do an annual general attribution and attributions on investor redemption, the tax deducted would need to be remitted to Inland Revenue by the 20th of the following month. Therefore if the annual attribution is on 31 March, the tax would need to be paid to Inland Revenue by 20 April. Similarly, for attributions when interests in a QCIV are redeemed, the tax would need to be remitted by the 20th of the month following the month in which the interest or part of the interest was cashed-out. For quarterly or more regular attributions, similar rules would apply.

4.51 At the end of the year the QCIV would, for reconciliation purposes, need to provide Inland Revenue electronically with a statement outlining each investor who was present in the fund during the year, the investor's share of investment income, tax deducted, tax deductible expenses and tax credits. This would be similar to the reconciliation requirements for interest payers and, as will be discussed later, is necessary for the matching of investor information.

4.52 The proposed process for remitting the tax withheld will have use-of-money implications for both the government and QCIVs. Currently, QCIVs are provisional taxpayers, meaning that they pay tax in three instalments during the year. Under an attribution on exit approach, there is likely to be a single tax payment at the end of the year, with smaller tax payments through the year when some investors exit. Under such an approach, the government would be adversely affected, as it would receive tax revenue later than it otherwise would. Under a quarterly attribution approach, the frequency of tax payments to Inland Revenue would increase, which would mean that QCIVs would be negatively affected as they would be required to remit tax revenue earlier than they otherwise would.

4.53 The options put forward are not driven by use-of-money concerns associated with tax payments. The aim of the flow-through model is to ensure that, broadly, the correct amount of tax is paid, by the correct investor. The level of precision will depend on the approach adopted by QCIVs for various reasons, such as investor equity.

Anti-avoidance rules

4.54 It will be necessary to develop certain rules that guard against tax-driven behaviour. One such rule is a "wash-sale" provision, which would effectively deem a sale and subsequent re-purchase of an interest in a QCIV to give rise to a taxable event (the sale) if the two parts of this transaction are carried out within, say, 30 days of each other. This is on the basis that such an arrangement is likely to have little commercial rationale. It is more likely to be tax-driven with the purpose of minimising tax payable. An instance where such a rule would be useful is if an investor in a QCIV who holds that interest on capital account were able to sell the interest to a revenue account investor just before the attribution of income by the QCIV (for example, payment of a dividend to the QCIV by a New Zealand company) and re-acquire it after the attribution is made.

4.55 In this scenario, the sale price would be the pre-attribution price. The revenue account investor would have tax deducted on attributed income, with the value of the investment falling to reflect the attribution. The revenue account investor would then sell the interest back to the capital account investor at the post-attribution price. The revenue account investor would receive a deductible loss on the transaction (to offset the tax payable on the attribution by the QCIV), while the capital account investor would receive a real gain (on the difference between what the investor sold the interest for and the price at which it was reacquired). In this scenario, the arrangement is structured in such a way that no tax is payable on the dividend.

4.56 Such an arrangement could also work if the QCIV sells an interest in a New Zealand company, before the company pays a dividend, to a revenue account taxpayer and re-purchases the interest after the dividend is paid. The QCIV would not be taxable on the sale because of the domestic capital gains carve-out.

4.57 A "wash-sale" rule would cover both scenarios by taxing any gains made by the capital account investor on the sale of the interest in the QCIV and taxing the QCIV on the sale of the interest in the New Zealand company.

When the flow-through model may not be feasible

4.58 There will be some funds that cannot allocate all of their income to their investors because the underlying value of their assets cannot be linked to contributions by or for specific individuals.

4.59 In defined benefit superannuation schemes, the benefits that are ultimately payable cannot readily be linked to what investors have contributed. That makes it difficult to determine, at any given point in time, what each investor's share of the underlying assets is. Also, defined benefit schemes have certain triggering events for payment of benefits, such as payment after a certain age or event. When a contributor exits a scheme, there may be a forfeiture of contributions or repayment of these contributions, but at a significant discount (calculated actuarially).

4.60 Furthermore, defined benefit superannuation schemes typically require a top-up to investor contributions to make up any shortfalls between contributions and eventual payouts. This makes it difficult to allocate fund assets to investors if contributions are being "topped up" by the scheme or employers in the case of employer-based defined benefit superannuation schemes. Defined benefit schemes represent a significant, though declining, part of the superannuation and savings landscape.

4.61 Schemes that offer a capital guarantee may also be unable to allocate all income to investors. It may be prudent to leave some income unallocated so that, if the scheme generates poor returns in the future, the unallocated income can then be used to provide the promised minimum rate of return.

4.62 Another instance when income cannot be fully allocated arises with "unvested" amounts. Unvested amounts can arise in the context of both defined contribution and defined benefit schemes when an employer, for example, matches or "tops up" contributions made by an investor. A key feature of the employer contributions is that unless certain criteria are met, such as length of service, the amounts do not vest with the employee. Unvested amounts typically flow back into the schemes and are redistributed among remaining policyholders, or can revert back to the employer. As vesting periods can, in certain cases be significant, in instances where there are unvested amounts it can be difficult to tax income relating to these amounts at the marginal tax rates of investors to whom these amounts may or may not eventually belong.

4.63 A fund that cannot completely allocate income to individuals would be unable to fully apply flow-through tax treatment. As such, unless a special provision were designed, such funds would be denied access to the proposed tax treatment of domestic capital gains. This would motivate a significant shift in investment away from such funds, which would represent a tax-generated distortion of investment behaviour. Consequently, special rules are required to deal with these types of funds.

4.64 Schemes with "unallocated" amounts should still have the option of electing into the new rules and receiving the benefit of the exemption on domestic share gains. There are three options to achieve this. The final approach taken by the government will take consideration of views expressed in submissions.

4.65 The first option is to continue to tax unallocated amounts at 33%. This approach would create incentives for funds managed on behalf of 39% rate taxpayers not to allocate income.

4.66 The second option would also tax unallocated income at 33%. It would involve a fund with unallocated income being allowed to access the proposed tax treatment for domestic capital gains only if it is a registered superannuation scheme operating as a defined benefit scheme as of 27 June 2005. This mechanism would discourage the establishment of new registered superannuation schemes with unallocated amounts. This limitation could be revisited if required. There may also be difficulties in appropriately defining "defined benefit" schemes.

4.67 Both options would allow schemes with unallocated amounts to obtain the same tax treatment of capital gains as other funds, but they limit the ability of such funds to access a valuable aspect of the reform, the ability to attribute the correct tax rate to their members. However, the requirement to apply marginal tax rates would apply only to the extent they are practically able to attribute income.

4.68 The third option would allow schemes to attribute income earned by the fund, when possible, to participating savers so that earnings so attributed could be taxed at their correct marginal rate. This would be allowed to the extent possible, with remaining earnings that could not be allocated taxed at 33%. The attribution could be based on current filing requirements to the Government Actuary, who reviews the filings of each registered superannuation scheme every three years. The reporting requirements would attempt to limit changes required from current reporting when possible. Funds could be allowed to attribute, or required to make a best effort to attribute at correct marginal rates when possible. Individuals would elect their marginal rates in the same manner as with other schemes.

4.69 To the extent that marginal tax rates can be applied, the income would be taxed at the fund level and not to the individual investors. This is because in the case of, say, unvested amounts, the employer contribution to which the income relates does not belong to the investor, so, technically, neither does the income until the amount is vested. Consequently, it would be inequitable for the income to be deemed to have been derived by investors, as this could trigger other obligations.

4.70 This approach would limit unallocated amounts within a scheme to an acceptable reserve level. It would also seek to ensure that attribution to lower rate taxpayers was made on an actuarially appropriate basis. It would provide a practical limit on vesting, capital protection reserves and general reserves of such schemes.

4.71 Excess amounts allocated to taxpayers on rates below 39% or excess reserves could be taxed at 39% at the discretion of the Commissioner of Inland Revenue. This approach would place additional requirements on the Government Actuary, and on Inland Revenue. Further, it could increase compliance costs for funds. It would provide funds with members having marginal tax rates of less than 33% a valuable advantage however. The government would welcome submissions indicating whether an approach such as the third option is considered valuable enough to justify incurring these costs.

Flowing through income, tax credits and losses

4.72 All assessable income will need to be flowed through to investors. Equally, any tax credits such as imputation credits and resident withholding tax on New Zealand interest and any foreign tax credits such as foreign non-resident withholding tax on dividends will need to be flowed through in proportion to each person's investment in the QCIV. These tax credits can be used to offset the tax that is deducted by the QCIV on behalf of individual investors. Similarly, tax deductible investment expenses can be offset against assessable income derived via the QCIV. Tax losses, for example, from any realised revenue account assets will also be available for use.

4.73 The ability of QCIVs to flow through foreign tax credits for non-resident withholding tax provides greater consistency with the treatment for direct non-controlled investment in offshore shares. Currently an investor in a managed fund such as a unit trust would not gain the benefit of the foreign tax credit if the fund pays a dividend because the foreign tax credit would have been used to offset assessable income at the fund level.

4.74 The availability of credits, expenses and losses raises the issue of the correct treatment of excess amounts, whether excess credits or losses. This would arise when the deductions or credits available exceed the assessable income in the QCIV. It could arise, for example, when a QCIV derives only fully imputed dividend income and has tax deductible expenses or investors on the lower marginal tax rates. Should these amounts be refundable, available to be claimed as a loss in the current year against non-QCIV income, or carried forward within the QCIV?

4.75 As a general rule, under imputation, excess imputation credits are not refunded, although excess resident withholding tax is. Theoretically, under a flow-through model, the different credits and income to which those credits relate should retain their character. This means that excess imputation credits available should be carried forward, while resident withholding tax credits should be refundable. This would provide better consistency with the tax treatment of an individual direct investor. The ability of investors in QCIVs to get value for these credits is discussed below.

4.76 It should be noted that as QCIVs are not flow-through entities at present – it is the QCIV and not the investors who explicitly receive tax credits. A similar situation arises relating to tax losses and deductible expenses. Consequently, excess tax losses or credits are generally quarantined at the fund level, with excess credits carried forward and offset against future fund income.

4.77 One method that would give investors value for excess tax losses and credits would be for QCIVs to flow them through to individual investors each year, as part of the general annual attribution to all investors. However, to gain the benefit of such excess losses or credits, investors would need to file a tax return. This would result in a large number of investors who have no other reason to file a tax return having to do so or risk losing the credits. The compliance cost of requiring investors to file a return to get value for their credits would, however, be onerous, especially if the value of any excess losses or credits is small and the return triggers other obligations. The broader implications for investors are discussed in more detail later.

4.78 A better mechanism for providing investors with value for excess tax credits, tax losses and expenses that cannot be used is for QCIVs to carry forward these amounts to be offset against the future assessable income of the investor, to be derived via the QCIV. This would preclude the need for investors having to file a return automatically each year to claim any excess amounts. It is likely that technology solutions are available to achieve this, which is the approach favoured by the government.

4.79 When investors redeem their interest (or part of their interest) in a QCIV during a year, they should have the option of filing a return to get the benefit of excess tax credits or losses in proportion to the amount realised. Claiming excess tax losses and credits in this way could result, however, in other obligations arising. These are discussed in greater detail later.

4.80 Alternatively, QCIVs could offset any tax losses and tax credits against assessable income before allocating income to investors' individual accounts. Under this arrangement, net income would be allocated to investors rather than gross income and tax losses and credits. Any excess tax losses or tax credits would be carried forward in the value of the QCIV. That approach is similar to what happens in managed funds today – where a fund has excess tax losses, they may be provided for in the fund's price by way of a higher unit price. While not as accurate as carrying forward the excess in individual accounts, it may result in less complexity for certain QCIVs. Therefore the government also considers that it would be an acceptable approach for dealing with excess losses and credits and envisions that the new rules would include both options.

4.81 One of the key issues is the ability of QCIVs to determine accurately what percentage of their tax losses are likely to be useable going forward, and therefore able to be included in the fund's price on the balance sheet. This issue would remain if tax losses were able to be offset on a gross income basis, with any excess losses carried forward in a fund's unit price. However, it would allow QCIVs to give value to investors for excess tax losses and credits via a higher price which is redeemable on exit from the QCIV.

Implications for investors in QCIVs

4.82 The tax rate applied by QCIVs when assessable income is attributed to investors will be the tax rate elected by the investor. Taxpayers will be able to elect a rate based on their marginal tax rate of 19.5%, 33% or 39%. Investors would need to provide this tax rate at the start of the year or when they enter a QCIV for the first time. If an investor fails to elect a rate, the QCIV will be required to deduct tax at the highest marginal tax rate of 39%.

4.83 Under the proposed flow-through model for QCIVs, any income derived via a QCIV will be treated in the same way as an investor's, if income from direct investments forms part of a direct holder's assessable income in a year. Currently, if an investor is a direct holder, any income including dividends and taxable equity gains must be returned each year, by filing a tax return, if the amount of assessable income is greater than $200. The time requirement applies at present to investments in managed funds such as unit trusts if the fund pays a dividend greater than $200 or if any gain on the sale of an interest in the fund is taxable. However, if any gains made by the fund are not distributed, or if an investor holding an investment on revenue account does not realise the interest in the QCIV, no taxable event is triggered for the investor. Consequently, a tax return is usually not required to be filed.

4.84 The flow-through model aims, as much as possible, to put investors who invest via a QCIV on a similar footing to individuals who invest directly. Absolute consistency between investors in a QCIV and direct investors would mean that to the extent individual direct investors are required to return income each year on their investments, the same rule should apply to investors in a QCIV. However, for investors in QCIVs this would impose compliance costs above the current level.

4.85 In particular, it should be noted that the proposed KiwiSaver scheme announced in this year's Budget will result, over time, in a large number of taxpayers having investments in vehicles that may qualify as QCIVs. The requirement for these taxpayers to file tax returns each year, when they currently are not required to, would result in significant compliance costs.

4.86 More importantly, the requirement for investors in a QCIV to file a return would also affect a number of social policy initiatives that are delivered or collected through the tax system. They include:

- payment of family assistance;
- collection of child support payments (from liable parents); and
- student loan repayments (from borrowers).

4.87 Currently, a taxpayer's assessable income generally determines entitlements and payment obligations. Under the proposed flow-through model for QCIVs, investment income derived via a QCIV would be the income of the individual investor, which in the absence of any changes to the contrary, would affect that person's entitlement to family assistance and payment obligations for child support and student loans.

4.88 Requiring taxpayers to declare investment income derived via a QCIV would affect entitlements under the Working for Families scheme. The package can result in access to assistance for families with fairly significant income levels, and there is a risk that those benefits might be clawed back in cases where a family saves via a QCIV. That would be inconsistent with both the aim of the Working for Families scheme and the broader intention to encourage more saving by New Zealanders.

4.89 Under the current rules, depending on the entity being invested into, investment income derived through that entity may not affect family assistance and other social policy initiatives. For example, for investments made via a registered superannuation scheme, a claw-back of family assistance would be a significant change to the existing tax treatment as the investment is taxed at the scheme level of 33% and does not affect family assistance, child support or student loans. An investment in a unit trust would claw-back family assistance only when the unit trust makes a taxable distribution such as a dividend over $200 or on the realisation of the investment for a revenue account taxpayer.

4.90 Given the current rules and the fact that for certain investments such as superannuation schemes investments may be locked in, it would not be appropriate to require claw-back of family assistance. Different problems arise in relation to the impact of investment income on any liability to pay child support, however. Investment income derived via a QCIV should not affect a liable parent's child support obligations if it reduces the level of child support received by the custodial parent.

4.91 That can occur at present if a liable parent invests through a registered superannuation scheme. Importantly, there are administrative mechanisms for dealing with this "excluded" income for child support purposes. Even if investment income derived via a QCIV is excluded from a taxpayer's gross income figure for the year, custodial parents can still apply for an administrative review for consideration of whether the excluded amount should be included in the calculation of a liable parent's capacity to pay child support. Consequently, it is proposed that income flowed through to investors in a QCIV would not give rise to re-assessments of child support obligations.

4.92 To prevent income derived by an investor via a QCIV requiring a tax return to be filed, and affecting family assistance entitlements, child support and student loan repayment obligations of investors, tax on investment income derived via a QCIV and deducted and paid by the QCIV on an investor's behalf would be a final withholding tax for most investors.

4.93 Here a distinction is being drawn between individuals and non-individuals (such as companies) who are investors in QCIVs. The tax deducted by the QCIV would be a final withholding tax for individuals, unless certain criteria were breached. It would not be a final withholding tax for non-individual investors. That is because a key reason for deeming tax withheld by a QCIV to be a final withholding tax is to prevent investors having to file returns when they otherwise would not have to. Non-individual investors such as companies are already required to file returns, so there is no need for the tax withheld by a QCIV to be a final tax. This distinction is discussed in more detail later.

Individuals investing in QCIVs

4.94 For individuals, a final withholding tax would operate based on the rate that is elected by the investor at the start of the year or when an investor enters a QCIV for the first time. Individual investors would elect the relevant marginal tax rate based on their previous year's income. Such a model would work as follows:

- If total assessable income from all sources in the previous year is below \$48,000, an investor must elect a rate not lower than 19.5%.
- If total assessable income from all sources in the previous year is between \$48,000 and \$70,000, the investor must elect a rate not lower than 33%.
- If total assessable income from all sources in the previous year is greater than \$70,000, the investor must elect a rate of 39%.

4.95 Under these rules, taxpayers would not be required to file a return in respect of QCIV income, or include this income in the return if they are required to file for other reasons. The thresholds above are greater than the thresholds for income tax to reflect the fact that investment income derived via a QCIV may result in a higher tax rate applying at the margin.

4.96 For example, if a taxpayer derived \$35,000 of wage and salary income in the previous income year and \$5,000 of QCIV income, the marginal tax rate on the next dollar of income would be 33%. However, strictly speaking, only \$2,000 of the QCIV income should be taxed at 33%, with \$3,000 taxed at 21%. In the following year, assuming that salary and wage income is not subject to significant inflation, electing a 33% tax rate on QCIV income would result in over-taxation. While it would be possible to require some apportionment based on different tax rates, such a mechanism would be difficult to apply in practice for individuals and QCIVs. Consequently, the government proposes to build in a \$10,000 buffer into the income thresholds to ensure that investment income derived through a QCIV is not over-taxed. While this could result in certain income derived via a QCIV being under-taxed – for example, when salary and wage income is \$38,000 and QCIV income is \$5,000, the marginal rate on the QCIV income should be 33% – the proposed approach should result in the right outcome for most individual investors without imposing undue compliance costs.

4.97 The approach outlined here would impose a statutory requirement on taxpayers to elect a tax rate based on the previous year's income. To ensure compliance with these rules, Inland Revenue would undertake selected matching of the tax rates elected. If a taxpayer did not elect the correct rate based on the previous year's income, together with the thresholds discussed earlier, Inland Revenue would collect any shortfall plus use-of-money interest and penalties.

4.98 Taxpayers who have elected too high a tax rate on their QCIV income for the current year would be able to file a return to receive a refund. However, that would require including income derived via a QCIV in an investor's tax return, which would trigger the claw-back of any family assistance and child support and student loan obligations.

4.99 An additional rule would require individuals who have significant QCIV income of over $15,000 a year to file a tax return if the tax rate they have elected (based on the previous year's total assessable income from all sources) is incorrect for the current year. That is necessary because when an individual derives a significant level of QCIV income that results in a higher marginal tax rate for the current year than the previous year, an election based on the previous year's income is clearly not the correct result. In such cases, taxpayers would be required to reconcile their tax rate on the QCIV income at the end of the year by filing a tax return. While this would result in QCIV income counting towards family assistance, child support and student loans, taxpayers would have the option of electing a higher rate at the start of a year. The thresholds discussed earlier specify a minimum tax rate that must be applied. Electing a higher rate would remove them from the application of the reconciliation rule.

4.100 A number of questions arise in relation to using the previous year's total assessable income from all sources as the method for electing the tax rate on QCIV income in the current year.

4.101 First, there is a timing question relating to when investors know their total income for the previous year. For those earning salary and wages, the necessary information should be available before 1 April. If they also have investment income such as interest or QCIV income in the previous year, notification of total income earned will take longer. This would make it difficult for investors to elect a tax rate and provide it to a QCIV at the start of an income year. In turn, not having a valid tax rate could affect a QCIV's ability to make attributions to its investors.

4.102 For QCIVs that choose to make a general attribution at the end of the year, with smaller attributions on investor redemption, not having a tax rate election at the start of the year should not generally be a problem. For QCIVs that choose quarterly or more frequent attributions, the first attribution may be affected. When a valid tax rate is not received by the QCIV before an attribution date, the QCIV should use the tax rate elected by the investor for the previous year. Or, if the investor is new to the QCIV, the 39% rate should be used, with a square-up on future attribution dates.

4.103 A second question concerns the information that must be provided to investors in relation to their QCIV income. Under the proposed final withholding tax approach, QCIVs would need to provide investors with notification of the level of QCIV income and tax deducted (after credits and losses) for an income year so that investors can elect the correct tax rate for the next income year. As the income year for individual investors is 1 April to 31 March, this information would need to be provided promptly after the end of an income year. This means that QCIVs with non-standard balance dates would need to move to a standard income year for their withholding tax obligations. That would allow QCIVs to provide income and tax withholding details to investors for a standard income year. Under a flow-through model for QCIVs, balance dates should not be a significant issue, although submissions are welcomed on the issue.

4.104 Another question that arises concerns the income measure in the previous year that should apply to individual investors that have business income such as self-employed taxpayers or other non-wage and salary taxpayers. They may not have the requisite income information if, for example, the return for a previous year has not yet been filed. In this case, it may be possible to require taxpayers to base their rate elections for the current year on total assessable income from all sources from two years ago (for which the information should be available). Submissions are invited on this issue.

Non-individual investors investing in a QCIV

4.105 The statutory rule for non-individual investors in QCIVs would generally be the withholding rate. (Investors holding an RWT exemption certificate would qualify for withholding at the appropriate rate.) This would be irrespective of the income of the investor in the previous year. Non-individual investors would also be required to return QCIV income in their tax return at the end of a year, which would allow any losses or excess tax credits allocated to the company by the QCIV to be claimed. It would also reconcile investors' tax position in respect of QCIV income with their other business income.

4.106 Tax-exempt entities with a resident withholding tax exemption certificate would be able to elect a 0% withholding tax rate.

Summary of a QCIV's withholding obligations

Step 1: Investor provides withholding rate to QCIV. If no rate is provided, a default rate of 39% will be used.

Step 2: The QCIV calculates assessable investment income for the investor. If this is negative, the result is an investor net loss, which is carried forward by the QCIV.

Step 3: The QCIV deducts expenses from assessable investment income for the investor. This results in investment income after expenses.

Step 4: Investment income after expenses is reduced by the:

(a) investor's share of the QCIV's transitional net loss carry forward, if any. This loss could have arisen only before the new tax rules for QCIVs applied and on the deemed wind-up on transition;
(b) investor's net loss carried forward from prior years, if any.

The result is net investment income.

If the investor has a net loss and is redeeming some or all of the interest in the QCIV, the investor net loss (or a portion thereof if only a partial redemption is made) flows through to the investor and may be claimed on a tax return.

Step 5:	Net investment income multiplied by the investor's selected withholding tax rate is the investor's gross tax liability.
Step 6:	The investor's gross tax liability is reduced by the investor's share of available foreign tax credits. The result is the investor's adjusted tax liability. The investor's share of available foreign tax credits is the lesser of: (a) the investor's share of foreign taxes paid by the QCIV (generally NRWT withheld on interest and dividends paid to the QCIV); (b) the investor's gross tax liability; or (c) the investor's share of net foreign-sourced income multiplied by their withholding tax rate. As under current law, excess foreign tax credits are not carried forward or refunded.
Step 7:	The investor's adjusted tax liability is reduced by the investor's allocated share of imputation credits, received or carried forward by the QCIV. This results in the investor's net tax liability. To the extent that an investor's share of imputation credits exceeds the adjusted tax liability, they are carried forward and may reduce tax deducted on behalf of the investor in future years. In the year an investor redeems the interest in a QCIV, any excess imputation credits (in proportion to the share of the interest that is redeemed) may be claimed if the investor elects to file a tax return.
Step 8:	The investor's net tax liability is reduced by the allocated share of source RWT on interest and dividends paid to the QCIV. QCIVs should generally be able to get an RWT exemption certificate, so there should be minimal source RWT deducted. To the extent source RWT exceeds an investor's net tax liability, the QCIV may have this refunded and paid out to (or included in the account of) the investor. To the extent an investor's net tax liability exceeds source RWT, the QCIV must deduct and pay additional withholding tax to Inland Revenue in satisfaction of the investor's net tax liability.

Non-resident investors in a QCIV

4.107 If an investor in a QCIV is a non-resident, the QCIV would withhold tax on any income derived via the QCIV at the rate that would have applied if the investor had invested directly. For example, if the assessable income relates to a dividend received from a New Zealand company – and the investor is resident in a country with which New Zealand has a double tax agreement – a 15% withholding rate would apply.

4.108 To the extent that a QCIV derives fully imputed dividend income, no tax would need to be deducted on attribution to non-resident investors. Such income would effectively be exempt. This approximates the result that would have occurred under the foreign investor tax credit rules if the non-resident investor had received the dividend directly from the New Zealand company.

4.109 This approach maintains the flow-through treatment in relation to non-resident investors and requires QCIVs to track different types of income for their non-resident investors and withhold tax at the applicable rate.

4.110 The government welcomes submissions on whether any problems arise as a result of this approach.

Flow-through when a QCIV invests in another QCIV

4.111 One of the key questions is how the flow-through model would operate in an environment where a QCIV invests in another QCIV that may then on-invest into another QCIV.

4.112 An example is a retail QCIV that invests in a wholesale QCIV, which is a common investment structure in the financial services industry. At present, the retail and wholesale QCIVs are treated as taxpayers in their own right. Under the flow-through model, the wholesale QCIV would effectively need to pass through income (in a notional sense) to the retail QCIV, which in turn would need to attribute the income to their investors. In practice, this will typically mean that on attribution date, the retail QCIV will need to know what income has been derived in the attribution period from the wholesale QCIV and withhold tax, at investors' marginal tax rates, based on that amount. This may require the retail QCIV either to realise some of its assets in the wholesale QCIV or maintain a pool of cash to fund any liability.

4.113 To the extent the wholesale QCIV can provide the information to the retail QCIV, the wholesale QCIV will be exempt from deducting tax on behalf of the retail fund. This is not to say that the wholesale fund will be altogether exempt from the withholding obligations. For example, if the wholesale QCIV has another retail client that is not a QCIV – for example, an individual who has a large interest – it will still be required to withhold tax. This would be similar to the resident withholding tax exemption certificate rules when there are multiple tiers of investors.

Key question: should the top withholding tax rate be capped at 33% under a flow-through model to encourage saving?

It is possible that some high-income taxpayers may view as unfavourable the prospect of being taxed at 39% on investment income derived through a QCIV, given that they may currently be taxed at a lower rate on certain investments (for example, 33% for investment in a registered superannuation scheme). To these taxpayers a flow-through model could be seen as disadvantageous. Capping the withholding tax rate applying to income derived via a QCIV at 33% (regardless of the investor's actual marginal tax rate) is a possible option to address this issue.

Such an approach would, however, effectively constitute a tax incentive to invest through a QCIV, rather than as a direct investment. This is because a direct investor would be taxed at their correct marginal tax rate while investment in a QCIV would be taxed at a maximum rate of 33%. This would retain a key distortion which the flow-through proposal is designed to remove.

Also, it is not clear that removal of the 6% differential would result in investors on the highest marginal tax rate being worse off. This is because the benefits of not having New Zealand share gains taxed, when investing via a QCIV should, in most cases, outweigh the benefit of the current tax rate differential for high income taxpayers.

Points for submission

The government welcomes submissions on any points raised in the discussion document, with specific comment welcomed on the following:

- Whether the suggested scope of the equity gains that would remain taxable under the new rules is appropriate.
- Whether legislation is required to allow QCIVs to cancel units in certain situations to allow tax to be paid.
- Whether the rules governing when a QCIV should make attributions to investors give QCIVs the appropriate choice of methods, and whether these methods would be workable.
- Whether the options proposed for defined benefit schemes are workable.
- Whether the proposed rules for carrying forward and offsetting tax losses and tax credits are appropriate.
- Whether the non-alignment of withholding tax obligations and income years for QCIVs would cause significant compliance costs.
- Whether the assessable income measure for establishing a withholding tax rate that should apply to self-employed individual taxpayers or other non-wage and salary taxpayers could be based on the assessable income from all sources from two years ago.
- Whether the flow-through model which requires QCIVs to track different types of income and apply the correct withholding rate for their non-resident investors is a workable approach.

Chapter 5

NEW TAX RULES FOR OFFSHORE PORTFOLIO INVESTMENT IN SHARES

5.1 The government proposes to update and modify the foreign investment fund (FIF) rules so that income attributable to investment in foreign portfolio equity is appropriately taxed. In doing so, it is important that the rules have regard to the level of tax levied on an equivalent New Zealand investment. Practical limitations and a lack of information prevent this from being done perfectly, however, so a proxy measure of the underlying income attributable to the interest must be used.

5.2 One objective of the reform is to align the taxation of investment in domestic assets and foreign assets. This is one of several competing objectives, however, and must be weighed against other objectives, such as ensuring that the underlying income from foreign investments in which New Zealanders invest is subject to New Zealand tax.

5.3 Taxpayers have raised concerns about the current FIF calculations and, in particular, that the income recognised could be highly volatile, especially when there are large fluctuations in the exchange rate. They may also have a tax liability without the cashflow (distribution of income) to satisfy the liability. A new FIF calculation method is therefore proposed, one that achieves the underlying objectives while dealing with volatility and cashflow concerns.

5.4 Other objectives of the reform include:

- neutralising the differences in taxation of foreign portfolio equity held directly or through a QCIV;
- ensuring there is no tax incentive to invest offshore instead of in New Zealand; and
- ensuring there is no tax incentive or disincentive to invest in different countries.

Practical constraints to offshore options

5.5 The proposals described in this chapter have been developed in light of a number of key constraints. Given that the majority of QCIVs will be taxed under a flow-through model, any calculation method for offshore income must allow QCIVs that use the flow-through model to attribute assessable income to their investors on a regular basis. The practical reality of flow-through, therefore, would rule out any option for taxing offshore income on a realisation basis. That is because it would be extremely difficult to allocate accurately, and track over time, each investor's share of unrealised assessable gains. Also, for individuals with reasonably sized portfolios, a realisation-based system is too open to abuse and quickly becomes complicated.

5.6 Given this constraint, just two options appear feasible for taxing QCIVs using the flow-through model on their offshore income. The first of these would be to exempt QCIVs on their offshore equity income. As is discussed later, this option is not favoured as it is inconsistent with New Zealand's interests. The second option is to tax QCIVs on their offshore income on an accrued basis. The government proposes the latter approach.

5.7 It is also necessary to ensure that people who invest directly offshore are taxed in a manner that is broadly similar to the way they would be taxed if they invested via a QCIV. That is to ensure that the tax rules do not create incentives to invest offshore in one form over another. Therefore the rules proposed for individuals investing offshore are designed to be as similar as possible to the rules for QCIVs, taking into account their ability to manage investment risks.

Background

Foreign investment fund rules

5.8 Investment in offshore portfolio equity outside countries included in the grey list is generally subject to the FIF rules. That provides a number of income calculation options, but the method most commonly used is comparative value (CV). It generally treats as income the increase in market value of the interest, plus any dividends paid. If the market value of the interest cannot be determined, the taxpayer can use the deemed rate of return method, which calculates assessable income by multiplying the opening book value of the interest by a deemed rate of return.

5.9 Taxpayers who have access to sufficient information are also allowed to use the branch-equivalent method. It is a more exact calculation of a company's assessable income using New Zealand tax rules.

5.10 Another calculation option that is less accurate than the branch-equivalent method, but potentially more accurate than the comparative value method, is the accounting profits method. It calculates the investor's assessable income by taking the after-foreign tax accounting income of the foreign entity and apportioning it by the investor's ownership interest.

5.11 Taxpayers have complained about some of the practical implications of the calculation methods. In particular, under the CV method, the assessable income may be highly volatile, especially when there are large fluctuations in the exchange rate. Also, because an increase in value of the interest may result in a tax liability, even when the interest has not paid much in dividends, the taxpayer may have insufficient cashflow to fund the tax.

Grey list and foreign investment fund rules

5.12 A significant exception to application of the FIF rules is the grey list exemption. Taxpayers are not subject to the FIF rules for investments in companies resident in a grey list country: Australia, Canada, Germany, Japan, Norway, the United Kingdom and the United States. Over 70% of outbound portfolio investment goes into grey list resident entities, so the FIF rules do not apply to a significant amount of foreign investment. The assessable income of individual direct portfolio investors in foreign companies resident in grey list countries would generally equal the dividends paid to them.

Minimum threshold

5.13 A minimum threshold exemption also applies to individuals. Individuals are subject to FIF rules only if the cost of all of their FIF interests (which do not include equity in grey list resident companies) exceeds $50,000.

Collective investment vehicles

5.14 QCIVs are subject to the FIF rules as all resident taxpayers are. That applies to the tax treatment of QCIVs and individuals investing directly in countries outside of the grey list. However, for investments made in grey list countries, QCIVs are generally taxable on their trading income, while individuals are not (unless they are dealers in shares). This results in a disincentive for investors to invest in grey list entities through a QCIV.

Economic and policy issues

Economic efficiency

5.15 The primary policy objective behind taxing income from offshore investments is economic efficiency. Ideally, investments that maximise New Zealanders' personal returns should also maximise the return to New Zealand. The return to New Zealand consists of both the return to the resident investor and the return to the New Zealand government as tax revenue. Thus investors should consider the post-foreign tax return of a foreign investment on an equivalent basis as the pre-New Zealand tax return of a domestic investment. This can be illustrated by the example in table 1 of returns from a domestic and foreign investment, assuming the foreign investment is not subject to New Zealand tax.

Table 1: Domestic and foreign investment returns

	Domestic	*Foreign*
Pre-all tax return	10%	12%
Foreign tax (33%)	-	(4%)
Pre-NZ tax return	10%	8%
NZ tax (33%)	(3.3%)	EXEMPT
Return to investor	**6.7%**	**8%**
Return to NZ	**10%**	**8%**

5.16 In the example in table 1, the investor would choose the foreign investment because it yields the higher return to the individual (8%). However, New Zealand as a whole would be better off if the investment were made domestically.

5.17 The example in table 2 illustrates how the incentives change if New Zealand taxes the post-foreign tax return.

Table 2: Tax on foreign investment returns

	Domestic	*Foreign*
Pre-all tax return	10%	12%
Foreign tax (33%)	-	(4%)
Pre-NZ tax return	10%	8%
NZ tax (33%)	(3.3%)	(2.6%)
Return to investor	**6.7%**	**5.4%**
Return to NZ	**10%**	**8%**

5.18 In the table 2 example, the investor would choose the domestic investment because it yields the highest return to the investor and to New Zealand.

5.19 Investing offshore may provide benefits for portfolio diversification to reduce the risk associated with a narrow range of investments or investing in just one economy. Some consider that this justifies favourable tax treatment for offshore investments. However, the risk diversification benefit is generally taken into account by investors when they choose their investments. It would therefore be distortionary for the government to provide further incentives for investors to choose offshore investments by providing favourable tax treatments for them.

5.20 In the case of domestic investments, New Zealand tax on the income earned by the company is imposed by New Zealand company tax, which is integrated with the investor's tax through the imputation system. New Zealand does not separately tax the capital gain on the increase in share values for domestic companies because tax on the company's income is satisfied by the New Zealand company tax.

5.21 New Zealand company tax does not apply to the income earned from investment into non-resident companies. Therefore another mechanism is necessary to ensure that New Zealand tax applies to income earned by non-resident companies in which New Zealand residents invest.

5.22 When implementing this framework, a key consideration is that excessive taxes on foreign portfolio equity investment could discourage individuals from migrating to New Zealand or encourage high net-wealth New Zealanders to emigrate. Therefore, particularly for individual investors, it is necessary that this factor is considered when designing tax rules for offshore investment.

The grey list and controlled foreign company rules

5.23 The grey list exemption is a New Zealand tax exemption on income accumulated in companies resident in seven countries. The origin of the exemption was an intention to reduce compliance costs under the controlled foreign company (CFC) rules.

5.24 The grey list consists of countries with fairly robust tax rules where the government is satisfied that, in most cases, companies resident there will pay a similar level of tax in that country as New Zealand companies do in New Zealand. The exemption was established for the CFC rules because they provide for an underlying foreign tax credit. It was thought that in most cases, application of the foreign tax credit would mean that little or no New Zealand tax would be imposed on CFCs resident in those countries. The grey list exemption was therefore established as a compliance-savings measure. It has also applied to FIFs to extend to them the same exemption as for CFCs.

5.25 The rationale for the grey list exemption, however, does not apply to FIFs, as FIFs generally do not qualify for an underlying foreign tax credit. This has resulted in a distortion when investors have an incentive to invest in FIFs in grey list countries (which are generally high-tax), even when that investment does not maximise the return to New Zealand. In other words, investors investing in grey list FIFs face the incentives illustrated in table 1, while investors in non-grey list FIFs face the incentives illustrated in table 2. This has led to an inefficient allocation of offshore investments from New Zealand's perspective.

5.26 Some may think it is fair or equitable to give an exemption or foreign tax credit on offshore investments since they have paid foreign tax. However, from a New Zealand perspective, foreign tax is simply another expense of the foreign company, and the expense should not be given special tax treatment, in the same way that there is no special tax treatment for other company expenses such as wages or rent. Further, the international tax environment New Zealand operates in has no expectation that a country must provide an exemption or underlying foreign tax credit for foreign portfolio investments. That is because it is simply not possible to expect portfolio investors to know the foreign tax paid on their investment.

5.27 The foreign tax credits granted for direct investment are made in the context of multilateral practice. Most countries give credits for underlying New Zealand tax on direct investment here, and New Zealand also gives credits for taxes on direct investments offshore. However, countries generally do not give credits for underlying New Zealand tax on portfolio investments made here. Giving credits for underlying taxes on portfolio investments may be more feasible under a bilateral arrangement where credit for New Zealand taxes is also granted by another country. That would be done only if it were clearly in New Zealand's interest.

5.28 Unlike a foreign tax credit, an exemption for foreign income does not maximise world wealth. Therefore the international tax environment, which generally expects countries to provide underlying foreign tax credits for offshore direct investments, does not encourage countries to exempt foreign portfolio income from taxation.

National welfare maximisation and world welfare maximisation

National welfare maximisation is the idea that policy settings should align investors' interests (the post-all tax return) with the national interest (the post-foreign tax and pre-domestic tax return). That is achieved by providing that domestic tax applies to foreign-sourced income with a deduction and not a credit for foreign taxes.

World welfare maximisation is the idea that policy settings should align investors' interests (the post-all tax return) with the world interest (the pre-all tax return), achieved by providing a credit for foreign taxes. That is the reason foreign tax credits are the norm in the international tax environment and are a standard provision in almost all tax treaties.

The two concepts are illustrated here:

Table 3: Results of deduction, credit and exemption

	Domestic	*Foreign with deduction (NWM)*	*Foreign with credit (WWM)*	*Foreign with exemption*
Pre-all tax return **(return to world)**	10%	12%	11%	9.5%
Foreign tax (20%)	-	(2.4%)	(2.2%)	(1.9%)
Pre-NZ tax return **(return to NZ)**	10%	9.6%	8.8%	7.6%
NZ tax (33%)	(3.3%)	(3.2%)	(1.4%)	-
Return to investor	6.7%	6.4%	7.4%	7.6%

continued from page 53

World wealth is maximised when investors choose to make investments with the highest returns before all tax (top row). National wealth is maximised when investors choose to make investments that maximise the return before domestic taxes (after deducting foreign taxes). Investors obviously choose to maximise their post-all tax returns.

The table illustrates a combination of different policy settings with different pre-tax rates of return and how the ultimate return to investors is distorted. In this example, the investor would choose the 9.5% pre-all tax return with an exemption for foreign income, even though this would provide the lowest return to the world and to New Zealand. A foreign income exemption is neither national welfare-maximising nor world welfare-maximising.

5.29 Another major problem with the grey list is that it assumes that a level of tax is paid in the grey list country that is broadly equivalent to that paid if the entity were resident in New Zealand. This is not so for a number of offshore vehicles resident in grey list countries. Examples of this include Australian unit trusts and United Kingdom open ended investment companies. As noted in chapter 2, the proliferation of vehicles of this nature is making the grey list unsustainable.

5.30 A further problem with the grey list is determining where companies invested into actually reside. For example, New Zealand investors can purchase an interest in a company on the Australian Stock Exchange that is resident, say, in The Netherlands without knowing that the company is resident outside the grey list. This results in compliance costs and uncertainty for taxpayers.

Accommodating QCIVs that flow through income

5.31 It is necessary that the proposed grey list reforms for QCIVs should reflect how they operate in a flow-through environment. QCIVs that flow through must attribute assessable income to their investors regularly. Therefore it is highly desirable that the calculation of offshore income for QCIVs does not contain a deferred tax liability that must be provisioned for by investors. It suggests strongly that assessable income should be calculated on an accrued basis and rules out a tax based on realisation.

Parity between investing in CIVs and investing directly

5.32 A key objective of the reform to the taxation of investment is to ensure that individual investors are not disadvantaged by investing in a CIV rather than directly. An investment in a CIV has the advantage of providing small savers the benefit of diversification. However, it has had the disadvantage of being taxed on its trading income while most individual savers would not be taxed on income from selling shares.

5.33 At present, there is parity between the taxation of direct ownership of foreign equities and ownership through CIVs to the extent those equities are in entities resident outside the grey list. However, most foreign equities in which New Zealanders invest are resident in the grey list. For investment in grey list equities, there is a disadvantage in investing through a CIV compared with investing directly. A CIV is taxed on its trading income, while an individual saver would not be.

Proposal 1: Repeal grey list FIF exemption for portfolio investments

5.34 The government proposes to repeal the grey list exemption as it applies to the FIF rules for portfolio investments. The rationale for the grey list exemption as it applies to CFC rules does not apply to the FIF rules, because the FIF rules do not provide an underlying foreign tax credit (unless the branch-equivalent calculation option is selected). This option would remain under the proposed amendments.

5.35 The grey list exemption would remain for non-portfolio investments that own more than 10% of the entity invested into. This aligns with accepted world norms, which generally require an underlying foreign tax credit. Therefore applying the high-tax presumption of the grey list is appropriate for these investments.

5.36 All offshore investments held by a QCIV, regardless of the size of the holding, will be treated as a FIF and the grey list exemption will not apply. That is because the QCIV would be holding them on behalf of its investors, and the investments would be classed as portfolio from the perspective of the QCIV's investors.

5.37 Repealing the grey list exemption would eliminate the current distortion which favours investing in the relatively high-taxed grey list countries over investing in low-tax countries. It would also largely eliminate the tax disadvantage from investing in a grey list country through a QCIV rather than investing directly. This should improve the efficiency of New Zealanders' savings and investments.

5.38 An example of the deficiencies of the grey list exemption was recently discussed in an article published in *The New Zealand Herald*.[4] According to the article, if a New Zealand investor bought shares in Dell 10 years ago, the investment would have multiplied more than 50 times. However, no New Zealand tax would have been payable because Dell has never paid a dividend and is resident in a grey list country.

[4] Brian Gaynor, *The New Zealand Herald*, 21 May 2005, Business page 2.

Practical problems with the FIF rules

5.39 Application of the FIF rules has raised some problems in practice. The most common income calculation method used is the CV method, which has required income from a FIF interest to be calculated using the following formula:

(A + B) – (C + D)

Where:

A is the market value of the interest at the end of the income year;

B is the aggregate of all gains derived from holding or disposing of the interest during the income year, including any foreign withholding tax that the holder is allowed to credit;

C is the market value of the interest at the end of the previous income year; and

D is the total expenditure incurred by the holder during the income year in acquiring or increasing the interest.

5.40 When the variables in the formula are denominated in a foreign currency, they must be translated into New Zealand currency either using the exchange rate on the day of the transaction or valuation, or using a 12-month average exchange rate. Given the high fluctuation of the New Zealand dollar over the last few years, it has made the outcome of this calculation highly volatile.

5.41 Another problem with the CV method is that because tax is imposed on the increase in value of shares and not just on dividends, a tax liability could arise even though the interest has not paid much in dividends and there is little cashflow to pay the tax.

5.42 For FIF interests which do not have a readily ascertainable market value, the deemed rate of return method is available. Assessable income on the interest is calculated by multiplying the cost of the interest by a set rate of return. However, this calculation can be complicated in cases where the interest is acquired or disposed of during the year, as daily apportionment is required. Also, the rate of return that must be used may be higher than the actual rate of return of the interest in some cases.

Proposal 2: FIF calculation method – comparative value

5.43 As stated earlier, it is important that New Zealand investors in foreign equities face an equivalent New Zealand tax impost on the underlying income earned on this investment as they would if investing in domestic equities. It is impossible to determine this directly, so a proxy must be used. The government has considered a number of proxy measures, including a risk-free return method, and a partial comparative value. It considers the best method to be comparative value, with some modifications to alleviate cashflow and income volatility concerns for individual investors.

5.44 It is proposed that a comparative value approach with no modification to the income calculation will apply to QCIVs and investments by non-individual investors. This method would apply to offshore portfolio share investments that have a readily verifiable market value. The fact that the comparative value approach taxes on an accrued basis should make it relatively easy to apply for QCIVs that flow through income.

5.45 This method should not represent a significant increase in the tax liability for funds that currently trade actively as these vehicles are likely to turn over their offshore share investments regularly and currently pay tax on realised share profits.

5.46 Given that income will be taxed on an accrued basis under a comparative value method, it is appropriate to allow a deduction for accrued losses. Accrued losses would be available to be offset against any assessable income derived via the QCIV.

What level of comparative value income should be taxed?

5.47 Income earned and retained by a company should affect its share value, as the company would have more net assets. This makes CV a useful proxy for the underlying income. Obviously, other factors affect a company's share price, including the general trend of the sharemarket, the general trend of the industry the company is in, and investors' perceptions of future income and growth prospects for the company.

5.48 The effect of this measure would be to capture the "external" capital gain in the share price as income, and not just the underlying income earned by the company. In this way, the taxation of the foreign investment would differ from taxation of the domestic investment when external gains are not taxed. While this is undesirable, the government is not aware of any superior method that captures the underlying income of the company.

5.49 It may be possible, for example, to tax a percentage – say, 70% – of a company's change in share price as suggested in the 2003 issues paper *Taxation of non-controlled offshore investment in equity*. The underlying assumption is that 70% of a company's change in share price over a year results from an increase in retained earnings, and 30% from an increase in goodwill (the excess of a company's total share value over its net asset value). However, there is no magic number that provides the right percentage. When there may be such a percentage, it differs wildly from company to company, market to market, and from year to year. Any percentage used would be inherently arbitrary.

5.50 In addition, the calculation of assessable income using a percentage of the change in an asset's value is likely to give rise to tax integrity concerns. That could occur if an investment were made in a country that does not impose any tax on the investment. In such cases it would clearly be inappropriate for New Zealand to tax only a percentage of the income derived.

5.51 By using the total change in share value as the proxy for the underlying income, it would at least ensure that the income earned at the investor level is taxed. Using a percentage would most likely mean that the amount taxed does not equate to actual underlying income at either the company or the investor level.

5.52 Another possible approach would be to give some partial credit for foreign taxes as long as there is a way to measure them or have a good proxy for them. It would be a mid-way approach between world wealth maximisation and national wealth maximisation criteria.

Modified CV with volatility cap

5.53 QCIVs and other commercial operations such as companies should be able to manage the risks associated with the volatility of offshore share investments, be they real or exchange-rate related. The government believes that individual investors are not as well placed to manage these risks – particularly where a large tax liability arises but the investor has no cashflow to meet the liability. For these investors, the government is proposing a modified CV with a volatility cap.

5.54 Under the proposed approach for taxing individuals on their offshore portfolio equity investment, before tax is calculated for the income year it would be necessary to determine the amount that is "available to tax". The "available to tax" amount can be represented as follows:

$(A + B) – (C + D) + E$

Where:

A is the market value of the pool of offshore assets at the end of the income year;

B is the aggregate cash receipts derived in the income year (from dividends and also any receipts from the sale of any asset in the pool), including foreign tax allowed as a credit and imputation credits attached;

C is the market value of the pool at the beginning of the income year;

D is the aggregate of expenditure incurred on acquiring any assets during the income year; and

E is the "available to tax" amount carried forward (from the previous year).

5.55 The amount that is actually taxable (the "deemed taxable" amount) would be the greater of dividends, plus realisations during the year or a deemed percentage (6%) of the total amount that is invested. The "deemed taxable" amount in a year would be capped by the amount that is "available to tax". Where the "available to tax" amount is greater than the "deemed taxable amount", the difference would be carried forward to the next income year (and added to the "available to tax" amount calculated for that year).

Pooling of FIF interests

5.56 A question arises as to whether taxpayers should be allowed to pool all FIF interests together in applying the formula, or whether a separate calculation should be required for each FIF investment.

5.57 Pooling should result in simpler tax compliance. One consequence of pooling, however, would be to allow a de facto rollover of gain when a taxpayer sells FIF interests by investing them into another FIF. In other words, the gain from selling the interest reflected in item B in the formula is offset by a higher item D in the formula when the taxpayer reinvests the proceeds in another FIF. That would allow the taxpayer to defer the income until proceeds from the sale of FIF interests are repatriated rather than reinvested, but could have the negative consequence of discouraging repatriations.

5.58 The government considers that the risks of allowing pooling are partly offset by having a higher income cap percentage. It is therefore proposed that the income cap percentage be 6%, with rollover relief so that tax is payable on the sale of offshore assets only on repatriation. The higher the income cap percentage, the lower the tax deferral amounts carrying forward will be and the less likely there would be a "lock-in" effect discouraging repatriations. The government's willingness to accept the rollover provision is directly related to the 6% rate. Submissions on this question are welcomed.

Treatment of foreign tax credits and imputation credits

5.59 Under the proposed approach, foreign non-resident withholding tax (NRWT) deducted on foreign dividends would continue to be allowed as a tax credit. Foreign NRWT credits would be included in the "available to tax" amount calculation (in part B of the formula), as under the comparative value approach used at present. No credit would be allowed on underlying foreign taxes, as the proposed approach deals with portfolio investment. Imputation credits attached to dividends paid by Australian companies would be treated in a similar manner.

Treatment of losses

5.60 Losses would be allowed under the proposed approach. A loss would arise if the "available to tax" amount were negative. The government proposes to allow a loss up to the deemed percentage that would have been taxable (again, 6%) if a gain had been made instead. Also, when the proposed approach applies in the context of a pool of offshore assets, and a portion of the assets is realised, any negative "available to tax" amount would be available as a loss in proportion to the ratio of the realisation to the market value of the pool at the time. The full loss would be allowed when the pool is realised.

5.61 Example 1 outlines how the proposed method would work. For simplicity, the example assumes that an investor holds only one offshore asset.

Example 1: Readily attainable market value

Jo purchases 100 F Co shares for $2 per share halfway through income year 1. Later in that same income year she derives a $10 gross dividend on her interest in F Co. The F Co shares have a market value of $3.20 per share at the end of income year 1.

Halfway through income year 2 Jo purchases 50 additional F Co shares for $3.20 per share. Later in that same income year she derives a $10 gross dividend on her interest in F Co. The F Co shares have a market value of $3.40 per share at the end of income year 2.

A quarter of the way into income year 3 Jo sells her entire portfolio of F Co shares for $3.60 per share. Jo does not purchase any other qualifying offshore equity in income year 3.

Assessable income (in NZ dollars):

Year 1

"Available to tax" calculation:

($320 + $10) – ($0 + $200) = $130

"Deemed assessable income" calculation:

Higher of $10 (dividend) and $0 (the deemed 6% tax does not apply as Jo does not hold the interest in F Co at the beginning of the income year) = $10

"Available to tax" amount carried forward = $130 – $10 = $120

Year 2

"Available to tax" calculation:

($510 + $10) – ($320 + $160) + $120 = $160

"Deemed assessable income" calculation:

Higher of $10 (dividend) or $19.20 ($320 x 6%) = $19.20

Available to tax carried forward = $160 – $19.20 = $140.80

Year 3

"Available to tax" calculation

($0 + $540) – ($510 + $0) + $140.80 = $170.80

"Deemed assessable income" calculation:

Higher of $170.80 ($540 gross revenue from sale capped to "available to tax" amount) and $30.60 ($510 x 6%) = $170.80

"Available to tax" amount carried forward = $170.80 – $170.80 = $0

Investments without a readily attainable market value – simplified standard rate of return

5.62 It will be necessary to provide investors with a method for calculating income on offshore assets for which it is not possible or practical to obtain market values. Currently, the deemed rate of return method in the foreign investment fund rules caters for such assets, although it is very complex to apply and uses a high rate.

5.63 A simplified version of the standard rate of return method has been developed as follows.

Method

5.64 An investor would be taxable on the following two aspects:

- on accrual – the higher of 6% or any dividends derived; and
- on realisation – the difference between the asset's cost base and the realisation value.

Accrual component

5.65 The first aspect, a simplified standard return approach, would consist of the following components:

- Cost base: the cost base would be an investor's entry price into the investment. It would also include all subsequent additions to the interest.
- Standard return rate of 6%: this is the deemed rate of return that would apply on the cost base at the start of the year.

5.66 In the year in which the investor enters an investment (for example, part-way through the year), the investor will have no cost base in that year. The investment would become part of the cost base only in the second year. As a general rule, any additions to the investment would be rolled into the cost base only in the following year.

5.67 In the first year of an investment, an investor will have no cost base and therefore the investor's income under a standard return will be zero. Consequently, in that first year, if the investor receives a dividend from that asset the dividend will be taxable because it would be higher than assessable income under the standard return. Similarly, in the year the investment is fully realised, any dividends received would be taxable.

5.68 In the second year, the investor's cost base would include any acquisitions in the previous year, plus assessable income for the previous year (in dividends) less any dividends derived in that year. Rolling up assessable income on accrual (at the standard return rate or on dividends) into the cost base in the following year will preclude the need for investors to keep track of how much income has been recognised on a year-by-year basis.

5.69 That is important when considering the implications for the tax wash-up when an asset or portion of an asset is sold. The assessable income in the previous year, when rolled up into the cost base, would also proxy for "investment growth". So, in the third year, the investor's cost base would be the cost base in the second year, plus any acquisitions in the second year, plus assessable income recognised in the second year (proxying for "investment growth" in that previous year) and less dividends derived in the second year. This will be the formula for calculating the cost base in each subsequent year.

Wash-up

5.70 For investments that are realised in a year, the difference between the cost base-value of those investments and their sale price will be taxable. Because the assessable income each year is rolled up into the cost base, any tax paid in each year before realisation (for example, on the dividend or at the standard return rate) will be available to offset the tax payable on realisation.

5.71 If the asset is realised in the first year (the year of purchase), as there will be no cost base, the difference between the purchase price and the sale price will be taxable.

5.72 When only a portion of an investment is realised, the cost base will need to be updated. An investor will need first to value the portion of the cost base that the realisation represents. The methods for determining which portion of an interest has been realised include FIFO (first in first out); LIFO (last in first out); and average cost.

5.73 It would seem preferable to use an average cost basis for valuing realisations as it does not require investors to keep track of the cost of acquisitions. Instead, the average cost would simply be the cost base value at the start of the year, divided by the number of units of the asset held (pre-realisation). The difference between the sale value and the portion of the cost base realised would be taxable.

5.74 Once the portion of the cost base that the realisation represents is valued, the difference between it and the cost base at the start of the year would be the updated cost base in that year (for working out tax paid on accrual) and would also carry over to the following year.

5.75 This method for calculating assessable income would result in the following formulas for calculating assessable income:

Year of acquisition (Year 1)

Cost base = 0
Any dividends received taxable

Year 2

Cost base = purchases in Year 1 – distributions derived in Year 1 (for example, dividends) + assessable income in Year 1

Higher of dividends and standard return income taxable
Standard return income in Year 2 = cost base x standard return rate

Year 3

Cost base = cost base in Year 2 – distributions derived in Year 2 (for example, dividends) + assessable income in Year 2

Higher of dividends and standard return income taxable
Standard return income in Year 3 = cost base x standard return rate

Year n

Cost base = cost base in Year n-1 – distributions in Year n-1 + assessable income in Year n-1

Higher of dividends and standard return income taxable
Standard return income in Year n = cost base x standard return rate

Sale of asset (or portion of asset)

Proportion of cost base realised = no of units realised x average cost

Average cost = cost base in year of realisation/no of units held

Gain or loss on realisation (taxable) = sale value – proportion of cost base realised

Updated cost base = cost base in year of realisation – proportion of cost base realised

Assessable income on accrual: higher of dividends or standard return income (standard return income = updated cost base x standard return rate)

Cost base in year post-realisation (n+1) = Updated cost base (year n) – distributions in year n + assessable income in year n

Example 2: No readily attainable market value

- Joe buys 10,000 shares in A Co on the 25th of September, 2007. The cost of these shares is $1.50 each. On the 29th of January, 2008 he buys 4,000 shares in A Co @ $1.75.
- In the following year (2008-09) Joe continues to hold 14,000 shares in A Co but purchases another 2,000 shares @ $1.77 on the 15th of October, 2008.
- In the third year (2009-10), on the 15th of March, 2010 he sells 7,000 shares in A Co @ $1.80.
- In the fourth year (2010-11), on the 20th of September, 2010 he sells the remaining 9,000 shares @ $2.00.
- In each year, except the last, on the 1st of February, Joe receives a dividend of $0.05 per share.

Year 1 (2007-08)

Cost base = $0
Assessable income is dividend of $700 (as this is higher than standard return income of $0)

Year 2 (2008-09)

Cost base = $15,000 + $7,000 (acquisitions in year 1) – $700 (distributions in year 1) + $700 (assessable income in year 1) = $22,000

Assessable income is $1,320 (the standard return of 6% on $22,000) as this is higher than the dividend of $700 (the actual dividend received in the current year is $800 but $100 of this, relating to the acquisition of 2,000 shares, has been carved out).

Year 3 (2009-10)

Cost base = $22,000 (cost base in previous year) + $3,540 (acquisition in previous year) – $800 (dividend in previous year) + $1,320 (assessable income in previous year) = $26,060

Realisation

Assuming average cost is used, average cost of share is $1.63 ($26,060/16,000). The cost base for the realisation is $11,401 ($1.63 x 7,000).

The value of the realisation is $12,600. The difference between the value of the realisation and the cost base for the realisation – $1,199 – is taxable.

The updated cost base is $26,060 – $11,401 = $14,659

Assessable income is $880 (the standard return of 6% on $14,659) as this is higher than the dividend of $800 paid in the year.

Year 4 (2010-11)

Cost base = $14,659 (updated cost base from previous year) – $800 (dividend in previous year) + $880 (assessable income in previous year but not from realisation) = $14,739

Realisation

The cost base for realisation is $14,739 (as the interest is realised in full). The value of the realisation is $18,000. The difference – $3,261 – is taxable.

No tax is payable on accrual as the interest has been fully realised.

Minimum threshold

5.76 The current FIF rules provide for a minimum threshold of $50,000 (total cost of FIF interests) before the rules apply to individuals. Here, an investor would generally only be taxed on dividends. With the repeal of the grey list exemption, many more individuals are likely to be subject to FIF rules.

5.77 If the minimum threshold remains at $50,000, moderate savers – say, those who have shares with savings of $20,000 to $50,000 – will be disadvantaged by investing in offshore equities through a QCIV rather than investing directly. Reducing the current minimum threshold would reduce this distortion. Keeping the threshold at a high level, however, minimises compliance costs for individuals.

5.78 On balance, a minimum threshold of $50,000 for individuals would seem appropriate as it would minimise compliance costs for small investors without creating significant incentives for investors with more sizeable portfolios to invest offshore directly rather than via a New Zealand-resident managed fund. The government proposes that the $50,000 minimum threshold should be available only for investments into companies that are listed on a recognised exchange in a country with which New Zealand has a double tax agreement. This should ensure that the vast majority of small investments into foreign companies fall below the threshold. It should also ensure that the minimum threshold cannot be used for tax minimisation rather than minimising compliance costs.

5.79 The government invites submissions on the appropriate level of the minimum threshold for individual investors.

Points for submission

The government welcomes submissions on any points raised in this discussion document, with specific comment welcomed on the following:

- Whether the modified comparative value with a volatility cap is a workable proposal for the taxation of individual offshore investments that can be easily valued.
- Whether the 6% income cap is an appropriate rate, given the proposals for rollover relief.
- Whether taxpayers should be allowed to pool foreign investment fund interests together in applying the modified comparative value method, or whether a separate calculation should be required for each investment.
- Whether the proposed treatment of losses in the context of the modified comparative value approach would be a workable solution.
- Whether the method proposed for taxing individuals on investments with no readily attainable market value is an appropriate and workable method.
- Whether the amount of the minimum threshold of $50,000 for individual investors is set at an appropriate level.

Chapter 6

TRANSITIONAL AND OUTSTANDING POLICY ISSUES

6.1 The proposed tax rules for QCIVs and the proposed changes to the taxation of offshore portfolio investment in shares raise several issues in relation to transitioning from the current rules.

6.2 For CIVs, the key issues are around moving from rules that may tax domestic share gains to rules that would generally exempt those gains. For investors in offshore shares, be they individual direct investors or a CIV, the key issues are likely to be around removal of the current grey list exemption and movement to rules where tax is based on changes in value. This chapter outlines some of the key transitional issues.

6.3 One of the key outstanding policy issues is life insurance. When life insurance companies offer savings products that mirror those offered by other CIVs, such as widely held unit trusts and registered superannuation schemes, similar tax rules should apply to these products.

6.4 Nonetheless, the taxation of life insurance is a complex area. While the government agrees that life insurance, as a collective savings vehicle, should get some benefit from the reforms it must consider how such benefit would be delivered within the overall framework of the life insurance rules.

6.5 Submissions on how to extend the benefits to life insurance as a savings vehicle are welcomed.

Transitional issues – new tax rules for QCIVs

6.6 Currently, most CIVs pay tax on realised domestic share gains as a result of the current capital/revenue boundary. Similarly, revenue account losses are deductible. Under the proposed changes, these gains and losses would generally not be taxable. This creates a problem of how to deal with unrealised revenue account gains and losses under the current rules when a QCIV elects into the new rules on 1 April 2007 or later.

6.7 The government considers that transition rules that do not penalise investors or the QCIV, but that also do not give rise to undue windfall gains at the expense of the tax base, are desirable. Broadly, any transitional rules should treat losses and gains symmetrically.

Losses and gains arising under the current tax rules

6.8 At present, if a CIV treats domestic share gains on revenue account, on election into the new tax rules for QCIVs (the transition date) there is a question of whether these gains should be taxed. Similarly, if unrealised losses have been made, the issue arises whether these losses should be crystallised and able to be used to offset income under the new tax rules.

6.9 Two options have been considered for dealing with this transitional problem. The first would effectively retain the current tax rules for investments made before the transition date. The second would require there to be a notional "wind-up" of the entity on transition into the new rules.

6.10 Under the first option, any domestic share investments made by a CIV would remain subject to the current taxation of investment income rules. In other words, if they are currently treated on revenue account they would continue to be taxable on any gains on realisation and, similarly, any losses would be deductible. Investments entered into after the date of transition would instead be subject to the new taxation of investment income rules. This option would principally serve to provide certainty that the transactions entered into under a historical regime remain subject to those rules. It would effectively quarantine any tax losses to existing investments. As a result, tax losses incurred in relation to historical investments could be offset against any gains made on investments entered into before the transition to the new rules (rather than allowing the losses to be carried forward into a system where the gains are no longer taxed).

6.11 There are some concerns about such an option. CIVs may, for example, take the opportunity to time their transition to the new rules so that it is in their favour. In this case, a CIV could choose to enter the new tax rules when gains are expected, to avoid a tax liability arising on those gains. Conversely, there would be no such incentive for CIVs to move into the rules when tax losses were being made (to ensure that the losses can be used up before entry).

6.12 A more important concern is that this transition rule could result in complexity, because it would result in separate rules applying for QCIVs, depending on when an investment was made, and would require QCIVs to track different investments. Consequently, an option requiring QCIVs to track separately investments made under the current tax rules and the new tax rules (and apply different tax rules for each) is not preferred.

6.13 The other option considered was to require a notional "wind-up" of the CIV on entry into the new rules. This wind-up would relate to the CIV's share investments, both onshore and offshore. Under the notional wind-up option, any unrealised share gains (or for that matter losses) would be crystallised on the date of transition. If there is a gain, and the gain is on revenue account, tax would be payable. Similarly, if a loss is made on revenue account, it would be available to be used against income arising on crystallisation of any gains, with any excess available to be carried forward and offset against future assessable income (under the new rules).

6.14 Requiring a notional wind-up on transition to the new rules would also allow CIVs to time their transition so that there would be an incentive to make the transition when they are making losses. Such incentives would exist because the new rules, while coming into effect on 1 April 2007, would not compel CIVs to enter on this date. This was discussed in chapter 3 and is a practical recognition that certain CIVs may not have the systems to operate fully as a flow-through vehicle by the proposed implementation date. A notional wind-up would preclude the need for separate tax rules to apply to investments made before and after the transition. It is therefore the preferred transition approach.

No reduced tax rate on unrealised gains

6.15 The government considered an option that would have applied a reduced tax rate to the taxation of unrealised equity gains on transition. Such an approach may have been justifiable on the basis that, under the current rules, the investments would be taxable only on a realised basis and, therefore, a crystallisation of gains on the date of transition would provide an advantage to the government because it would receive tax revenue earlier than it otherwise would.

6.16 Such a reduction is not considered appropriate. Active CIVs are likely to turn over their portfolios fairly regularly, with the result that gains would be brought to tax relatively quickly under the current rules. In addition, the removal of tax on most domestic equity gains represents a major benefit for QCIVs which should more than compensate for any timing disadvantage.

How should any tax losses that enter the new rules be dealt with?

6.17 Under the proposed transitional rules, any tax losses arising from periods before the new QCIV rules take effect and on the notional wind-up of the entity that cannot be used to offset other taxable gains could be carried forward and offset against future income that is taxable under the new tax rules. However, these would be strictly quarantined so that they could be used only against QCIV income, since losses arising under the old entity rules should be able to offset only income arising from that entity. For that reason, and to minimise filing obligations and complexity to investors, it is proposed that the transitional losses of a QCIV be carried forward and offset against investor income arising only from that QCIV. Transitional losses should be tracked by the QCIV and taken into account in calculating investors' withholding taxes.

6.18 The government recognises that requiring QCIVs to track losses in individual investors' accounts would give rise to compliance costs for QCIVs. Therefore an option whereby the QCIV effectively pools losses and uses these against QCIV income (before such income is allocated to individual investors' accounts) would also be acceptable. This is effectively how losses are dealt with by QCIVs currently, and would result in losses being reflected in the QCIV's unit price.

Treatment of tax credits on notional wind-up

6.19 While the discussion so far has focused on tax losses arising on transition to the new tax rules for QCIVs, qualifying vehicles may also have tax credits, such as imputation credits, credits for resident withholding tax paid, foreign non-resident withholding tax and dividend withholding payments, which have yet to be distributed. The options for dealing with these credits are similar to the losses issue – refunding the credits, allowing the credits to be offset against any assessable income of the investor (not just QCIV income) or requiring them to be offset against QCIV income (with any excess to be carried forward and offset against future investment income).

6.20 The preferred option is for tax credits that exist on the date of transition being used to offset tax on investment income derived via a QCIV and, if excess credits are available, for them to be carried forward if they would be allowed to be carried forward under normal rules. Such a treatment would necessarily be identical to the treatment of tax losses arising on transition and would also remove the need for taxpayers to file a tax return to get the benefit of these tax credits.

6.21 There is, however, a problem in relation to tax credits that, if distributed to individual investors (or if derived directly by individual holders) would be refundable. Credits for resident withholding tax paid and dividend withholding payments should be refunded to the QCIV, as a taxpayer, which could then apportion credits to investors' accounts in the same way that tax credit refunds are made under current rules.

Transitional considerations – new tax rules for offshore portfolio investment in shares

6.22 Transitional considerations would also arise in relation to the proposed changes to the taxation of offshore portfolio investment in shares. They would arise for QCIVs and individual direct investors alike.

6.23 The key problem is the value at which offshore share holdings enter the new rules. Under the new rules, tax would apply to changes in the value of share holdings – a comparative value basis of taxation.

6.24 Under the current tax rules for offshore portfolio investments in shares, when the investment is in a grey list country and the holding is on capital account, investors would not need to respond to the change in value of the shares. That is likely to be the case for most direct holders. For active QCIVs with grey list investments, it is likely that the investments are currently on revenue account and, depending on turnover, that tax is being paid on something close to a comparative value basis.

6.25 For QCIVs, given that the current tax treatment is already likely to proxy a comparative value basis of taxation, existing investments should enter the new rules at their market value on 1 April 2007. It would apply for both savings vehicles that enter the new rules for QCIVs and undertake a notional wind-up on 1 April 2007, as well as those vehicles that do not elect into the new rules on this date. It would also apply to non-individual investors, such as companies and trusts with offshore holdings.

6.26 For individual investors currently in the grey list, it is more complicated. The issue is whether existing investments should enter the new tax rules at their market value on 1 April 2007, at cost, or at some other value, such as the median between the cost and market value on the transition date. The government considers that for individual investors, the entry value of their grey list interests should be at the higher of cost or the market value on the transition date. This may allow them to realise the benefit of an unrealised loss on interests acquired before they became subject to the new rules, as that would reflect their total economic loss on the investment up to that time. If the investor does not remember or have records of the original cost, the opening value would be the market value on the transition date.

Outstanding policy issues

6.27 The proposals outlined in this discussion document are aimed at delivering a reform package that is comprehensive in scope and detail. In particular, the new tax rules for QCIVs are aimed at ensuring that, for investment vehicles generally, tax does not act as a deterrent to owning a diversified portfolio of investments or drive entity form. However, the range of savings vehicles is significant.

6.28 While complexity has not specifically precluded consideration of other investment vehicles, and the proposals for reform put forward should be consistent with the treatment of savings via these alternate entities, it has meant that it has not been possible to consider certain detailed design issues for these other vehicles fully. In particular, this has been the case with life insurance companies that offer savings products which, in many cases, can be similar to those offered by unit trusts and superannuation schemes.

6.29 The taxation of life insurance is a complex area. Life insurance companies are taxed on two bases. The first, the life office base, is the profits from the life insurance business – premium income, mortality profit and investment returns. The second, the policyholder base, attempts to tax the returns to policy holders, with a credit for tax paid on the life office base. In practice, the tax rules for life insurance companies result in all investments being held on revenue account. Consequently, there are problems associated with changing the tax rules for savings vehicles such as unit trusts and superannuation schemes, while leaving investment income made via life insurance companies taxable under the current life insurance rules. The inequity in treatment is not desirable as the savings products on offer may be equivalent to that offered through a vehicle that does qualify for QCIV treatment (and should therefore be treated the same).

6.30 However, there has been insufficient time to consider the implications of moving life insurance companies into the new tax rules for QCIVs, as part of this reform phase. In his review, Craig Stobo noted that life insurance should be included within the scope of any reform of the investment tax rules.

6.31 Since the report-back from the Stobo review, the government has been working with key stakeholders to further develop the recommendations for reform put forward. The detailed nature of these discussions, and the desire to get the framework right for the majority of savings vehicles that are likely to use the new rules, has precluded looking in detail at the issue of life insurance companies. The government is, however, committed to ensuring that investments via a life insurance company will not be tax-disadvantaged compared with investments in a superannuation scheme or a unit trust under the new rules for QCIVs and will examine ways to ensure that this does not occur.

Points for submission

The government welcomes submissions on any points raised in this discussion document, with specific comment welcomed on the following:

- Whether the notional wind-up rules proposed for the treatment of historic losses and gains is the appropriate approach.
- Whether the proposal for individuals to bring assets into the new offshore rules at the higher of the asset's cost or market value is appropriate.

15 March 2004

THE 2005 UPDATE TO THE MODEL TAX CONVENTION

Public discussion draft

This note includes the contents of the next update to the OECD Model Tax Convention, which will be finalized in the spring of 2005. The OECD Committee on Fiscal Affairs has a well-established policy of consulting with business and other interested parties. As part of this policy, it has been decided that prior to issuing an update to the Model Tax Convention, all the changes to the Articles and the Commentary that will be included in the update will be issued as a draft for a final round of public comments even if they have been previously released in separate reports.

The contents of the 2005 update result primarily from the following previously released documents:

- *"Proposed changes to the Commentary on Article 8"*: that report was first released for public comments in April 2004. A few changes were made on the basis of the comments received and the final version of the report was made public on 15 December 2004 (see http://www.oecd.org/dataoecd/20/53/34083450.doc).

- *"Cross-border income tax issues arising from employee stock-option plans"*: the final version of that report, which was approved by the Committee on Fiscal Affairs on 16 June 2004, was made public on 3 September 2004 (see http://www.oecd.org/dataoecd/35/53/33700277.pdf). The final version took into account comments received on two previous drafts of the report which had been made public in March 2002 and July 2003.

- *"Proposed changes to the Commentary on Article 5 concerning multiple permanent establishments"*: a draft version of that report was released for public comments on 12 April 2004 (see http://www.oecd.org/dataoecd/34/9/31483903.pdf). A number of changes were made on the basis of the comments received, which were supportive of the amendments to the Commentary proposed in the draft. This note includes the final version of the amendments (changes made to the April 2004 draft are underlined in this note).

- *"Changes to Articles 25 and 26 of the Model Tax Convention*": the document that includes these changes was approved by the Committee on Fiscal Affairs on 1 June 2004 and made public on 23 July 2004 (see http://www.oecd.org/dataoecd/28/4/33614065.pdf).

- "*Technical issues related to cross-border pensions"*: a draft version of that report was released for public comments on 14 November 2003 (see http://www.oecd.org/dataoecd/12/21/34562290.pdf). A number of changes were made on the basis of the comments received. This note includes the final version of the amendments (changes made to the November 2003 draft are underlined in this note).

The update also includes the following technical changes to the Model Tax Convention:

- A change to paragraph 31 of the Introduction to clarify that no reservation is required to indicate that a country merely wishes to modify the wording of a provision of the Model to confirm or incorporate an interpretation of that provision put forward in the Commentary.

- The addition of commas to the French version of subparagraph 2 *b*) of Article 15 to conform to the English version.

- Changes to the Commentary on Article 11 to include alternative provisions that provide for the exclusive residence taxation of all interest or of some categories thereof and to explain the reasons underlying these provisions.

- Changes to paragraphs 29 and 30 of the Commentary on Article 11 to address more accurately the triangular problem arising in the case of interest borne by a permanent establishment located in a third state.

- Changes to the Commentary on Article 12 to clarify when payments for forbearance to grant rights to use property constitute royalties.

- Changes to the Commentary on Articles 10, 11 and 13 to include a cross-reference to the suggested provision dealing with the investment income of pension funds found in the Commentary on Article 18.

- A change to paragraph 4 of the Commentary on Article 15 to clarify how to take account of overlapping periods when applying the moving 12-month limit of subparagraph 2 *b*) of Article 15.

- A minor change to paragraph 10 of the Commentary on Article 15 to indicate that States may wish to deal bilaterally with the situation of employees working on trucks and trains travelling between countries.

- Changes to the Commentary on Article 20 to clarify the relationship between Articles 15 and 20.

This draft does not include changes to the observations and reservations of OECD Member countries and to the positions of non-Member countries that will be included in the Model Tax Convention as part of the final version of the update.

Comments on the 2005 update to the Model Tax Convention should be sent **before 27 April 2005** to:

Jeffrey Owens
Director, CTPA
OECD
2, rue André Pascal
75775 Paris
FRANCE
e-mail: jeffrey.owens@oecd.org

CHANGES TO BE INCLUDED IN THE 2005 UPDATE TO THE MODEL TAX CONVENTION

[The changes to the existing text of the Model Tax Convention appear in ~~strikethrough~~ for deletions and ***bold italics*** for additions]

A. INTRODUCTION

1. Replace paragraph 31 of the Introduction by the following:

"31. Although all Member countries are in agreement with the aims and the main provisions of the Model Convention, nearly all have entered reservations on some provisions, which are recorded in the Commentaries on the Articles concerned. There has been no need for countries to make reservations indicating their intent to use the alternative or additional provisions that the Commentaries allow countries to include in their bilateral conventions ***or to modify the wording of a provision of the Model to confirm or incorporate an interpretation of that provision put forward in the Commentary***. It is understood that insofar as a Member country has entered reservations, the other Member countries, in negotiating bilateral conventions with the former, will retain their freedom of action in accordance with the principle of reciprocity."

B. ARTICLES

Article 15

2. Replace the French version of subparagraph 15(2)b) by the following:

"*b*) les rémunérations sont payées par un employeur**,** ou pour le compte d'un employeur**,** qui n'est pas un résident de l'autre Etat, et"

Article 19

3. Replace the existing Article 19 by the following:

Article 19
GOVERNMENT SERVICE

1. *a*) Salaries, wages and other similar remuneration paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:

(*i*) is a national of that State; or

(*ii*) did not become a resident of that State solely for the purpose of rendering the services.

2. *a*) ***Notwithstanding the provisions of paragraph 1, a***~~A~~ny pension ***or other similar remuneration*** paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

b) However, such pension ***or other similar remuneration*** shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.

3. The provisions of Articles 15, 16, 17, and 18 shall apply to salaries, wages, ~~and other similar remuneration, and~~ ~~to~~ pensions, ***and other similar remuneration*** in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof."

Article 26

4. Replace the existing Article 26 by the following:

"Article 26

EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is ~~necessary~~ ***foreseeably relevant*** for carrying out the provisions of this Convention or ***to the administration or enforcement*** of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.

2. Any information received ***under paragraph 1*** by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, ~~or~~ the determination of appeals in relation to the taxes referred to ***in paragraph 1,*** ~~in the first sentence~~ ***or the oversight of the above***. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

3.~~2~~ In no case shall the provisions of paragraph***s*** 1 ***and 2*** be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (*ordre public*).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person."

C. COMMENTARY

Commentary on Article 3

5. Replace paragraph 6.3 of the Commentary on Article 3 by the following:

"6.3 The definition of "international traffic" does not apply to a~~ny~~ transport ***by an enterprise which has its place of effective management in one Contracting State*** when the ship ***or aircraft*** is operated between two places in the ~~same Contracting~~ ***other*** State, even if part of the transport takes place outside that State. Thus, for example, a cruise beginning and ending in ~~the same Contracting~~ ***that other*** State without a stop in a foreign port does not constitute a transport of passengers in international traffic. Contracting States wishing to expressly clarify that point in their conventions may agree bilaterally to amend the definition accordingly."

Commentary on Article 5

6. Replace paragraph 33 of the Commentary on Article 5 by the following:

"33. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated ***or if the ~~agent~~ first person has not formally been given a power of representation***. ***The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise.*** Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either."

7. Replace paragraphs 41 and 42 of the Commentary on Article 5 by the following:

"41. ***A parent company may, however, be found, under the rules of paragraphs 1 or 5 of the Article, to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company (see paragraphs 4, 5 and 6 above) and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraph 3 and 4 of the Article (see for instance, the example in paragraph 4.3 above). Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude contracts in the name of the parent (see paragraphs 32, 33 and 34 above), unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article applies.*** ~~However, a subsidiary company will constitute a permanent establishment for its parent company under the same conditions stipulated in paragraph 5 as are valid for any other unrelated company, i.e. if it cannot be regarded as an independent agent in the meaning of paragraph 6, and if it has and habitually exercises an authority to conclude contracts in the name of the parent company. And the effects would be the same as for any other unrelated company to which paragraph 5 applies.~~

41.1 ~~42. The same rules should apply to activities which one subsidiary carries on for any other subsidiary of the same company~~. ***The same principles apply to any company forming part of a multinational group so that such a company may be found to have a permanent establishment in a State where it has at its disposal (see paragraphs 4, 5 and 6 above) and uses premises belonging to another company of the group, or if the <u>former company is deemed to have a permanent establishment under paragraph 5 of the Article</u> ~~latter company acts on its behalf~~ (see paragraphs 32, 33 and 34 above) ~~so that a permanent establishment is deemed to exist under paragraph 5 of the Article~~. The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State."***

8. Add the following new paragraph 42 immediately after paragraph 41.1 (see above change) of the Commentary on Article 5

"42. Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. <u>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</u>."

Commentary on Article 8

9. Replace the Commentary on Article 8 by the following:

"COMMENTARY ON ARTICLE 8 CONCERNING THE TAXATION OF PROFITS FROM SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

Paragraph 1

1. The object of paragraph 1 concerning profits from the operation of ships or aircraft in international traffic is to secure that such profits will be taxed in one State alone. The provision is based on the principle that the taxing right shall be left to the Contracting State in which the place of effective management of the enterprise is situated. The term "international traffic" is defined in sub-paragraph *d*) of paragraph 1 of Article 3.

2. In certain circumstances the Contracting State in which the place of effective management is situated may not be the State of which an enterprise operating ships or aircraft is a resident, and some States therefore prefer to confer the exclusive taxing right on the State of residence. Such States are free to substitute a rule on the following lines:

> "Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State."

3. Some other States, on the other hand, prefer to use a combination of the residence criterion and the place of effective management criterion by giving the primary right to tax to the State in which the place of effective management is situated while the State of residence eliminates double taxation in accordance with Article 23, so long as the former State is able to tax the total profits of the enterprise, and by giving the primary right to tax to the State of residence when the State of effective management is not able to tax total profits. States wishing to follow that principle are free to substitute a rule on the following lines:

> "Profits of an enterprise of a Contracting State from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the other Contracting State, shall be taxable only in the first-mentioned State. However, where the place of effective management of the enterprise is situated in the other State and that other State imposes tax on the whole of the profits of the enterprise from the operation of ships or aircraft, the profits from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the first-mentioned State, may be taxed in that other State."

4. ~~The profits covered consist in the first place of the profits obtained by the enterprise from the carriage of passengers or cargo. With this definition, however, the provision would be unduly restrictive, in view of the development of shipping and air transport, and for practical considerations also. The provision therefore covers other classes of profits as well, i.e. those which by reason of their nature or their close relationship with the profits directly obtained from transport may all be placed in a single category. Some of these classes of profits are mentioned in the following paragraphs.~~ ***The profits covered consist in the first place of the profits directly obtained by the enterprise from the transportation of passengers or cargo by ships or aircraft (whether owned, leased or otherwise at the disposal of the enterprise) that it operates in international traffic. However, as international transport has evolved, shipping and air transport enterprises invariably carry on a large variety of activities to permit, facilitate or support their international traffic***

operations. The paragraph also covers profits from activities directly connected with such operations as well as profits from activities which are not directly connected with the operation of the enterprise's ships or aircraft in international traffic as long as they are ancillary to such operation.

4.1 Any activity carried on primarily in connection with the transportation, by the enterprise, of passengers or cargo by ships or aircraft that it operates in international traffic should be considered to be directly connected with such transportation.

4.2 Activities that the enterprise does not need to carry on for the purposes of its own operation of ships or aircraft in international traffic but which make a minor contribution relative to such operation and are so closely related to such operation that they should not be regarded as a separate business or source of income of the enterprise should be considered to be ancillary to the operation of ships and aircraft in international traffic.

4.3 In light of these principles, the following paragraphs discuss the extent to which paragraph 1 applies with respect to some particular types of activities that may be carried on by an enterprise engaged in the operation of ships or aircraft in international traffic.

5. ~~Profits obtained by leasing a ship or aircraft on charter fully equipped, manned and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision. However, Article 7, and not Article 8, applies to profits from leasing a ship or aircraft on a bare boat charter basis except when it is an occasional source of income for an enterprise engaged in the international operation of ships or aircraft.~~ ***Profits obtained by leasing a ship or aircraft on charter fully equipped, crewed and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision. However, Article 7, and not Article 8, applies to profits from leasing a ship or aircraft on a bare boat charter basis except when it is an ancillary activity of an enterprise engaged in the international operation of ships or aircraft.***

~~6. The principle that the taxing right should be left to one Contracting State alone makes it unnecessary to devise detailed rules, e.g. for defining the profits covered, this being rather a question of applying general principles of interpretation.~~

~~7. Shipping and air transport enterprises — particularly the latter — often engage in additional activities more or less closely connected with the direct operation of ships and aircraft. Although it would be out of the question to list here all the auxiliary activities which could properly be brought under the provision, nevertheless a few examples may usefully be given.~~

~~8. The provision applies, inter alia, to the following activities:~~

~~a) the sale of passage tickets on behalf of other enterprises;~~

~~b) the operation of a bus service connecting a town with its airport;~~

~~c) advertising and commercial propaganda;~~

~~d) transportation of goods by truck connecting a depot with a port or airport.~~

~~9. If an enterprise engaged in international transport undertakes to see to it that, in connection with such transport, goods are delivered directly to the consignee in the other Contracting State, such inland transportation is considered to fall within the scope of the international operation of ships or aircraft and, therefore, is covered by the provisions of this Article.~~

6. Profits derived by an enterprise from the transportation of passengers or cargo otherwise than by ships or aircraft that it operates in international traffic are covered by the paragraph to the extent that such transportation is directly connected with the operation, by that enterprise, of ships or aircraft in international traffic or is an ancillary activity. One example would be that of an enterprise engaged in international transport that would have some of its passengers or cargo transported internationally by ships or aircraft operated by other enterprises, e.g. under code-sharing or slot-chartering arrangements or to take advantage of an earlier sailing. Another example would be that of an airline company that operates a bus service connecting a town with its airport primarily to provide access to and from that airport to the passengers of its international flights.

7. A further example would be that of an enterprise that transports passengers or cargo by ships or aircraft operated in international traffic which undertakes to have those passengers or that cargo picked up in the country where the transport originates or transported or delivered in the country of destination by any mode of inland transportation operated by other enterprises. In such a case, any profits derived by the first enterprise from arranging such transportation by other enterprises are covered by the paragraph even though the profits derived by the other enterprises that provide such inland transportation would not be.

8. An enterprise will frequently sell tickets on behalf of other transport enterprises at a location that it maintains primarily for purposes of selling tickets for transportation on ships or aircraft that it operates in international traffic. Such sales of tickets on behalf of other enterprises will either be directly connected with voyages aboard ships or aircraft that the enterprise operates (e.g. sale of a ticket issued by another enterprise for the domestic leg of an international voyage offered by the enterprise) or will be ancillary to its own sales. Profits derived by the first enterprise from selling such tickets are therefore covered by the paragraph.

8.1 Advertising that the enterprise may do for other enterprises in magazines offered aboard ships or aircraft that it operates or at its business locations (e.g. ticket offices) is ancillary to its operation of these ships or aircraft and profits generated by such advertising fall within the paragraph.

9. Containers are used extensively in international transport. Such containers frequently are also used in inland transport. Profits derived by an enterprise engaged in international transport from the lease of containers are usually either directly connected or ancillary to its operation of ships or aircraft in international traffic and in such cases fall within the scope of the paragraph. The same conclusion would apply with respect to profits derived by such an enterprise from the short-term storage of such containers (e.g. where the enterprise charges a customer for keeping a loaded container in a warehouse pending delivery) or from detention charges for the late return of containers.

~~10. Recently, "containerisation" has come to play an increasing role in the field of international transport. Such containers frequently are also used in inland transport. Profits derived by an enterprise engaged in international transport from the lease of containers which is supplementary or incidental to its international operation of ships or aircraft fall within the scope of this Article.~~

~~10.1 Another case would be that of a transport enterprise that would be required to have assets or personnel in a foreign country for purposes of operating its ships or aircraft in international traffic and that would derive income from providing goods or services in that country to other transport enterprises. This would include (for example) the provision of goods and services by engineers, ground staff, cargo handlers, catering staff and customer services personnel. Since the income so derived would not be related to the operation of ships or aircraft by the enterprise itself, that income would normally not fall within the scope of Article 8. Where, however, the enterprise provides goods~~

~~to, or performs services for, another person that are supplementary or incidental to its operation of ships or aircraft in international traffic, the profits from the provision of such goods or services will fall under Article 8. Although the same considerations apply to a pool, joint business or international operating agency for the purposes of paragraph 4, what is required in that case is to examine how closely the activity is connected with the international transport activities of the pool, joint business or international operating agency as opposed to the activities of the individual enterprises participating in such arrangements.~~

10. An enterprise that has assets or personnel in a foreign country for purposes of operating its ships or aircraft in international traffic may derive income from providing goods or services in that country to other transport enterprises. This would include (for example) the provision of goods and services by engineers, ground and equipment-maintenance staff, cargo handlers, catering staff and customer services personnel. Where the enterprise provides such goods to, or performs services for, other enterprises and such activities are directly connected or ancillary to the enterprise's operation of ships or aircraft in international traffic, the profits from the provision of such goods or services to other enterprises will fall under the paragraph.

10.1 For example, enterprises engaged in international transport may enter into pooling arrangements for the purposes of reducing the costs of maintaining facilities needed for the operation of their ships or aircraft in other countries. For instance, where an airline enterprise agrees, under an International Airlines Technical Pool agreement, to provide spare parts or maintenance services to other airlines landing at a particular location (which allows it to benefit from these services at other locations), activities carried on pursuant to that agreement will be ancillary to the operation of aircraft in international traffic.

~~11. On the other hand, the provision does not cover a clearly separate activity such as the keeping of a hotel as a separate business; the profits from such an establishment are in any case easily determinable. In certain cases, however, circumstances are such that the provision must apply even to a hotel business e.g. the keeping of a hotel for no other purpose than to provide transit passengers with night accommodation, the cost of such a service being included in the price of the passage ticket. In such a case, the hotel can be regarded as a kind of waiting room.~~

12. ~~There is another activity which is excluded from the field of application of the provision, namely a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country.~~ ***The paragraph does not apply to a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country.***

~~13. It may be agreed bilaterally that profits from the operation of vessels engaged in fishing, dredging or hauling activities on the high seas be treated as income falling under this Article~~. *[this paragraph becomes 17.1]*

14. ~~Investment income of shipping, inland waterways or air transport enterprises (e.g. income from stocks, bonds, shares or loans) is to be subjected to the treatment ordinarily applied to this class of income, except where the investment that generates the income is made as an integral part of the carrying on of the business of operating the ships or aircraft in international traffic in the Contracting State. Thus, the Article would apply to interest income generated, for example, by the cash required in a Contracting State for the carrying on of that business or by bonds posted as security where this is required by law in order to carry on the business; it would not apply, however, to interest income derived in the course of the handling of cash-flow or other treasury activities for permanent establishments of the enterprise to which the income is not attributable or for associated enterprises, regardless of whether these are located within or outside that Contracting State, or for the head office (centralisation of treasury and investment activities), nor would it apply to interest income generated~~

~~by the short-term investment of the profits generated by the local operation of the business where the funds invested are not required for that operation.~~ ***Investment income of shipping or air transport enterprises (e.g. income from stocks, bonds, shares or loans) is to be subjected to the treatment ordinarily applied to this class of income, except where the investment that generates the income is made as an integral part of the carrying on of the business of operating the ships or aircraft in international traffic in the Contracting State so that the investment may be considered to be directly connected with such operation. Thus, the paragraph would apply to interest income generated, for example, by the cash required in a Contracting State for the carrying on of that business or by bonds posted as security where this is required by law in order to carry on the business: in such cases, the investment is needed to allow the operation of the ships or aircraft at that location. The paragraph would not apply, however, to interest income derived in the course of the handling of cash-flow or other treasury activities for permanent establishments of the enterprise to which the income is not attributable or for associated enterprises, regardless of whether these are located within or outside that Contracting State, or for the head office (centralisation of treasury and investment activities), nor would it apply to interest income generated by the short-term investment of the profits generated by the local operation of the business where the funds invested are not required for that operation.***

Paragraph 2

15. The rules with respect to the taxing right of the State of residence as set forth in paragraphs 2 and 3 above apply also to this paragraph of the Article.

16. The object of this paragraph is to apply the same treatment to transport on rivers, canals and lakes as to shipping and air transport in international traffic. The provision applies not only to inland waterways transport between two or more countries, but also to inland waterways transport carried on by an enterprise of one country between two points in another country.

16.1 Paragraphs 4 to 14 above provide guidance with respect to the profits that may be considered to be derived from the operation of ships or aircraft in international traffic. The principles and examples included in these paragraphs are applicable, with the necessary adaptations, for purposes of determining which profits may be considered to be derived from the operation of boats engaged in inland waterways transport.

17. The provision does not prevent specific tax problems which may arise in connection with inland waterways transport, in particular between adjacent countries, from being settled specially by bilateral agreement.

17.1 It may also be agreed bilaterally that profits from the operation of vessels engaged in fishing, dredging or hauling activities on the high seas be treated as income falling under this Article.

Enterprises not exclusively engaged in shipping, inland waterways transport or air transport

18. It follows from the wording of paragraphs 1 and 2 that enterprises not exclusively engaged in shipping, inland waterways transport or air transport nevertheless come within the provisions of these paragraphs as regards profits arising to them from the operation of ships, boats or aircraft belonging to them.

19. If such an enterprise has in a foreign country permanent establishments exclusively concerned with the operation of its ships or aircraft, there is no reason to treat such establishments differently from the permanent establishments of enterprises engaged exclusively in shipping, inland waterways transport or air transport.

20. Nor does any difficulty arise in applying the provisions of paragraphs 1 and 2 if the enterprise has in another State a permanent establishment which is not exclusively engaged in shipping, inland waterways transport or air transport. If its goods are carried in its own ships to a permanent establishment belonging to it in a foreign country, it is right to say that none of the profit obtained by the enterprise through acting as its own carrier can properly be attributed to the permanent establishment. The same must be true even if the permanent establishment maintains installations for operating the ships or aircraft (e.g. consignment wharves) or incurs other costs in connection with the carriage of the enterprise's goods (e.g. staff costs). In this case, the permanent establishment's expenditure in respect of the operation of the ships, boats or aircraft should be attributed not to the permanent establishment but to the enterprise itself, since none of the profit obtained through the carrying benefits the permanent establishment.

21. Where ships or aircraft are operated in international traffic, the application of the Article to the profits arising from such operation will not be affected by the fact that the ships or aircraft are operated by a permanent establishment which is not the place of effective management of the whole enterprise (for example, ships or aircraft put into service by the permanent establishment or figuring on the balance sheet of the permanent establishment).

Paragraph 3

22. This paragraph deals with the particular case where the place of effective management of the enterprise is aboard a ship or a boat. In this case tax will only be charged by the State where the home harbour of the ship or boat is situated. It is provided that if the home harbour cannot be determined, tax will be charged only in the Contracting State of which the operator of the ship or boat is a resident.

Paragraph 4

23. Various forms of international co-operation exist in shipping or air transport. In this field international co-operation is secured through pooling agreements or other conventions of a similar kind which lay down certain rules for apportioning the receipts (or profits) from the joint business.

24. In order to clarify the taxation position of the participant in a pool, joint business or in an international operating agency and to cope with any difficulties which may arise the Contracting States may bilaterally add the following, if they find it necessary:

> "but only to so much of the profits so derived as is attributable to the participant in proportion to its share in the joint operation."

25. [Renumbered as paragraph 34]"

Commentary on Article 10

10. Add the following paragraph 13.1 immediately after paragraph 13 of the Commentary on Article 10:

"7.10 Under the domestic laws of many States, pension funds and similar entities are generally exempt from tax on their investment income. In order to achieve neutrality of treatment as regards domestic and foreign investments by these entities, some States provide bilaterally that income, including dividends, derived by such an entity resident of the other State shall be exempt from source taxation. States wishing to do so may agree bilaterally on a provision drafted along the lines of the provision found in paragraph 69 of the Commentary on Article 18."

Commentary on Article 11

11. Replace paragraphs 7 to 17 of the Commentary on Article 11 by the following:

"7. Paragraph 2 reserves a right to tax interest to the State in which the interest arises; but it limits the exercise of that right by determining a ceiling for the tax, which may not exceed 10 per cent. This rate may be considered a reasonable maximum bearing in mind that the State of source is already entitled to tax profits or income produced on its territory by investments financed out of borrowed capital. The Contracting States may agree in bilateral negotiations upon a lower tax or on exclusive taxation in the State of the beneficiary's residence ***with respect to all interest payments or, as explained below, as regards some specific categories of interest.***

7.1 [OLD 13] ~~It should, however, be pointed out that the solution adopted, given the combined effect of the right to tax accorded to the State of source and the allowance to be made for the tax levied there against that due in the State of residence, could, in certain cases, result in maintaining partial double taxation and lead to adverse economic consequences~~. ***In certain cases, the approach adopted in paragraph 2, which is to allow source taxation of payments of interest, can constitute an obstacle to international trade or may be considered inappropriate for other reasons***. ~~In fact~~ ***For instance***, when the beneficiary of the interest has ~~himself~~ ~~had to~~ borrow***ed*** in order to finance the operation which earns ~~him~~ ***the*** interest, the profit ~~he will~~ realise***d*** by way of interest will be much smaller than the nominal amount of interest ~~he~~ receive***d***~~s~~; if the interest ~~he pays~~ ***paid is equal to or exceeds the interest received*** ~~and that which he receives balance~~, there will be ***either*** no profit at all ***or even a loss***. ***The problem, in that case, cannot be solved by the State of residence, since little or no tax will be levied in that State where the beneficiary is taxed on the net profit derived from the transaction. That problem arises because the tax in the State of source is typically levied on the gross amount of the interest regardless of expenses incurred in order to earn such interest.*** ~~In such a case, the allowance to be made under paragraph 2 of Article 23 A, or paragraph 1 of Article 23 B, raises a difficult and sometimes insoluble problem in view of the fact that the tax levied in the State the relief of double taxation by the State of residence will where the interest arises is calculated on the gross amount thereof, whereas the same interest is reflected in the beneficiary's business results at its net amount only. The result of this is that part, or sometimes even the whole amount, of the tax levied in the State where the interest arises cannot be allowed as a credit in the beneficiary's State of residence and so constitutes an excess charge for the beneficiary, who, to that extent, suffers double taxation~~. ~~Moreover, the latter, i~~***I***n order to avoid ***that problem*** ~~the disadvantage just mentioned~~, ***creditors*** will, ***in practice***, tend to ***shift to the debtor the burden of the tax levied by the State of source on the interest and therefore*** increase the rate of interest ~~he~~ charge***d***~~s his~~ ***to the*** debtor, whose financial burden ***is then increased by an amount corresponding to the tax payable to the State of source*** ~~would then be increased to a corresponding extent~~. ~~Thus in certain cases the practice of taxation at the source can constitute an obstacle to international trade. Furthermore, if the payer of the interest happens to be the State itself, a public sector institution, or an enterprise guaranteed by the State, the end result may well be that the tax levied at source is actually borne by the Treasury of the debtor's State, which latter thus derives no real benefit from its own taxation.~~

7.2 [OLD 15] ~~If two Contracting States, in order to eliminate all risks of double taxation, should desire to avoid the imposition of a tax in the State of source on interest arising from the above-mentioned categories of debts, their common intention can be expressed by an additional paragraph which would follow paragraph 2 of the Article, and which might be drafted in the following terms~~ ***The Contracting States may wish to add an additional paragraph to provide for the exclusive taxation in the State of the beneficiary's residence of certain interest. The preamble of that paragraph, which would be followed by subparagraphs describing the various interest subject to that treatment (see below), might be drafted along the following lines:***

"3. Notwithstanding the provisions of paragraph 2, ~~any such interest as is mentioned in paragraph~~ 1 ***interest referred to in paragraph 1*** shall be taxable only in the Contracting State of which the recipient is a resident ***if the beneficial owner of the interest is a resident of that State***, ~~if such recipient is the beneficial owner of the interest and if such interest is~~ ~~paid~~ ***and***:

a) [description of the relevant category of interest] …

~~a) in connection with the sale on credit of any industrial, commercial or scientific equipment,~~

~~b) in connection with the sale on credit of any merchandise by one enterprise to another enterprise, or~~

~~c) on any loan of whatever kind granted by a bank."~~

7.3 The following are some of the categories of interest that Contracting States may wish to consider for the purposes of paragraph 7.2 above.

Interest paid to State and State agencies, including central banks

7.4 Some States refrain from levying tax on income derived by other States, at least to the extent that such income is derived from activities of a governmental nature. In their bilateral conventions, many States wish to confirm or clarify the scope of that exemption with respect to interest. States wishing to do so may therefore agree to include the following category of interest in a paragraph providing for exemption of certain interest from taxation in the State of source:

"a) is that State or the central bank, a political subdivision or local authority thereof;"

Interest paid by a State or its political subdivisions

7.5 ~~Furthermore, if~~ Where the payer of the interest happens to be the State itself, ***a political subdivision or a statutory body*** ~~public sector institution~~ ~~or an enterprise guaranteed by the State~~, the end result may well be that the tax levied at source ~~is~~ ***may*** actually ***be*** borne ***by that*** ~~by the Treasury of the debtor's~~ State ***if the lender increases the interest rate to recoup the tax levied at source. In that case, any benefits for the State taxing the interest at source will be offset by the increase of its borrowing costs. For that reason, many States provide that such interest will be exempt from any tax at source. States wishing to do so may agree to include the following category of interest in a paragraph providing for exemption of certain interest from taxation in the State of source:***

"b) if the interest is paid by the State in which the interest arises or by a political subdivision, a local authority or statutory body thereof;"

In this suggested provision, the phrase "statutory body" refers to any public sector institution. Depending on their domestic law and terminology, some States may prefer to use phrases such as "agency or instrumentality" or "legal person of public law" [personne morale de droit public] to refer to such an institution.

Interest paid pursuant to export financing programmes

7.6 In order to promote international trade, many States have established export financing programmes or agencies which may either provide export loans directly or insure or guarantee export loans granted by commercial lenders. Since that type of financing is supported by public funds, a number of States provide bilaterally that interest arising from loans covered by these programmes shall be exempt from source taxation. States wishing to do so may agree to include

the following category of interest in a paragraph providing for exemption of certain interest from taxation in the State of source:

> ***"c) if the interest is paid in respect of a loan, debt-claim or credit that is owed to, or made, provided, guaranteed or insured by, that State or a political subdivision, local authority or export financing agency thereof;"***

Interest paid to financial institutions

7.7 The problem described in paragraph 7.1, which essentially arises because taxation by the State of source is typically levied on the gross amount of the interest and therefore ignores the real amount of income derived from the transaction for which the interest is paid, is particularly important in the case of financial institutions.[NEXT SENTENCE FROM OLD 14] ***For instance,*** ~~similarly, the~~ ***a*** bank~~er~~ generally finances the loan which ~~he~~ ***it*** grants with funds lent to ***it*** ~~his bank~~ and, in particular, funds accepted ~~by him~~ on deposit. ***Since the State of source, in determining the amount of tax payable on the interest, will usually ignore the cost of funds for the bank, the amount of tax may prevent the transaction from occurring unless the amount of that tax is borne by the debtor. For that reason, many States provide that interest paid to financial institution such as a bank will be exempt from any tax at source. States wishing to do so may agree to include the following-interest in a paragraph providing from exemption of certain interest from taxation in the State of source:***

> ***"d) is a financial institution;"***

Interest on sales on credit

7.8 [OLD 14] The disadvantages ~~just mentioned arise in business, particularly with the~~ ***described in paragraph 7.1 also arise frequently in the case of*** sale***s*** on credit of equipment ***and~~,~~*** other commercial credit sales~~, and loans granted by banks~~. The supplier in such cases very often merely passes on to the customer, without any additional charge, the price he will himself have had to pay to a bank or an export finance agency to finance the credit~~; similarly, the banker generally finances the loan which he grants with funds lent to his bank and, in particular, funds accepted by him on deposit~~. In the***se*** case***s*** ~~especially of the person selling equipment on credit~~, the interest is more an element of the selling price than income from invested capital. ***In fact, in many cases, the interest incorporated in the amounts of instalments to be paid will be difficult to separate from the actual sale price***. ***States may therefore wish to include interest arising from such sales on credit in a paragraph providing for exemption of certain interest from taxation in the State of source, which they can do by adding the following subparagraph :***

> ***"e) if the interest is paid with respect to indebtedness arising as a consequence of the sale on credit of any equipment, merchandise or services;"***

7.9 [OLD 16] ~~As regards, more particularly, t~~***T***he types of ***sales on*** credit ~~sale~~ referred to in ~~sub-paragraph *a*) of the text suggested above~~ ***this suggested provision***~~, they~~ comprise not only sales of complete units, but also sales of separate components thereof. ***Sales financed through a general line of credit provided by a seller to a customer constitute sales on credit as well for the purposes of the provision***. ~~Furthermore, as regards credit sales of the types referred to in sub-paragraphs *a*) and *b*) of the suggested text,~~ ***Also,*** it is immaterial whether the interest is stipulated separately ~~and as additional~~ ***in addition*** to the sale price~~,~~ or is included from the outset in the price payable by instalments.

Interest paid to some tax-exempt entities (e.g. pension funds):

7.10 Under the domestic laws of many States, pension funds and similar entities are generally exempt from tax on their investment income. In order to achieve neutrality of treatment as

regards domestic and foreign investments by these entities, some States provide bilaterally that income, including interest, derived by such an entity resident of the other State shall also be exempt from source taxation. States wishing to do so may agree bilaterally on a provision drafted along the lines of the provision found in paragraph 69 of the Commentary on Article 18.

7.11 If the Contracting States do not wish to exempt completely any or all of the above categories of interest from taxation in the State of source, they may wish to apply to them a lower rate of tax than that provided for in paragraph 2 (that solution would not, however, seem very practical in the case of interest paid by a State or its political subdivision or statutory body). In that case, paragraph 2 might be drafted along the following lines:

> ***"2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed:***
>
> > ***a) [lower rate of tax] per cent of the gross amount of the interest in the case of interest paid [description of the relevant category of interest] …***
> >
> > ***b) 10 per cent of the gross amount of the interest in all other cases.***
>
> ***The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation."***

If the Contracting States agree to exempt some of the above categories of interest, this alternative provision would be followed by a paragraph 3 as suggested in paragraph 7.2 above.

7.12 [OLD 17] Contracting States may add to the categories of interest enumerated in the ~~text suggested in paragraph 15~~ ***paragraphs*** above, other categories in regard to which the imposition of a tax in the State of source might appear to them to be undesirable. ~~They may also agree that the exclusion of a right to tax in the State of source shall be limited to certain of the categories of interest mentioned~~.

8. [OLD 12] Attention is drawn generally to the following case: the beneficial owner of interest arising in a Contracting State is a company resident in the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether, in the case of such a company, it is justifiable to allow in the State of source of the interest the limitation of tax which is provided in paragraph 2. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this Article, in order to define the treatment applicable to such companies.

9. [OLD 8] Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. (The text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries.) States which wish to make this more explicit are free to do so during bilateral negotiations.

10. [OLD 9] The paragraph lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment. Procedural questions are not dealt with in this Article. Each State should be able to apply the procedure provided in its own law (see, however, paragraph 26.2 of the Commentary on Article 1). Specific questions arise with triangular cases (see paragraph 53 of the Commentary on Article 24).

11. [OLD 10]. It does not specify whether or not the relief in the State of source should be conditional upon the interest being subject to tax in the State of residence. This question can be settled by bilateral negotiations.

12. [OLD 11] The Article contains no provisions as to how the State of the beneficiary's residence should make allowance for the taxation in the State of source of the interest. This question is dealt with in Articles 23 A and 23 B.

13-17. [Renumbered and amended]"

12. Replace paragraphs 29 and 30 of the Commentary on Article 11 by the following:

"29. It has ~~not, however, been considered possible to refer to such a case in a bilateral convention . and provide for it a solution consisting for example, in obliging~~ ***been decided not to deal with that case in the Convention. T***~~T~~he Contracting State of the payer's residence ***does not, therefore, have*** to relinquish its tax at the source in favour of the third State in which is situated the permanent establishment for the account of which the loan was effected and by which the interest is borne. ***If this were not the case and the third State did not subject the interest borne by the permanent establishment to source taxation, there could be attempts to avoid source taxation in the Contracting State through the use of a permanent establishment situated in such a third State. States for which this is not a concern and that wish to address the issue described in the paragraph above may do so by agreeing to use, in their bilateral convention, the alternative formulation of paragraph 5 suggested in paragraph 30 below***. The risk of double taxation just referred to ~~can~~ ***could also*** ~~only~~ be ~~fully~~ avoided ~~through a bilateral convention containing a similar provision to that in paragraph 5or~~ through a multilateral convention. ~~containing such a provision. 30. Moreover, in the case not settled in paragraph 5 where whichever of the two Contracting States is that of the payer's residence~~ ***Also, if in the case described in paragraph 28, the State of the payer's residence*** and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne, together claim the right to tax the interest at the source, there would be nothing to prevent those two States together with, where appropriate, the State of the beneficiary's residence from concerting measures to avoid the double taxation that would result from such claims ***using, where necessary, the mutual agreement procedure (as envisaged in paragraph 3 of Article 25).*** ~~The proper remedy, it must be said again, would be the establishment between these different States of bilateral conventions, or a multilateral convention, containing a provision similar to that in paragraph 5. Another~~

30. As mentioned in paragraph 29, any such double taxation could be avoided either through a multilateral convention or if ~~solution would be for two Contracting States~~ ***the State of the beneficiary's residence and the State of the payer's residence agreed*** to word the second sentence of paragraph 5 in the following way, ***which would have the effect of ensuring that paragraphs 1 and 2 of the Article did not apply to the interest, which would then typically fall under Article 7 or 21:***

> "Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."

Commentary on Article 12

13. Add the following paragraph 8.1 to the Commentary on Article 12:

"8.1 Where information referred to in paragraph 2 is supplied or where the use or the right to use a type of property referred to in that paragraph is granted, the person who owns that information or property may agree not to supply or grant to anyone else that information or right. Payments made as consideration for such an agreement constitute payments made to

secure the exclusivity of that information or an exclusive right to use that property, as the case may be. These payments being payments "of any kind received as a consideration for [...] the right to use" the property "or for information", fall under the definition of royalties."

Commentary on Article 13

14. Replace paragraphs 28.8 of the Commentary on Article 13: by the following:

"28.8 Another possible exception relates to shares held by pension funds and similar entities. Under the domestic laws of many States, pension funds and similar entities are generally exempt from tax on their investment income. In order to achieve neutrality of treatment as regards domestic and foreign investments by these entities, some States provide bilaterally that income derived by such an entity resident of the other State, which would include capital gains on shares referred to in paragraph 4, shall be exempt from source taxation. States wishing to do so may agree bilaterally on a provision drafted along the lines of the provision found in paragraph 69 of the Commentary on Article 18.

28.9 ~~28.8~~ Since the domestic laws of some States do not allow them to tax the gains covered by paragraph 4, States that adopt the exemption method should be careful to ensure that the inclusion of the paragraph does not result in a double exemption of these gains. These States may wish to exclude these gains from exemption and apply the credit method, as suggested by paragraph 35 of the Commentary on Articles 23 A and 23 B."

15. Add the following paragraph 32 to the Commentary on Article 13:

"32. There is a need to distinguish the capital gain that may be derived from the alienation of shares acquired upon the exercise of a stock-option granted to an employee or member of a board of directors from the benefit derived from the stock-option that is covered by Articles 15 or 16. The principles on which that distinction is based are discussed in paragraphs 12.2 to 12.5 of the Commentary on Article 15 and paragraph 3.1 of the Commentary on Article 16."

Commentary on Article 15

16. Replace paragraph 2.1 of the Commentary on Article 15 by the following:

"2.1. Member countries have generally understood the term "salaries, wages and other similar remuneration" to include benefits in kind received in respect of an employment (e.g. ***stock-options***, the use of a residence or automobile, health or life insurance coverage and club memberships)."

17. Add the following paragraph 2.2 to the Commentary on Article 15:

"2.2 The condition provided by the Article for taxation by the State of source is that the salaries, wages or other similar remuneration be derived from the exercise of employment in that State. This applies regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee."

18. Replace paragraph 4 of the Commentary on Article 15 by the following:

"4. The three conditions prescribed in this paragraph must be satisfied for the remuneration to qualify for the exemption. The first condition is that the exemption is limited to the 183 day period. It is further stipulated that this time period may not be exceeded "in any twelve month period commencing or ending in the fiscal year concerned". This contrasts with the 1963 Draft Convention and the 1977 Model Convention which provided that the 183 day period should not be exceeded "in the fiscal year concerned", a formulation that created difficulties where the fiscal years of the Contracting States did not coincide and which opened up opportunities in the sense that operations were sometimes organised in such a way that, for example, workers stayed in the State concerned for the last 5 1/2 months of one year and the first 5 1/2 months of the following year. The present wording of subparagraph 2 *a*) does away with such opportunities for tax avoidance. ***In applying that wording, all possible periods of twelve consecutive months must be considered, even periods which overlap others to a certain extent. For instance, if an employee is present in a State during 150 days between 1 April 01 and 31 March 02 but is present there during 210 days between 1 August 01 and 31 July 02, the employee will have been present for a period exceeding 183 days during the second 12 month period identified above even though he did not meet the minimum presence test during the first period considered and that first period partly overlaps the second."***

19. Replace paragraph 7 of the Commentary on Article 15 by the following:

"7. Under the third condition, if the employer has ***a permanent establishment*** in the State in which the employment is exercised~~ a permanent establishment~~, the exemption is given ~~only ~~on condition that the remuneration is not borne by ***that*** ~~a ~~permanent establishment ~~which he has in that State~~. The phrase "borne by" must be interpreted in the light of the underlying purpose of subparagraph *c*) of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that ~~is deductible~~***could give rise to a deduction***, having regard to the principles of Article 7 ***and the nature of the remuneration***, in computing the profits of a permanent establishment situated in the State in which the employment is exercised. In this regard, it must be noted that the fact that the employer has, or has not, actually ~~deducted the~~ ***claimed a deduction for the*** remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether ***any deduction otherwise available for that remuneration would be allocated to the permanent establishment***~~the remuneration would be allowed as a deduction for tax purposes;~~. ***That*** ~~that ~~test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled. ***The test would also be met where the remuneration is not deductible merely because of its nature (e.g. where the State takes the view that the issuing of shares pursuant to an employee stock-option does not give rise to a deduction) rather than because it should not be allocated to the permanent establishment."***

20. Replace paragraph 10 of the Commentary on Article 15 by the following:

"10. It should be noted that no special rule***s*** regarding the taxation of income of frontier workers ***or of employees working on trucks and trains travelling between States are*** included as it would be more suitable for the problems created by local conditions to be solved directly between the States concerned."

21. Add the following heading and paragraphs 12 to 12.15 to the Commentary on Article 15:

"The treatment of employee stock-options

12. The different country rules for taxing employee stock-options create particular problems which are discussed below. While many of these problems arise with respect to other forms of employee remuneration, particularly those that are based on the value of shares of the employer or a related company, they are particularly acute in the case of stock-options. This is

largely due to the fact that stock-options are often taxed at a time (e.g. when the option is exercised or the shares sold) that is different from the time when the employment services that are remunerated through these options are rendered.

12.1 As noted in paragraph 2.2, the Article allows the State of source to tax the part of the stock-option benefit that constitutes remuneration derived from employment exercised in that State even if the tax is levied at a later time when the employee is no longer employed in that State.

12.2 While the Article applies to the employment benefit derived from a stock-option granted to an employee regardless of when that benefit is taxed, there is a need to distinguish that employment benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the employer or issuer). Once the option is exercised or alienated, however, the employment benefit has been realized and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the employee in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is what the employee obtained from his employment, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so). Where, however, the option that has been exercised entitles the employee to acquire shares that will not irrevocably vest until the end of a period of required employment, it will be appropriate to apply this Article to the increase in value, if any, until the end of the required period of employment that is subsequent to the exercise of the option.

12.3 The fact that the Article does not apply to a benefit derived after the exercise or alienation of the option does not imply in any way that taxation of the employment income under domestic law must occur at the time of that exercise or alienation. As already noted, the Article does not impose any restriction as to when the relevant income may be taxed by the State of source. Thus, the State of source could tax the relevant income at the time the option is granted, at the time the option is exercised (or alienated), at the time the share is sold or at any other time. The State of source, however, may only tax the benefits attributable to the option itself and not what is attributable to the subsequent holding of shares acquired upon the exercise of that option (except in the circumstances described in the last sentence of the preceding paragraph).

12.4 Since paragraph 1 must be interpreted to apply to any benefit derived from the option until it has been exercised, sold or otherwise alienated, it does not matter how such benefit, or any part thereof, is characterized for domestic tax purposes. As a result, whilst the Article will be interpreted to allow the State of source to tax the benefits accruing up to the time when the option has been exercised, sold or otherwise alienated, it will be left to that State to decide how to tax such benefits, e.g. as either employment income or capital gain. If the State of source decides, for example, to impose a capital gains tax on the option when the employee ceases to be a resident of that country, that tax will be allowed under the Article. The same will be true in the State of residence. For example, while that State will have sole taxation right on the increase of value of the share obtained after exercise since this will be considered to fall under Article 13 of the Convention, it may well decide to tax such increase as employment income rather than as a capital gain under its domestic law.

12.5 The benefits resulting from a stock-option granted to an employee will not, as a general rule, fall under either Article 21, which does not apply to income covered by other Articles, or Article 18, which only applies to pension and other similar remuneration, even if the option is exercised after termination of the employment or retirement.

12.6 Paragraph 1 allows the State of source to tax salaries, wages and other similar remuneration derived from employment exercised in that State. The determination of whether and to what extent an employee stock-option is derived from employment exercised in a particular State must be done in each case on the basis of all the relevant facts and circumstances, including the contractual conditions associated with that option (e.g. the conditions under which the option granted may be exercised or disposed of). The following general principles should be followed for that purpose.

12.7 The first principle is that, as a general rule, an employee stock-option should not be considered to relate to any services rendered after the period of employment that is required as a condition for the employee to acquire the right to exercise that option. Thus, where a stock-option is granted to an employee on the condition that he provides employment services to the same employer (or an associated enterprise) for a period of three years, the employment benefit derived from that option should generally not be attributed to services performed after that three-year period.

12.8 In applying the above principle, however, it is important to distinguish between a period of employment that is required to obtain the right to exercise an employee stock-option and a period of time that is merely a delay before such option may be exercised (a blocking period). Thus, for example, an option that is granted to an employee on the condition that he remains employed by the same employer (or an associated enterprise) during a period of three years can be considered to be derived from the services performed during these three years while an option that is granted, without any condition of subsequent employment, to an employee on a given date but which, under its terms and conditions, can only be exercised after a delay of three years, should not be considered to relate to the employment performed during these years as the benefit of such an option would accrue to its recipient even if he were to leave his employment immediately after receiving it and waited the required three years before exercising it.

12.9 It is also important to distinguish between a situation where a period of employment is required as a condition for the acquisition of the right to exercise an option, i.e. the vesting of the option, and a situation where an option that has already vested may be forfeited if it is not exercised before employment is terminated (or within a short period after). In the latter situation, the benefit of the option should not be considered to relate to services rendered after vesting since the employee has already obtained the benefit and could in fact realise it at any time. A condition under which the vested option may be forfeited if employment is terminated is not a condition for the acquisition of the benefit but, rather, one under which the benefit already acquired may subsequently be lost. The following examples illustrate this distinction:

- ***Example 1: On 1 January of year 1, a stock-option is granted to an employee. The acquisition of the option is conditional on the employee continuing to be employed by the same employer until 1 January of year 3. The option, once this condition is met, will be exercisable from 1 January of year 3 until 1 January of year 10 (a so-called "American" option[1]). It is further provided, however, that any option not previously exercised will be lost upon cessation of employment. In that example, the right to exercise that option has been acquired on 1 January of year 3 (i.e. the date of vesting) since no further period of employment is then required for the employee to obtain the right to exercise the option.***

1 Under an "American" stock-option, the right to acquire a share may be exercised during a certain period (typically a number of years) while under a "European" stock-option, that right may only be exercised at a given moment (i.e. on a particular date).

- *Example 2: On 1 January of year 1, a stock-option is granted to an employee. The option is exercisable on 1 January of year 5 (a so-called "European" option). The option has been granted subject to the condition that it can only be exercised on 1 January of year 5 if employment is not terminated before that date. In that example, the right to exercise that option is not acquired until 1 January of year 5, which is the date of exercise, since employment until that date is required to acquire the right to exercise the option (i.e. for the option to vest).*

***12.10** There are cases where that first principle might not apply. One such case could be where the stock-option is granted without any condition to an employee at the time he either takes up an employment, is transferred to a new country or is given significant new responsibilities and, in each case, the option clearly relates to the new functions to be performed by the employee during a specific future period. In that case, it may be appropriate to consider that the option relates to these new functions even if the right to exercise the option is acquired before these are performed. There are also cases where an option vested technically but where that option entitles the employee to acquire shares which will not vest until the end of a period of required employment. In such cases, it may be appropriate to consider that the benefit of the option relates to the services rendered in the whole period between the grant of the option and the vesting of the shares.*

***12.11** The second principle is that an employee stock-option should only be considered to relate to services rendered before the time when it is granted to the extent that such grant is intended to reward the provision of such services by the recipient for a specific period. This would be the case, for example, where the remuneration is demonstrably based on the employee's past performance during a certain period or is based on the employer's past financial results and is conditional on the employee having been employed by the employer or an associated enterprise during a certain period to which these financial results relate. Also, in some cases, there may be objective evidence demonstrating that during a period of past employment, there was a well-founded expectation among participants to an employee stock-option plan that part of their remuneration for that period would be provided through the plan by having stock-options granted at a later date. This evidence might include, for example, the consistent practice of an employer that has granted similar levels of stock-options over a number of years, as long as there was no indication that this practice might be discontinued. Depending on other factors, such evidence may be highly relevant for purposes of determining if and to what extent the stock-option relates to such a period of past employment.*

***12.12** Where a period of employment is required to obtain the right to exercise an employee's stock-option but such requirement is not applied in certain circumstances, e.g. where the employment is terminated by the employer or where the employee reaches retirement age, the stock-option benefit should be considered to relate only to the period of services actually performed when these circumstances have in fact occurred.*

***12.13** Finally, there may be situations in which some factors may suggest that an employee stock-option is rewarding past services but other factors seem to indicate that it relates to future services. In cases of doubt, it should be recognised that employee stock-options are generally provided as an incentive to future performance or as a way to retain valuable employees. Thus, employee stock-options are primarily related to future services. However, all relevant facts and circumstances will need to be taken into account before such a determination can be made and there may be cases where it can be shown that a stock-option is related to combined specific periods of previous and future services (e.g. options are granted on the basis of the employee having achieved specific performance targets for the previous year, but they become exercisable only if the employee remains employed for another three years).*

12.14 Where, based on the preceding principles, a stock-option is considered to be derived from employment exercised in more than one State, it will be necessary to determine which part of the stock-option benefit is derived from employment exercised in each State for purposes of the application of the Article and of Articles 23A and 23B. In such a case, the employment benefit attributable to the stock-option should be considered to be derived from a particular country in proportion of the number of days during which employment has been exercised in that country to the total number of days during which the employment services from which the stock-option is derived has been exercised. For that purpose, the only days of employment that should be taken into account are those that are relevant for the stock-option plan, e.g. those during which services are rendered to the same employer or to other employers the employment by whom would be taken into account to satisfy a period of employment required to acquire the right to exercise the option.

12.15 It is possible for Member countries to depart from the case-by-case application of the above principles (in paragraphs 12.7 to 12.14) by agreeing to a specific approach in a bilateral context. For example, two countries that tax predominantly at exercise of an option may agree, as a general principle, to attribute the income from an option that relates primarily to future services to the services performed by an employee in the two States between date of grant and date of exercise. Thus, in the case of options that do not become exercisable until the employee has performed services for the employer for a specific period of time, two States could agree to an approach that attributes the income from the option to each State based on the number of days worked in each State by the employee for the employer in the period between date of grant and date of exercise. Another example would be for two countries that have similar rules for the tax treatment of employee stock-options to adopt provisions that would give to one of the Contracting States exclusive taxation rights on the employment benefit even if a minor part of the employment services to which the option relates have been rendered in the other State. Of course, Member countries should be careful in adopting such approaches because they may result in double taxation or double non-taxation if part of the employment is exercised in a third State that does not apply a similar approach."

Commentary on Article 16

22. Replace paragraph 1.1 of the Commentary on Article 16 by the following:

"1.1 Member countries have generally understood the term "fees and other similar payments" to include benefits in kind received by a person in that person's capacity as a member of the board of directors of a company (e.g. ***stock-options***, the use of a residence or automobile, health or life insurance coverage and club memberships)."

23. Add the following paragraph 3.1 to the Commentary on Article 16:

"3.1 Many of the issues discussed under paragraphs 12 to 12.15 of the Commentary on Article 15 in relation to stock-options granted to employees will also arise in the case of stock-options granted to members of the board of directors of companies. To the extent that stock-options are granted to a resident of a Contracting State in that person's capacity as a member of the board of directors of a company which is a resident of the other State, that other State will have the right to tax the part of the stock-option benefit that constitutes director's fees or a similar payment (see paragraph 1.1. above) even if the tax is levied at a later time when the person is no longer a member of that board. While the Article applies to the benefit derived from a stock-option granted to a member of the board of directors regardless of when that benefit is taxed, there is a need to distinguish that benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article,

and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the company or issuer). Once the option is exercised or alienated, however, the benefit taxable under this Article has been realized and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the member of the board of directors in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is what the director obtained in his capacity as such, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so)."

Commentary on Article 18

24. Replace the existing Commentary on Article 18 of the OECD Model Tax Convention by the following:

"1. According to this Article, pensions paid in respect of private employment are taxable only in the State of residence of the recipient. ***Various policy and administrative considerations support the principle that the taxing right with respect to this type of pension, and other similar remuneration, should be left to the State of residence. For instance, the State of residence of the recipient of a pension is in a better position than any other State to take into account the recipient's overall ability to pay tax, which mostly depends on worldwide income and personal circumstances such as family responsibilities. This solution also avoids imposing on the recipient of this type of pension the administrative burden of having to comply with tax obligations in States other than that recipient's State of residence.***

2. Some States, however, are reluctant to adopt the principle of exclusive residence taxation of pensions and propose alternatives to the Article. Some of these alternatives and the issues that they raise are discussed in paragraphs 12 to 21 below, which deal with the various considerations related to the allocation of taxing rights with respect to pension benefits and the reasons supporting the Article as drafted.

Scope of the Article

3. ~~According to this Article, pensions paid in respect of private employment are taxable only in the State of residence of the recipient.~~ ~~The provision also~~ ~~***covers***~~ ***The types of payment that are covered by the Article include not only pensions directly paid to former employees*** ~~widows' and orphans' pensions~~ ***<u>but also to other beneficiaries (e.g. surviving spouses, companions or children of the employees)</u>*** and other similar payments, such as annuities, paid in respect of past employment. The ~~provision~~ ***Article*** also applies to pensions in respect of services rendered to a State or a political subdivision or local authority thereof which are not covered by the provisions of paragraph 2 of Article 19. ***The Article only applies, however, to payments that are in consideration of past employment; it would therefore not apply, for example, to an annuity acquired directly by the annuitant from capital that has not been funded from an employment pension scheme. <u>The Article applies regardless of the tax treatment of the scheme under which the relevant payments are made; thus, a payment made under a pension plan that is not eligible for tax relief could nevertheless constitute a "pension or other similar remuneration" (the tax mismatch that could arise in such a situation is discussed below).</u>***

4. Various payments may be made to an employee following cessation of employment. Whether or not such payments fall under the Article will <u>be determined by the nature of the payments, having regard to the facts and circumstances in which they are made,</u> as explained in the following two paragraphs.

5. ***While the word "pension", under the ordinary meaning of the word, covers only periodic payments, the words "other similar remuneration" are broad enough to cover non-periodic payments. For instance, a lump-sum payment in lieu of periodic pension payments that is made on or after cessation of employment may ~~therefore~~ fall within the Article.***

6. ***Whether a particular~~ lump-sum ~~payment ~~made on or after the cessation of employment ~~is to be considered as other remuneration similar to a pension or as final remuneration for work performed falling under Article 15 is a question of fact. For example, if~~ If~~ it is shown that the consideration for the ~~lump-sum~~ payment is the commutation of the pension or the compensation for a reduced pension then the payment may be characterised as "other similar remuneration" falling under the Article. This would be the case~~, for example,~~ where a person was entitled to elect upon retirement between the payment of a pension or a lump-sum computed either by reference to the total amount of the contributions or to the amount of pension to which that person would otherwise be entitled under the rules in force for the pension scheme. The source of the payment is an important ~~factor ~~consideration; payments made from a pension scheme would normally be covered by the Article. Other factors which could assist in determining whether a payment or series of payments~~ the payment ~~fall~~s~~ under the Article include: whether a payment is made on or after the cessation of the employment giving rise to the payment, whether the recipient continues working, whether the recipient has reached the normal age of retirement with respect to that particular type of employment, the status of other recipients who qualify for the same type of lump-sum payment and whether the recipient is simultaneously eligible for other pension benefits. Reimbursement of pension contributions (e.g. after temporary employment) does not constitute "other similar remuneration" under Article 18. ~~Some of these factors are also relevant in determining whether a series of payments may be considered as a pension within Article 18 or as deferred remuneration within Article 15. ~~Where cases of difficulty arise in the taxation of such payments, the Contracting States should solve the matter by recourse to the provisions of Article 25.***

7. ***Since the Article applies only to pensions and other similar remuneration that are paid in consideration for past employment, it does not cover other pensions such as those that are paid with respect to previous independent personal services. Some States, however, extend the scope of the Article to cover all types of pension, including Government pensions; States wishing to do so are free to agree bilaterally to include provisions to that effect .***

Cross-border issues related to pensions

8. ***The globalisation of the economy and the development of international communications and transportation have considerably increased the international mobility of individuals, both for work-related and personal reasons. This has significantly increased the importance of cross-border issues arising from the interaction of the different pension arrangements which exist in various States and which were primarily designed on the basis of purely domestic policy considerations. As these issues often affect large numbers of individuals, it is desirable to address them in tax conventions so as to remove obstacles to the international movement of persons, and employees in particular.***

9. ***Many such issues relate to mismatches resulting from differences in the general tax policy that States adopt with respect to retirement savings. In many States, tax incentives are provided for pension contributions. Such incentives frequently take the form of a tax deferral so that the part of the income of an individual that is contributed to a pension arrangement as well as the income earned in the scheme or any pension rights that accrue to the individual are exempt from tax. Conversely, the pension benefits from these arrangements are taxable upon receipt. Other States, however, treat pension contributions like other forms of savings and neither exempt these contributions nor the return thereon; logically, therefore, they do not tax pension benefits. Between***

these two approaches exist a variety of systems where contributions, the return thereon, the accrual of pension rights or pension benefits are partially taxed or exempt.

10. Other issues arise from the existence of very different arrangements to provide retirement benefits. These arrangements are often classified under the following three broad categories:

- *statutory social security schemes;*
- *occupational pension schemes;*
- *individual retirement schemes.*

The interaction between these three categories of arrangements presents particular difficulties. These difficulties are compounded by the fact that each State may have different tax rules for the arrangements falling in each of these categories as well as by the fact that there are considerable differences in the extent to which States rely on each of these categories to ensure retirement benefits to individuals (e.g. some States provide retirement benefits almost exclusively through their social security system while others rely primarily on occupational pension schemes or individual retirement schemes).

11. The issues arising from all these differences need to be fully considered in the course of bilateral negotiations, <u>in particular to avoid double taxation or non-taxation,</u> and, where appropriate, addressed through specific provisions. The following sections examine some of these cross-border issues.

Allocation of taxing rights with respect to pension benefits

12. As explained in paragraph 9 above, many States have adopted the approach under which, subject to various restrictions, tax is totally or partially deferred on contributions to, and earning<u>s</u> in, pension schemes or on the accrual of pension rights, but is recovered when pension benefits are paid.

~~13. Some of these States are concerned about the loss of tax revenues that may result, under the provisions of the Article, because they would not be able to recoup the tax so deferred where the individual has ceased to be a resident before the payment of all or part of the pension benefits.~~

<u>13. Some of these States consider that because a deduction for pension contributions is a deferral of tax on the part of the employment income that is saved towards retirement, they should be able to recover –the tax so deferred where the individual has ceased to be a resident before the payment of all or part of the pension benefits. This view is particularly prevalent where the benefits are paid through a lump-sum amount or over a short period of time as this increases risks of double non-taxation.</u>

14. If the other State of which that individual then becomes a resident has adopted a similar approach and therefore taxes these pension benefits when received, the issue is primarily one of allocation of taxing rights between the two States. If, however, the individual becomes a resident of a State which adopts a different approach so as not to tax pension benefits, the mismatch in the approaches adopted by the two States will result in a situation where no tax will ever be payable on the relevant income.

15. For these reasons, some States seek to include in their tax conventions alternative provisions designed to secure either exclusive or limited source taxation rights with respect to pensions in consideration of past employment. The following are examples of provisions that some members have adopted in consequence of these policy and administrative considerations<u>; States are free to agree bilaterally to include such provisions:</u>

a) ***Provisions allowing exclusive source taxation of pension payments***

Under such a provision, the Article is drafted along the following lines:

> ***"Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration arising in a Contracting State and paid to a resident of the other Contracting State in consideration of past employment shall be taxable only in the first-mentioned State."***

b) ***Provisions allowing non-exclusive source taxation of pension payments***

Under such a provision, the State of source is given the right to tax pension payments and the rules of Articles 23A or 23B results in that right being either exclusive or merely prior to that of the State of residence. The Article is then drafted along the following lines:

> ***"Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State. However such pensions and other similar remuneration may also be taxed in the other Contracting State if they arise in that State."***

c) ***Provisions allowing limited source taxation of pension***

Under such a provision, the State of source is given the right to tax pension payments but that right is subjected to a limit, usually expressed as a percentage of the payment. The Article is then drafted along the following lines:

> ***"1. Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.***
>
> ***2. However such pensions and other similar remuneration may also be taxed in the Contracting State in which they arise and according to the laws of that State but the tax so charged shall not exceed [percentage] of the gross amount of the payment."***

Where such a provision is used, a reference to paragraph 2 of Article 18 is added to paragraph 2 of Article 23 A to ensure that the residence State, if it applies the exemption method, is allowed to tax the pension payments but needs to provide a credit for the tax levied by the source State.

d) ***Provisions allowing source taxation of pension payments only where the State of residence does not tax these payments***

Such a provision is used by States that are primarily concerned with the structural mismatch described in paragraph 14 above. A paragraph 2 is then added along the following lines:

> ***"2. However such pensions and other similar remuneration may also be taxed in the Contracting State in which they arise if these payments are not subject to tax in the other Contracting State under the ordinary rules of its tax law."***

16. Apart from the reasons presented in paragraphs 13 and 14 above, various policy and administrative considerations should be taken into account when considering such provisions.

17. First, the State of residence is in a better position to provide for adequate taxation of pension payments as it is easier for that State to take into account the worldwide income, and therefore the overall ability to pay tax, of the recipient so as to apply appropriate rates and personal allowances. By contrast, the source taxation of pensions may well result in excessive taxation where the source State imposes a final withholding tax on the gross amount paid. If little or no tax is levied in the residence State (e.g. because of available allowances), the pensioner may not be able to claim a

credit in the residence State for the tax paid. However, some States have sought to relieve that problem by extending their personal allowances to non-residents who derive almost all their income from these States. Also, some States have allowed the pension payments made to non-resident recipients to be taxed at the marginal rate that would be applicable if that recipient were taxed on worldwide income (that system, however, involves administrative difficulties as it requires a determination of the worldwide income of the non-resident only for the purpose of determining the applicable rate of tax).

18. Second, equity considerations could be relevant since the level of pensions paid in the source State will generally have been set factoring local rates of tax. In this situation, an individual who has emigrated to another State with different tax rates will either be advantaged or disadvantaged by receiving an after-tax pension that will be different from that envisaged under the pension scheme.

~~19. Third, alternative provisions under which there is either exclusive or limited source taxation rights with respect to pensions having their source in a State or being derived from that State may create difficulties in the case of individuals who work in more than one State, change residence during their career or derive pensions from funds established in a State other than that in which they have worked. For example, many individuals now spend significant parts of their careers outside the State in which their pension funds are established and from which their pension benefits are ultimately paid. In such triangular cases, if taxation rights are not allocated exclusively to the residence State, it would seem fair to regard as the State of source the State of employment which has previously allowed deductions, as opposed to the State in which the fund has been established. This solution, however, would raise considerable administrative difficulties for both taxpayers and tax authorities, particularly in the case of individuals who have worked in many States during their career. States that wish to use such alternative provisions may therefore want to clarify which State should be considered the State of source of a pension payment. They may also want to deal with the administrative aspects of the solution that they adopt in that respect. Since a reference to a pension "arising in" a Contracting State could be construed as meaning either a pension paid by a fund established in that State or a pension derived from work performed in that State, clarification is necessary to avoid situations where two States would claim to have source taxation rights on the same pension.~~

19. Third, alternative provisions under which there is either exclusive or limited source taxation rights with respect to pensions require a determination of the State of source of pensions. Since a mere reference to a pension "arising in" a Contracting State could be construed as meaning either a pension paid by a fund established in that State or a pension derived from work performed in a State, States using such wording should clarify how it should be interpreted and applied.

19.1 Conceptually, the State of source might be considered to be the State in which the fund is established, the State where the relevant work has been performed or the State where deductions have been claimed. Each of these approaches would raise difficulties in the case of individuals who work in more than one State, change residence during their career or derive pensions from funds established in a State other than that in which they have worked. For example, many individuals now spend significant parts of their careers outside the State in which their pension funds are established and from which their pension benefits are ultimately paid. In such a case, treating the State in which the fund is established as the State of source would seem difficult to justify. The alternative of considering as the State of source the State where the work has been performed or deductions claimed would address that issue but would raise administrative difficulties for both taxpayers and tax authorities, particularly in the case of individuals who have worked in many States during their career, since it would create the possibility of different parts of the same pension having different States of source.

<u>19.2 States that wish to use provisions under which there is either exclusive or limited source taxation rights with respect to pensions should take account of these issues related to the determination of the State of source of pensions. They should then address the administrative difficulties that will arise from the rule that they adopt for that purpose, for example to avoid</u> situations where two States would claim to have source taxation rights on the same pension.

20. Fourth, another argument against these alternative provisions is that exclusive taxation by the State of residence means that pensioners only need to comply with the tax rules of their State of residence as regards payments covered by Article 18. Where, however, limited or exclusive source taxation of pensions is allowed, the pensioner will need to comply with the tax rules of both Contracting States.

21. Exclusive residence taxation may, however, give rise to concerns about the non-reporting of foreign pension income. Exchange of information coupled with adequate taxpayer compliance systems will, however, reduce the incidence of non-reporting of foreign pension payments.

Exempt pensions

22. As mentioned in paragraph 9 above, some States do not tax pension payments generally or otherwise exempt particular categories or parts of pension payments. In these cases, the provisions of the Article, which provides for taxation of pensions in the State of residence, may result in the taxation-by that State of pensions which were designed not to be taxed and the amount of which may well have been determined having regard to that exemption. This may result in undue financial hardship for the recipient of the pension.

23. To avoid the problems resulting from this type of mismatch~~es~~, some States include in their tax treaties provisions to preserve the exempt treatment of pensions ~~arising in a Contracting State~~ when the recipient is a resident of the other Contracting State. These provisions may be restricted to specific categories of pensions or may address the issue in a more comprehensive way. An example of that latter approach would be a provision drafted along the following lines:

> *"Notwithstanding any provision of this Convention, any ~~amount~~ <u>pension or other similar remuneration</u> paid ~~from a pension scheme~~ to a resident of a Contracting State <u>in respect of past employment exercised</u> ~~which arises from sources~~ in the other Contracting State shall be exempt from tax in the first-mentioned State if that pension or other amount would be exempt from tax in the other State if the recipient were a resident of that other State."*

Issues related to statutory social security schemes

24. Depending on the circumstances, social security payments can fall under the Article as "pensions and other similar remuneration in consideration of past employment", under Article 19 as "pension<u>[s]</u> paid by, or out of funds created by, a Contracting State [...] in respect of services rendered to that State..." or under Article 21 as "items of income [...] not dealt with in the foregoing Articles". Social security pensions fall under the Article when they are paid in consideration of past employment, unless paragraph 2 of Article 19 applies (see below). A social security pension may be said to be "in consideration of past employment" if employment is a condition for that pension. For instance, this will be the case where, under the relevant social security scheme:

- *the amount of the pension is determined on the basis of either or both the period of employment and the employment income so that years when the individual was not employed do not give rise to pension benefits,*

- ***the amount of the pension is determined on the basis of contributions to the scheme that are made under the condition of employment and in relation to the period of employment, or***
- ***the amount of the pension is determined on the basis of the period of employment and either or both the contributions to the scheme and the investment income of the scheme.***

25. Paragraph 2 of Article 19 will apply to a social security pension that would fall within Article 18 except for the fact that the past employment in consideration of which it is paid constituted services rendered to a State or a political subdivision or a local authority thereof, other than services referred to in paragraph 3 of Article 19.

26. Social security payments that do not fall within Articles 18 or 19 fall within Article 21. This would be the case, for instance, ~~of~~ for payments made to self-employed persons as well as a pension purely based on resources, on age or disability which would be paid regardless of past employment or factors related to past employment (such as years of employment or contributions made during employment) .

27. Some States***, however,*** consider pensions paid out under a public pension scheme which is part of their social security system similar to Government pensions. Such States argue on that basis that the State of source, i.e. the State from which the pension is paid, should have a right to tax ***all*** such pensions. Many conventions concluded by these States contain provisions to that effect, sometimes including also other payments made under the social security legislation of the State of source. ~~Such payments are for instance sickness benefits, unemployment benefits and benefits on account of industrial injury~~. Contracting States having that view may agree bilaterally on an additional paragraph to the Article giving the State of source a right to tax payments made under its social security legislation. A paragraph of that kind could be drafted along the following lines:

> "Notwithstanding the provisions of paragraph 1, pensions and other payments made under the social security legislation of a Contracting State may be taxed in that State."

Where the State of which the recipient of such payments is a resident applies the exemption method the payments will be taxable only in the State of source while States using the credit method may tax the payments and give credit for the tax levied in the State of source. Some States using the credit method as the general method in their conventions may, however, consider that the State of source should have an exclusive right to tax such payments. Such States should then substitute the words "shall be taxable only" for the words "may be taxed" in the above draft provision.

28. Although the above draft provision refers to the social security legislation of each Contracting State, there are limits to what it covers. "Social security" generally refers to a system of mandatory protection that a State puts in place in order to provide its population with a minimum level of income or retirement benefits or to mitigate the financial impact of events such as unemployment, employment-related injuries, sickness or death. A common feature of social security systems is that the level of benefits is determined by the State. Payments that may be covered by the provision include retirement pensions available to the general public under a public pension scheme, old age pension payments as well as unemployment, disability, maternity, survivorship, sickness, social assistance, and family protection payments that are made by the State or by public entities constituted to administer the funds to be distributed. As there may be substantial differences in the social security systems of the Contracting States, it is important for the States that intend to use the draft provision to verify, during the course of bilateral negotiations, that they have a common understanding of what will be covered by the provision.

Issues related to individual retirement schemes

29. ***In many States, preferential tax treatment (usually in the form of the tax deferral described in paragraph 9 above) is available to certain individual private saving schemes established to provide retirement benefits. These individual retirement schemes are usually available to individuals who do not have access to occupational pension schemes; they may also, however, be available to employees who wish to supplement the retirement benefits that they will derive from their social security and occupational pension schemes. These schemes take various legal forms. For example, they may be bank savings accounts, individual investment funds or individually subscribed full life insurance policies. Their common feature is a preferential tax treatment which is subject to certain contribution limits.***

30. ***These schemes raise many of the cross-border issues that arise in the case of occupational schemes, such as the tax treatment, in one Contracting State, of contributions to such a scheme established in the other State (see paragraphs 31 to 65 below). There may be, however, issues that are specific to individual retirement schemes and which may need to be addressed separately during the negotiation of a bilateral convention. One such issue is the tax treatment, in each State, of income accruing in such a scheme established in the other State. Many States have rules (such as foreign ~~income~~ investment funds (FIF) rules, rules that attribute the income of a trust to a settlor or beneficiary in certain circumstances or rules that provide for the accrual taxation of income with respect to certain types of investment, including full life insurance policies) that may, in certain circumstances, result in the taxation of income accruing in an individual retirement scheme established abroad. States which consider that result inappropriate in light of their approach to the taxation of retirement savings may wish to prevent such taxation. A provision dealing with the issue and restricted to those schemes which are recognised as individual retirement schemes could be drafted along the following lines:***

> ***"For purposes of computing the tax payable in a Contracting State by an individual who is a resident of that State and who was previously a resident of the other Contracting State, any income accruing under an arrangement***
>
> ***a)*** ***~~that has been~~ entered into with a person established outside that State in order to secure retirement benefits for that individual ,***
>
> ***b)*** ***in which the individual participates and had participated when ~~he~~ the individual was a resident of the other State,***
>
> ***c)*** ***that is accepted by the competent authority of the first-mentioned State as generally corresponding to an individual retirement scheme recognized as such for tax purposes by that State,***
>
> ***shall be treated as income accruing in an individual retirement scheme established in that State. This paragraph shall not restrict in any manner the taxation of any benefit distributed under the arrangement."***

The tax treatment of contributions to foreign pension schemes

A. *General comments*

~~**4**~~ ***31***. It is characteristic of multinational enterprises that their staff are expected to be willing to work outside their home country from time to time. The terms of service under which staff are sent to work in other countries are of keen interest and importance to both the employer and the employee. One consideration is the pension arrangements that are made for the employee in question. ***Similarly, individuals who move to other countries to provide independent services are often confronted with***

cross-border tax issues related to the pension arrangements that they have established in their home country.

~~5~~ ***32***. ~~Employees sent abroad to work~~ ***Individuals working abroad*** will often wish to continue contributing to a pension scheme (***including a social security scheme that provides pension benefits)*** in their home country during their absence abroad. This is both because switching schemes can lead to a loss of rights and benefits, and because many practical difficulties can arise from having pension arrangements in a number of countries.

~~6~~ ***33***. The tax treatment accorded to pension contributions ***made by or for individuals working outside*** ~~of employees who are assigned to work outside~~ their home country varies both from country to country and depending on the circumstances of the individual case. Before taking up an overseas assignment ***or contract***, ***pension contributions made by or for these individuals*** ~~employees~~ commonly qualify for tax relief ~~on pension contributions paid~~ in the home country. When ***the individual works*** ~~assigned~~ abroad, ~~***employees***~~ ***the contributions*** in some cases continue to qualify for relief. Where ~~an~~ ***the*** individual, for example, remains resident and fully taxable in the home country, pension contributions made to a pension scheme established in the home country will generally continue to qualify for relief there. But frequently, contributions paid in the home country by an individual ~~assigned to~~ work***ing*** abroad do not qualify for relief under the domestic laws of either the home country or the host country. Where this is the case it can become expensive, if not prohibitive, to maintain membership of a pension scheme in the home country during a foreign ***assignment or contract***. Paragraph ~~11~~ ***37*** below suggests a provision which Member countries can, if they wish, include in bilateral treaties to provide reliefs for the pension contributions ***made by or for individuals*** ~~of employees assigned to~~ work***ing*** outside their home country.

~~7~~ ***34***. However, some Member countries may not consider that the solution to the problem lies in a treaty provision, preferring, for example, the pension scheme to be amended to secure deductibility of contributions in the host State. Other countries may be opposed to including the provision ***below*** in treaties where domestic legislation allows ~~deductions only for~~ relief only with respect to contributions paid to residents. In such cases it may be inappropriate to include the suggested provision in a bilateral treaty.

~~8~~ ***35***. ~~The suggested provision does not address itself to contributions made to social security schemes (general State pension schemes dependent upon contribution records, whether or not contributors are employees) as the right or obligation to join a social security scheme is primarily a matter of social legislation rather than tax law. Many Member countries have entered into bilateral social security totalisation agreements which may help to avoid the problem with respect to contributions to social security schemes. The provision also does not contain provisions relating either to the deductibility by the employer of employer pension contributions in respect of employees working abroad or to the treatment of income accrued within the plan. All of these issues can be dealt with in bilateral negotiations.~~ ***The suggested provision covers contributions made to all forms of pension schemes, including individual retirement schemes as well as social security schemes. Many Member countries have entered into bilateral social security totalisation agreements which may help to partially avoid the problem with respect to contributions to social security schemes; these agreements, however, usually do not deal with the tax treatment of cross-border contributions. In the case of an occupational scheme to which both the employer and the employees contribute, the provision covers both these contributions. Also, the provision is not restricted to the issue of the deductibility of the contributions as it deals with all aspects of the tax treatment of the contributions as regards the individual who derive benefits from a pension scheme. Thus the provision deals with issues such as whether or not the employee should be taxed on the employment benefit that an employer's contribution constitutes and whether or not the investment income derived from the contributions should be taxed in the hands of the individual. It does not, however, deal with the taxation of the pension fund on its income (this issue is dealt with in paragraph 69 below).***

Contracting States wishing to modify the scope of the provision with respect to any of these issues may do so in their bilateral negotiations.

~~9. The provision is confined to the tax treatment of contributions to pension schemes by or on behalf of individuals who exercise employments within the meaning of Article 15 away from their home State. It does not deal with contributions by individuals who perform business activities covered by Article 7. However, States may wish, in bilateral negotiations, to agree on a provision covering individuals rendering services within both Article 7 and Article 15.~~

B. Aim of the provision

~~10~~ ***36.*** The aim of the provision is to ensure that, as far as possible, ~~an employee is~~ ***individuals are*** not discouraged from taking up ~~an~~ overseas ***work*** ~~assignment~~ by the tax treatment of ~~his~~ ***their*** contributions ~~made~~ to a home country pension scheme ~~by an employee working abroad~~. The provision seeks, first, to determine the general equivalence of pension plans in the two countries and then to establish limits to the ~~deductibility of employee contributions~~ ***contributions to which the tax relief applies*** based on the limits in the laws of both countries.

C. Suggested provision

~~11~~ ***37.*** The following is the suggested text of the provision that could be included in bilateral conventions to deal with the problem identified above:

> "~~*a*) Contributions borne by an individual who renders services in the course of an employment in a Contracting State to a pension scheme established in and recognised for tax purposes in the other Contracting State shall be deducted, in the first-mentioned State, in determining the individual's taxable income, and treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that first-mentioned State, provided that:~~
>
> 1. Contributions to a pension scheme established in and recognised for tax purposes in a Contracting State that are ***made by or on behalf of*** an individual who renders services in the other Contracting State shall, ***for the purposes of determining the individual's tax payable and the profits of an enterprise which may be taxed in that State, be*** treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that State, provided that:
>
> ***a)*** ~~(i)~~ the individual was not a resident of that State, and was ~~contributing to~~ ***participating in*** the pension scheme, immediately before ***beginning to provide services*** ~~he began to exercise employment~~ in that State, and
>
> ***b)*** ~~(ii)~~ the pension scheme is accepted by the competent authority of that State as generally corresponding to a pension scheme recognised as such for tax purposes by that State.
>
> ***2.***~~*b*)~~ For the purposes of ***paragraph 1*** ~~sub-paragraph *a*)~~:
>
> ***a)*** ~~(*i*)~~ the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the ***services*** ~~employment~~ referred to in ***paragraph 1*** ~~sub-paragraph *a*);~~ and
>
> ***b)*** ~~(ii)~~ a pension scheme is recognised for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State."

~~" ***1.****a*) Contributions borne by ***made by or on behalf of*** an individual who renders services in the course of an employment in a Contracting State to a pension scheme established in and recognised for tax purposes in the other Contracting State shall, ***for the purposes of***~~

~~***a) determining the individual's tax payable in the first-mentioned State and***,~~

~~***b) determining the profits of an enterprise which may be taxed in the first-mentioned State***,~~

~~be deducted, in the first-mentioned State, in determining the individual's taxable income, and ***be*** treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that first-mentioned State, provided that:~~

~~***c)*** (i) the individual was not a resident of that State, and was contributing to ***participating in*** the pension scheme, immediately before ***beginning to provide services*** he began to exercise employment in that State; and~~

~~***d)*** (ii) the pension scheme is accepted by the competent authority of that State as generally corresponding to a pension scheme recognised as such for tax purposes by that State.~~

~~***2.****b*) For the purposes of ***paragraph 1*** sub-paragraph *a*):~~

~~***a)***(*i*) the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the ***services*** employment referred to in ***paragraph 1*** sub-paragraph *a*); and~~

~~***b)***(ii) a pension scheme is recognised for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State."~~

38. The above provision is restricted to pension schemes established in one of the two Contracting States. As it is not unusual for individuals to work in a number of different countries in succession, some States may wish to extend the scope of the provision to cover situations where an individual moves from one Contracting State to another while continuing to make contributions to a pension scheme established in a third State. Such an extension may, however, create administrative difficulties if the host State cannot have access to information concerning the pension scheme (e.g. through the exchange of information provisions of a tax convention concluded with the third State); it may also create a situation where relief would be given on a non-reciprocal basis because the third State would not grant similar relief to an individual contributing to a pension scheme established in the host State. States which, notwithstanding these difficulties, want to extend the suggested provision to funds established in third States can do so by adopting an alternative version of the suggested provision drafted along the following lines:

"1. Contributions made by or on behalf of an individual who renders services in a Contracting State to a pension scheme

a) recognised for tax purposes in the other Contracting State,

b) in which the individual participated immediately before beginning to provide services in the first-mentioned State,

c) in which the individual participated at a time when that individual was employed in, or was a resident of, the other State, and

d) that is accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognized as such for tax purposes by that State,

shall, for the purposes of

e) determining the individual's tax payable in the first-mentioned State and,

f) ***determining the profits of an enterprise which may be taxed in the first-mentioned State,***

be treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that first-mentioned State.

2. For the purposes of paragraph 1:

a) ***the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the services ~~employment~~ referred to in paragraph 1~~ sub-paragraph a)~~; and***

b) ***a pension scheme is recognised for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State."***

D. Characteristics of the suggested provision

39. The following paragraphs discuss the main characteristics of the suggested provision found in paragraph 37 above.

~~12~~ ***40.*** ~~Sub-paragraph *a)*~~***Paragraph 1*** of the suggested provision lays down the characteristics of both the ***individual*** ~~employee~~ and the contributions ***in respect of*** ~~to~~ which the provision applies. It also provides the principle that contributions ***made by or on behalf of*** ~~borne by~~ an individual rendering services ~~in the course of an employment within the meaning of Article 15~~ in one Contracting State (the host State) to a defined pension scheme in the other Contracting State (the home State) are to be ~~relieved from tax~~ ***treated for tax purposes*** in the host State~~,~~ ***in the same way and*** subject to the same conditions and limitations as ~~relief for~~ contributions to domestic pension schemes of the host State.

~~13~~ ***41. Tax*** relief ~~for~~ ***with respect*** to contributions to the home country pension scheme under the conditions outlined can be given by either the home country, being the country where the pension scheme is situated or by the host country, where the economic activities giving rise to the contributions are carried out.

~~14~~ ***42.*** A solution in which relief would be given by the home country might not be effective, since the ~~employee~~ ***individual*** might have no or little taxable income in that country. Practical considerations therefore suggest that it would be preferable for relief to be given by the host country and this is the solution adopted in the suggested provision.

~~15~~ ***43.*** In looking at the characteristics of the ~~employee~~ ***individual***, ~~sub-paragraph a)~~ ***paragraph 1*** makes it clear that, in order to get the relief from taxation in the host State, the ~~employee~~ ***individual*** must not have been resident in the host State immediately prior to working there.

~~16~~ ***44.*** ~~Sub-paragraph a)~~ ***Paragraph 1*** does not, however, limit the application of the provision to ~~secondees~~ ***individuals*** who become resident in the host State. In many cases, ~~employees~~ ***individuals*** working abroad who remain resident in their home State will continue to qualify for relief there, but this will not be so in all cases. The suggested provision therefore applies to non-residents working in the host State as well as to ~~secondees~~***individuals*** ~~to the host State~~ who attain residence status there. In some Member countries the domestic legislation may restrict deductibility to contributions borne by residents, and these Member countries may wish to restrict the suggested provision to cater for this. Also, States with a special regime for non-residents (e.g. taxation at a special low rate) may, in bilateral negotiations, wish to agree on a provision restricted to residents.

~~17~~ ***45.*** In the case where individuals temporarily cease to be resident in the host country in order to join a pension scheme in a country with more relaxed rules, individual States may want a provision which would prevent the possibility of abuse. One form such a provision could take would be a nationality test which could exclude from the suggested provision individuals who are nationals of the host State.

~~18~~ ***46.*** As ***already noted***, it is not unusual for ~~employees to be seconded to~~ ***individuals to work in*** a number of different countries in succession***; for that reason***, the suggested provision is not limited to ~~employees~~ ***individuals*** who are residents of the home State immediately prior to ~~exercising employment~~ ***providing services*** in the host State. The provision covers an ~~employee~~ ***individual*** coming to the host State from a third country as it is only limited to ~~employees~~ ***individuals*** who were not resident in the host country before ~~taking up employment~~ ***starting to work*** there. However, Article 1 restricts the scope of the Convention to residents of one or both Contracting States. An ~~employee~~ ***individual*** who is neither a resident of the host State nor of the home State where the pension scheme is established is therefore outside the scope of the Convention between the two States.

~~19~~ ***47.*** The suggested provision places no limits on the length of time for which an ~~employee~~ ***individual*** can work in a host State. It could be argued that, if an ~~employee~~ ***individual*** works in the host State for long enough, it in effect becomes his home country and the provision should no longer apply. Indeed, some host countries already restrict relief for contributions to foreign ~~employee/employer~~ pension schemes to cases where the ~~seconded employees~~ ***individuals*** are present on a temporary basis.

~~20~~ ***48.*** In addition, the inclusion of a time limit may be helpful in preventing the possibility of abuse outlined in paragraph ~~17~~ ***45*** above. In bilateral negotiations, individual countries may find it appropriate to include a limit on the length of time for which an ~~employee~~ ***individual*** may ~~exercise an employment~~ ***provide services*** in the host State after which reliefs granted by the suggested provision would no longer apply.

~~21~~ ***49.*** In looking at the characteristics of the contributions, ~~sub-paragraph *a*)~~ ***paragraph 1*** provides a number of tests. It makes it clear that the provision applies only to contributions ~~borne *by*~~ ***made by or on behalf of*** an individual to a pension scheme established in and recognised for tax purposes in the home State. The phrase "recognised for tax purposes" is further defined in ~~subdivision *b*)(*ii*)~~ ***sub-paragraph 2b)*** of the suggested provision. ***The phrase "made by or on behalf of" is intended to apply to contributions that are made directly by the individual as well as to those that are made for that individual's benefit by an employer or another party (e.g. a spouse). While paragraph 4 of Article 24 ensures that the employer's contributions to a pension fund resident of the other Contracting State are deductible under the same conditions as contributions to a resident pension fund, that provision may not be sufficient to ensure the similar treatment of employer's contributions to domestic and foreign pension funds. This will be the case, for example, where the employer's contributions to the foreign fund are treated as a taxable benefit in the hands of the employee or where the deduction of the employer's contributions is not dependent on the fund being a resident but, rather, on other conditions (e.g. registration with tax authorities or the presence of offices) which have the effect of generally excluding foreign pension funds. For these reasons, employer's contributions are covered by the suggested provision even though paragraph 4 of Article 24 may already ensure a similar relief in some cases***.

~~22~~ ***50.*** The second test applied to the characteristics of the contributions is that the contributions should be made to a home State scheme recognised by the competent authority of the host State as generally corresponding to a scheme recognised as such for tax purposes by the host State. This operates on the premise that only contributions to recognised schemes qualify for relief in Member countries. This limitation does not, of course, necessarily secure equivalent tax treatment of contributions paid where an ~~employee~~ ***individual*** was working abroad and of contributions while working in the home country. If the host State's rules for recognising pension schemes were narrower than those of the home State, the ~~employee~~ ***individual*** could find that contributions to his home country pension scheme were less favourably treated when he was working in the host country than when working in the home country.

~~23~~ ***51.*** However, it would not be in accordance with the stated aim of securing, as far as possible, equivalent tax treatment of ~~employee~~ contributions to ***foreign schemes to*** give relief for contributions which do not—at least broadly—correspond to domestically recognised schemes. To do so would mean that the amount of relief in the host State would become dependent on legislation in the home State. In addition, it could be hard to defend treating ~~employees~~ ***individuals*** working side by side differently depending on whether their pension scheme was at home or abroad (and if abroad, whether it was one country rather than another). By limiting the suggested provision to schemes which generally correspond to those in the host country such difficulties are avoided.

~~24~~ ***52.*** The suggested provision makes it clear that it is for the competent authority of the host State to determine whether the scheme in the home State generally corresponds to recognised schemes in the host State. Individual States may wish, in bilateral negotiations, to ***specify expressly to which existing schemes the provision will apply or to*** establish what interpretation the competent authority places on the term "generally corresponding"; for example how widely it is interpreted and what tests are imposed.

~~25~~ ***53.*** The contributions covered by the provision are limited to payments to schemes ~~to~~ ***in*** which the ~~employee~~ ***individual*** was ~~contributing~~ ***participating*** before ***beginning*** to ~~exercise his employment~~ ***provide services*** in the host State. This means that contributions to new pension schemes which an ~~employee~~ ***individual*** joins while in the host State are excluded from the suggested provision.

~~26~~ ***54.*** It is, however, recognised that special rules may be needed to cover cases where new pension schemes are substituted for previous ones. For instance, in some Member countries the common practice may be that, if a company employer is taken over by another company, the existing company pension scheme for its employees may be ended and a new scheme opened by the new employer. In bilateral negotiations, therefore, individual States may wish to supplement the provision to cover such substitution schemes; ***this could be done by adding the following sub-paragraph to paragraph 2 of the suggested provision:***

> ***"c) a pension scheme that is substituted for, but is substantially similar to, a pension scheme accepted by the competent authority of a Contracting State under subparagraph b) of paragraph 1 shall be deemed to be the pension scheme that was so accepted."***

~~27~~ ***55.*** ~~Sub-paragraph *a*)~~ ***Paragraph 1*** also sets out the relief to be given by the host State if the characteristics of the ~~employee~~ ***individual*** and the contributions fall within the terms of the provision. In brief, the ~~relief is to be given in a way which corresponds to the manner in which relief would be given~~ contributions ***must be treated for tax purposes in a way which corresponds to the manner in which they would be treated*** if the***se*** contributions were to a scheme established in the host State. ***Thus***, ***the contributions will qualify for the same tax relief (e.g. be deductible), for both the individual and the ~~his~~ employer (where the individual is employed and contributions are made by the employer) as if these contributions had been made to a scheme in the host State. Also, the same treatment has to be given as regards the taxation of an employee on the employment benefit derived from an employer's contribution to either a foreign or a local scheme (see paragraph 58 below).***

~~28~~ ***56.*** This measure of relief does not, of course, necessarily secure equivalent tax treatment given to contributions paid when an ~~employee~~ ***individual*** is working abroad and contributions paid when he is working in the home country. Similar considerations apply here to those discussed in paragraphs ~~22 and 23~~ ***50 and 51*** above. The measure does, however, ensure equivalent treatment of the contributions of ~~colleagues~~ ***co-workers***. The following example is considered. The home country allows relief for pension contributions subject to a limit of 18 % of income. The host country allows relief subject to a limit of 20 %. The suggested provision in paragraph ~~11~~ ***37*** would require the host country to allow relief up to its domestic limit of 20 %. Countries wishing to adopt the limit in the home country would need to amend the wording of the provision appropriately.

~~29~~ ***57.*** The amount and method of giving the relief would depend upon the domestic tax treatment of pension contributions by the host State. This would settle such questions as whether contributions qualify for relief in full, or only in part, and whether relief should be given as a deduction in computing taxable income (and if so, which income, e.g. ***in the case of an individual,*** only employment ***or business*** income or all income) or as a tax credit.

~~30~~ ***58. For an individual who participates in an occupational pension scheme,*** ~~B~~***b***eing assigned to work abroad may not only mean that ~~an~~ ***this*** employee's contributions to a pension scheme in his home country cease to qualify for tax relief. It may also mean that contributions to the pension scheme by the employer are regarded as the employee's income for tax purposes. In some Member countries employees are taxed on employer's contributions to domestic schemes whilst working in the home country whereas in others these contributions remain exempt. ~~The provision, therefore, is silent on the treatment of such contributions, although Member countries may wish to extend the suggested provision in bilateral treaties, to~~***Since it applies to both employees' and employers' contributions ,*** the suggested provision ensure***s*** that employers***'*** contributions in the context of the employees' tax liability are accorded the same treatment that such contributions to domestic schemes would receive.

~~31~~ ***59.*** ~~Subdivision *b*)(*i*)~~ ***Sub-paragraph 2 a)*** defines a pension scheme for the purposes of ~~sub-~~paragraph ***1*** ~~*a*~~). It makes it clear that, for these purposes, a pension scheme is an arrangement in which the individual who makes the payments participates in order to secure retirement benefits. These benefits must be payable in respect of ***services*** ~~exercise of the employment~~ ***provided*** in the host State. All the above conditions must apply to the pension scheme before it can qualify for relief under the suggested provision.

~~32~~ ***60.*** ~~Subdivision *b*)(*i*)~~ ***Sub-paragraph 2 a)*** refers to the participation of the individual in the pension scheme in order to secure retirement benefits. This definition is intended to ensure that the proportion of contributions made to secure benefits other than periodic pension payments on retirement, e.g. a lump sum on retirement, will also qualify for relief under the provision.

~~33~~ ***61.*** The initial definition of a pension scheme is "an arrangement". This is a widely drawn term, the use of which is intended to encompass the various forms which pension schemes ***(whether social security, occupational or individual retirement schemes)*** may take in ~~individual~~ ***different*** Member countries.

~~34~~ ***62.*** Although ~~subdivision *b*)(*i*)~~ ***sub-paragraph 2 a)*** sets out that participation in this scheme has to be by the individual who ~~exercises the employment~~ ***provides services*** referred to in ***paragraph 1*** ~~sub-para-graph *a*),~~ there is no reference to the identity of the recipient of the retirement benefits secured by participation in the scheme. This is to ensure that any proportion of contributions intended to generate a widow***'s*** or dependent's pension may be eligible for relief under the suggested provision.

~~35~~ ***63.*** The definition of a pension scheme makes no distinction between pensions paid from State-run occupational pension schemes and similar privately-run schemes. Both are covered by the scope of the provision. ***Social security schemes are therefore covered by the provision to the extent that contributions to such schemes can be considered to be with respect to the services provided in the host State by an individual, whether as an employee or in an independent capacity***. ~~Any pensions, such as pensions from general State pension schemes dependent on contribution records whether or not contributors are employees, are excluded from the provision as the individual will not contribute to such schemes in order to receive benefits payable in respect of his employment.~~

~~36~~ ***64.*** ~~Subdivision *b*)(*ii*)~~ ***Sub-paragraph 2 b)*** further defines the phrase "recognised for tax purposes". As the aim of the provision is, so far as possible, to ensure that contributions are neither more nor less favourably treated for tax purposes than they would be if the ~~employee~~ ***individual*** ~~was~~ ***were*** resident in his home State, it is right to limit the ***scope of the*** provision to contributions which would have qualified for relief if the ~~employee~~ ***individual*** had remained in the home State. The provision seeks to achieve this aim by limiting its scope to contributions made to a scheme only if contributions to this scheme would qualify for tax relief in that State.

~~37~~ ***65.*** This method of attempting to achieve parity of treatment assumes that in all Member countries only contributions to recognised pension schemes qualify for relief. The tax treatment of contributions to pension schemes under Member countries' tax systems may differ from this assumption. It is recognised that, in bilateral negotiations, individual countries may wish to further define the qualifying pension schemes in terms that match the respective domestic laws of the treaty partners. ***They may also wish to define other terms used in the provision, such as "renders services" and "provides services".***

Tax obstacles to the portability of pension rights

66. Another issue, which also relates to international labour mobility, is that of the tax consequences that may arise from the transfer of pension rights from a pension scheme established in one Contracting State to another scheme located in the other Contracting State. When an individual moves from one employer to another, it is frequent for the pension rights that this individual accumulated in the pension scheme covering the ~~his~~ first employment to be transferred to a different scheme covering the ~~his~~ second employment. Similar arrangements may exist to allow for the portability of pension rights to or from an individual retirement scheme.

67. Such transfers usually give rise to a payment representing the actuarial value, at the time of the transfer, of the pension rights of the individual or representing the value of the contributions and earnings that have accumulated in the scheme with respect to the individual. These payments may be made directly from the first scheme to the second one; alternatively, they may be made by requiring the individual to contribute to the new pension scheme all or part of the amount ~~that he has~~ received upon withdrawing from the previous scheme. In both cases, it is frequent for tax systems to allow such transfers, when they are purely domestic, to take place on a tax-free basis.

68. Problems may arise, however, where the transfer is made from a pension scheme located in one Contracting State to a scheme located in the other State. In such a case, the Contracting State where the individual resides may consider that the payment arising upon the transfer is a taxable benefit. A similar problem arises when the payment is made from a scheme established in a State to which the relevant tax convention gives source taxing rights on pension payments arising therefrom as that State may want to apply that taxing right to any benefit derived from the scheme. Contracting States that wish to address that issue are free to include a provision drafted along the following lines:

> ***"Where pension rights or amounts have accumulated in a pension scheme established in and recognised for tax purposes in one Contracting State for the benefit of an individual who is a resident of the other Contracting State, any transfer of these rights or amounts to a pension scheme established in and recognised for tax purposes in that other State shall, in each State, be treated for tax purposes in the same way and subject to the same conditions and limitations as if it had been made from one pension scheme established in and recognised for tax purposes in that State to another pension scheme established in and recognised for tax purposes in the same State."***

The above provision could be modified to also cover transfers to or from pensions funds established and recognised in third States (this, however, could raise similar concerns as those described in the preamble of paragraph 38 above).

Exemption of the income of a pension fund

69. Where, under their domestic law, two States follow the same approach of generally exempting from tax the investment income of pension funds established in their territory, these States, in order to achieve greater neutrality with respect to the location of capital, may want to extend that exemption to the investment income that a pension fund established in one State derives from the other State. In order to do so, States sometimes include in their conventions a provision drafted along the following lines:

> ***"Notwithstanding any provision of this Convention, income arising in a Contracting State that is derived by a resident of the other Contracting State that was constituted and is operated exclusively to administer or provide pension benefits and has been accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognised as such for tax purposes by that State, shall be exempt from tax in the first-mentioned State."***

Commentary on Article 19

25. Replace the existing paragraphs 4 to 6 of the Commentary on Article 19 by the following:

"4. An exception from the principle of giving exclusive taxing power to the paying State is contained in sub-paragraph *b*) of paragraph 1. It is to be seen against the background that, according to the Vienna Conventions mentioned above, the receiving State is allowed to tax remuneration paid to certain categories of personnel of foreign diplomatic missions and consular posts, who are permanent residents or nationals of that State. Given that pensions paid to retired government officials ought to be treated for tax purposes in the same way as salaries or wages paid to such employees during their active time, an exception like the one in sub-paragraph *b*) of paragraph 1 is incorporated also in sub-paragraph *b*) of paragraph 2 regarding pensions. Since the condition laid down in subdivision *b*)(*ii*) of paragraph 1 cannot be valid in relation to a pensioner, the only pre-requisite for the receiving State's power to tax the pension is that the pensioner must be one of its own residents and nationals. ~~It should be noted that the expression "out of funds created by" in sub-paragraph *a*) of paragraph 2 covers the situation where the pension is not paid directly by the State, a political subdivision or a local authority but out of separate funds created by them.~~

5. According to Article 19 of the 1963 Draft Convention, the services rendered to the State, political subdivision or local authority had to be rendered "in the discharge of functions of a governmental nature". That expression was deleted in the 1977 Model Convention. Some OECD Member countries, however, thought that the exclusion would lead to a widening of the scope of the Article. Contracting States who are of that view and who feel that such a widening is not desirable may continue to use, and preferably specify, the expression "in the discharge of functions of a governmental nature" in their bilateral conventions.

5.1 While the word "pension", under the ordinary meaning of the word, covers only periodic payments, the words "other similar remuneration", which were added to paragraph 2 in <u>2005</u>, are broad enough to cover non-periodic payments. For example, a lump-sum payment in lieu of periodic pension payments that is made to a former State employee after cessation of employment may fall within paragraph 2 of the Article. Whether a particular lump-sum payment made in these circumstances is to be considered as other remuneration similar to a pension falling under

paragraph 2 or as final remuneration for work performed falling under paragraph 1 is a question of fact which can be resolved in light of the factors presented in paragraph 5 of the Commentary on Article 18.

5.2 It should be noted that the expression "out of funds created by" in sub-paragraph a) of paragraph 2 covers the situation where the pension is not paid directly by the State, a political subdivision or a local authority but out of separate funds created by a government body. In addition, the original capital of the fund would not need to be provided by the State, a political subdivision or a local authority. The phrase would cover payments from a privately administered fund established for the government body.

5.3 An issue arises where pensions are paid for combined private and government services. This issue may frequently arise where a person has been employed in both the private and public sector and receives one pension in respect of both periods of employment. This may occur either because the person participated in the same scheme throughout the employment or because the person's pension rights were portable. A trend towards greater mobility between private and public sectors may increase the significance of this issue.

5.4 Where a civil servant having rendered services to a State has transferred ~~his~~ a right to a pension from a public scheme to a private scheme the pension payments would be taxed only under Article 18 because such payment would not meet the technical requirement of subparagraph 2 a).

5.5 Where the transfer is made in the opposite direction and the pension rights are transferred from a private scheme to a public scheme, some States tax the whole pension payments under Article 19. Other States, however, apportion the pension payments based on the relative source of the pension entitlement so that part is taxed under Article 18 and another part under Article 19. In so doing, some States consider that if one source has provided by far the principal amount of the pension, then the pension should be treated as having been paid exclusively from that source. Nevertheless, it is recognised that apportionment often raises significant administrative difficulties.

5.6 Contracting States may be concerned about the revenue loss or the possibility of double non-taxation if the treatment of pensions could be changed by transferring the fund between public and private schemes. Apportionment may counter this; however, to enable apportionment to be applied to pensions rights that are transferred from a public scheme to a private scheme, Contracting States may, in bilateral negotiations, consider extending subparagraph 2 a) to cover the part of any pension or other similar remuneration that it is paid in respect of services rendered to a Contracting State or a political subdivision or a local authority thereof. Such a provision could be drafted as follows:

> ***"2. a) Notwithstanding the provisions of paragraph 1, the part of any pension or other similar remuneration that is paid in respect of services rendered to a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that Contracting State."***

Alternatively Contracting States may address the concern by subjecting all pensions to ~~the same~~ a common treatment.

6. Paragraphs 1 and 2 do not apply if the services are performed in connection with business carried on by the State, or one of its political subdivisions or local authorities, paying the salaries, wages, ~~or other similar remuneration or the~~ pensions ***or other similar remuneration***. In such cases the ordinary rules apply: Article 15 for wages and salaries, Article 16 for directors' fees and other similar payments, Article 17 for artistes and sportsmen, and Article 18 for pensions. Contracting States, wishing for specific reasons to dispense with paragraph 3 in their bilateral conventions, are free to do so thus

bringing in under paragraphs 1 and 2 also services rendered in connection with business. In view of the specific functions carried out by certain public bodies, e.g. State Railways, the Post Office, State-owned theatres etc., Contracting States wanting to keep paragraph 3 may agree in bilateral negotiations to include under the provisions of paragraphs 1 and 2 salaries, wages, ~~and other similar remuneration, and~~ ***pensions, and other similar remuneration*** paid by such bodies, even if they could be said to be performing business activities."

Commentary on Article 20

26. Add the following paragraphs 2.1 and 2.2 to the Commentary on Article 20:

"2.1 The Article covers only payments received for the purpose of the recipient's maintenance, education or training. It does not, therefore, apply to a payment, or any part thereof, that is remuneration for services rendered by the recipient and which is covered by Article 15 (or by Article 7 in the case of independent services). Where the recipient's training involves work experience, however, there is a need to distinguish between a payment for services and a payment for the recipient's maintenance, education or training. The fact that the amount paid is similar to that paid to persons who provide similar services and are not students or business apprentices would generally indicate that the payment is a remuneration for services. Also, payments for maintenance, education or training should not exceed the level of expenses that are likely to be incurred to ensure the recipient's maintenance, education or training.

2.2 For the purpose of the Article, payments that are made by or on behalf of a resident of a Contracting State or that are borne by a permanent establishment which a person has in that State are not considered to arise from sources outside that State."

Commentary on Articles 23A and 23B

27. Add the following paragraphs 4.1 to 4.3 to the Commentary on Articles 23 A and 23 B:

"***4.1 Article 4, however, only deals with cases of concurrent full liability to tax. The conflict in case a) may therefore not be solved if the same item of income is subject to the full liability to tax of two countries but at different times. The following example illustrates that problem. Assume that a resident of State R1 derives a taxable benefit from an employee stock-option that is granted to that person. State R1 taxes that benefit when the option is granted. The person subsequently becomes a resident of State R2, which taxes the benefit at the time of its subsequent exercise. In that case, the person is taxed by each State at a time when he is a resident of that State and Article 4 does not deal with the issue as there is no concurrent residence in the two States.***

4.2 The conflict in that situation will be reduced to that of case b) and solved accordingly to the extent that the employment services to which the option relates have been rendered in one of the Contracting States so as to be taxable by that State under Article 15 because it is the State where the relevant employment is exercised. Indeed, in such a case, the State in which the services have been rendered will be the State of source for purposes of elimination of double taxation by the other State. It does not matter that the first State does not levy tax at the same time (see paragraph 32.8). It also does not matter that the other State considers that it levies tax as a State of residence as opposed to a State of source (see the last sentence of paragraph 8).

4.3 Where, however, the relevant employment services have not been rendered in either State, the conflict will not be one of source-residence double taxation. The mutual agreement procedure could be used to deal with such a case. One possible basis to solve the case would be for the competent authorities of the two States to agree that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State. Thus, in the above example, if the relevant services were rendered in a third State before the person became a resident of State R2, it would be logical for the competent authority of State R2 to agree to provide relief (either through the credit or exemption method) for the State R1 tax that has been levied on the part of the employment benefit that relates to services rendered in the third State since, at the time when these services were rendered, the taxpayer was a resident of State R1 and not of State R2 for purposes of the convention between these two States."

28. Add the following paragraph 32.8 and the preceding heading to the Commentary on Articles 23 A and 23 B:

"F. Timing Mismatch

32.8 The provisions of the Convention that allow the State of source to tax particular items of income or capital do not provide any restriction as to when such tax is to be levied (see, for instance, paragraph 2.2 of the Commentary on Article 15). Since both Articles 23 A and 23 B require that relief be granted where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention, it follows that such relief must be provided regardless of when the tax is levied by the State of source. The State of residence must therefore provide relief of double taxation through the credit or exemption method with respect to such item of income or capital even though the State of source taxes it in an earlier or later year. Some States, however, do not follow the wording of Article 23A or 23B in their bilateral conventions and link the relief of double taxation that they give under tax conventions to what is provided under their domestic laws. These countries, however, would be expected to seek other ways (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levies tax in a different taxation year."

Commentary on Article 25

29. Replace paragraph 4 of the Commentary on Article 25 by the following:

"4. Finally, as regards the practical operation of the mutual agreement procedure, the Article, in paragraph 4, merely authorises the competent authorities to communicate with each other directly, without going through diplomatic channels, and, if it seems advisable to them, to have an oral exchange of opinions through a joint commission appointed especially for the purpose. ***Article 26 applies to the exchange of information for the purposes of the provisions of this Article. The confidentiality of information exchanged for the purposes of a mutual agreement procedure is thus ensured."***

Commentary on Article 26

30. Replace the existing Commentary on Article 26 by the following:

**"COMMENTARY ON ARTICLE 26
CONCERNING THE EXCHANGE OF INFORMATION**

I. Preliminary remarks

1. There are good grounds for including in a convention for the avoidance of double taxation provisions concerning co-operation between the tax administrations of the two Contracting States. In the first place it appears to be desirable to give administrative assistance for the purpose of ascertaining facts in relation to which the rules of the convention are to be applied. Moreover, in view of the increasing internationalisation of economic relations, the Contracting States have a growing interest in the reciprocal supply of information on the basis of which domestic taxation laws have to be administered, even if there is no question of the application of any particular article of the Convention.

2. Therefore the present Article embodies the rules under which information may be exchanged to the widest possible extent, with a view to laying the proper basis for the implementation of the domestic ***tax*** laws of the Contracting States ~~concerning taxes covered by the Convention~~ and for the application of specific provisions of the Convention. The text of the Article makes it clear that the exchange of information is not restricted by Article***s*** 1 ***and 2***, so that the information may include particulars about non-residents ***and may relate to the administration or enforcement of taxes not referred to in Article 2***.

3. The matter of administrative assistance for the purpose of tax collection is dealt with in Article 27.

~~4. Experience between 1963 and 1977 had shown that the text of the Article in the 1963 Draft Convention left room for differing interpretations. Therefore it was felt desirable to clarify its meaning in the 1977 Model Convention by a change in the wording of the Article and its Commentary without altering its effects. Apart from a single point of substance (cf. paragraph 13 below) the main purpose of the changes made has been to remove grounds for divergent interpretations.~~

4. In 2002 the Committee on Fiscal Affairs undertook a comprehensive review of Article 26 to ensure that it reflects current country practices. That review also took into account recent developments such as the Model Agreement on Exchange of Information on Tax Matters [2] developed by the OECD Global Forum Working Group on Effective Exchange of Information and the ideal standard of access to bank information as described in the report Improving Access to Bank Information for Tax Purposes.[3] As a result, several changes to both the text of the Article and the Commentary were made in [2005.]

4.1. Many of the changes that were then made to the Article were not intended to alter its substance, but instead were made to remove doubts as to its proper interpretation. For instance, the change from "necessary" to "foreseeably relevant" and the insertion of the words "to the administration or enforcement" in paragraph 1 were made to achieve consistency with the Model Agreement on Exchange of Information on Tax Matters and were not intended to alter the effect of the provision. New paragraph 4 was added to incorporate into the text of the Article the general understanding previously expressed in the Commentary (cf. paragraph 19.6). New paragraph 5 was added to reflect current practices among the vast majority of

[2] Available on www.oecd.org/taxation

[3] Improving Access to Bank Information for Tax Purposes, OECD 2000. Available on www.oecd.org/taxation.

OECD member countries (cf. paragraph 19.10). The insertion of the words "or the oversight of the above" into new paragraph 2, on the other hand, constitutes a reversal of the previous rule.

4.2. The Commentary also has been expanded considerably. This expansion in part reflects the addition of new paragraphs 4 and 5 to the Article. Other changes were made to the Commentary to take into account recent developments and current country practices and more generally to remove doubts as to the proper interpretation of the Article.

II. Commentary on the provisions of the Article

Paragraph 1

5. The main rule concerning the exchange of information is contained in the first sentence of the paragraph. The competent authorities of the Contracting States shall exchange such information as is ~~necessary~~ ***foreseeably relevant*** to secure the correct application of the provisions of the Convention or of the domestic laws of the Contracting States concerning taxes of every kind and description imposed in these States even if, in the latter case, a particular Article of the Convention need not be applied. ~~Some countries replace "necessary" with "relevant" in their bilateral conventions regarding this as a better way to express the sense of the provision: in the view of the Committee on Fiscal Affairs, either word may be used in that context.~~ ***The standard of "foreseeable relevance" is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to engage in "fishing expeditions" or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer. Contracting States may agree to an alternative formulation of this standard that is consistent with the scope of the Article (e.g. by replacing, "foreseeably relevant" with "necessary" or "relevant"). The scope of exchange of information covers all tax matters without prejudice to the general rules and legal provisions governing the rights of defendants and witnesses in judicial proceedings. Exchange of information for criminal tax matters can also be based on bilateral or multilateral treaties on mutual legal assistance (to the extent they also apply to tax crimes).*** In order to keep the exchange of information within the framework of the Convention, a limitation to the exchange of information is set so that information should be given only insofar as the taxation under the domestic taxation laws concerned is not contrary to the Convention.

5.1 The information covered by paragraph 1 is not limited to taxpayer-specific information. The competent authorities may also exchange other sensitive information related to tax administration and compliance improvement, for example risk analysis techniques or tax avoidance or evasion schemes.

5.2 [FROM OLD 11.2]***The possibilities of assistance provided by Article 26 do not limit, nor are they limited by, those contained in existing international agreements or other arrangements between the Contracting States which relate to co-operation in tax matters***. Since the exchange of information concerning the application of custom duties ***has a legal basis in*** ~~is governed by~~ other international ~~conventions~~ ***instruments***, the provisions of these more specialised ***instruments*** ~~conventions~~ will generally prevail and the exchange of information concerning custom duties will not, in practice, be governed by the Article.

6. The following examples may clarify the principle dealt with in paragraph 5 above. In all such cases information can be exchanged under paragraph 1.

7. Application of the Convention

a) When applying Article 12, State A where the beneficiary is resident asks State B where the payer is resident, for information concerning the amount of royalty transmitted.

b) Conversely, in order to grant the exemption provided for in Article 12, State B asks State A whether the recipient of the amounts paid is in fact a resident of the last-mentioned State and the beneficial owner of the royalties.

c) Similarly, information may be needed with a view to the proper allocation of taxable profits between associated companies in different States or the adjustment of the profits shown in the accounts of a permanent establishment in one State and in the accounts of the head office in the other State (Articles 7, 9, 23 A and 23 B).

d) Information may be needed for the purposes of applying Article 25.

e) When applying Articles 15 and 23 a), State A, where the employee is resident, informs State B, where the employment is exercised for more than 183 days, of the amount exempted from taxation in State A.

8. Implementation of the domestic laws

a) A company in State A supplies goods to an independent company in State B. State A wishes to know from State B what price the company in State B paid for the goods with a view to a correct application of the provisions of its domestic laws.

b) A company in State A sells goods through a company in State C (possibly a low-tax country) to a company in State B. The companies may or may not be associated. There is no convention between State A and State C, nor between State B and State C. Under the convention between A and B, State A, with a view to ensuring the correct application of the provisions of its domestic laws to the profits made by the company situated in its territory, asks State B what price the company in State B paid for the goods.

c) State A, for the purpose of taxing a company situated in its territory, asks State B, under the convention between A and B, for information about the prices charged by a company in State B, or a group of companies in State B with which the company in State A has no business contacts in order to enable it to check the prices charged by the company in State A by direct comparison (e.g. prices charged by a company or a group of companies in a dominant position). It should be borne in mind that the exchange of information in this case might be a difficult and delicate matter owing in particular to the provisions of subparagraph c) of paragraph ~~2~~ ***3*** relating to business and other secrets.

d) State A, for the purpose of verifying VAT input tax credits claimed by a company situated in its territory for services performed by a company resident in State B, requests confirmation that the cost of services was properly entered into the books and records of the company in State B.

9. The rule laid down in paragraph 1 allows information to be exchanged in three different ways:

a) on request, with a special case in mind, it being understood that the regular sources of information available under the internal taxation procedure should be relied upon in the first place before ***a*** request for information is made to the other State;

b) automatically, for example when information about one or various categories of income having their source in one Contracting State and received in the other Contracting State is transmitted systematically to the other State (cf. the OECD Council Recommendation C(81)39, dated 5 May 1981, entitled "Recommendation of the Council concerning a standardised form for automatic exchanges of information under international tax agreements", the OECD Council Recommendation C(92)50, dated 23 July 1992, entitled "Recommendation of the Council concerning a standard magnetic format for automatic exchange of tax information"~~1~~***, the OECD Council Recommendation on the use of Tax Identification Numbers in an international context C(97)29/FINAL dated 13 March 1997, the OECD Council Recommendation C(97)30/FINAL dated 10 July 1997 entitled "Recommendation of the Council of the OECD on the Use of the Revised Standard Magnetic Format for Automatic Exchange of Information" and the OECD Council Recommendation on the use of the OECD Model Memorandum of Understanding on Automatic Exchange of Information for Tax Purposes C(2001)28/FINAL);***[4]

c) spontaneously, for example in the case of a State having acquired through certain investigations, information which it supposes to be of interest to the other State.

9.1 These three forms of exchange (on request, automatic and spontaneous) may also be combined. It should also be stressed that the Article does not restrict the possibilities of exchanging information to these methods and that the Contracting States may use other techniques to obtain information which may be relevant to both Contracting States such as simultaneous examinations, tax examinations abroad and industry-wide exchange of information. These techniques are fully described in the publication *Tax Information Exchange between OECD Member Countries: A Survey of Current Practices*[5]~~2~~ and can be summarised as follows:

— a simultaneous examination is an arrangement between two or more parties to examine simultaneously each in its own territory, the tax affairs of (a) taxpayer (s) in which they have a common or related interest, with a view of exchanging any relevant information which they so obtain (see the OECD Council Recommendation C(92)81, dated 23 July 1992, on an OECD Model agreement for the undertaking of simultaneous examinations);

— a tax examination abroad allows for the possibility to obtain information through the presence of representatives of the competent authority of the requesting Contracting ***State. To the extent allowed by its domestic law, a Contracting State may permit authorised representatives of the other Contracting State to enter the first Contracting State to interview individuals or examine a person's books and records, -- or to be present at such interviews or examinations carried out by the tax authorities of the first Contracting State -- in accordance with procedures mutually agreed upon by the competent authorities. Such a request might arise, for example, where the taxpayer in a Contracting State is permitted to keep records in the other Contracting State.*** This type of assistance is granted on a reciprocal basis. Countries' laws and practices differ as to the scope of rights granted to foreign tax officials. For instance, there are States where a foreign tax official will be prevented from any active participation in an investigation or examination on the territory of a country; there are also States where such participation is only possible with the taxpayer's consent. ***The Joint Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters specifically addresses tax examinations abroad in its Article 9;***

— an industry-wide exchange of information is the exchange of tax information especially concerning a whole economic sector (e.g. the oil or pharmaceutical industry, the banking sector, etc.) and not taxpayers in particular.

10. The manner in which the exchange of information agreed to in the Convention will finally be effected can be decided upon by the competent authorities of the Contracting States. ***For example, Contracting States may wish to use electronic or other communication and information technologies, including appropriate security systems, to improve the timeliness***

~~1 These two recommendations are reproduced and discussed in Tax Information Exchange between OECD Member Countries: A Survey of Current Practices, OECD, Paris, 1994.~~

[4] ***OECD Recommendations are available on www.oecd.org/taxation***

~~2~~ [5] ~~Id~~ ***OECD, 1994.***

and quality of exchanges of information. Contracting States which are required, according to their law, to observe data protection laws, may wish to include provisions in their bilateral conventions concerning the protection of personal data exchanged. Data protection concerns the rights and fundamental freedoms of an individual, and in particular, the right to privacy, with regard to automatic processing of personal data. See, for example, the Council of Europe Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data of 28 January 1981[6].

~~11. Reciprocal assistance between tax administrations is feasible only if each administration is assured that the other administration will treat with proper confidence the information which it will receive in the course of their co-operation. At the same time maintenance of such secrecy in the receiving Contracting State is a matter of domestic laws. It is therefore provided in paragraph 1 that information communicated under the provisions of the Convention shall be treated as secret in the receiving State in the same manner as information obtained under the domestic laws of that State. Sanctions for the violation of such secrecy in that State will be governed by the administrative and penal laws of that State.~~

10.1 ~~11.1~~ Before 2000, the paragraph only authorised the exchange of information, and the use of the information exchanged, in relation to the taxes covered by the Convention under the general rules of Article 2. As drafted, the paragraph did not oblige the requested State to comply with a request for information concerning the imposition of a sales tax as such a tax was not covered by the Convention. The paragraph was then amended so as to apply to the exchange of information concerning any tax imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, and to allow the use of the information exchanged for purposes of the application of all such taxes. Some Contracting States may not, however, be in a position to exchange information, or to use the information obtained from a treaty partner, in relation to taxes that are not covered by the Convention under the general rules of Article 2. Such States are free to restrict the scope of paragraph 1 of Article 26 ***to the taxes covered by the Convention***. ~~by adopting bilaterally the following previous wording of the paragraph:~~

> ~~"1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions."~~

~~11.2. Since the exchange of information concerning the application of custom duties is governed by other international conventions, the provisions of these more specialised conventions will generally prevail and the exchange of information concerning custom duties will not, in practice, be governed by the Article.~~

10.2 In some cases, a Contracting State may need to receive information in a particular form to satisfy its evidentiary or other legal requirements. Such forms may include depositions of witnesses and authenticated copies of original records. Contracting States should endeavour as far as possible to accommodate such requests. Under paragraph 3, the requested

[6] see http://conventions.coe.int.

State may decline to provide the information in the specific form requested if, for instance, the requested form is not known or permitted under its law or administrative practice. A refusal to provide the information in the form requested does not affect the obligation to provide the information.

10.3 Nothing in the Convention prevents the application of the provisions of the Article to the exchange of information that existed prior to the entry into force of the Convention, as long as the assistance with respect to this information is provided after the Convention has entered into force and the provisions of the Article have become effective. Contracting States may find it useful, however, to clarify the extent to which the provisions of the Article are applicable to such information, in particular when the provisions of that convention will have effect with respect to taxes arising or levied from a certain time.

Paragraph 2

11. Reciprocal assistance between tax administrations is feasible only if each administration is assured that the other administration will treat with proper confidence the information which it will receive in the course of their co-operation. ***The confidentiality rules of paragraph 2 apply to all types of information received under paragraph 1, including both information provided in a request and information transmitted in response to a request.*** ~~At the same time~~ ***The*** maintenance of ~~such~~ secrecy in the receiving Contracting State is a matter of domestic laws. It is therefore provided in paragraph ***2***~~1~~ that information communicated under the provisions of the Convention shall be treated as secret in the receiving State in the same manner as information obtained under the domestic laws of that State. Sanctions for the violation of such secrecy in that State will be governed by the administrative and penal laws of that State.

12. The information obtained may be disclosed only to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, ~~or~~ the determination of appeals in relation to the taxes with respect to which information may be exchanged according to the first sentence of ~~the~~ paragraph ***1, or the oversight of the above***. This means that the information may also be communicated to the taxpayer, his proxy or to the witnesses. ***This also means that information can be disclosed to governmental or judicial authorities charged with deciding whether such information should be released to the taxpayer, his proxy or to the witnesses.*** The information received by a Contracting State may be used by such persons or authorities only for the purposes mentioned in paragraph ***2***~~*1*~~. ***Furthermore, information covered by paragraph 1, whether taxpayer-specific or not, should not be disclosed to persons or authorities not mentioned in paragraph 2, regardless of domestic information disclosure laws such as freedom of information or other legislation that allows greater access to governmental documents.*** ~~If the information appears to be of value to the receiving State for other purposes than those referred to, that State may not use the information for such other purposes but it must resort to means specifically designed for those purposes (e.g. in case of a non-fiscal crime, to a treaty concerning judicial assistance).~~

12.1 ***Information can also be disclosed to oversight bodies. Such oversight bodies include*** ~~Under this Article, information may not be disclosed to~~ authorities that supervise ***tax administration and enforcement authorities as part of*** the general administration of the Government of a Contracting State~~, but are not involved specifically in tax matters~~. In their bilateral negotiations, however, ***Contracting States may depart from this principle and*** ~~Member countries may~~ agree to ***exclude the*** ~~provide for~~ disclosure ***of information*** to such supervisory bodies.

12.2 The information received by a Contracting State may not be disclosed to a third country unless there is an express provision in the bilateral treaty between the Contracting States allowing such disclosure.

12.3 Similarly, if the information appears to be of value to the receiving State for other purposes than those referred to in paragraph 12, that State may not use the information for such other purposes but it must resort to means specifically designed for those purposes (e.g. in case of a non-fiscal crime, to a treaty concerning judicial assistance). However, Contracting States may wish to allow the sharing of tax information by tax authorities with other law enforcement agencies and judicial authorities on certain high priority matters (e.g., to combat money laundering, corruption, terrorism financing). Contracting States wishing to broaden the purposes for which they may use information exchanged under this Article may do so by adding the following text to the end of paragraph 2:

> "***Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use."***

13. As stated ~~above~~ ***in paragraph 12,*** the information obtained can be communicated to the persons and authorities mentioned ~~but it does not follow from this that it~~ ***and on the basis of the last sentence of paragraph 2 of the Article*** can be disclosed by them in court sessions held in public or in decisions which reveal the name of the taxpayer. ~~The last sentence of the paragraph, however, opens up this possibility.~~ Once information is used in public court proceedings or in court decisions and thus rendered public, it is clear that from that moment such information can be quoted from the court files or decisions for other purposes even as possible evidence. But this does not mean that the persons and authorities mentioned in paragraph ~~1~~ ***2*** are allowed to provide on request additional information received. If either or both of the Contracting States object to the information being made public by courts in this way, or, once the information has been made public in this way, to the information being used for other purposes, because this is not the normal procedure under their domestic laws, they should state this expressly in their convention.

~~*Paragraph 2*~~

Paragraph 3

14. This paragraph contains certain limitations to the main rule in favour of the requested State. In the first place, the paragraph contains the clarification that a Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State. ~~However, types of administrative measures authorised for the purpose of the requested State's tax must be utilised, even though invoked solely to provide information to the other Contracting State.~~ ***However*** ~~Likewise~~, internal provisions concerning tax secrecy should not be interpreted as constituting an obstacle to the exchange of information under the present Article. As mentioned above, the authorities of the requesting State are obliged to observe secrecy with regard to information received under this Article. ~~A Contracting State that under its domestic law is required to notify the taxpayer that an exchange of information is proposed should inform its treaty partners in writing that it has this requirement and what the consequences are for its obligations in relation to mutual assistance.~~

14.1 Some countries' laws include procedures for notifying the person who provided the information and/or the taxpayer that is subject to the enquiry prior to the supply of information. Such notification procedures may be an important aspect of the rights provided under domestic law. They can help prevent mistakes (e.g. in cases of mistaken identity) and facilitate exchange

(by allowing taxpayers who are notified to co-operate voluntarily with the tax authorities in the requesting State). Notification procedures should not, however, be applied in a manner that, in the particular circumstances of the request, would frustrate the efforts of the requesting State. In other words, they should not prevent or unduly delay effective exchange of information. For instance, notification procedures should permit exceptions from prior notification, e.g. in cases in which the information request is of a very urgent nature or the notification is likely to undermine the chance of success of the investigation conducted by the requesting State. A Contracting State that under its domestic law is required to notify the person who provided the information and/or the taxpayer that an exchange of information is proposed should inform its treaty partners in writing that it has this requirement and what the consequences are for its obligations in relation to mutual assistance. Such information should be provided to the other Contracting State when a convention is concluded and thereafter whenever the relevant rules are modified.

15. Furthermore, the requested State does not need to go so far as to carry out administrative measures that are not permitted under the laws or practice of the requesting State or to supply items of information that are not obtainable under the laws or in the normal course of administration of the requesting State. It follows that a Contracting State cannot take advantage of the information system of the other Contracting State if it is wider than its own system. ***Thus, a State may refuse to provide information where the requesting State would be precluded by law from obtaining or providing the information or where the requesting State's administrative practices (e.g., failure to provide sufficient administrative resources) result in a lack of reciprocity. However, it is recognised that too rigorous an application of the principle of reciprocity could frustrate effective exchange of information and that reciprocity should be interpreted in a broad and pragmatic manner. Different countries will necessarily have different mechanisms for obtaining and providing information. Variations in practices and procedures should not be used as a basis for denying a request unless the effect of these variations would be to limit in a significant way the requesting State's overall ability to obtain and provide the information if the requesting State itself received a legitimate request from the requested State.***

15.1 The principle of reciprocity has no application where the legal system or administrative practice of only one country provides for a specific procedure. For instance, a country requested to provide information could not point to the absence of a ruling regime in the country requesting information and decline to provide information on a ruling it has granted, based on a reciprocity argument. Of course, where the requested information itself is not obtainable under the laws or in the normal course of the administrative practice of the requesting State, a requested State may decline such a request.

15.2 Most countries recognise under their domestic laws that information cannot be obtained from a person to the extent that such person can claim the privilege against self-incrimination. A requested State may, therefore, decline to provide information if the requesting State would have been precluded by its own self-incrimination rules from obtaining the information under similar circumstances. In practice, however, the privilege against self-incrimination should have little, if any, application in connection with most information requests. The privilege against self-incrimination is personal and cannot be claimed by an individual who himself is not at risk of criminal prosecution. The overwhelming majority of information requests seek to obtain information from third parties such as banks, intermediaries or the other party to a contract and not from the individual under investigation. Furthermore, the privilege against self-incrimination generally does not attach to persons other than natural persons.

16. Information is deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax

determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons, provided that the tax authorities would make similar investigations or examinations for their own purposes. ~~This means that the requested State has to collect the information the other State needs in the same way as if its own taxation was involved, under the proviso mentioned in paragraph 15 above. This obligation is clearly evidenced by the practices followed by Member countries which show that, when collecting information requested by a treaty partner, Contracting States often use the special examining or investigative powers provided by their laws for purposes of the application of their domestic taxes even though they do not themselves need the information for applying these taxes.~~

17. The requested State is at liberty to refuse to give information in the cases referred to in the paragraphs above. However if it does give the requested information, it remains within the framework of the agreement on the exchange of information which is laid down in the Convention; consequently it cannot be objected that this State has failed to observe the obligation to secrecy.

18. If the structure of the information systems of two Contracting States is very different, the conditions under subparagraphs *a*) and *b*) of paragraph ***3***~~2~~ will lead to the result that the Contracting States exchange very little information or perhaps none at all. In such a case, the Contracting States may find it appropriate to broaden the scope of the exchange of information.

18.1 Unless otherwise agreed to by the Contracting States, it can be assumed that the requested information could be obtained by the requesting State in a similar situation if that State has not indicated to the contrary.

19. In addition to the limitations referred to above, subparagraph *c*) of paragraph ***3***~~2~~ contains a reservation concerning the disclosure of certain secret information. Secrets mentioned in this subparagraph should not be taken in too wide a sense. Before invoking this provision, a Contracting State should carefully weigh if the interests of the taxpayer really justify its application. Otherwise it is clear that too wide an interpretation would in many cases render ineffective the exchange of information provided for in the Convention. The observations made in paragraph 17 above apply here as well. The requested State in protecting the interests of its taxpayers is given a certain discretion to refuse the requested information, but if it does supply the information deliberately the taxpayer cannot allege an infraction of the rules of secrecy. ~~It is open to the Contracting States to add further dispensations from the obligation to supply information to the items listed in subparagraph *c*), for example, information protected by provisions on banker's discretion. It has been felt necessary also to prescribe a limitation with regard to information which concerns the vital interests of the State itself. To this end, it is stipulated that Contracting States do not have to supply information the disclosure of which would be contrary to public policy (*ordre public*).~~

19.1 In its deliberations regarding the application of secrecy rules, the Contracting State should also take into account the confidentiality rules of Article 26, paragraph 2. The domestic laws and practices of the requesting State together with the obligations imposed under Article 26, paragraph 2, may ensure that the information cannot be used for the types of unauthorised purposes against which the trade or other secrecy rules are intended to protect. Thus, a Contracting State may decide to supply the information where it finds that there is no reasonable basis for assuming that a taxpayer involved may suffer any adverse consequences incompatible with information exchange.

19.2 In most cases of information exchange no issue of trade, business or other secret will arise. A trade or business secret is generally understood to mean facts and circumstances that are of considerable economic importance and that can be exploited practically and the unauthorised use of which may lead to serious damage (e.g. may lead to severe financial

hardship). The determination, assessment or collection of taxes as such could not be considered to result in serious damage. Financial information, including books and records, does not by its nature constitute a trade, business or other secret. In certain limited cases, however, the disclosure of financial information might reveal a trade, business or other secret. For instance, a request for information on certain purchase records may raise such an issue if the disclosure of such information revealed the proprietary formula used in the manufacture of a product. The protection of such information may also extend to information in the possession of third persons. For instance, a bank might hold a pending patent application for safe keeping or a secret trade process or formula might be described in a loan application or in a contract held by a bank. In such circumstances, details of the trade, business or other secret should be excised from the documents and the remaining financial information exchanged accordingly.

19.3 A requested State may decline to disclose information relating to confidential communications between attorneys, solicitors or other admitted legal representatives in their role as such and their clients to the extent that the communications are protected from disclosure under domestic law. However, the scope of protection afforded to such confidential communications should be narrowly defined. Such protection does not attach to documents or records delivered to an attorney, solicitor or other admitted legal representative in an attempt to protect such documents or records from disclosure required by law. Also, information on the identity of a person such as a director or beneficial owner of a company is typically not protected as a confidential communication. While the scope of protection afforded to confidential communications might differ among states, it should not be overly broad so as to hamper effective exchange of information. Communications between attorneys, solicitors or other admitted legal representatives and their clients are only confidential if, and to the extent that, such representatives act in their capacity as attorneys, solicitors or other admitted legal representatives and not in a different capacity, such as nominee shareholders, trustees, settlors, company directors or under a power of attorney to represent a company in its business affairs. An assertion that information is protected as a confidential communication between an attorney, solicitor or other admitted legal representative and its client should be adjudicated exclusively in the Contracting State under the laws of which it arises. Thus, it is not intended that the courts of the requested State should adjudicate claims based on the laws of the requesting State.

19.4 Contracting States wishing to refer expressly to the protection afforded to confidential communications between a client and an attorney, solicitor or other admitted legal representative may do so by adding the following text at the end of paragraph 3:

> *"d) to obtain or provide information which would reveal confidential communications between a client and an attorney, solicitor or other admitted legal representative where such communications are:*
>
> *(i) produced for the purposes of seeking or providing legal advice or*
> *(ii) produced for the purposes of use in existing or contemplated legal proceedings."*

19.5 Paragraph 3 also includes a limitation with regard to information which concerns the vital interests of the State itself. To this end, it is stipulated that Contracting States do not have to supply information the disclosure of which would be contrary to public policy (ordre public). However, this limitation should only become relevant in extreme cases. For instance, such a case could arise if a tax investigation in the requesting State were motivated by political, racial, or religious persecution. The limitation may also be invoked where the information constitutes a state secret, for instance sensitive information held by secret services the disclosure of which would be contrary to the vital interests of the requested State. Thus, issues *of public policy (ordre public) rarely arise in the context of information exchange between treaty partners.*

Paragraph 4

19.6 Paragraph 4 was added in [2005] to deal explicitly with the obligation to exchange information in situations where the requested information is not needed by the requested State for domestic tax purposes. Prior to the addition of paragraph 4 this obligation was not expressly stated in the Article, but was clearly evidenced by the practices followed by Member countries which showed that, when collecting information requested by a treaty partner, Contracting States often use the special examining or investigative powers provided by their laws for purposes of levying their domestic taxes even though they do not themselves need the information for these purposes. This principle is also stated in the Report Improving Access to Bank Information for Tax Purposes, OECD 2000. [7]

19.7 According to paragraph 4, Contracting States must use their information gathering measures, even though invoked solely to provide information to the other Contracting State. The term "information gathering measures" means laws and administrative or judicial procedures that enable a Contracting State to obtain and provide the requested information.

19.8 The second sentence of paragraph 4 makes clear that the obligation contained in paragraph 4 is subject to the limitations of paragraph 3 but also provides that such limitations cannot be construed to form the basis for declining to supply information where a country's laws or practices include a domestic tax interest requirement. Thus, while a requested State cannot invoke paragraph 3 and argue that under its domestic laws or practices it only supplies information in which it has an interest for its own tax purposes, it may, for instance, decline to supply the information to the extent that the provision of the information would disclose a trade secret.

19.9 For many countries the combination of paragraph 4 and their domestic law provide a sufficient basis for using their information gathering measures to obtain the requested information even in the absence of a domestic tax interest in the information. Other countries, however, may wish to clarify expressly in the convention that Contracting States must ensure that their competent authorities have the necessary powers to do so. Contracting States wishing to clarify this point may replace paragraph 4 with the following text:

> *"4. In order to effectuate the exchange of information as provided in paragraph 1, each Contracting State shall take the necessary measures, including legislation, rule-making, or administrative arrangements, to ensure that its competent authority has sufficient powers under its domestic law to obtain information for the exchange of information regardless of whether that Contracting State may need such information for its own tax purposes."*

Paragraph 5

19.10 Paragraph 1 imposes a positive obligation on a Contracting State to exchange all types of information. Paragraph 5 is intended to ensure that the limitations of paragraph 3 cannot be used to prevent the exchange of information held by banks, other financial institutions, nominees, agents and fiduciaries as well as ownership information. While paragraph 5, which was added in [2005], represents a change in the structure of Article 26 it should not be interpreted as suggesting that the previous version of Article 26 did not authorise the exchange

[7] *See paragraph 21b.*

of such information. The vast majority of OECD member countries already exchanged such information under the previous version of Article 26 and the addition of paragraph 5 merely reflects current practice.

19.11 Paragraph 5 stipulates that a Contracting State shall not decline to supply information to a treaty partner solely because the information is held by a bank or other financial institution. Thus, paragraph 5 overrides paragraph 3 to the extent that paragraph 3 would otherwise permit a requested Contracting State to decline to supply information on grounds of bank secrecy. The addition of this paragraph to Article 26 reflects the international trend in this area as reflected in the Model Agreement on Exchange of Information on Tax Matters [8] and as described in the report, Improving Access to Bank Information for Tax Purposes, OECD 2000. In accordance with that report, access to information held by banks or other financial institutions may be by direct means or indirectly through a judicial or administrative process. The procedure for indirect access should not be so burdensome and time-consuming as to act as an impediment to access to bank information.

19.12 Paragraph 5 also provides that a Contracting State shall not decline to supply information solely because the information is held by persons acting in an agency or fiduciary capacity. For instance, if a Contracting State had a law under which all information held by a fiduciary was treated as a "professional secret" merely because it was held by a fiduciary, such State could not use such law as a basis for declining to provide the information to the other Contracting State. A person is generally said to act in a "fiduciary capacity" when the business which the person transacts, or the money or property which the person handles, is not its own or for its own benefit, but for the benefit of another person as to whom the fiduciary stands in a relation implying and necessitating confidence and trust on the one part and good faith on the other part, such as a trustee. The term "agency" is very broad and includes all forms of corporate service providers (e.g. company formation agents, trust companies, registered agents, lawyers).

19.13 Finally, paragraph 5 states that a Contracting State shall not decline to supply information solely because it relates to an ownership interest in a person, including companies and partnerships, foundations or similar organisational structures. Information requests cannot be declined merely because domestic laws or practices may treat ownership information as a trade or other secret.

19.14 Paragraph 5 does not preclude a Contracting State from invoking paragraph 3 to refuse to supply information held by a bank, financial institution, a person acting in an agency or fiduciary capacity or information relating to ownership interests. However, such refusal must be based on reasons unrelated to the person's status as a bank, financial institution, agent, fiduciary or nominee, or the fact that the information relates to ownership interests. For instance, a legal representative acting for a client may be acting in an agency capacity but for any information protected as a confidential communication between attorneys, solicitors or other admitted legal representatives and their clients, Article 26, paragraph 3, continues to provide a possible basis for declining to supply the information.

19.15 The following examples illustrate the application of paragraph 5:

> ***a) Company X owns a majority of the stock in a subsidiary company Y, and both companies are incorporated under the laws of State A. State B is conducting a tax examination of business operations of company Y in State B. In the course of this***

[8] Available on www.oecd.org/taxation

examination the question of both direct and indirect ownership in company Y becomes relevant and State B makes a request to State A for ownership information of any person in company Y's chain of ownership. In its reply State A should provide to State B ownership information for both company X and Y.

b) An individual subject to tax in State A maintains a bank account with Bank B in State B. State A is examining the income tax return of the individual and makes a request to State B for all bank account income and asset information held by Bank B in order to determine whether there were deposits of untaxed earned income. State B should provide the requested bank information to State A."

CHANGES TO THE MODEL TAX CONVENTION

Approved by the Committee on Fiscal Affairs on 1 June 2004

[Changes to the previous text of the Model appear in ***bold italics*** for additions and ~~strikethrough~~ for deletions]

ARTICLE 25

Commentary on Article 25

1. Replace paragraph 4 of the Commentary on Article 25 by the following:

> "4. Finally, as regards the practical operation of the mutual agreement procedure, the Article, in paragraph 4, merely authorises the competent authorities to communicate with each other directly, without going through diplomatic channels, and, if it seems advisable to them, to have an oral exchange of opinions through a joint commission appointed especially for the purpose. ***Article 26 applies to the exchange of information for the purposes of the provisions of this Article. The confidentiality of information exchanged for the purposes of a mutual agreement procedure is thus ensured."***

ARTICLE 26

Article 26

2. Replace Article 26 and the Commentary thereon by the following:

ARTICLE 26
EXCHANGE OF INFORMATION

> 1. The competent authorities of the Contracting States shall exchange such information as is ~~necessary~~ ***forseeably relevant*** for carrying out the provisions of this Convention or ***to the administration or enforcement*** of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.
>
> ***2.*** Any information received ***under paragraph 1*** by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, ~~or~~ the determination of appeals in relation to the taxes referred to ***in paragraph 1,*** ~~in the first~~

~~sentence~~ ***or the oversight of the above***. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

3.~~2~~ In no case shall the provisions of paragraph***s*** 1 ***and 2*** be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

Commentary on Article 26

COMMENTARY ON ARTICLE 26
CONCERNING THE EXCHANGE OF INFORMATION

I. Preliminary remarks

1. There are good grounds for including in a convention for the avoidance of double taxation provisions concerning co-operation between the tax administrations of the two Contracting States. In the first place it appears to be desirable to give administrative assistance for the purpose of ascertaining facts in relation to which the rules of the convention are to be applied. Moreover, in view of the increasing internationalisation of economic relations, the Contracting States have a growing interest in the reciprocal supply of information on the basis of which domestic taxation laws have to be administered, even if there is no question of the application of any particular article of the Convention.

2. Therefore the present Article embodies the rules under which information may be exchanged to the widest possible extent, with a view to laying the proper basis for the implementation of the domestic ***tax*** laws of the Contracting States ~~concerning taxes covered by the Convention~~ and for the application of specific provisions of the Convention. The text of the Article makes it clear that the exchange of information is not restricted by Article***s*** 1 ***and 2***, so that the information may include particulars about non-residents ***and may relate to the administration or enforcement of taxes not referred to in Article 2***.

3. The matter of administrative assistance for the purpose of tax collection is dealt with in Article 27.

~~4. Experience between 1963 and 1977 had shown that the text of the Article in the 1963 Draft Convention left room for differing interpretations. Therefore it was felt desirable to clarify its meaning in the 1977 Model Convention by a change in the wording of the Article and its Commentary without altering its effects. Apart from a single point of substance (cf. paragraph 13 below) the main purpose of the changes made has been to remove grounds for divergent interpretations.~~

4. In 2002 the Committee on Fiscal Affairs undertook a comprehensive review of Article 26 to ensure that it reflects current country practices. That review also took into account recent developments such as the Model Agreement on Exchange of Information on Tax Matters [1] developed by the OECD Global Forum Working Group on Effective Exchange of Information and the ideal standard of access to bank information as described in the report Improving Access to Bank Information for Tax Purposes.[2] As a result, several changes to both the text of the Article and the Commentary were made in [2005.]

4.1. Many of the changes that were then made to the Article were not intended to alter its substance, but instead were made to remove doubts as to its proper interpretation. For instance, the change from "necessary" to "foreseeably relevant" and the insertion of the words "to the administration or enforcement" in paragraph 1 were made to achieve consistency with the Model Agreement on Exchange of Information on Tax Matters and were not intended to alter the effect of the provision. New paragraph 4 was added to incorporate into the text of the Article the general understanding previously expressed in the Commentary (cf. paragraph 19.6). New paragraph 5 was added to reflect current practices among the vast majority of OECD member countries (cf. paragraph 19.10). The insertion of the words "or the oversight of the above" into new paragraph 2, on the other hand, constitutes a reversal of the previous rule.

4.2. The Commentary also has been expanded considerably. This expansion in part reflects the addition of new paragraphs 4 and 5 to the Article. Other changes were made to the Commentary to take into account recent developments and current country practices and more generally to remove doubts as to the proper interpretation of the Article.

II. Commentary on the provisions of the Article

Paragraph 1

5. The main rule concerning the exchange of information is contained in the first sentence of the paragraph. The competent authorities of the Contracting States shall exchange such information as is ~~necessary~~ ***foreseeably relevant*** to secure the correct application of the provisions of the Convention or of the domestic laws of the Contracting States concerning taxes of every kind and description imposed in these States even if, in the latter case, a particular Article of the Convention need not be applied. ~~Some countries replace "necessary" with "relevant" in their bilateral conventions regarding this as a better way to express the sense of the provision: in the view of the Committee on Fiscal Affairs, either word may be used in that context.~~ ***The standard of***

[1] Available on www.oecd.org/taxation

[2] Improving Access to Bank Information for Tax Purposes, OECD 2000. Available on www.oecd.org/taxation.

"foreseeable relevance" is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to engage in "fishing expeditions" or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer. Contracting States may agree to an alternative formulation of this standard that is consistent with the scope of the Article (e.g. by replacing, "foreseeably relevant" with "necessary" or "relevant"). The scope of exchange of information covers all tax matters without prejudice to the general rules and legal provisions governing the rights of defendants and witnesses in judicial proceedings. Exchange of information for criminal tax matters can also be based on bilateral or multilateral treaties on mutual legal assistance (to the extent they also apply to tax crimes). In order to keep the exchange of information within the framework of the Convention, a limitation to the exchange of information is set so that information should be given only insofar as the taxation under the domestic taxation laws concerned is not contrary to the Convention.

5.1 The information covered by paragraph 1 is not limited to taxpayer-specific information. The competent authorities may also exchange other sensitive information related to tax administration and compliance improvement, for example risk analysis techniques or tax avoidance or evasion schemes.

5.2 [FROM OLD 11.2]***The possibilities of assistance provided by Article 26 do not limit, nor are they limited by, those contained in existing international agreements or other arrangements between the Contracting States which relate to co-operation in tax matters***. Since the exchange of information concerning the application of custom duties ***has a legal basis in*** ~~is governed by~~ other international ~~conventions~~ ***instruments***, the provisions of these more specialised ***instruments*** ~~conventions~~ will generally prevail and the exchange of information concerning custom duties will not, in practice, be governed by the Article.

6. The following examples may clarify the principle dealt with in paragraph 5 above. In all such cases information can be exchanged under paragraph 1.

7. Application of the Convention

a) When applying Article 12, State A where the beneficiary is resident asks State B where the payer is resident, for information concerning the amount of royalty transmitted.
b) Conversely, in order to grant the exemption provided for in Article 12, State B asks State A whether the recipient of the amounts paid is in fact a resident of the last-mentioned State and the beneficial owner of the royalties.
c) Similarly, information may be needed with a view to the proper allocation of taxable profits between associated companies in different States or the adjustment of the profits shown in the accounts of a permanent establishment in one State and in the accounts of the head office in the other State (Articles 7, 9, 23 A and 23 B).
d) Information may be needed for the purposes of applying Article 25.
e) When applying Articles 15 and 23 a), State A, where the employee is resident, informs State B, where the employment is exercised for more than 183 days, of the amount exempted from taxation in State A.

8. Implementation of the domestic laws

a) A company in State A supplies goods to an independent company in State B. State A wishes to know from State B what price the company in State B paid for the goods with a view to a correct application of the provisions of its domestic laws.

b) A company in State A sells goods through a company in State C (possibly a low-tax country) to a company in State B. The companies may or may not be associated. There is no convention between State A and State C, nor between State B and State C. Under the convention between A and B, State A, with a view to ensuring the correct application of the provisions of its domestic laws to the profits made by the company situated in its territory, asks State B what price the company in State B paid for the goods.

c) State A, for the purpose of taxing a company situated in its territory, asks State B, under the convention between A and B, for information about the prices charged by a company in State B, or a group of companies in State B with which the company in State A has no business contacts in order to enable it to check the prices charged by the company in State A by direct comparison (e.g. prices charged by a company or a group of companies in a dominant position). It should be borne in mind that the exchange of information in this case might be a difficult and delicate matter owing in particular to the provisions of subparagraph c) of paragraph ~~2~~ ***3*** relating to business and other secrets.

d) State A, for the purpose of verifying VAT input tax credits claimed by a company situated in its territory for services performed by a company resident in State B, requests confirmation that the cost of services was properly entered into the books and records of the company in State B.

9. The rule laid down in paragraph 1 allows information to be exchanged in three different ways:

a) on request, with a special case in mind, it being understood that the regular sources of information available under the internal taxation procedure should be relied upon in the first place before ***a*** request for information is made to the other State;

b) automatically, for example when information about one or various categories of income having their source in one Contracting State and received in the other Contracting State is transmitted systematically to the other State (cf. the OECD Council Recommendation C(81)39, dated 5 May 1981, entitled "Recommendation of the Council concerning a standardised form for automatic exchanges of information under international tax agreements", the OECD Council Recommendation C(92)50, dated 23 July 1992, entitled "Recommendation of the Council concerning a standard magnetic format for automatic exchange of tax information"~~[1]~~***, the OECD Council Recommendation on the use of Tax Identification Numbers in an international context C(97)29/FINAL dated 13 March 1997, the OECD Council Recommendation C(97)30/FINAL dated 10 July 1997 entitled "Recommendation of the Council of the OECD on the Use of the Revised Standard Magnetic Format for Automatic Exchange of Information" and the OECD Council Recommendation on the use of the OECD Model Memorandum of Understanding on Automatic Exchange of Information for Tax Purposes C(2001)28/FINAL);[3]***

c) spontaneously, for example in the case of a State having acquired through certain investigations, information which it supposes to be of interest to the other State.

9.1 These three forms of exchange (on request, automatic and spontaneous) may also be combined. It should also be stressed that the Article does not restrict the possibilities of exchanging information to these methods and that the Contracting States may use other techniques to obtain information which may be relevant to both Contracting States such as simultaneous examinations, tax examinations abroad and industry-wide exchange of information. These techniques are fully

~~[1] These two recommendations are reproduced and discussed in Tax Information Exchange between OECD Member Countries: A Survey of Current Practices, OECD, Paris, 1994.~~

[3] OECD Recommendations are available on www.oecd.org/taxation

described in the publication *Tax Information Exchange between OECD Member Countries: A Survey of Current Practices*[4]~~[2]~~ and can be summarised as follows:

- a simultaneous examination is an arrangement between two or more parties to examine simultaneously each in its own territory, the tax affairs of (a) taxpayer (s) in which they have a common or related interest, with a view of exchanging any relevant information which they so obtain (see the OECD Council Recommendation C(92)81, dated 23 July 1992, on an OECD Model agreement for the undertaking of simultaneous examinations);
- a tax examination abroad allows for the possibility to obtain information through the presence of representatives of the competent authority of the requesting Contracting ***State. To the extent allowed by its domestic law, a Contracting State may permit authorised representatives of the other Contracting State to enter the first Contracting State to interview individuals or examine a person's books and records, -- or to be present at such interviews or examinations carried out by the tax authorities of the first Contracting State -- in accordance with procedures mutually agreed upon by the competent authorities. Such a request might arise, for example, where the taxpayer in a Contracting State is permitted to keep records in the other Contracting State.*** This type of assistance is granted on a reciprocal basis. Countries' laws and practices differ as to the scope of rights granted to foreign tax officials. For instance, there are States where a foreign tax official will be prevented from any active participation in an investigation or examination on the territory of a country; there are also States where such participation is only possible with the taxpayer's consent. ***The Joint Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters specifically addresses tax examinations abroad in its Article 9;***
- an industry-wide exchange of information is the exchange of tax information especially concerning a whole economic sector (e.g. the oil or pharmaceutical industry, the banking sector, etc.) and not taxpayers in particular.

10. The manner in which the exchange of information agreed to in the Convention will finally be effected can be decided upon by the competent authorities of the Contracting States. ***For example, Contracting States may wish to use electronic or other communication and information technologies, including appropriate security systems, to improve the timeliness and quality of exchanges of information. Contracting States which are required, according to their law, to observe data protection laws, may wish to include provisions in their bilateral conventions concerning the protection of personal data exchanged. Data protection concerns the rights and fundamental freedoms of an individual, and in particular, the right to privacy, with regard to automatic processing of personal data. See, for example, the Council of Europe Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data of 28 January 1981[5].***

~~11. Reciprocal assistance between tax administrations is feasible only if each administration is assured that the other administration will treat with proper confidence the information which it will receive in the course of their co-operation. At the same time maintenance of such secrecy in the receiving Contracting State is a matter of domestic laws. It is therefore provided in paragraph 1 that information communicated under the provisions of the Convention shall be treated as secret in the receiving State in the same manner as information obtained under the domestic laws of that State. Sanctions for the violation of such secrecy in that State will be governed by the administrative and penal laws of that State.~~

~~[2]~~ [4] ~~Id~~ ***OECD, 1994.***

[5] ***see http://conventions.coe.int.***

10.1 ~~11.1~~ Before 2000, the paragraph only authorised the exchange of information, and the use of the information exchanged, in relation to the taxes covered by the Convention under the general rules of Article 2. As drafted, the paragraph did not oblige the requested State to comply with a request for information concerning the imposition of a sales tax as such a tax was not covered by the Convention. The paragraph was then amended so as to apply to the exchange of information concerning any tax imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, and to allow the use of the information exchanged for purposes of the application of all such taxes. Some Contracting States may not, however, be in a position to exchange information, or to use the information obtained from a treaty partner, in relation to taxes that are not covered by the Convention under the general rules of Article 2. Such States are free to restrict the scope of paragraph 1 of Article 26 ***to the taxes covered by the Convention***. ~~by adopting bilaterally the following previous wording of the paragraph:~~

> ~~"1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions."~~

~~11.2. Since the exchange of information concerning the application of custom duties is governed by other international conventions, the provisions of these more specialised conventions will generally prevail and the exchange of information concerning custom duties will not, in practice, be governed by the Article.~~

10.2 In some cases, a Contracting State may need to receive information in a particular form to satisfy its evidentiary or other legal requirements. Such forms may include depositions of witnesses and authenticated copies of original records. Contracting States should endeavour as far as possible to accommodate such requests. Under paragraph 3, the requested State may decline to provide the information in the specific form requested if, for instance, the requested form is not known or permitted under its law or administrative practice. A refusal to provide the information in the form requested does not affect the obligation to provide the information.

10.3 Nothing in the Convention prevents the application of the provisions of the Article to the exchange of information that existed prior to the entry into force of the Convention, as long as the assistance with respect to this information is provided after the Convention has entered into force and the provisions of the Article have become effective. Contracting States may find it useful, however, to clarify the extent to which the provisions of the Article are applicable to such information, in particular when the provisions of that convention will have effect with respect to taxes arising or levied from a certain time.

Paragraph 2

11. Reciprocal assistance between tax administrations is feasible only if each administration is assured that the other administration will treat with proper confidence the information which it will receive in the course of their co-operation. ***The confidentiality rules of paragraph 2 apply to all types of information received under paragraph 1, including both information provided in a request and information transmitted in response to a request.*** ~~At the same time~~ ***The*** maintenance of ~~such~~ secrecy in the receiving Contracting State is a matter of domestic laws. It is therefore provided in paragraph ***2***~~1~~ that information communicated under the provisions of the Convention shall be treated as secret in the receiving State in the same manner as information obtained under the domestic laws of that State. Sanctions for the violation of such secrecy in that State will be governed by the administrative and penal laws of that State.

12. The information obtained may be disclosed only to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, ~~or~~ the determination of appeals in relation to the taxes with respect to which information may be exchanged according to the first sentence of ~~the~~ paragraph ***1, or the oversight of the above***. This means that the information may also be communicated to the taxpayer, his proxy or to the witnesses. ***This also means that information can be disclosed to governmental or judicial authorities charged with deciding whether such information should be released to the taxpayer, his proxy or to the witnesses.*** The information received by a Contracting State may be used by such persons or authorities only for the purposes mentioned in paragraph ***2*** ~~*1*~~. ***Furthermore, information covered by paragraph 1, whether taxpayer-specific or not, should not be disclosed to persons or authorities not mentioned in paragraph 2, regardless of domestic information disclosure laws such as freedom of information or other legislation that allows greater access to governmental documents.*** ~~If the information appears to be of value to the receiving State for other purposes than those referred to, that State may not use the information for such other purposes but it must resort to means specifically designed for those purposes (e.g. in case of a non-fiscal crime, to a treaty concerning judicial assistance).~~

12.1 ***Information can also be disclosed to oversight bodies. Such oversight bodies include*** ~~Under this Article, information may not be disclosed to~~ authorities that supervise ***tax administration and enforcement authorities as part of*** the general administration of the Government of a Contracting State~~, but are not involved specifically in tax matters~~. In their bilateral negotiations, however, ***Contracting States may depart from this principle and*** ~~Member countries may~~ agree to ***exclude the*** ~~provide for~~ disclosure ***of information*** to such supervisory bodies.

12.2 The information received by a Contracting State may not be disclosed to a third country unless there is an express provision in the bilateral treaty between the Contracting States allowing such disclosure.

12.3 Similarly, if the information appears to be of value to the receiving State for other purposes than those referred to in paragraph 12, that State may not use the information for such other purposes but it must resort to means specifically designed for those purposes (e.g. in case of a non-fiscal crime, to a treaty concerning judicial assistance). However, Contracting States may wish to allow the sharing of tax information by tax authorities with other law enforcement agencies and judicial authorities on certain high priority matters (e.g., to combat money laundering, corruption, terrorism financing). Contracting States wishing to broaden the purposes for which they may use information exchanged under this Article may do so by adding the following text to the end of paragraph 2:

“***Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use.”***

13. As stated ~~above~~ ***in paragraph 12,*** the information obtained can be communicated to the persons and authorities mentioned ~~but it does not follow from this that it~~ ***and on the basis of the last sentence of paragraph 2 of the Article*** can be disclosed by them in court sessions held in public or in decisions which reveal the name of the taxpayer. ~~The last sentence of the paragraph, however, opens up this possibility.~~ Once information is used in public court proceedings or in court decisions and thus rendered public, it is clear that from that moment such information can be quoted from the court files or decisions for other purposes even as possible evidence. But this does not mean that the persons and authorities mentioned in paragraph ~~1~~ ***2*** are allowed to provide on request additional information received. If either or both of the Contracting States object to the information being made public by courts in this way, or, once the information has been made public in this way, to the information being used for other purposes, because this is not the normal procedure under their domestic laws, they should state this expressly in their convention.

~~*Paragraph 2*~~

Paragraph 3

14. This paragraph contains certain limitations to the main rule in favour of the requested State. In the first place, the paragraph contains the clarification that a Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State. ~~However, types of administrative measures authorised for the purpose of the requested State's tax must be utilised, even though invoked solely to provide information to the other Contracting State.~~ ***However*** ~~Likewise~~, internal provisions concerning tax secrecy should not be interpreted as constituting an obstacle to the exchange of information under the present Article. As mentioned above, the authorities of the requesting State are obliged to observe secrecy with regard to information received under this Article. ~~A Contracting State that under its domestic law is required to notify the taxpayer that an exchange of information is proposed should inform its treaty partners in writing that it has this requirement and what the consequences are for its obligations in relation to mutual assistance.~~

14.1 Some countries’ laws include procedures for notifying the person who provided the information and/or the taxpayer that is subject to the enquiry prior to the supply of information. Such notification procedures may be an important aspect of the rights provided under domestic law. They can help prevent mistakes (e.g. in cases of mistaken identity) and facilitate exchange (by allowing taxpayers who are notified to co-operate voluntarily with the tax authorities in the requesting State). Notification procedures should not, however, be applied in a manner that, in the particular circumstances of the request, would frustrate the efforts of the requesting State. In other words, they should not prevent or unduly delay effective exchange of information. For instance, notification procedures should permit exceptions from prior notification, e.g. in cases in which the information request is of a very urgent nature or the notification is likely to undermine the chance of success of the investigation conducted by the requesting State. A Contracting State that under its domestic law is required to notify the person who provided the information and/or the taxpayer that an exchange of information is proposed should inform its treaty partners in writing that it has this requirement and what the consequences are for its obligations in relation to mutual assistance. Such information should be provided to the other

Contracting State when a convention is concluded and thereafter whenever the relevant rules are modified.

15. Furthermore, the requested State does not need to go so far as to carry out administrative measures that are not permitted under the laws or practice of the requesting State or to supply items of information that are not obtainable under the laws or in the normal course of administration of the requesting State. It follows that a Contracting State cannot take advantage of the information system of the other Contracting State if it is wider than its own system. ***Thus, a State may refuse to provide information where the requesting State would be precluded by law from obtaining or providing the information or where the requesting State's administrative practices (e.g., failure to provide sufficient administrative resources) result in a lack of reciprocity. However, it is recognised that too rigorous an application of the principle of reciprocity could frustrate effective exchange of information and that reciprocity should be interpreted in a broad and pragmatic manner. Different countries will necessarily have different mechanisms for obtaining and providing information. Variations in practices and procedures should not be used as a basis for denying a request unless the effect of these variations would be to limit in a significant way the requesting State's overall ability to obtain and provide the information if the requesting State itself received a legitimate request from the requested State.***

15.1 The principle of reciprocity has no application where the legal system or administrative practice of only one country provides for a specific procedure. For instance, a country requested to provide information could not point to the absence of a ruling regime in the country requesting information and decline to provide information on a ruling it has granted, based on a reciprocity argument. Of course, where the requested information itself is not obtainable under the laws or in the normal course of the administrative practice of the requesting State, a requested State may decline such a request.

15.2 Most countries recognise under their domestic laws that information cannot be obtained from a person to the extent that such person can claim the privilege against self-incrimination. A requested State may, therefore, decline to provide information if the requesting State would have been precluded by its own self-incrimination rules from obtaining the information under similar circumstances. In practice, however, the privilege against self-incrimination should have little, if any, application in connection with most information requests. The privilege against self-incrimination is personal and cannot be claimed by an individual who himself is not at risk of criminal prosecution. The overwhelming majority of information requests seek to obtain information from third parties such as banks, intermediaries or the other party to a contract and not from the individual under investigation. Furthermore, the privilege against self-incrimination generally does not attach to persons other than natural persons.

16. Information is deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons, provided that the tax authorities would make similar investigations or examinations for their own purposes. ~~This means that the requested State has to collect the information the other State needs in the same way as if its own taxation was involved, under the proviso mentioned in paragraph 15 above. This obligation is clearly evidenced by the practices followed by Member countries which show that, when collecting information requested by a treaty partner, Contracting States often use the special examining or investigative powers provided by their laws for purposes of the application of their domestic taxes even though they do not themselves need the information for applying these taxes.~~

17. The requested State is at liberty to refuse to give information in the cases referred to in the paragraphs above. However if it does give the requested information, it remains within the framework of the agreement on the exchange of information which is laid down in the Convention; consequently it cannot be objected that this State has failed to observe the obligation to secrecy.

18. If the structure of the information systems of two Contracting States is very different, the conditions under subparagraphs *a*) and *b*) of paragraph ***3***~~2~~ will lead to the result that the Contracting States exchange very little information or perhaps none at all. In such a case, the Contracting States may find it appropriate to broaden the scope of the exchange of information.

18.1 Unless otherwise agreed to by the Contracting States, it can be assumed that the requested information could be obtained by the requesting State in a similar situation if that State has not indicated to the contrary.

19. In addition to the limitations referred to above, subparagraph *c*) of paragraph ***3***~~2~~ contains a reservation concerning the disclosure of certain secret information. Secrets mentioned in this subparagraph should not be taken in too wide a sense. Before invoking this provision, a Contracting State should carefully weigh if the interests of the taxpayer really justify its application. Otherwise it is clear that too wide an interpretation would in many cases render ineffective the exchange of information provided for in the Convention. The observations made in paragraph 17 above apply here as well. The requested State in protecting the interests of its taxpayers is given a certain discretion to refuse the requested information, but if it does supply the information deliberately the taxpayer cannot allege an infraction of the rules of secrecy. ~~It is open to the Contracting States to add further dispensations from the obligation to supply information to the items listed in subparagraph *c*), for example, information protected by provisions on banker's discretion. It has been felt necessary also to prescribe a limitation with regard to information which concerns the vital interests of the State itself. To this end, it is stipulated that Contracting States do not have to supply information the disclosure of which would be contrary to public policy (*ordre public*).~~

19.1 In its deliberations regarding the application of secrecy rules, the Contracting State should also take into account the confidentiality rules of Article 26, paragraph 2. The domestic laws and practices of the requesting State together with the obligations imposed under Article 26, paragraph 2, may ensure that the information cannot be used for the types of unauthorised purposes against which the trade or other secrecy rules are intended to protect. Thus, a Contracting State may decide to supply the information where it finds that there is no reasonable basis for assuming that a taxpayer involved may suffer any adverse consequences incompatible with information exchange.

19.2 In most cases of information exchange no issue of trade, business or other secret will arise. A trade or business secret is generally understood to mean facts and circumstances that are of considerable economic importance and that can be exploited practically and the unauthorised use of which may lead to serious damage (e.g. may lead to severe financial hardship). The determination, assessment or collection of taxes as such could not be considered to result in serious damage. Financial information, including books and records, does not by its nature constitute a trade, business or other secret. In certain limited cases, however, the disclosure of financial information might reveal a trade, business or other secret. For instance, a request for information on certain purchase records may raise such an issue if the disclosure of such information revealed the proprietary formula used in the manufacture of a product. The protection of such information may also extend to information in the

possession of third persons. For instance, a bank might hold a pending patent application for safe keeping or a secret trade process or formula might be described in a loan application or in a contract held by a bank. In such circumstances, details of the trade, business or other secret should be excised from the documents and the remaining financial information exchanged accordingly.

19.3 A requested State may decline to disclose information relating to confidential communications between attorneys, solicitors or other admitted legal representatives in their role as such and their clients to the extent that the communications are protected from disclosure under domestic law. However, the scope of protection afforded to such confidential communications should be narrowly defined. Such protection does not attach to documents or records delivered to an attorney, solicitor or other admitted legal representative in an attempt to protect such documents or records from disclosure required by law. Also, information on the identity of a person such as a director or beneficial owner of a company is typically not protected as a confidential communication. While the scope of protection afforded to confidential communications might differ among states, it should not be overly broad so as to hamper effective exchange of information. Communications between attorneys, solicitors or other admitted legal representatives and their clients are only confidential if, and to the extent that, such representatives act in their capacity as attorneys, solicitors or other admitted legal representatives and not in a different capacity, such as nominee shareholders, trustees, settlors, company directors or under a power of attorney to represent a company in its business affairs. An assertion that information is protected as a confidential communication between an attorney, solicitor or other admitted legal representative and its client should be adjudicated exclusively in the Contracting State under the laws of which it arises. Thus, it is not intended that the courts of the requested State should adjudicate claims based on the laws of the requesting State.

19.4 Contracting States wishing to refer expressly to the protection afforded to confidential communications between a client and an attorney, solicitor or other admitted legal representative may do so by adding the following text at the end of paragraph 3:

> ***"d) to obtain or provide information which would reveal confidential communications between a client and an attorney, solicitor or other admitted legal representative where such communications are:***
>
> ***(i) produced for the purposes of seeking or providing legal advice or***
> ***(ii) produced for the purposes of use in existing or contemplated legal proceedings."***

19.5 Paragraph 3 also includes a limitation with regard to information which concerns the vital interests of the State itself. To this end, it is stipulated that Contracting States do not have to supply information the disclosure of which would be contrary to public policy (ordre public). However, this limitation should only become relevant in extreme cases. For instance, such a case could arise if a tax investigation in the requesting State were motivated by political, racial, or religious persecution. The limitation may also be invoked where the information constitutes a state secret, for instance sensitive information held by secret services the disclosure of which would be contrary to the vital interests of the requested State. Thus, issues of public policy (ordre public) rarely arise in the context of information exchange between treaty partners.

Paragraph 4

19.6 Paragraph 4 was added in [2005] to deal explicitly with the obligation to exchange information in situations where the requested information is not needed by the requested State for domestic tax purposes. Prior to the addition of paragraph 4 this obligation was not expressly stated in the Article, but was clearly evidenced by the practices followed by Member countries which showed that, when collecting information requested by a treaty partner, Contracting States often use the special examining or investigative powers provided by their laws for purposes of levying their domestic taxes even though they do not themselves need the information for these purposes. This principle is also stated in the Report Improving Access to Bank Information for Tax Purposes, OECD 2000. [6]

19.7 According to paragraph 4, Contracting States must use their information gathering measures, even though invoked solely to provide information to the other Contracting State. The term "information gathering measures" means laws and administrative or judicial procedures that enable a Contracting State to obtain and provide the requested information.

19.8 The second sentence of paragraph 4 makes clear that the obligation contained in paragraph 4 is subject to the limitations of paragraph 3 but also provides that such limitations cannot be construed to form the basis for declining to supply information where a country's laws or practices include a domestic tax interest requirement. Thus, while a requested State cannot invoke paragraph 3 and argue that under its domestic laws or practices it only supplies information in which it has an interest for its own tax purposes, it may, for instance, decline to supply the information to the extent that the provision of the information would disclose a trade secret.

19.9 For many countries the combination of paragraph 4 and their domestic law provide a sufficient basis for using their information gathering measures to obtain the requested information even in the absence of a domestic tax interest in the information. Other countries, however, may wish to clarify expressly in the convention that Contracting States must ensure that their competent authorities have the necessary powers to do so. Contracting States wishing to clarify this point may replace paragraph 4 with the following text:

> ***"4. In order to effectuate the exchange of information as provided in paragraph 1, each Contracting State shall take the necessary measures, including legislation, rule-making, or administrative arrangements, to ensure that its competent authority has sufficient powers under its domestic law to obtain information for the exchange of information regardless of whether that Contracting State may need such information for its own tax purposes."***

Paragraph 5

19.10 Paragraph 1 imposes a positive obligation on a Contracting State to exchange all types of information. Paragraph 5 is intended to ensure that the limitations of paragraph 3 cannot be used to prevent the exchange of information held by banks, other financial institutions, nominees, agents and fiduciaries as well as ownership information. While paragraph 5, which was added in [2005], represents a change in the structure of Article 26 it should not be interpreted as suggesting that the previous version of Article 26 did not authorise the exchange of such information. The vast majority of OECD member countries already exchanged such

---

[6] ***See paragraph 21b.***

information under the previous version of Article 26 and the addition of paragraph 5 merely reflects current practice.

19.11 Paragraph 5 stipulates that a Contracting State shall not decline to supply information to a treaty partner solely because the information is held by a bank or other financial institution. Thus, paragraph 5 overrides paragraph 3 to the extent that paragraph 3 would otherwise permit a requested Contracting State to decline to supply information on grounds of bank secrecy. The addition of this paragraph to Article 26 reflects the international trend in this area as reflected in the Model Agreement on Exchange of Information on Tax Matters [7] and as described in the report, Improving Access to Bank Information for Tax Purposes, OECD 2000. In accordance with that report, access to information held by banks or other financial institutions may be by direct means or indirectly through a judicial or administrative process. The procedure for indirect access should not be so burdensome and time-consuming as to act as an impediment to access to bank information.

19.12 Paragraph 5 also provides that a Contracting State shall not decline to supply information solely because the information is held by persons acting in an agency or fiduciary capacity. For instance, if a Contracting State had a law under which all information held by a fiduciary was treated as a "professional secret" merely because it was held by a fiduciary, such State could not use such law as a basis for declining to provide the information to the other Contracting State. A person is generally said to act in a "fiduciary capacity" when the business which the person transacts, or the money or property which the person handles, is not its own or for its own benefit, but for the benefit of another person as to whom the fiduciary stands in a relation implying and necessitating confidence and trust on the one part and good faith on the other part, such as a trustee. The term "agency" is very broad and includes all forms of corporate service providers (e.g. company formation agents, trust companies, registered agents, lawyers).

19.13 Finally, paragraph 5 states that a Contracting State shall not decline to supply information solely because it relates to an ownership interest in a person, including companies and partnerships, foundations or similar organisational structures. Information requests cannot be declined merely because domestic laws or practices may treat ownership information as a trade or other secret.

19.14 Paragraph 5 does not preclude a Contracting State from invoking paragraph 3 to refuse to supply information held by a bank, financial institution, a person acting in an agency or fiduciary capacity or information relating to ownership interests. However, such refusal must be based on reasons unrelated to the person's status as a bank, financial institution, agent, fiduciary or nominee, or the fact that the information relates to ownership interests. For instance, a legal representative acting for a client may be acting in an agency capacity but for any information protected as a confidential communication between attorneys, solicitors or other admitted legal representatives and their clients, Article 26, paragraph 3, continues to provide a possible basis for declining to supply the information.

19.15 The following examples illustrate the application of paragraph 5:

a) Company X owns a majority of the stock in a subsidiary company Y, and both companies are incorporated under the laws of State A. State B is conducting a tax examination of business operations of company Y in State B. In the course of this

[7] Available on www.oecd.org/taxation

examination the question of both direct and indirect ownership in company Y becomes relevant and State B makes a request to State A for ownership information of any person in company Y's chain of ownership. In its reply State A should provide to State B ownership information for both company X and Y.

b) ***An individual subject to tax in State A maintains a bank account with Bank B in State B. State A is examining the income tax return of the individual and makes a request to State B for all bank account income and asset information held by Bank B in order to determine whether there were deposits of untaxed earned income. State B should provide the requested bank information to State A.***

Observations on the Commentary

20. *Japan* wishes to indicate that with respect to paragraph 11 above, it would be difficult for Japan, in view of its strict domestic laws and administrative practice as to the procedure to make public the information obtained under the domestic laws, to provide information requested unless a requesting State has comparable domestic laws and administrative practice as to this procedure.

21. In connection with paragraph 15.1. Greece wishes to clarify that according to Article 28 of the Greek Constitution international tax treaties are applied under the terms of reciprocity.

22. Austria wishes to indicate that due to its general reservation on paragraph 5 it is not in a position to adhere to the Commentary on that paragraph.

~~21. Contrary to the interpretation put forward in paragraphs 14 to 16 above, Japan takes the view that the Article imposes no obligation on it to carry out enquiries on behalf of a Contracting State in cases where no liability to its own tax is at issue, since to carry out such enquiries would be contrary to its laws and administrative practice.~~

~~22. Contrary to the interpretation put forward in paragraph 14 to 16 above, the United Kingdom takes the view that the Article as drafted does not impose an obligation on it to invoke statutory information powers on behalf of a Contracting State in cases where no liability to its own tax is at issue, since to invoke such powers in these circumstances is in some cases contrary to its law. In order to foster the effective exchange of information, UK legislation has therefore been enacted to permit the introduction of such an obligation into the text of the Article by making appropriate modifications.~~

Reservations on the Article

~~23. *Germany* reserves the right to propose in bilateral negotiations additional specific provisions on data protection.~~

23. Austria reserves the right not to include paragraph 5 in its conventions. However, Austria is authorised to exchange information held by a bank or other financial institution where such information is requested within the framework of a criminal investigation which is carried on in the requesting State concerning the commitment of tax fraud.

24. *Switzerland* reserves its position on ~~this Article~~ ***paragraphs 1 and 5***. It will propose to limit the scope of this Article to information necessary for carrying out the provisions of the Convention. ***This reservation shall not apply in cases involving acts of fraud subject to imprisonment according to the laws of both Contracting States.***

25. Belgium reserves the right not to include paragraph 5 in its conventions.

26. Luxembourg reserves the right not to include paragraph 5 in its conventions.

OECD OCDE

DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENT – PART I (GENERAL CONSIDERATIONS)

2nd August 2004

TABLE OF CONTENTS

PREFACE

1. The permanent establishment (PE) concept has a history as long as the history of double taxation conventions. Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD Model Tax Convention on Income and on Capital, which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between many OECD Member and non-member countries.

2. There is considerable variation in the domestic laws of OECD Member countries regarding the taxation of PEs. In addition, there is no consensus amongst the OECD Member countries as to the correct interpretation of Article 7. This lack of a common interpretation and consistent application of Article 7 can lead to double, or less than single, taxation. The development of global trading of financial products and electronic commerce has helped to focus attention on the need to establish a broad consensus regarding the interpretation and practical application of Article 7.

3. As a first step in establishing a broad consensus, a Working Hypothesis (WH) was developed as to the preferred approach for attributing profits to a PE under Article 7. This approach built upon developments since the last revision of the Model Commentary on Article 7 in March 1994[1], especially the fundamental review of the arm's length principle, the results of which were reflected in the 1995 OECD Transfer Pricing Guidelines (the Guidelines). The Guidelines address the application of the arm's length principle to transactions between associated enterprises under Article 9. The basis for the development of the WH was to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise could be taken and how the guidance in the Guidelines could be applied, by analogy, to attribute profits to a PE in accordance with the arm's length principle of Article 7. The development of the WH was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Rather the intention was to formulate the preferred approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade.

4. To meet the policy goals described above, the WH was tested by considering how it could be applied in practice to attribute profits both to PEs in general and, in particular, to PEs of businesses operating in the financial sector, where trading through a PE is widespread. A Discussion Draft containing the interim results of testing the application of the WH to PEs in general (Part I) and to PEs of banking enterprises (Part II) was released for public comment in February 2001. Twenty five responses were received from the business community, banking associations and advisory firms, reflecting a diversity of views and interests. Because of the variety of positions expressed and the complexity of the issues, a consultation was held in Paris in April 2002 with the commentators on the Discussion Draft. The consultation was very valuable as it allowed the identification of common ground in terms of principles, of areas that needed further clarification and of areas where further work was needed.

5. A revised Part II and a Part III (Global Trading) were released for public comment on 4 March 2003. Nineteen responses were received from the business community, banking associations and advisory

1 This revision followed the publication of "Issues in International Taxation No. 5: Model Tax Convention: Attribution of Income to Permanent Establishments".

firms. Again because of the complexity of the issues, a second consultation was held in Geneva in March 2004. This Revision of Part I takes account of the comments received and the discussions during both consultations.

Comments are invited on the revised Part I particularly in areas

- **Where the meaning or practical impact is not clear.**

6. The intention is now to finalise Parts I-III in early 2005. Once finalised**,** the conclusions of these Reports will be implemented through amendments to the Commentary on Article 7. Further practical guidance will be produced in the form of background Reports and/or Chapter(s) of the OECD Transfer Pricing Guidelines. The testing of the WH is reaching its conclusion and sufficient progress has been made in the development of the WH to mean that the WH has now become the authorised OECD approach.

Comments from the public are invited on

- **Any transitional issues that might arise from the implementation of the current conclusions of Part I through changes to the Commentary on Article 7, including suggestions as to how best to deal with them. An example of a potential transitional issue is how to attribute economic ownership of existing intangibles which were created at a time when taxpayers had no requirement to document the decision making process which led to the creation of the intangible (see Section C-2(b) for a description of how to attribute economic ownership of intangibles). Commentators should note that such transitional issues will not be dealt with in the Reports themselves but will be the subject of further work once the Reports have been finalised. Comments received will be taken into account at that stage.**

REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

PART I: GENERAL CONSIDERATIONS

A. Introduction

1. The permanent establishment (PE) concept has a history as long as the history of double taxation conventions. At the multilateral level, the wording of the various draft conventions has evolved from the League of Nations drafts of 1927, 1933, 1943 and 1946 through to the Draft Double Taxation Convention on Income and on Capital in 1963 and its successor in 1977 the Model Double Taxation Convention on Income and on Capital. Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD Model Tax Convention on Income and on Capital (OECD Model Tax Convention), which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between many OECD Member and non-member countries. These principles are also incorporated in the Model United Nations Double Taxation Convention between Developed and Developing Nations.

1. The importance of the PE concept can be seen from the following extract from paragraph 1 of the Commentary on Article 7 of the OECD Model Tax Convention:

> "When an enterprise of a Contracting State carries on business in the other Contracting State, the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 of the OECD Model Tax Convention on Income and Capital (OECD Model Tax Convention) is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with another enterprise of another Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9 of the OECD Model Tax Convention".

2. There is considerable variation in the domestic laws of the Member countries regarding the taxation of PEs. Currently, there is also not a consensus amongst the Member countries as to the correct interpretation of Article 7. Indeed, the divergent interpretations as regards the meaning and application of Article 7 in some situations are reflected in the Commentary on the OECD Model Tax Convention ("Commentary"). As pointed out by the business community, the lack of a common interpretation of

Article 7 can lead to double taxation. The lack of consensus may also lead to less than single taxation. The development of global trading of financial products and electronic commerce has helped to focus attention on the current unsatisfactory situation.

3. Accordingly, Working Party No 6, which has primary responsibility for this issue, decided that the establishment of a broad consensus regarding the interpretation and practical application of Article 7 (especially for the purposes of conducting mutual agreement proceedings and interpreting tax treaties based upon the OECD Model Tax Convention) is essential to achieve the goal of eliminating the risk of double, or less than single, taxation. To assist in this objective, the Working Party formulated a Working Hypothesis (WH) as to the preferred approach for attributing profit to a PE under Article 7 in terms of simplicity, administerability, and sound tax policy. The WH has been tested by considering its practical application, in general situations, and with regard to special issues involving PEs in the financial sector, i.e. banks, global trading and insurance. The testing of the WH is reaching its conclusion and sufficient progress has been made in the development of the WH to mean that the WH has now become the authorised OECD approach.

4. The development of the authorised OECD approach has not been constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus has been on formulating the most preferable approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade. Once finalised, the conclusions of Parts I –III will be implemented through the Commentary on Article 7. This will require consideration as to whether a particular conclusion is adequately authorised under the existing language of the Commentary on Article 7. It may be that clarifying changes to the Commentary will be necessary or desirable in order to validate the proposed conclusion. In that case, further work would be needed to consider how best to make the changes, and depending on the nature of the changes their possible implications for both future and existing treaties. This further work would be carried out in conjunction with Working Party No. 1. As the project approaches completion it is also appropriate to consider transitional issues arising from any changes to the Commentary on Article 7.

5. The Commentary to Article 7 has itself been regularly updated, including a substantial revision in March 1994 following the publication of "Issues in International Taxation No. 5: Model Tax Convention: Attribution of Income to Permanent Establishments" (hereafter referred to as the 1994 Report). However, the 1994 Report was completed before the Committee of Fiscal Affairs (CFA) had completed its fundamental review of the arm's length principle, the results of which were reflected in the publication in 1995 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter referred to as the Guidelines). The Guidelines address the application of the arm's length principle to transactions between associated enterprises under Article 9 of the OECD Model Tax Convention. The basis for the development of the WH was to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise could be taken. The testing and development of the WH has examined how the guidance in the Guidelines can be applied to attribute profits to a PE of a banking or global trading enterprise in accordance with the arm's length principle of Article 7. In particular, the examination has focussed on the extent to which modifications, if any, would be needed in order to take into account differences between a PE and a legally distinct and separate enterprise. It should be noted that under the authorised OECD approach, the same principles should be applied to attribute losses as to attribute profits. References to attributing "profits" should therefore be taken as applying equally to attributing losses.

6. This Report focuses on determining the preferred interpretation and application of Article 7. The question of whether the current interpretation of other relevant Articles of the OECD Model Tax Convention (such as Articles 5, 13 and 23) produces a desirable result is beyond the scope of this Report. For example, the Report does not address the question whether a PE exists in respect of any particular

business activity. The definition of a PE is described by Article 5 of the OECD Model Tax Convention and readers are referred to its Commentary for further information (including the changes made in the January 2003 update).

7. This revision of Part I (General) of the Report takes account of the comments made in the public consultations in April 2002 and March 2004. Part I was not scheduled for discussion in the March 2004 consultation, but in the event a lot of the debate on revised Part II and Part III proved highly relevant to issues covered in Part I. The project on the attribution of profits to PEs will not be finished until the publication of Part IV which deals with insurance. Given that this is a sufficiently self contained topic the intention is to finalise the other Parts of the Report even if Part IV is not complete. Accordingly the intention is to produce a final version of Parts I, II, and III in the first half of 2005.

8. The rest of Part I of this Report provides general background and further information about the authorised OECD approach in relation to the first five paragraphs of Article 7. Part B analyses Article 7, paragraph 1, which provides the central rule concerning the allocation of taxing rights over the business profits of an enterprise[2] between the country in which the PE is situated (the "host country") and the country of residence of the enterprise (the "home country"). Part C analyses Article 7, paragraph 2, which provides the central rule concerning the attribution of the business profits of an enterprise to a PE and the statement of the arm's length principle in the context of PEs. Part D addresses the meaning of Article 7, paragraph 3, regarding expenses, and its relationship to Article 7, paragraph 2. Part E examines Article 7, paragraph 4, which permits in certain circumstances the use of an apportionment method for attributing profits to a PE, based on the total profits of the enterprise. Part F examines Article 7, paragraph 5, which provides a special rule for PEs, engaged in the "mere purchase" of goods or merchandise. The authorised OECD approach is applicable to all types of PEs, but there is a separate Section examining the special considerations applicable to dependent agent PEs (Section C-3 (v)).

B. Interpretation of paragraph 1 of Article 7: Determining the profits of an enterprise

B-1. Approaches to determining profits

9. Article 7 (1) permits the host country to tax the "profits of an enterprise", but only so much of them as is "attributable to" a PE of the enterprise in the host country. Much historical attention has been given to the question of how to determine the attribution under Article 7(2), but in fact another question must first be addressed: what are the "profits of an enterprise" for the purposes of Article 7(1).

10. Unfortunately, the Commentary on Article 7 provides little in the way of guidance on how to interpret the term "profits of an enterprise", beyond confirming that, "the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment." This language limits the scope of the taxing rights of the host country so that there is no "force of attraction" resulting from the existence of a PE (see paragraphs 5-10 of the Commentary on Article 7). However, the question arises as to whether the term "profits of an enterprise" requires a further limitation on the taxing rights of the host country. Historical practice has developed such that two broad interpretations of the term are most common by the Member countries**.** Additionally, there are further variations, which may have to be taken into account, the most important of which relates to the meaning of the term "profits". This part of the Report analyses the two broad interpretations in more detail and discusses briefly possible variations in the interpretation of the term "profits".

---

2. For the purposes of this Report, references to the "enterprise" or to the "enterprise as a whole" should be interpreted as describing the juridical entity.

(i) The “relevant business activity” approach

11. The first broad interpretation, referred to as the “relevant business activity approach”, defines the “profits of an enterprise” as referring only to the profits of the business activity in which the PE has some participation (the “relevant business activity”).

12. Under the “relevant business activity” approach, Article 7(1) imposes a limit on the profits that could be attributed, under Article 7(2) to a PE: the attributed profits could not exceed the profits that the whole enterprise earns from the relevant business activity. The profits of the whole enterprise would be those earned from transactions with third parties and those earned from transactions with associated enterprises, the latter of which would need to be adjusted under transfer pricing rules if they did not reflect the application of the arm’s length principle.

13. The profits of the enterprise as a whole would be considered as comprising the aggregate of profit and losses derived from all its business activities. Any limitation on the profits attributable to a PE under paragraph 1 of Article 7 would be determined relative only to the profits of the relevant business activity. More specifically, if the “relevant business activity” includes operations by other parts of the enterprise, and those operations incur a loss, the “loss” created by the other parts of the enterprise would effectively reduce the profit that could be attributed to the PE, because the “loss” would reduce the overall profits of the enterprise from the relevant business activity. By contrast, losses from a business activity not considered to be part of the same “relevant business activity” as that carried on by the PE would not reduce the PE’s attributable profit.

14. There are different views among countries as to how the “relevant business activity” approach would be applied in practice. For instance, the breadth or narrowness with which the “relevant business activity” is defined has a significant impact on whether the theoretical profit limitation described above will have any practical effect. There is a greater likelihood that the performance of other parts of the enterprise will limit the attribution of profit to the PE, the more broadly the term “relevant business activity” is defined. For example, consider an enterprise, which manufactures a new type of product at the head office and has a PE, which only carries out a distribution activity. Considerable research expenditure is incurred in developing the product, which results in an overall loss for the product line. The product is not well received in the market and is eventually discontinued. If the “relevant business activity” is considered to encompass all the business activities of the product line, i.e. research and development, manufacturing and distributing, it would not be possible to attribute a profit to the PE for performing only the distribution activity, even if a comparability analysis with uncontrolled transactions undertaken by independent distributors would support such an attribution.

15. On the other hand, if the “relevant business activity” is defined more narrowly by reference to function, rather than product line, there may be less participation by other parts of the enterprise in that function, so that there would be fewer instances in which the profit limitation would be operative. In the example above, it would be possible to attribute profit to the distributor PE based on a functional definition of the relevant business activity, i.e. only by reference to the performance of the distribution function. However, the determination of the “relevant business activity” becomes more difficult where both the PE and other parts of the enterprise participate in similar activities. Suppose that the enterprise has distributor PEs in two jurisdictions (A and B) and that by following a comparability analysis with uncontrolled transactions undertaken by independent distributors in each jurisdiction, profits could be attributed to A of 10 but B would be attributed a loss of 15, so that the overall distribution business activity for the enterprise as a whole produces a loss of 5. Should Country A limit the definition of “relevant business activity” to the distribution function in its jurisdiction and ignore the distribution function carried on in jurisdiction B? Historically, host countries have proved reluctant to consider limiting their attribution of profit by reference to activities performed by other PEs.

16. The taxing rights of the host country may also be restricted if the "relevant business activity" is interpreted to mean that profits cannot be attributed to the PE unless the activity is carried on only in the jurisdiction of the host country. Such an interpretation may give rise to problems in some cases, for example where the global trading of financial instruments is carried on in such a way that a number of jurisdictions, rather than just one, would be considered as participating in the "relevant business activity".

17. There have also been variations between countries in the period over which the "relevant business activity" is evaluated. Some may not evaluate the situation solely by reference to one year. Consequently, if the business activity produced a loss in one year that would not prevent profit being attributed to the PE for that year, if the "relevant business activity" is profitable when looked at over a number of years. A further variation would be for the host country to base its taxing rights on the presumption (always rebuttable by reference to actual experience) that the relevant business activity would make sufficient profits over a period of years so that no restriction to the taxing rights of the host country would arise. In the circumstances described above, some countries would conclude that there are "profits of the enterprise" to attribute, even though they may have been realised at different times in different parts of the enterprise, perhaps because of differences in economic and business cycles. However, the actual attribution of profits would be made separately for each year by reference to the facts and circumstances pertaining in that year. The guidance on using multiple year data in paragraphs 1.49-1.51 of the Guidelines should be applied.

18. Further, some countries apply the limitation under the "relevant business activity" approach by reference to gross profits. Others apply the limitation separately to income and expenses. Some countries apply the profit limitation based on business activity by reference to the combined net profit of the various parts of the enterprise. The first two approaches are likely to produce fewer instances in which the profit limitation would be operative, since the calculation of the limitation would take less account of expenses incurred by other parts of the enterprise.

(ii) The "functionally separate entity" approach

19. The second broad interpretation of the phrase "profits of an enterprise" is referred to as the "functionally separate entity" approach. This approach does not limit the profit attributed to the PE by reference to the profit of the enterprise as a whole or a particular business activity in which the PE has participated and properly applied the approach should reduce the incidence of double taxation. Under this approach, paragraph 1 of Article 7 is interpreted as not affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that, "the right to tax [of the host country] does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment", i.e. there is no "force of attraction" resulting from the existence of a PE (see paragraph 13 above). The profits to be attributed to the PE are the profits that the PE would have earned at arm's length as if it were a "distinct and separate" enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under Article 7(2). This is discussed in detail in Section C below.

20. One key issue in understanding the above approaches relates to the time when profits can be attributed to the PE by the host country. As stated in paragraph 15 of the Commentary on Article 7, "Many States consider that there is a realisation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State". The "functionally separate entity" approach permits profits to be attributed to the PE, even though no profit has yet been realised by the enterprise as a whole, for example when the PE finishes manufacturing goods and transfers them to another part of the enterprise for distribution or assembly. On

the other hand, the "relevant business activity" approach has generally not regarded profits as being attributable to the PE until profits have been realised by the enterprise as a whole from transactions with other enterprises. A transfer of an asset may result in double or less than single, taxation where the host and home country take different approaches to the question of whether profit can be attributed in respect of that transfer.

21. Another key issue to understanding the above approaches, and which potentially gives rise to double taxation, relates to how the profits to be attributed to the PE are computed. The ways of computing profits may differ because the "functionally separate entity" approach is likely to take as its starting point the dealings of the PE (including those with other parts of the enterprise of which it is a part), whilst the "relevant business activity" approach is likely to take as its starting point the dealings of the enterprise as a whole in respect of that business activity. In situations where, under the "relevant business activity" approach, there are "profits of the enterprise" to attribute that are at least equal to the quantum of profits computed under the "functionally separate entity" approach, there should, in theory, be no difference to the profits attributed to the PE under either approach. This is because under Article 7(2), the arm's length principle should be applied in the same rigorous manner to both approaches. However, where the home and host country use different ways of computing profits there may be an increased risk of double, or less than single, taxation in practice, if not in theory.

(iii) Conclusion

22. In summary, two broad interpretations of Article 7, paragraph 1, are currently used by Member countries[3]. Despite the fact that the different approaches may produce a similar result in a number of cases, the current lack of consensus is unsatisfactory as it results in a real risk of double, or less than single, taxation, especially in cases where one jurisdiction uses the "functionally separate entity" approach and the other jurisdiction uses the "relevant business activity" approach. Modern business practice and the development of global trading and electronic commerce may make such cases likely to occur with increasing frequency.

23. Of the Member countries that follow the "relevant business activity" approach, most believe that approach is required by Article 7**,** paragraph 1, given the precise language used in the OECD Model Tax Convention, but that the "functionally separate entity" approach would be preferred if there were more explicit support for it in the Commentary of Article 7. These countries believe that the "functionally separate entity" approach would be preferred because it is simpler, more administrable, and more consistent with the understanding of the arm's length principle as applied in the context of Article 9.

---

3. It is noted for information that the Member countries of the Working Party have also considered two other possible interpretations of the phrase "profits of an enterprise", even though these other interpretations have not been used in practice. The first interpretation is that the phrase "profits of the enterprise" refers to the total net profits of the enterprise as a whole. Under this approach, the PE could not have a profit attributed to it in excess of the total *net* profits of the enterprise of which it is a part. Such an interpretation has no regard to the possibility that the total net profits may have been reduced due to losses from activities completely unrelated to the activities of the PE.

The second interpretation would define "profits of the enterprise" as the enterprise's total gross profit. Under this approach, the PE could not have a profit attributed to it in excess of the total *gross* profits of the enterprise of which it is a part. Such an approach suffers from the same problem identified in the preceding paragraph, although to a lesser extent because the limitation is applied at the level of gross, and not net, profit. In short, both approaches were rejected as not being supported by the language of Article 7, and not achieving a result consistent with sound tax policy.

24. From the perspective of simplicity, the “functionally separate entity” approach is preferred because (force of attraction considerations aside), it does not impose any profit limitation on the profits attributable to the PE that might affect the determination of the profits attributable to the PE in accordance with the arm’s length principle under Article 7(2).

25. From the perspective of administrability, the “functionally separate entity” approach is preferred because it does not require the host country to try and determine the enterprise’s world-wide profits from the relevant business activity (except where a profit split method is applied). Furthermore, the “functionally separate entity” approach avoids the need to revisit the assessment when the period of years has elapsed during which it is necessary to consider the performance or non-performance of the “relevant business activity”.

26. The “functionally separate entity” approach may not be more administrable in all cases. The amount of information required under the “relevant business activity” approach may not be too burdensome if a narrow definition of the “relative business activity” is adopted or the approach is applied in the context of an APA under the Mutual Agreement Procedure.

27. From the perspective of consistency, the “functionally separate entity” approach is preferred because it mirrors the type of analysis that would be undertaken if the PE were a legally distinct and separate enterprise. Further, it is more likely to produce a profit attribution in respect of a particular business activity, which is neutral as to whether the activity is carried on by a resident or a non-resident enterprise.

28. Paragraph 4 of this report identified the need to establish a consensus position as to “the preferred approach to attributing profit to a PE under Article 7”. To achieve this goal it is necessary to choose, for the purpose of testing the WH, one of the two approaches described above. After considering the expected merits of both approaches, the Working Party has decided, on balance, to adopt the “functionally separate entity” approach as the authorised OECD approach or the preferred interpretation of paragraph 1 of Article 7. In addition, there was wide support for the “functionally separate entity” approach from the public comments and the consultation.

29. Accordingly, the authorised OECD approach is that the 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 legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm’s length principle under Article 7(2). The phrase “profits of an enterprise” in Article 7(1) should not be interpreted as affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that “the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment” (i.e. there should be no “force of attraction principle”).

B-2 Symmetrical application of the authorised OECD approach

30. The concept of symmetry has a number of meanings in the context of the attribution of profits to a PE in a manner which does not give rise to double taxation and it is important to be clear about which issues are addressed by the authorised OECD approach and which are not. A number of issues related to the interaction of Article 7 and Article 23, such as differences in host and home country computations of taxable profits, e.g. due to different rules on deductibility of expense, details in domestic rules for giving relief by way of credit or exemptions etc., predate the development of the authorised OECD approach and are unaffected by it.

31. The authorised OECD approach does, on the other hand, directly address the problems created by the current lack of consensus on the fundamental approach to applying the arm's length principle (i.e. whether to apply a "functionally separate entity" approach or a "relevant business activity" approach) by definitively deciding upon the "functionally separate entity" approach. One consequence of the authorised OECD approach is that "the functionally separate entity" approach is used irrespective of whether a country is the host country or the home country, or whether it gives relief from double taxation by exemption or credit methods. The development under the authorised OECD approach of a common interpretation of Article 7 should reduce the incidence of double taxation by reducing one common cause of double taxation, i.e. differences in the way countries compute the quantum of profit to be attributed to a PE under the arm's length principle. The development of the authorised OECD approach therefore represents a clear improvement over the existing situation, even if it does not address all issues.

(i) Issues addressed by the authorised OECD approach- the symmetrical application of the arm's length principle under Article 7

32. The existing Commentary on Article 7 describes symmetrical preparation of the PE accounts by the taxpayer as a necessary, but not sufficient, condition for the accounts to be accepted by tax administrations. Symmetrical preparation of accounts means that "the values of transactions or the ***methods*** (emphasis added) of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office" (paragraph 12.1).

33. Taxpayers who prepared symmetrical accounts in the way recommended by the Commentary were in the past exposed to the risk of double taxation in situations where the host country applied one method of attributing profits, say, the "relevant business activity approach" and the home country applied the "functionally separate entity" approach. Under the authorised OECD approach taxpayers who produce symmetrical accounts applying the functionally separate entity approach (along with the other steps of the authorised OECD approach, including the attribution of capital) should, in principle, be able to satisfy both tax administrations that an arm's length amount of profits have been attributed to the PE.

34. There are, however, a number of issues that need to be addressed in order to achieve the goal of a symmetrical application of the arm's length principle under Article 7. Article 7, and hence the authorised OECD approach, does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. In order to comply with Article 7(2), it is not necessary for the domestic law of the host country to expressly incorporate the arm's length principle – although this is the course taken by some countries' laws. Rather, the domestic law of a host jurisdiction may be phrased in different terms, and adopt different mechanical rules, so long as it is recognised that if these domestic rules result in an excessive attribution of profit, as compared to what may be justified under the arm's length principle of Article 7(2), then the Article 7(2) limit prevails. The exact way in which the Article 7(2) limitation applies depends on the interaction between domestic and treaty law in the host country. For example, in some countries the treaty position overrides the country's domestic rules through the Competent Authority mechanism. Other countries allow the taxpayer to file a treaty authorised approach in the tax return which differs from the domestic approach without reference to the Competent Authority process.

35. The interaction of the treaty and domestic rules is particularly important in addressing the fact that the authorised OECD approach permits more than one approach for attributing capital to a PE as consistent with the arm's length principle, whilst the domestic rules of many countries recognise only one method as discussed in Section C-2 (v)(c). Concern has been expressed that problems might arise where the host country's domestic rules prescribe one of the authorised approaches for attributing capital and the

domestic rules of the home country prescribe another approach. The main concern is that where the domestic rules of home and host countries require different authorised approaches for attributing an arm's length amount of capital to the PE, the home country may not give relief for tax on profits calculated under the host country approach. Taxpayers have also expressed concerns about the administrative burden of routinely re-computing the PE's capital under the home country rules.

36. However, a solution to the problem of two countries applying different approaches to capital attribution both of which are in accordance with the Convention can be found in the existing Commentary to Article 23 under the heading Conflicts of qualification (paragraphs 32.1-32.7). In cases where the home country and the host country treat the same item differently for the purposes of the convention, Article 23 obliges the home state to give relief (by credit or exemption as the case may be, and subject to domestic limitations) in relation to profit which has been attributed to the host state "in accordance with the provisions of the convention". This means that where the domestic rules of the host country are in accordance with the convention then the home state must give relief on that basis, notwithstanding the fact that its own domestic rules (even if in accordance with the provisions of the convention) treat the item differently.

37. In the context of the authorised OECD approach, which permits more than one approach to attributing capital to PEs, this means that any domestic host country rule that is consistent with one or more of these authorised approaches attributes profits to the permanent establishment in accordance with the provisions of the convention, provided the result in the particular case is consistent with the arm's length principle, i.e. that the approach attributes an amount of capital to the PE in a manner that is consistent with the discussion in section C-2 (v). It follows that in such circumstances the home country should give relief for tax on profits calculated under the host country basis. This is the case even where the home country has a domestic rule which attributes capital in accordance with another of the authorised approaches.

38. In short, when giving double taxation relief, the home country will accept that the tax imposed by the host country is in accordance with the convention if the host country has used an authorised approach, unless that approach does not give a result in accordance with the arm's length principle in the particular case. However, as in the case of any other tax that is imposed by a host country, the relief provided by the home country may be subject to domestic limitations.

39. The above principle is intended to provide taxpayers with certainty and to minimise the risk of double taxation in a cost efficient way by avoiding the need to routinely invoke the Mutual Agreement Procedure where host and home country have different authorised approaches to capital attribution. However, as in transfer pricing in general, tax administrations may disagree with taxpayers, and with each other, over whether a particular approach produces an arm's length result in particular circumstances. The attribution of capital to a PE gives rise to extremely complex issues and it is not reasonable or realistic to expect the authorised OECD approach to produce a solution which eliminates entirely the scope for dispute.

40. Where the result of the authorised host country approach to attributing capital does not appear to the home country to be consistent with the arm's length principle, the home country may adjust the results using the host country approach or may apply another of the authorised approaches in order to adjust the amount of capital attributed to the PE, and hence the profits qualifying for double taxation relief, to an arm's length amount. Where the tax administrations disagree over whether a particular authorised approach to the attribution of capital gives rise to an arm's length result in particular circumstances the Mutual Agreement Procedure is available to resolve those differences.

41. It is worth recalling at this point that the Mutual Agreement Procedure does not necessarily involve negotiations between two administrations. Article 25 (2) requires the Competent Authority to enter

into negotiations with the other Competent Authority "when it is *not itself* able to arrive at a satisfactory solution" (emphasis added). Different countries may have different preferences for authorised approaches to capital attribution, but there is consensus among tax administrations, notwithstanding any domestic rules on capital attribution, that there may be circumstances where their preferred domestic approach gives a result that is not consistent with the arm's length principle. In such circumstances it is open to the Competent Authority of one of the Contracting States to resolve the case without reference to the other Competent Authority.

42. Similarly, as with transfer pricing in general, the authorised OECD approach cannot eliminate entirely the scope for tax administrations to disagree on other components in the attribution of profits to a PE, for example the price at which goods are transferred from one part of the enterprise to another. Symmetrical application of the authorised OECD approach does not mean, of course, that the home country must automatically give relief based on whatever price the host country chooses to assign to a transaction. There is still a requirement under the authorised OECD approach for host countries to attribute profits to the PE in accordance with the arm's length principle.

43. Where the tax administrations of home and host countries disagree over the price of a dealing double taxation may occur, just as it would if the administrations disagreed over the price of transactions between associated enterprises. In such circumstances the Mutual Agreement Procedure would be available to resolve the dispute, just as it would be to resolve similar disputes arising from adjustments to transactions between associated enterprises. As with any Mutual Agreement Procedure the resolution may involve withdrawal of the host country administration's adjustment if it proves not to be in accordance with the arm's length principle. One test of the appropriateness of the host country's method for determining the profits of the PE might be whether it gives a sensible result for the profits of the rest of the enterprise, taking into account the differences between the way in which the home and host countries measure tax profits.

44. Finally, it is worth noting that the symmetrical application of the authorised OECD approach should in *principle* mean that in any given year the aggregate profits attributed to the head office and its PEs should equal the profits of the enterprise in that year, assuming that the accounting and tax rules of the home country and any host countries are identical.. Where an enterprise with a single PE other than the head office makes a profit of, say 15, and the profits properly attributed to the PE by the host country under the authorised OECD approach are 30, it would follow in theory that the profit attributed to the head office would be a loss of 15 (so that the aggregate profits of PE and head office equal the enterprise profit of 15) However, in practice it is unlikely that there would be identical tax and accounting rules in the home and host countries so some measure of asymmetry within a single accounting period is inevitable. Where, asymmetry arises (other than for accounting or other differences which are not treaty issues) the Mutual Agreement Procedure, as previously noted, would be available to resolve any significant initial divergence that did arise, just as it is for resolving disputes that arise on applying Article 9 to transactions between associated enterprises.

(ii) Issues not addressed by authorised OECD approach

45. Symmetrical application of the authorised OECD approach means symmetrical application of the arm's length principle to the attribution of profits to a PE for the purposes of both home and host country tax administrations. However, it is recognised that there are issues other than the symmetrical application of the arm's length principle that may give rise to double taxation. Moreover, there are limitations on the ability of countries to eliminate double taxation in certain situations, even through the Mutual Agreement

Procedure. These limitations are not created by the authorised OECD approach, but predate its development and result from fundamental issues concerning the scope and interpretation of tax treaties[4].

46. One limitation concerns how countries define the term "profits". There is no definition of this term in Article 7 (7) (see paragraph 32 of the Commentary) and so the host country may apply the relevant definition found in its domestic law. For the purposes of eliminating double taxation under Article 23 of the OECD Model Tax Convention, the home country would compute profits according to the definition found in its domestic law. This may well differ from the amount of profits attributed by the host country (see paragraphs 39-41 and 62 of the Commentary on Article 23). The host and home countries may apply different rates of depreciation on assets. For example, if the host country applies a lower rate of depreciation to capital assets than the home country then the profits attributed to the PE may (because of the smaller depreciation) exceed the PE profits as recognised in the accounts of the enterprise as a whole. In that year the aggregate profits attributable in the PE and the home country will exceed the actual profits of the enterprise (as they would also in the case of transfers of inventory from a manufacturing part of the enterprise to another part of the enterprise that are not sold in the same year). Taking all years together these timing differences should in principle disappear with the result that in aggregate the profits attributable to the home country and the PE should equal the profits recognised in the enterprise as a whole.

47. However, there may also be more permanent differences between the way host and home country define profits, for example the host country may not give a deduction for entertaining expenses where the home country does. In these circumstances the difference will not of course disappear over time. However, such differences between countries' rules for calculating taxable profits are outside the scope of tax treaties, and in particular are outside the scope of Articles 7 and 9. Accordingly the issue of taxation not in accordance with the treaty does not arise from such differences and there is no requirement for countries to resolve such differences.

48. In short, the problem for PEs is that the elimination of double taxation (by credit or exemption) depends not just on a common interpretation of the attribution of profit rules under the arm's length principle of Article 7 but also on the interaction between the domestic laws of the home country for relieving double taxation and Article 23 of the OECD Model Tax Convention. Remedying this situation would require changes to countries' domestic law on double taxation relief, and possibly changes to Article 23, and so is beyond the scope of this Report.

C. Interpretation of paragraph 2 of Article 7: Determining the profits attributable to the Permanent Establishment

49. Paragraph 2 of Article 7 provides that, "subject to the provisions of paragraph 3" of Article 7, the profits to be attributed to a PE are:

> "the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

4 . The Joint Working Group on Dispute Resolution is looking at the issues relating to the scope and purpose of the Mutual Agreement Procedure"

50. This language has its origins in the draft convention adopted by the League of Nations in 1932/33 and can be considered the statement of the arm's length principle in the context of PEs. Paragraph 11 of the Commentary on Article 7 indicates that this language "corresponds to the "arm's length principle" discussed in the Commentary on Article 9." The Guidelines issued in 1995, contain a detailed analysis of how to apply the arm's length principle under Article 9 in the context of an MNE group. This guidance is more recent than the latest changes made to the Commentary concerning the application of the arm's length principle under Article 7.

51. Accordingly, the Working Party formulated the authorised OECD approach on the premise that the guidance on the application of the arm's length principle of Article 9 given by the Guidelines should be applied to the attribution of profit to a PE using the arm's length principle under Article 7(2). The Working Party has tested the authorised OECD approach in a number of factual situations and business sectors to examine whether this premise should be adopted as the standard for attributing profit under Article 7(2).

52. However, apart from the issues already discussed in Part B in relation to paragraph 1 of Article 7, there are two further issues that warrant attention under Article 7 as distinguished from Article 9.

(1) For the purposes of Article 7, it is necessary to postulate the PE as a hypothetical enterprise that is distinct and separate from the enterprise of which it is a PE, whereas in an Article 9 case the enterprises being examined are actually legally distinct and separate; and

(2) One of the two common interpretations of paragraph 3 of Article 7 would modify the arm's length principle as regards the quantum of expenses to be allowed as deductions when attributing profit to a PE, as discussed in Part D below.

53. To reflect the above issues, the authorised OECD approach is to apply the guidance given in the Guidelines not directly but by analogy. This Report discusses how and to what extent the guidance in the Guidelines can be applied, by analogy, to attribute profits to a PE and how to adapt and supplement that guidance to take into account factual differences between a PE and a legally distinct and separate enterprise.

54. The interpretation of Article 7(2) under the authorised OECD approach is that a two-step analysis is required. First, a functional and factual analysis in order to appropriately hypothesise the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, using assets, and assuming risks. Second, an analysis of the Guidelines relevant to applying the arm's length principle to the hypothesised enterprises so undertaking functions, using assets, and assuming risks. Section C-2 below discusses the factual and functional analysis and the attribution of functions, assets, risks and "free" capital to the PE. Section C-3 below discusses the attribution of profits to the PE in accordance with its functions, assets used and risks assumed by comparison to independent enterprises performing the same or similar functions, using the same or similar assets and assuming the same or similar risks. By way of introduction, an outline of the basic principles to be used is set out below.

C-1 Basic principles used to attribute profits to a PE

This Section provides an introduction to the basic principles of the authorised OECD approach. The basic principles described below are discussed in more detail in the rest of the Report.

Basic premise of the authorised OECD approach

55. The authorised OECD approach seeks to postulate the PE as a hypothesised distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and to attribute

profits to the PE under Article 7, using the guidance on the application of the arm's length principle of Article 9 given by the OECD Transfer Pricing Guidelines, by applying these Guidelines by analogy and, where required, by adapting and supplementing these Guidelines to take into account factual differences between a PE and a legally distinct and separate enterprise. In this context, it should be noted that the aim of the authorised OECD approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. There are generally economic differences between using a subsidiary and a PE. Application of the authorised OECD approach should achieve equality of treatment between different types of PE, but will not achieve equality of outcome between subsidiaries and PEs where there are economic differences between them. The legal form chosen, PE or subsidiary, may have some economic effects that should be reflected in the determination of taxable profits. Thus, it might be expected that business done through PEs is actually more profitable because of the possibilities of efficient capital utilisation, risk diversification, economies of scale etc.

Functional and factual Analysis

56. In the context of the authorised OECD approach the functional and factual analysis is used to delineate the PE as a hypothesised distinct and separate enterprise, and determines the functions (i.e. activities) of this hypothesised distinct and separate enterprise and the conditions (i.e. economically relevant characteristics) relating to the performance of those functions, based on the Guidance on comparability in the Guidelines applied by analogy. The functional analysis will also take into account the assets used and risks assumed as a result of performing those functions. Of particular importance will be the determination of the key entrepreneurial risk-taking functions of the enterprise and the extent to which the PE undertakes one or more of those functions as this has consequences for the attribution of assets and risks as discussed below. The key entrepreneurial risk-taking functions will vary from business sector to business sector (e.g. the key entrepreneurial risk taking functions for an oil extraction company and a bank are unlikely to be the same) and from enterprise to enterprise within sectors (not all oil extraction companies or all banks are the same). Further, it should be stressed that a particular business may have one or more key entrepreneurial risk taking functions, each of which has to be taken into account. Clearly the determination should be on a case-by-case basis as the key entrepreneurial risk-taking functions and their relative importance will depend on the particular facts and circumstances. In addition to the key entrepreneurial risk taking functions, it will also be important to reward other functions in accordance with the arm's length principle. In short, the functional and factual analysis determines the attribution of profits to the PE in accordance with its functions performed, assets used and risks assumed, and informs also the attribution of free capital and interest bearing debt to the PE.

57. The factual and functional analysis is of critical importance. In attributing profits to a PE it is not sufficient to prepare symmetrically balanced books attributing profits in the books of the PE that correspond exactly to the values used in the books of the head office. Book entries must be consistent with, and follow from, the factual and functional analysis. Where this is the case**,** the books provide the starting point for determining the profits attributable to the PE.

Attribution of assets

58. The functional and factual analysis will examine all the facts and circumstances to determine the extent to which the assets of the enterprise are used in the functions performed by the PE and the conditions under which the assets are used, including the factors to be taken into account to determine which part of the enterprise is regarded as the economic owner of the assets. This analysis will attribute assets to the PE and determine whether the assets are created by the activities of the enterprise itself or acquired from another enterprise. The attribution of assets and their classification will have consequences for both the attribution of profit and the attribution of capital and interest bearing debt to the PE. The

attribution of tangible and intangible assets is based upon economic ownership as determined by a functional and factual analysis of both parts of the enterprise involved in the dealing, focussing on the key entrepreneurial risk-taking functions in respect of those assets.._The part of the enterprise attributed the asset will also be attributed any associated profit (taking into account any dealings at arm's length to reward other parts of the enterprise for functions performed in relation to that asset).

Attribution of risks

59. The functional and factual analysis will attribute to the PE any risks inherent in, or created by, the PEs' own functions, and take into account any subsequent dealings related to the subsequent transfer of risks or to the transfer of the management of those risks to different parts of the enterprise. The attribution and measurement of risk is an important part of the functional and factual analysis since the presence of risk impacts upon both the attribution of profits and the attribution of capital to the PE. Since capital follows risks, the economic owner would be attributed the capital necessary to support the associated risks. Depending on the nature of the enterprise's business, risk may either be intimately linked to assets attributed to the PE or it may not be so closely linked to the existence of assets. The attribution of risk is particularly important in the financial sector where it has a substantial impact on the attribution of both capital and income and expenses to the PE, but it can also be important in other businesses. The financial sector, because of the nature of its business, has very sophisticated risk measurement tools. Outside the financial sector it will often be more difficult to measure risk, but it will still be necessary to try and measure significant risks, for example those arising from the development of unique intangible property. The substance of the assumption of risks by each part of the enterprise depends on the actual performance of, or risk management of, the key functions associated with the activity.

Attribution of capital

60. The functional and factual analysis will attribute free capital (i.e. funding that does not give rise to a tax deductible return) to the PE for tax purposes, to ensure an arm's length attribution of profits to the PE. The factual starting point for the attribution of capital is that under the arm's length principle a PE should have sufficient capital to support the functions it undertakes, the assets it uses and the risks it assumes. In the financial sector regulations stipulate minimum levels of capital to provide a cushion in the event that risks inherent in the business crystallise into financial loss. Capital provides a similar cushion against crystallisation of risk in non-financial sectors. The PE must have equity capital to act as a cushion, that is funds subordinated to the rights of all creditors (including loan creditors) and placed at the disposal of the business by investors who are prepared to accept higher levels of risk in respect of their investment in exchange for an economic return which is expected to be significantly higher than the risk-free rate.

61. A key distinction between a separate legal enterprise and a PE is that one legal enterprise can enter into a legally binding agreement to guarantee all the risks assumed as a result of the functions performed by another legal enterprise. For such a guarantee to have substance, the capital needed to support the risks assumed would reside in a different legal enterprise from that in which the transactions giving rise to the risks are booked. In contrast one of the key factual conditions of an enterprise trading through a PE is that the capital and risks are not segregated from each other within a single legal enterprise. To attempt to do so for tax purposes would contradict the factual situation and would not be consistent with the authorised OECD approach. Capital must be regarded as following risks. In other words, capital is to be attributed to a PE by reference to the risks arising from its activities and not the other way round.

62. This attribution of capital should be carried out in accordance with the arm's length principle to ensure that a fair and appropriate amount of profits is allocated to the PE. The purpose of the attribution is to inform the attribution of profits to the PE under Article 7(2). The Report describes a number of different possible approaches for applying that principle in practice, recognising that the attribution of capital to a

PE is not an exact science, and that any particular facts and circumstances are likely to give rise to a range of arm's length results for the capital attributable to a PE, not a single figure. There is a common premise to the authorised approaches to attributing capital, that an internal condition of the PE is that the creditworthiness of the PE is generally the same as the enterprise of which it is a part.

63. The authorised OECD approach recognises a range of acceptable approaches for attributing capital that are capable of giving an arm's length result, each with their own strengths and weaknesses, which become more or less material depending on the facts and circumstances of particular cases. Different methods adopt different starting points for determining the amount of capital attributable to a PE, which either put more emphasis on the actual structure of the enterprise of which the PE is a part or alternatively, on the capital structures of comparable independent enterprises. The key to attributing capital is to recognise:

- The existence of strengths and weaknesses in any approach and when these are likely to be present (discussed in more detail in Section C-2 (v) (c)).

- That there is no single arm's length amount of capital, but a range of potential capital attributions within which it is possible to find an amount of capital that can meet the basic principle set out above.[5]

Funding costs:

64. The PE requires a certain amount of funding, made up of free capital and interest bearing debt. The objective is to attribute an arm's length amount of interest to the PE, commensurate with the functions, assets and risks attributed, using one of the authorised approaches to attributing capital. These issues are discussed in more detail in Section C-2 (v) (d).

Recognition of dealings

65. There are a number of aspects to the recognition (or not) of dealings between a PE and the rest of the enterprise of which it is a part. First, a PE is not the same as a subsidiary, and is not in fact legally or economically separate from the rest of the enterprise of which it is a part. It follows that:

- Save in exceptional circumstances, all parts of the enterprise have the same creditworthiness. This means that dealings between a PE and the rest of the enterprise of which it is a part should be priced on the basis that both share the same creditworthiness; and

- There is no scope for the rest of the enterprise guaranteeing the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise.

66. Second, dealings between a PE and the rest of the enterprise of which it is a part normally have no legal consequences for the enterprise as a whole. This increases the scope for tax motivated transfers between the two and also acts to reduce the usefulness of any documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist. It therefore implies a need for greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions

5 Section B.2 on the symmetrical application of the authorised OECD approach discusses the interaction between the host and home country rules and describes how the incidence of double taxation can be reduced.

between two associated enterprises and places the onus on the taxpayer to be able to demonstrate clearly that it would be appropriate to recognise the dealing.

67. This greater scrutiny means a threshold needs to be passed before a dealing is accepted as equivalent to a transaction that would have taken place between independent enterprises acting at arm's length. Only once that threshold is passed can a dealing be reflected in the attribution of profits under Article 7(2). A functional and factual analysis will determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and another part of the enterprise. An accounting record and contemporaneous documentation showing a "dealing" that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits, but would not be determinative where it was found to be inconsistent with the functional and factual analysis and therefore the economic reality of the dealing.

68. Dealings undertaken between the PE and another part of the enterprise (as structured by them) will be compared with transactions between independent enterprises, following, by analogy, the comparability analysis described in the Guidelines. Even transactions between associated enterprises may not be recognised where they do not take place under the normal commercial conditions that would apply between independent enterprises (see 1.38 of the Guidelines which discusses the circumstances in which transactions between associated enterprises would not be recognised or would be restructured in accordance with economic and commercial reality).

69. Third, where dealings are capable of being recognised, they should be priced on an arm's length basis, assuming the PE and the rest of the enterprise of which it is a part to be independent of one another. This should be done by analogy, with the Guidelines, following a factual and functional analysis.

Attribution of profits

70. The attribution of profits to a PE of an enterprise on an arm's length basis will follow from:

- The attribution of functions, assets and risks between it and the rest of the enterprise of which it is a part based on a functional and factual analysis, taking account of the dealings that can appropriately be recognised.

- The attribution of capital based on the assets and risks attributed to the PE.

- The pricing on an arm's length basis of dealings that can appropriately be recognised, having passed the threshold test.

- The recognition of transactions between the enterprise and independent third parties that are attributed to the PE (subject to, for example, any displacement of third party borrowings as a result of the attribution of capital to the PE's assets and risk).

- The determination of comparability between dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, functional analysis, economic circumstances and business strategies) or by analogy (contractual terms) in light of the particular factual circumstances of the PE; and

- The determination of an arm's length compensation for the functions that the PE performs, taking into account the assets and risks attributed to the PE, achieved by applying by analogy the Guidelines' traditional transactions methods, or, where such methods cannot be applied reliably, the transactional profit methods.

71. The authorised OECD approach, does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. Accordingly, the 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 legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the Guidelines by analogy. This is in line with one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises in respect of their activities (having regards to assets used and risks assumed) in the source jurisdiction. In addition, the authorised OECD approach is not designed to prevent the application of any domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets or risks. Finally, where their domestic law does not recognise loss transactions in certain circumstances between associated enterprises, countries may consider that the authorised OECD approach would not require the recognition of an analogous dealing in order to determine the profits of a PE.

C-2 First step: Determining the activities and conditions of the hypothesised distinct and separate enterprise

72. In accordance with Article 7(2), the first step of the authorised OECD approach is to hypothesise the PE as a distinct and separate enterprise "engaged in the same or similar activities under the same or similar conditions". The approach of the Guidelines in linking the earning of profit to the performance of "functions" would appear to be capable of being applied in the PE context by equating "functions" to "activities".

73. Further, the guidance on comparability at paragraph 1.15 of the Guidelines equates "conditions" with "economically relevant characteristics". There is also an obvious similarity between the concept of "same or similar" and the concept of "comparability" discussed in Chapter I of the Guidelines. As noted by paragraph 1.17, "it is necessary to compare attributes of the *transactions or enterprises* (emphasis added) that would affect conditions in arm's length dealings." In the PE context, some of the "conditions" of the PE as a hypothesised distinct and separate enterprise will be derived from a functional and factual analysis of the internal attributes of the enterprise itself ("internal conditions"), whilst other "conditions" will be derived from a functional and factual analysis of the external environment in which the functions of the PE are performed ("external conditions"). It is therefore necessary in the first step of the authorised OECD approach to analyse not only the functions of the hypothesised distinct and separate enterprise but also the "conditions" under which those functions are performed. Unless stated otherwise in the text, the term "conditions" refers to both "internal" and "external" conditions.

74. In short, the first step of the authorised OECD approach will apply a functional and factual analysis to the PE (based on the guidance in Chapter 1 of the Guidelines) in order to determine the functions of the hypothesised distinct and separate enterprise and the economically relevant characteristics (both "internal" and "external" conditions) relating to the performance of those functions.

(i) Functions (activities)

75. Chapter I of the Guidelines provides a considerable amount of detail about functional analysis and its application. The Guidelines at 1.20 state that a functional analysis "seeks to identify and compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises." In the PE context, the functional analysis will be initially applied to the hypothesised distinct and separate enterprise and the rest of the enterprise of which it is a part in order to determine what economically significant activities and responsibilities are undertaken by the PE and how they relate to the activities and responsibilities of the enterprise as a whole. The functional

analysis must also determine which of the identified activities and responsibilities of the enterprise are associated with the PE, and to what extent. Where the PE is created through a fixed place of business within the meaning of Article 5(1), the determination of which activities and responsibilities of the enterprise are associated with the PE should be determined from an analysis of the "fixed place" that constitutes the PE and the functions performed at that "fixed place". Where there is a PE by virtue of Article 5(5) of the OECD Model Tax Convention (a " dependent agent PE"), the functional analysis would have to take into account any functions undertaken by the agent on behalf of the enterprise. This issue is discussed in more detail in section C-3(v) below.

76. The guidance in the Guidelines on functional analysis seems capable of being applied fairly directly in the PE context in order to determine the "activities" of the hypothesised distinct and separate enterprise. The main difficulties are with determining how to take into account assets used and risks assumed. These are discussed later in this section. However, the guidance on comparability cannot be applied directly in the PE context and needs to be applied by analogy. This is because the guidance in the Guidelines is based on a comparison of the conditions of controlled and uncontrolled transactions. However, what is needed in the first step of the authorised OECD approach is a functional and factual analysis of all the economically relevant characteristics ("conditions") relating to the PE so as to ensure that the "distinct and separate" enterprise is appropriately hypothesised to be engaged in "comparable" activities under "comparable" conditions to the PE.

77. The functional and factual analysis takes account of the functions performed by the personnel of the enterprise as a whole including the PE –"people functions" – and assesses what significance if any they have in generating the profits of the business. People functions can range from the routine to the key entrepreneurial risk-taking functions of the business. The latter are those which require active decision making with regard to the most important profit generators of the business and so it will be particularly important for these to be identified under the functional analysis. Part II of the Report deals with the significance of people functions in the financial sector, but whilst people functions may be less critical in generating profits in some types of non-financial sector businesses, they may be important in certain non-financial enterprises, where for example the creation of valuable intangibles is a key profit driver.

78. The guidance on comparability in Chapter I of the Guidelines identifies a number of factors in addition to a functional analysis which may have to be taken into account when undertaking a comparison of conditions:- characteristics of property or services, contractual terms, economic circumstances and business strategies. By analogy, such factors should also be considered when undertaking the factual and functional analysis to determine the "conditions" of the hypothesised distinct and separate enterprise and to ensure that they are "same or similar" to those of the PE. So under the authorised OECD approach, care needs to be taken to ensure that the attribution of profit takes into account the conditions of the enterprise to the extent those conditions are relevant to the performance of the PE's functions.

79. In the distributor example at paragraph 15 above, a full functional and factual analysis of the distribution function would be undertaken under the first step of the authorised OECD approach. This would determine the economically relevant characteristics relevant to the performance of the distribution function by the PE, for example, the identification of a business strategy such as a market penetration scheme. It would be important to identify any business strategy in order to undertake properly the comparability analysis under the second step of the authorised OECD approach between the dealings between the PE and the rest of the enterprise of which it is part and transactions between independent enterprises. Such a "condition" might explain why in the example at paragraph 15 above, it may be appropriate to attribute a loss to B but not to A, for example because the enterprise as a new entrant to the market in B has been carrying out a market penetration scheme.

80. In many cases, all the activities necessary to carry on the business through a fixed place take place within the PE's host country. For example, the PE may act as a distributor and carry on all the associated activities, including market research, in its jurisdiction. However, it is important that the functional analysis includes not just activities taking place in the jurisdiction of the PE, but all activities performed on behalf of the PE and all activities performed by the PE on behalf of other parts of the enterprise. In another case, a functional analysis may show that some activities necessary to carry out the distribution function, say market research, are performed in a different jurisdiction. Such activities will have to be taken into account when attributing profit to the PE, although the exact manner of doing so will depend on an analysis of the facts and circumstances.

81. The functional and factual analysis needs to be carried out in a thorough and detailed manner in order to establish the exact nature of the function being performed. This is because where the functional analysis has determined that the PE has performed the key entrepreneurial risk-taking functions, the PE will be attributed the assets and risks associated with those functions. This in turn leads to the attribution to the PE of the income and expenses associated with those assets and risks.

82. An interesting issue can arise in an e-commerce operation in circumstances where it is accepted that the location of a server of itself constitutes a PE, as functions may be performed at that location without personnel. Nevertheless, the same principles apply and the functional analysis will determine what automated functions are performed by the server-PE and what assets are used and risks assumed in the performance of those functions. As noted in the draft from the Business Profits TAG released in 2001, the automated and routine nature of the functions means that the assets or risks attributed to the PE are only likely to be those directly associated with the server hardware. A server-PE will not be carrying out any key entrepreneurial risk-taking functions in the absence of personnel.

(ii) Assets used and conditions of use

83. The Guidelines note at paragraph 1.20 that compensation will usually reflect not just functions performed but also the assets used and the risks assumed in performing those functions. The assets may be used in different capacities, e.g. as sole or joint owner, lessee or member of a Cost Contribution Agreement. They may be intangible assets or physical. They may be acquired or created internally by the enterprises own activities. The functional analysis needs to determine all these facts, because the attribution of profits to the PE will depend upon such characteristics.

84. In applying Article 7(2), the facts and circumstances must, in the first instance, be examined in order to determine the extent to which the assets (physical or intangible) of the enterprise are used in the functions performed by the PE. This is because income from third parties will include a return from assets used (whether or not owned) by enterprises to the extent that the assets are used to generate that income, though the profits of an enterprise which owns the asset will be different to the profits of an enterprise which uses an asset owned by someone else and so has to pay for that use. To the extent that assets are used in the functions performed by the PE, the use of those assets should be taken into account in attributing profit to the functions performed by the PE. Assets of the enterprise that are not used by the PE should not be taken into account for the purposes of attributing profits to the PE. The assets attributed may also need to be taken into account in the comparability analysis under the second step of the authorised OECD approach. For example, a business which needs to use expensive plant and machinery would, all things being equal, expect to generate greater profit than a business which did not require the use of such assets.

85. Determining the use of an asset is not however, the end of the matter. Regard has also to be given in the functional analysis as to the conditions under which the asset is used; e.g. as owner, lessee or

member of Cost Contribution Agreement. The capacity in which the PE uses the asset will impact on the amount of profits to be attributed to it. This is because income from third parties will include a return from the assets used by an enterprise to the extent that the assets are used to generate that income, and the amount of that return attributed to the PE varies depending on whether the PE is the owner, lessee or member of a CCA. The part of the enterprise that is the "economic" owner of the asset may or may not be the PE making use of the asset.

86. Determining ownership of the assets used by a PE can present problems not found in separate enterprises where legal agreements can be relied upon to determine ownership. In a PE context, however, the assets owned by the enterprise belong, legally, to the enterprise of which the PE is part. It is therefore necessary to introduce the notion of "economic ownership" in order to appropriately allocate the return from third parties in respect of the asset. In determining the characteristics of the PE for taxation purposes, it is the economic (rather than legal) conditions that are most important because they are likely to have a greater effect on the economic relationships between the various parts of the single legal entity. Economic ownership of an asset, whether physical or intangible, is determined by a functional and factual analysis, and in particular rests upon performance of the key entrepreneurial risk-taking functions in relation to the asset. A discussion of the factors to be taken into account in the determination of the economic ownership of both tangible and intangible assets in a PE context is contained in section C-3 (iv) (a) and (b).

(iii) Risks assumed

87. As regards risk, in the context of a PE and its head office, as contrasted with a parent company and its subsidiary, it is the enterprise as a whole, which legally bears the risk. However, following the analysis of assets, the Working Party likewise concludes that it is possible to treat the PE as assuming risk, even though legally the enterprise as a whole assumes the risk. Indeed, the PE should be considered as assuming any risks inherent in, or created by, the PE's own functions (i.e. for the purpose of the PE), and any risks that relate directly to those activities. For example, the PE should, generally, be treated as assuming the risks arising from negligence of employees engaged in the function performed by the PE. The determination of the risks assumed by the PE has consequences for determining the attribution of capital and the capital adequacy of the PE. This is because an enterprise assuming material additional risks would need to correspondingly increase its capital in order to maintain the same creditworthiness. The capital issue is discussed in general in section C-2. This issue is extremely significant for banks and is discussed in detail in Part II.

88. In the absence of contractual terms between the PE and the rest of the enterprise of which it is a part, determining what assumption of risks should be attributed to the PE will have to be highly fact specific. Following, by analogy, paragraph 1.28 of the Guidelines, the division of risks and responsibilities within the enterprise will have to be, "deduced from their [the parties] conduct and the economic principles that govern relationships between independent enterprises." This deduction may be aided by examining internal practices of the enterprise (e.g. compensation arrangements), by making a comparison with what similar independent enterprises would do and by examining any internal data or documentation purporting to show how that attribution of risk has been made. The extent to which such documentation is determinative is discussed in more detail in Sections C-3 (ii) and C-3 (iv)(d).

89. In summary, to the extent that risks are found to have been assumed by the enterprise as a result of a function performed by the PE, the assumption of those risks should be taken into account when attributing profit to the PE performing that function. If risks are found not to have been assumed by the enterprise as a result of a function performed by the PE, the assumption of those risks should not be taken into account for the purposes of attributing profits to the PE. It should be noted that this discussion of risk only relates to the assumption of risks, inherent in, or created by, the performance of a function. It will be a

separate question (to be dealt with in Section C-3 below) how to take into account any subsequent dealings related to the subsequent transfer of risks (e.g. when an asset and the associated risks are transferred from a PE to another part of the enterprise) or to the transfer of the management of those risks to different parts of the enterprise.

90. The amount and nature of the risks assumed by the PE also impacts upon the amount of capital that needs to be attributed to the PE. This is most clearly seen in the financial sector where regulators may oblige banks to have minimum levels of capital to support the risks to which they are exposed. But the link between risk and capital is also present in non financial sectors. All business activity involves some element of risk, though some are more risky than others. The activities of an enterprise engaged, for example, in cutting-edge biotechnology research will assume risks that will generally require a greater level of "free" capital support, than an enterprise engaged, say, in property investment with blue chip tenancy agreements. Risks associated with the former activity are more likely to result in a differential between income generated and the costs (funding and non-funding) of carrying out the activity. It is the role of free capital to provide a cushion against the crystallisation of risks into actual losses.

(iv) Attributing Credit worthiness to the PE

91. It is an observable condition that permanent establishments generally enjoy the same creditworthiness as the enterprise of which they are a part. Accordingly, under the authorised OECD approach, the "distinct and separate enterprise" hypothesis requires that an appropriate portion of the enterprise's "free" capital be attributed to its PEs for tax purposes and that the PE be attributed the creditworthiness of the enterprise as a whole. It is worth re-emphasising that an attribution of "free" capital in excess of the amounts recorded in or allotted to the PE by the home country may have to be made for tax purposes, even though there may be no need to formally allot "free" capital to the PE for any other purpose.

92. Generally, under the authorised OECD approach, the same creditworthiness is attributed to a PE as is enjoyed by the enterprise as a whole; an exception being where for regulatory reasons the capital attributed to the PE of one jurisdiction is not available to meet liabilities incurred elsewhere in the enterprise. In addition, it was also determined that there is no scope for the rest of the enterprise guaranteeing the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise.

93. It has been suggested that in hypothesising the same creditworthiness throughout the enterprise and not recognising intra-enterprise guarantee payments the authorised OECD approach fails to recognise the fact that the creditworthiness of an enterprise is greater than the sum of its parts; i.e. that the very act of hypothesising the PE as a distinct and separate entity has the effect of degrading the creditworthiness of all parts of the enterprise below that of the enterprise as a whole. Whilst not denying this effect it is not clear why one part of the enterprise, such as the Head Office, would have the higher creditworthiness necessary to enable it to guarantee the transactions undertaken by the PE. The authorised OECD approach is based on the factual situation of the enterprise, which is that the capital, risks etc are fungible, so it would be inconsistent to grant all the benefits of synergy to the Head Office.

94. Secondly, there are factors other than capital such as reputation, profitability, management quality, risk diversification that also affect creditworthiness. Again it is hard to understand why all these factors should be treated as belonging to one part of the enterprise.

95. The authorised OECD approach does not recognise dealings in respect of guarantee fees between the PE and its head office or between the PE and another PE. Guarantee payments between associated

enterprises are recognised in certain circumstances.[6] This has lead some commentators to conclude that the authorised OECD approach discriminates between subsidiaries and PEs by applying transfer pricing principles in different ways. However, it is not the authorised OECD approach that discriminates between the two legal forms. Rather the legal forms have different economic consequences: a PE, except in the circumstances referred to in paragraph 31 of Part II, generally has the same creditworthiness as the enterprise of which it is a part. The same is not necessarily true of a subsidiary and its parent company.

96. Moreover, a key distinction between a separate legal enterprise and a PE is that an enterprise can enter into a legally binding agreement to guarantee the debts of a second enterprise, and third party lenders may take that guarantee into account when assessing the creditworthiness of the second enterprise. For such a guarantee to have substance, the capital needed to support the risks assumed would reside in a separate enterprise from that in which the risk of default occurs. In contrast, one of the key factual conditions of a PE is that capital and risks are not segregated from each other within a single legal enterprise. And if capital is not segregated then there is no basis for guarantee fees. Discrimination arises when taxpayers in the same or similar circumstances are treated differently. For the reasons given above, PEs in their dealings with other parts of the same enterprise in the context of guarantee fees may not be in similar circumstances to a subsidiary.

(v) Capital attribution and funding the operations of the PE

a) Introduction – the importance of "free" capital

97. Enterprises require capital to fund day to day business activities, the cost of creating or acquiring assets (tangible and intangible), and as explained in the previous section to assume the risks associated with an ongoing business (e.g. credit or market risk). Broadly, capital comes from three sources: (1) contributions of equity by shareholders; (2) retained profits (including sometimes reserves, though practices among member countries may vary); and (3) borrowings. Sources (1) and (2) are referred to collectively in this Report as equity capital and source (3) is debt capital. Under tax law, deductions are generally not given for payments made to equity holders, whereas deductions are generally available (subject to thin capitalisation rules etc) for payments of interest or interest equivalents to the holders of debt capital. There may be differences between accounting, regulatory and tax definitions of debt and equity. For example, in the financial sector, certain types of subordinated debt may be treated as debt for accounting purposes, equity for regulatory purposes, and either debt or equity for tax purposes, and the tax classification may vary with jurisdiction. Accordingly within this Report the term "free capital" is defined as an investment which does not give rise to an investment return that is deductible for tax purposes under the rules of the host country of the PE.

98. Because interest expense is generally deductible for tax purposes, it will be necessary to ensure an appropriate attribution of the enterprise's "free" capital to a PE in order to ensure an arm's length attribution of profits to the PE. The impact on non-financial PEs may be significant, since the ratio of free capital to interest bearing debt is generally much higher outside the financial sector. Historically, the attribution of capital has been made difficult by a lack of consensus on a number of key issues related to the capital attribution and funding of a PE. This section analyses the current interpretation of Article 7 in respect of the key issues before going on to describe how the authorised OECD approach applies to attribute capital and funding costs to a PE.

---

6 . see the 1995 Transfer Pricing Guidelines at paragraph 7.13.

b) Current Interpretation of Article 7

99. There are a number of key issues identified in the Commentary on Article 7 that require resolution under the authorised OECD approach. One key issue in attributing capital and funding costs to a PE relates to the treatment of internal movement of funds. The conclusion at paragraph 18.3 of the Commentary is that the "ban on deductions for internal debts and receivables should continue to apply generally, subject to the special problems of banks mentioned below." Paragraph 19 goes on to recognise that "special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises." The current interpretation of this issue is revisited below in Section C-2 (v) (d) dealing with determining the funding costs of the PE.

100. Another key issue to address is how to take the capital of the whole enterprise into account when attributing profit. Paragraph 20 of the 1994 report considers that some internal interest adjustment should be allowed where there is a bilateral agreement that the PE is either over or under capitalised and indicates that:

> "The answer to the question as to whether a permanent establishment is under- or over-capitalised will, in principle, depend on the rules and practice of the host country, unless there is a divergent mutual agreement under Article 25 of the Model Tax Convention".

101. However, a mutual agreement may be difficult to achieve because of the different approaches member countries currently take to attributing the capital of the enterprise as a whole to its constituent parts. This is because the Commentary to Article 7 offers no clear principle or practical guidance as to how to determine whether a PE is appropriately capitalised, thereby making it difficult for the Competent Authorities to form a common view. The rest of this section attempts to remedy this deficiency by setting forth a clear principle and providing practical guidance on how to apply that principle in practice.

c) Principles of the authorised OECD approach

102. Under the authorised OECD approach, the PE is treated as having an appropriate amount of capital in order to support the functions it performs, the assets it uses and the risks it assumes. Under the authorised OECD approach, assets are attributed to a PE based on where the economic ownership of the assets lies and where the risks associated with those assets, or the attempted creation of assets, are assumed. Once the factual and functional analysis has attributed the appropriate assets and risks of the enterprise to the PE based on economic ownership, the next stage in attributing an arm's length amount of profits to the PE is to determine how much of the enterprise's "free" capital is needed to cover those assets and to support the risks assumed. This process involves 2 stages. The first is to measure the risks and value the assets attributed to the PE. The second is to determine the "free" capital needed to support the risks and assets attributed to the PE.

Stage 1 – Measuring the risk and valuing the assets attributed to the PE

103. As noted above, in attributing profits to a PE the authorised OECD approach uses a functional and factual analysis to attribute assets and risks to the PE and it also works on the premise that capital and risk cannot be segregated. It follows that under the authorised OECD approach it is necessary to attribute "free" capital to the PE in accordance with the risks and assets so attributed. Certain financial enterprises are obliged by regulators to measure risks and attribute capital (see Part II sections B-4 (iii) and (iv) for more detail). Enterprises that are not banks or non-bank financial institutions ("non-financial institutions")

are less likely to measure risks and value assets for business purposes on a day to day basis and will not be subject to regulatory requirements requiring them to do so**.**

104. Where enterprises which are non-financial institutions do not measure risks, one possible approach would be to attribute capital to a PE by reference only to the assets attributed to the PE. This is because, for non- financial enterprises, more so than for financial enterprises where the role of capital is to support risk, the capital would primarily be serving a funding purpose and it is the assets that are being funded. There are a number of possible valuation options. One option would be to use the book value of the asset as shown in the accounts for the relevant period. Another option would be to use the market value of assets, either as a matter of course or in cases where there is a significant difference between book and market value.

105. Another option would be to use the original purchase price or cost of the asset. This approach would appear to offer a number of advantages. Firstly, the borrowed amounts would bear a close relation to the historical value of assets funded by the borrowings. Secondly, the approach facilitates a consistent measurement of assets across jurisdictions (in particular where different accounting rules exist to determine the book value of assets) and thirdly it would be simpler to comply with than an approach requiring the periodical determination of the market value of assets. However, the cost approach can produce inappropriate results where, for example, different parts of the enterprise have assets of similar value, but very different costs (because one part of the enterprise bought the asset at a different time when the cost was different). There is no prescribed method for valuing assets but any method used must be used consistently from year to year. Ideally, similar asset classes would be valued in a consistent manner across different parts of the enterprise, whilst recognising that there are practical difficulties in doing so given different domestic laws and/or accounting rules.

106. However, further consideration shows that for non-financial enterprises risks are not necessarily directly correlated to particular assets. It may be the activity putting the assets to use that creates the risk rather than the assets themselves An approach that just used assets to attribute capital would therefore seem unlikely to lead to an arm's length result in situations where significant risks are assumed by the PE; for example where the PE takes on all the risks of developing a marketing intangible but is unsuccessful so no intangible asset is ever produced. Such developmental or entrepreneurial risks were effectively not taken into account when attributing capital to financial enterprises except to the extent that they were recognised by the regulator, on the basis that anything not recognised by the regulator was, in context of financial enterprises relatively insignificant compared to the other types of risk assumed by financial institutions. However such risks may be more significant in some non financial businesses, and where this is the case it would be appropriate to recognise that more "free" capital would need to be attributed to support this entrepreneurial risk.

107. Significant risk in the context of a non financial business means risks which would be regarded as requiring capital by the market in which the PE operates. For example, whilst the risk of, say, a fast food vendor being sued in a particular location for contributions to obesity in the population is a theoretical risk, if independent fast food vendors in that location would not provide capital to support that risk, then it is not a "significant risk" for the purposes of attributing capital. In other jurisdictions the risk might be more than theoretical and independent fast food vendors might reserve against such litigation risks. In such jurisdictions this would be a significant risk for the purposes of attributing capital. Equally, some business activities are subject to more volatile economic cycles than others, and additional capital may be needed to support the business against the cyclical downturns. Again, outside the financial sector, there is little regulatory constraint on capital adequacy for different business sectors. The amount of free capital being determined rather by market perceptions of what is appropriate for given sectors, business strategies etc, and by the shareholders' and loan creditors' appetite for risk.

108. Quantifying the amount of additional capital in such circumstances will be difficult given the lack of a regulatory environment. However, one might expect that businesses are likely to try and evaluate significant risks at least to some extent and it might be possible to use an enterprise's own measurement tools, where they exist, as a starting point. Even if it is accepted that significant risks may not be capable of being measured exactly, where the PE assumes significant risks, an attempt should be made to take account of these risks. Where on the other hand the risk is not significant it may not be necessary to try to measure such risk and simply valuing the assets is enough.

109. The rest of this section discusses how to apply the authorised OECD approach to non-financial PEs in the context of capital allocation and funding issues. Three main issues arise and are discussed below. The first is how to determine the funding costs of the PE, especially how to allocate "free" capital to a PE. The second is whether a movement of funds within an enterprise could be treated as a dealing giving rise to interest. The third is how to determine the amount of interest expense that should be attributable to a PE and how to make any necessary adjustments to the interest expense recorded in the books of the PE.

Stage 2 Determining the "Free" capital needed to fund the assets and support the risks attributed to the PE

110. Tax considerations aside, and in the absence of regulatory requirements, there is ordinarily no need for any "free" capital to be formally allotted to a PE. Consequently, the PE's funding needs could legally be entirely debt funded. Nevertheless, while the PE may not need to have "free" capital allotted to it, under the authorised OECD approach the PE is treated as having an appropriate amount of "free" capital in order to support the functions it performs and the assets and risks attributed to it. Moreover, if the same operations were carried on through a subsidiary in the host country, the subsidiary may be required by thin capitalisation rules to have some equity or "free" capital.

111. Under the authorised OECD approach, the PE needs for tax purposes to have attributed to it an arm's length amount of "free" capital, irrespective of whether any such capital is formally allotted to the PE. To do otherwise would be unacceptable on tax policy grounds. The result would not follow the arm's length principle, would not reflect the profits earned in the PE, and it would provide considerable scope for tax avoidance. Accordingly, a management decision in the home office to allot a certain amount of capital to the PE, or to record capital on the books, is not determinative of the risks assumed by the PE and the amount of capital that is attributed under the functional and factual analysis.

112. The next issue is how to attribute an appropriate amount of "free" capital and interest bearing debt to the various parts of the enterprise. The attribution would be made in accordance with where the assets and the associated risks have been attributed and should take into account, as far as practicable, the specific functions, assets and risks of the PE relative to the functions, assets and risks of the enterprise as a whole. This recognises that some business activities involve greater risks and require more capital than other activities; hence the business activities undertaken through a PE may require proportionately more or less capital than the enterprise as a whole.

113. A number of approaches to determining funding costs are considered below, but a few points of general application are made first. As indicated in Section B-2 which discusses the symmetrical application of the authorised OECD approach, where an authorised approach to attributing capital appears to produce results in a particular case that are not consistent with the arm's length principle, another authorised approach which does so may be substituted for it. For the purpose of the authorised OECD approach, the debt to equity characterisation rules used for tax purposes in the PE's host country would be applied to the enterprise's capital for the purpose of determining which items would be treated as "free" capital for tax purposes under the domestic laws of the host country.

114. It is noted that debt/equity characterisation rules for financial instruments may vary from country to country and that such variation may result in double, or less than single, taxation. While less variation in such rules between jurisdictions may be desirable, it is not appropriate to address this issue in the authorised OECD approach. This issue is of wider significance and is not confined to PEs.

115. A final point to bear in mind is that there are some important differences between a regulated banking enterprise and a non financial enterprise, which give rise to additional difficulties in resolving funding issues within non-financial enterprises. A combination of the regulatory environment and market forces will generally ensure banking enterprises have a narrower range of debt to free capital ratios than non-financial enterprises, a category of businesses which by definition covers a wider range of activities than banking.

The Capital Allocation Approach

116. The capital allocation approach seeks to allocate an enterprise's actual "free" capital to a PE in accordance with the attribution of assets owned and risks assumed. Under this approach, "free" capital is allocated on the basis of the proportion of assets and risks attributed to the PE by the functional analysis. So if the PE has 10% of the enterprise's assets and/or risks it will have attributed to it 10% of the enterprise's free capital.

117. Where enterprises have capital structures that are consistent with those observed in comparable independent enterprises, then allocating capital of any such enterprise to its PE can produce an arm's length result. Similarly where the enterprise of which the PE is a part is resident in a different jurisdiction to the group parent company, the thin capitalisation rules of the enterprise's country of residence may ensure that the enterprise is adequately capitalised and the capital of the enterprise may again provide an appropriate starting point for allocating capital to the PE.

118. Since the capital allocation approach seeks to attribute the actual capital of the enterprise the effect is that it distributes the benefits of synergy to the constituent parts of the enterprise in a way that, in theory, minimises the likelihood of double taxation. In practice however differences in definition of "capital" between home and host countries may result in the attribution of more or less than the total amount of capital of the enterprise.

119. A problem with the capital allocation approach is that there will be instances where the PE conducts a very different type of business to the enterprise as a whole (e.g. the PE is a distributor and the enterprise as a whole is also a manufacturer) or the market conditions in the host country of the PE are very different from those applying to the rest of the enterprise (for example the enterprise has a dominant market position in its home territory but is in a very competitive market in the host country). In general, the focus of the authorised OECD approach on attributing "free" capital by reference to the functional and factual analysis should mean that such differences are adequately taken into account. However, in cases where the differences, for example in market conditions, are not appropriately reflected in the measurement of risk, the results of the capital allocation approach might be outside the arm's length range unless reasonably accurate adjustments could be made to account for the differences in the way the PE operates or the conditions under which it operates

120. Another potential problem with the capital allocation approach is that where the enterprise of which the PE is a part is itself thinly capitalised, a simple allocation of the actual "free" capital of the enterprise is unlikely to produce an arm's length result without adjustment. This issue is discussed later in this section.

121. In situations where the capital allocation approach may be applied straightforwardly (i.e. where the enterprise is adequately capitalised) there are still a number of issues to be resolved. It has been suggested, for example, that whilst in principle the total "free" capital should be allocated, there are circumstances in which this should not be the case. For example, a company might have designated capital to acquire a business (a "war chest") or might have a temporary cash surplus from selling a business. How these situations would be treated would be determined on a case-by-case basis. If the company has a general intention to acquire a business in a jurisdiction, but no commitment, so that the capital still could be used for other purposes, that capital should be allocated along with other capital. In those cases, the company frequently will have cash or other short term investments that need to be actively managed to maximise the investment return. Where this is the case the authorised OECD approach would be to attribute economic ownership of those financial assets to the part of the enterprise performing the key entrepreneurial risk taking functions associated with managing the surplus cash or other short term investments. If, however, the company has a commitment to purchase a particular business (such as legally binding purchase contract), then the capital may be segregated. Segregation might also be appropriate if the enterprise has earmarked the proceeds for timely distribution to shareholders or otherwise committed itself to using the funds in a particular manner within a reasonable period of time.

122. The discussion in this sub-section attempts to provide an agreed framework for the OECD member countries that favour a capital allocation approach. The framework does not cover all the issues, including what deductions to allow when computing capital, over what period to compute the capital ratios (perhaps using some kind of weighted or moving average) or how to deal with foreign exchange gains and losses issues. There may also be problems for the host country in obtaining the information necessary to apply the approach. It should also be stressed that in the case of non financial enterprises, because of the absence of a regulatory framework which requires measurement of risk, there are practical difficulties in producing a meaningfully narrow range of acceptable outcomes, even after determining the creditworthiness.

Economic Capital Allocation approach

123. In the banking context another approach to allocating "free" capital has been suggested based not on regulatory measures of capital but by reference to economic capital. This approach has the potential to conform to the authorised OECD approach as it is explicitly based on measuring risks. The rationale for this approach is that regulators only look at the types of risk that cause concern for regulators and are not concerned with other types of risk that may well have a greater impact on bank profitability. Such an approach could in theory be useful in non-financial sectors; in seeking to measure for example, the economic risk inherent in developing patented technology. However, such measures do not appear to be very well developed even in banking institutions that have very sophisticated risk measurement systems. It is likely to be rare therefore for non-financial institutions to have risk measurement systems in place. Nevertheless such measures might provide a useful starting point where the PE has significant developmental risks. Moreover, developments in the area might mean that economic measures of capital usage may become more accurate and an increasingly acceptable proxy to arrive at a result within the arm's length range.

Thin capitalisation approach

124. Another approach would be to require that the PE has the same amount of "free" capital as would an independent enterprise carrying on the same or similar activities under same or similar conditions in the host country of the PE by undertaking a comparability analysis of such independent enterprises. The functional and factual analysis would identify the assets and risks to be attributed to the PE and this would determine the amount of funding per se (i.e. without distinguishing between debt and "free" capital) that

would be required by the PE. The next stage would be to determine the allocation of the funding into interest bearing debt and "free" capital.

125. There are a number of factors relevant to the determination of an arm's length amount of debt and "free" capital for PEs. These include:

- The capital structure of the enterprise as a whole

- The range of actual capital structures of independent host country enterprises carrying on the same or similar activities as the PE under the same or similar conditions (including the condition discussed in Section C-2(iv) that generally the PE has the same creditworthiness as the enterprise as a whole)

126. Issues arise in seeking to apply a thin capitalisation approach to non-financial enterprises. For non-financial enterprises it will probably be necessary to focus on capital structure, such as debt to equity ratios rather than on free capital in isolation and it would be desirable to use the same method as is used to limit the interest expense for associated enterprises. This would require a determination first of all the arm's length amount of funding that should be attributed to the PE to support its functions, assets and risks. Then comparable debt/equity ratios in the host country could be used to determine which part of the arm's length funding should be made up of free capital.

127. One concern with such an approach is what appears to be the wide range of debt to equity ratios observable at arm's length (i.e. between MNE Groups and their third party lenders) and whether, given the diverse range, it is possible to apply a thin capitalisation approach outside the financial sector. However, the debt to equity ratio of a particular enterprise within the wide range is unlikely to be the result of random chance, but is rather likely to be the outcome of a number of factors. A critical issue is whether it is possible to take into account all the factors that underlie such different debt to equity ratios. Further consideration perhaps needs to be given as to why certain MNE Groups are highly geared and some are not. Differences in shareholders appetite for risk has already been identified as one contributing factor, but in the context of an adequately capitalised enterprise the authorised OECD approach significantly decreases the importance of that variable by making the creditworthiness/ capital structure of the enterprise one of the internal conditions of the PE.

128. Other key variables, the "external" conditions – location of the borrowing PE, quality and nature of assets, cash flows, business sector, business strategies, capital acquisitions and disposals, market conditions in the host jurisdiction etc., could be identified and an effort made to quantify the effect of those variables on gearing; where possible by examination of the accounts of comparable independents or by researching the criteria used by independent bankers when lending to particular categories of borrowers. A functional and factual analysis of the assets, risks and activities of the PE would reveal the extent to which the key variables were present in its business, and it could be possible to attribute to the PE an appropriate amount of "free" capital for a business with these features. Further work on these issues is currently being undertaken by the Working Party No. 6 in a separate project dealing with associated enterprises and thin capitalisation.

129. The thin capitalisation approach has the advantage of avoiding some of the issues that arise in determining the amount of free capital to be attributed in situations where the enterprise as a whole is entirely debt funded. However, a weakness of a thin capitalisation approach is that the aggregate amount of "free capital" it attributes to individual PEs may be greater than the amount of "free capital" in the enterprise as a whole

Safe harbour approach - Quasi thin capitalisation / regulatory minimum capital approach

130. Another possibility discussed in Part II for banks would be to require the PE to have at least the same amount of “free” capital required for regulatory purposes as would an independent banking enterprise operating in the host country (quasi thin capitalisation/regulatory minimum capital approach). This approach is not an authorised OECD approach as it ignores important internal conditions of the authorised OECD approach, e.g. that the PE generally has the same creditworthiness as the enterprise as a whole. However, it may be acceptable as a safe harbour as long as it does not result in the attribution of more profits to the PE than would be attributed by an authorised OECD approach.

131. In practice there are likely to be significant problems in finding sufficiently objective benchmarks outside the regulated financial sector to apply the quasi thin capitalisation/regulatory minimum capital approach. More generally, there may be limited scope for having fixed ratios based on sector benchmarks for particular industries outside the financial sector, but only as part of a safe harbour regime.

132. However, the main disadvantage of the *quasi thin capitalisation / regulatory minimum capital* approach is that it is unlikely to provide a solution for all taxpayers in all sectors, it relies on sector benchmarks which may not meet comparability standards; and the more refined and wide ranging the approach becomes the more it resembles the thin capitalisation approach (and therefore loses the advantages of administrative simplicity).

133. The quasi thin capitalisation/regulatory minimum capital and the thin capitalisation approaches may be used in conjunction with safe harbours. The Guidelines contain much discussion of the pros and cons of safe harbours in general before concluding in paragraph 4.123 that “the use of safe harbours is not recommended”. However, as noted in paragraph 4.96 the discussion in the Guidelines “does not extend to tax provisions designed to prevent excessive debt in a foreign subsidiary (“thin capitalisation” rules) which will be the subject of subsequent work”. That subsequent work is currently being undertaken by the Working Party No. 6 in a separate project dealing with associated enterprises and thin capitalisation. Whatever views are expressed as a result of that work as to whether domestic thin capitalisation rules that adopt a safe harbour approach may be considered to accord with the arm’s length principle should apply in a PE context.

Other Methods

134. In the context of the insurance sector, other potential approaches to attributing capital are being analysed. The results of this analysis will be included in Part IV.

Attribution of capital to the PE of a thinly capitalised enterprise

135. Outside the regulated financial sector a difficulty arises that there is often no requirement for individual enterprises within the Group to have an arm’s length amount of free capital. The enterprise of which the PE is a part may for example be almost entirely debt funded (so called $2 companies, with 2$ equity and $1m debt)) so that even attributing all such an entity’s free capital to the PE is likely to leave the PE thinly capitalised. Accordingly a separate discussion of the problems connected with thinly capitalised enterprises now follows the main discussion of capital attribution approaches.

136. In circumstances where the capital structure of the enterprise to which the PE is a part does not provide an arm’s length result it is necessary to look outside the enterprise itself for suitable data. There are two possible solutions to arrive at a result consistent with Article 7.

- A thin capitalisation approach

- An approach which adjusts the capital of the enterprise to an arm's length amount before allocating that capital to the PE.

137. The thin capitalisation approach looks at the capital structures of comparable independent enterprises in comparable circumstances etc. The objective under this approach is to determine an arm's length amount of free capital. Consistent with the conclusion for PEs of non-thinly capitalised enterprises, the creditworthiness implied by that amount of free capital would be assumed to belong to the enterprise as a whole, with the consequence that internal dealings in respect of guarantee fees and creditworthiness differentials impacting on intra-enterprise interest rates would not be recognised.

138. A second approach would be to first adjust the capital of the enterprise of which the PE is a part to an arm's length amount. The PE would subsequently be attributed an arm's length amount of the adjusted capital under Article 7 through a capital allocation approach.

139. As discussed in Section B-2, since both approaches are capable of giving an arm's length result, the approach used by the host country should be accepted by the home country, except in situations where the host country method does not give an answer that is consistent with the arm's length principle. In determining whether a particular capital attribution approach gives an arm's length result for a PE of a thinly capitalised enterprise it may be necessary to consider why the enterprise as a whole is thinly capitalised.

140. In applying a thin capitalisation approach, if any commercial reasons for the enterprise being thinly capitalised had nothing to do with the business operations of the PE, then the attribution to the PE of more than the enterprise's capital may well be consistent with the arm's length principle. If such commercial reasons *did* relate to the business operations of the PE, then this must be accounted for in seeking to benchmark the PE's capitalisation against whatever uncontrolled comparables are selected. This would be either by selecting comparables that are similarly impacted by such factors, by adjusting the comparables to account for any differences in such factors, or if the available comparables data cannot reliably be used because of such factors, using a different authorised OECD approach that would be more consistent with the arm's length principle.

Conclusion on attributing capital to the PE

141. The attribution of "free capital" among the parts of an enterprise is a pivotal step in the process of attributing profits to the PE. The general principle is that the PE should have sufficient "free capital" to support the functions, assets and risks attributed to the PE. For this reason, the method by which capital is attributed is an important step in avoiding or minimising double taxation or less than single taxation.

142. The consultation process has shown that there is an international consensus amongst governments and business on the principle that a PE should have sufficient capital to support the functions, assets and risks it assumes. However, the consultation process has also shown that it is not possible to develop a single internationally accepted approach for attributing the necessary free capital. As can be seen from the discussions above, there is no single approach which is capable of dealing with all circumstances.

143. Rather the focus of the Report is on articulating the principles under which such an attribution should be made and on providing guidance on applying those principles in practice in a flexible and pragmatic manner. As such, whilst any of the authorised approaches described in this section are capable of producing an arm's length result, there may be particular situations where the approach does not produce an arm's length result and so flexibility may be required but in a manner that should reduce the incidence of double taxation.

144. The fact that countries may incorporate different authorised approaches to attributing capital in their domestic regimes has raised concerns that double taxation may arise. However, Article 23 requires home countries to accept host country domestic rules consistent with one or more of the authorised approaches, provided the result is consistent with the arm's length principle in a particular case. It follows that in such circumstances the home country should give relief for tax on profits calculated under the host country basis. This is the case even where the home country has a domestic rule which attributes capital in accordance with another of the authorised approaches.

145. Nevertheless, there will inevitably be some cases where tax administrations disagree over whether the results produced by the host country method are consistent with the arm's length principle. The Mutual Agreement Procedure is available to resolve such differences. The fact that it will sometimes be necessary to resolve disputes through MAP is not a weakness of the authorised OECD approach. Rather it reflects the fact that the attribution of capital to a PE can be a very difficult and complex issue. The authorised OECD approach describes the strengths and weakness of different approaches and therefore provides a framework for resolving difficult cases.

d) Determining the Funding Costs of the PE

Introduction

146. The authorised OECD approach acknowledges that the PE requires a certain amount of funding (made up of both free capital and interest bearing debt). Once that amount has been determined, one of the authorised capital attribution approaches as described in the preceding section is used to determine the amount of the funding that is made up of free capital. The balance of the funding requirement is therefore the amount by reference to which the interest deduction is calculated and is the focus of this section. For simplicity sake the discussion is couched in terms of "debt" and "interest" but the comments below are applicable to any financial instrument and any funding costs, whether strictly classified as interest for tax purposes or not.

147. Just as there is more than one authorised approach to attributing free capital to a PE so too there is more than one authorised approach to attributing interest bearing debt and to determining the rate of interest to be applied to that debt. Under the authorised OECD approach the attribution can include, in appropriate circumstances, the recognition of internal "interest" dealings. The various approaches are discussed in the first sub-section below. The recognition of internal dealings represents a departure from the existing Commentary on Article 7(3), which only recognises internal dealings in financial enterprises. This recognition creates the potential for tax avoidance as discussed in the second sub-section below. The third subsection discusses the extent to which it is appropriate to recognise a mark up on any internal "interest" dealings.

Authorised approaches to attributing funding costs to PEs

148. A key feature of the authorised OECD approach as it applies to funding costs is that it moves the focus away from the recognition of dealings as such to a wider consideration of determining an allowable interest deduction for the PE The objective of the authorised OECD approach is to establish using one of the authorised approaches described below an arm's length amount of interest in the PE, commensurate with the functions, assets and risks attributed.

149. The current approach of the Commentary makes a distinction between financial and non-financial enterprises based on the fact that the making and receiving of advances is closely related to their ordinary business (the "direct or indirect approach"). On this basis it is said to be permissible to recognise internal interest dealings for financial enterprises but not for non-financial enterprises (para 18.3 of Commentary on

Article 7). The authorised OECD approach rejects the "direct" and "indirect" approach in favour of applying the functional approach of the Guidelines. The question then becomes how to account for the movement of funds within the enterprise. Whilst movements of funds between parts of the enterprise do not necessarily give rise to dealings, there would be circumstances where they could be recognised as internal interest dealings within non financial enterprises, for the purposes of rewarding a treasury function ("treasury dealing"). Treasury functions are described in Part II of this Report, sub-section D-2 (iii) (b).

150. Where such an approach is used, the question of whether any movement of funds would be recognised as a "treasury dealing" would depend on a functional and factual analysis of the "dealing" and the conditions under which it was performed. In particular, it would be necessary in order to recognise a dealing as a "treasury dealing" to identify one part of the enterprise as undertaking in substance the key entrepreneurial risk-taking functions in relation to the cash or financial asset in order to be treated as the "owner" of the cash or financial asset and therefore entitled to an arm's length return from the cash or asset under an internal "treasury dealing". In the absence of such entrepreneurial risk-taking functions, it would not be possible to recognise any internal "treasury dealings" at arm's length prices.

151. The existing Commentary mentions two other approaches for attributing the external interest expense of the enterprise to its PE (neither of which is fully endorsed): (1) a tracing approach, and (2) a fungibility approach. A number of countries currently use some variation of these approaches. Under a "pure" tracing approach, any internal movements of funds provided to a PE are traced back to the original provision of funds by third parties. The interest rate on the funds provided to the PE are determined to be the same as the actual rate incurred by the enterprise to the third party provider of funds. A tracing approach could, in certain circumstances be evidenced by internal dealings that allocate the actual interest expense of the enterprise to the PE. Under a "pure" fungibility approach, money borrowed by a PE of an enterprise is regarded as contributing to the whole enterprise's funding needs, and not simply to that particular PE's funding needs. This approach ignores the actual movements of funds within the enterprise and any payments of inter branch or head office/branch interest. Each PE is allocated a portion of the whole enterprise's actual interest expense paid to third parties on some pre-determined basis. Hence, there would be no need under a fungibility approach for any recognition of internal interest dealings.

152. Both a tracing approach and a fungibility approach, at least in their pure form, have problems. The Commentary on Article 7 also remains equivocal on this issue. Paragraph 18.2 states:

"The approach previously suggested in this Commentary, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality."

153. Just as for capital attribution, it does not seem possible to develop a single approach that could be applicable in all circumstances. Some countries favour a fungibility approach, whilst others want to retain tracing of funds for non-financial institutions. Others want a more flexible approach, perhaps by using tracing for "big-ticket" items and a fungibility approach for the rest of the assets. Other countries want to determine the amount of interest by reference to the amount of interest of comparable independent enterprises in comparable circumstances. Other countries may want to use appropriately recognised "treasury dealings" to reward a treasury function. The important point to stress is that the goal of all the approaches described above is the same, i.e. that the amount of interest expense claimed by the PE does not exceed an arm's length amount and that any treasury functions are appropriately rewarded. Accordingly,

all these approaches should be treated as authorised under the authorised OECD approach and the home country should accept the results of any of the authorised approaches in a particular case, provided that the result is consistent with the arm's length principle.

154. One of the reasons given in the current Commentary on Article 7 (3) for not recognising internal dealings is the scope for avoidance. In particular the scope for giving an interest expense to the PE in cases where the enterprise as a whole is solely or predominantly equity funded (see paragraph 18 of Commentary to Article 7(3)). However, it should be noted that the recognition of "treasury dealings" only rewards the performance of any key entrepreneurial risk-taking functions performed in respect of the cash and financial assets of the enterprise. If there are no key entrepreneurial risk-taking functions then only the actual external interest expense of the enterprise will be allocated amongst the various parts of the enterprise. For example, in the absence of any external debt it is unlikely that there will be key entrepreneurial risk-taking functions performed by one part of the enterprise such that one part of the enterprise would be treated as the economic owner of all the cash and financial assets of the enterprise.

155. Under the authorised OECD approach, therefore, the concern for avoidance identified at paragraph 18 in the current Commentary for non-financial enterprises disappears because internal interest dealings are recognized only for the purpose of rewarding treasury functions and therefore do not affect the attribution of free capital and, by way of consequence, the quantum of debt attributed to the PE determined under the basic principles set out in Section C-2 (v) (c) above.

Determining the arm's length price of treasury dealings

156. Finally, it remains to consider how to reward the "treasury dealings". The answer will be to do so under the arm's length principle and by reference to a comparability analysis applying by analogy the methods of the OECD Transfer Pricing Guidelines. For example, where the "treasury dealing" relates to external debt, one method of arriving at an arm's length price might be to add a margin to the external debt by reference to comparable margins earned by independent enterprises performing comparable functions. One feature of the WH is that it generally attributes the creditworthiness of the enterprise to its constituent PEs. It follows from this that no margin should be added in respect of credit differentials between one part of the enterprise and another. The addition of a margin would therefore only be appropriate where there is clear evidence that one part of the enterprise is providing a real treasury function to the other parts of the same enterprise. Where the "treasury" PE is doing little more than acting as a conduit (borrowing funds and immediately on-lending) the functional analysis is unlikely to show that the "treasury" PE has been performing the key entrepreneurial risk-taking functions and so should be treated as the economic owner of those funds and so entitled to the associated return. Instead, it may be appropriate to reward the "treasury" PE not as the owner but instead as a service provider, for example with a reimbursement of any administrative costs incurred or on a cost plus basis, depending on what precisely was involved (i.e. the costs do not include interest cost).

157. Where the PE of a non-financial enterprise, is performing a fully fledged treasury function, the functional analysis may well determine that the treasury centre is the economic owner of the internal financial assets as it has been performing the key entrepreneurial risk-taking functions in respect of those assets and so is entitled to the return on those assets. The pricing of that return can be determined in accordance with the discussion of treasury centres in the revised Part II (Section D-2 (iii) (b)). As noted in Part II, the addition of a margin to an internal interest dealing is only one of a number of possible methods to reward the performance of a treasury function. Where these other methods are used, the treasury function would be rewarded separately through an arm's length remuneration.

158. There are other financial dealings which may occur in non-financial enterprises, for example hedging transactions, but such purported transfers of risk would need to meet the threshold hurdle, i.e. they

would not be recognised unless, for example, the part of the enterprise the risk was transferred to had the expertise to manage the risk and so was performing the key entrepreneurial risk-taking functions in respect of those risks.

e) The authorised OECD approach for adjusting interest expense

159. Where the amount of “free” capital allotted by the enterprise is less than the arm’s length amount as determined by one of the authorised approaches, an appropriate adjustment would need to be made to reduce the amount of interest expense claimed by the PE in order to reflect the amount of the enterprise’s “free” capital that is actually needed to support the activities of the PE. The adjustment will be made following the rules of the PE’s host country, subject to Article 7.

160. It should be noted that the host country PE may be taxing less than an arm’s length amount if no adjustment is made to increase the allotted amount of ‘free” capital. The focus of Article 7 is on determining the appropriate taxing rights of the PE host country in that it cannot tax in excess of the arm’s length amount of profit. No adjustment is mandated under Article 7 in this case. However host countries may wish to exercise their full taxing rights by adjusting upwards the amount of “free” capital. Article 7 permits this adjustment provided that the host country does not make an upwards adjustment in excess of the arm’s length amount.

161. Where interest bearing debt attributed to the PE (including recognised “treasury dealings” in respect of internal movements of funds) covers some part of the arm's length amount of "free" capital properly attributable to the PE, any interest on the amount so covered would not be deductible in arriving at the PE's taxable profits. In some cases, the PE's accounts may specifically identify the interest liability in relation to the amount of "free" capital that has been covered by interest bearing debt. In these cases, it may be a fairly simple matter to determine the amount of non-deductible interest. In other cases, the PE's accounts may not readily identify any specific interest liability in relation to the amount of "free" capital that has been covered by interest bearing debt. This raises the question of how to determine the amount of non-deductible interest.

162. A variety of methods are possible. One method for determining the amount of non-deductible interest might simply be to apportion the actual interest expense claimed by the PE (after any adjustment to reflect arm's length amounts) by using a ratio based on the average debt level that the PE had during the year, and the average debt level that the PE would have had during the year after adjustment to reflect the additional "free" capital that should have been attributed to the PE. Another method might be to use a weighted average of rates actually charged on the interest bearing debt attributed to the PE. It is also desirable to allow the use of other methods where the results produced are more acceptable to the taxpayer and to the tax administration of the host jurisdiction.

163. Another issue that can arise is where the PE has allotted capital in excess of the arm’s length range of “free” capital. This might be because the host jurisdiction has a domestic tax law requirement on allotted capital. In that case the host jurisdiction is taxing more than is permitted under Article 7. Any such domestic tax law requirement that provided for an amount of free capital in excess of the arm’s length range would be restricted by Article 7 to an amount that was within the limit set by the arm’s length range. Alternatively, an enterprise may allot an excessive amount of “free” capital to a PE, for example where the PE is subject to a low rate of taxation and the enterprise wishes to maximise interest deductions in its home jurisdiction subject to higher taxation. In such situations the authorised OECD approach would enable the home country to adjust the amount of capital attributed to the PE to an amount within the limits set by the arm’s length range – this issue is discussed in more detail in Section B-2 above.

164. Another issue relates to the situation where all the operations of the PE are funded by borrowings from third parties. Is it still necessary to disallow part of the interest expense by reference to an amount of "free" capital? The answer is that it would be consistent with Article 7 to make such an adjustment, given that the PE when hypothesised as a distinct and separate enterprise would have "free" capital as discussed earlier in the Report. However as noted earlier in this section Article 7 does not mandate such an adjustment when the host country imposes tax on an amount of business profits that reflects the recognition of an amount of "free" capital in the PE that is below the limits set by the arm's length range of "free" capital.

165. Some practical issues arise as to how to make any such adjustment. Where the PE borrows funds from the treasury centre a "free" capital adjustment can potentially be made in respect of the internal "treasury" dealing. However, this solution is not possible where the PE's borrowings are wholly with third parties. One way of making the adjustment for "free" capital would be to impute a "loan" from the PE to the treasury location of the enterprise which would have the effect of decreasing the interest deduction of the PE by reference to the amount of "free" capital.

f) Conclusion

166. The first step of the authorised OECD approach determines the activities and conditions of the hypothesised distinct and separate enterprise. A functional and factual analysis attributes functions, assets and risks to the PE, and sufficient "free" capital is attributed to support those functions, assets and risks. The attribution of capital and funding to PEs of non-financial enterprises presents certain difficulties not encountered in the financial sector, however the approach is practical and effective.

167. As with the attribution of free capital to the PEs of financial enterprises, the testing in the general situation has demonstrated the need for flexibility over such issues as the attribution of free capital and the determination of funding costs. To some extent, this flexibility also reflects the real practical difficulties of translating the authorised OECD approach in precise guidance in this area. On the other hand, the attribution of capital is now governed by a clear principle the observance of which will help minimise instances of double taxation. The application of the authorised OECD approach represents a significant departure from the existing Commentary by authorising an approach to attributing interest expense based on the recognition of internal interest dealings in non-financial enterprises in appropriate circumstances. The authorised OECD approach is able to do this because it is rooted in a detailed factual and functional analysis which attributes functions, assets and risks to the PE, then attributes a sufficient amount of "free" capital to support the assets used and the risks assumed.

168. Given the importance of the attribution of assets and risks to the determination of both the profits of the PE and an appropriate funding structure, it will be necessary to require PEs to document how they have attributed assets, measured risks, (or why they do not consider it necessary to measure risks) and attributed "free" capital and interest expense. Documentation requirements are discussed in more detail below in section C-3 (iv) (d).

C-3. Second step: Determining the profits of the hypothesised distinct and separate enterprise based upon a comparability analysis

(i) Introduction

169. The authorised OECD approach provides for the choice and application of methods described in the Guidelines for purposes of determining the profits to be attributed to a PE, based upon its functions performed and the assets and risks attributed in the manner described in the foregoing section. The PE

should obtain an arm's length return for its functions, taking into account the assets used and risks assumed, in the same manner as would a comparable independent enterprise.

170. A functional and factual analysis of the PE will already have been accomplished in the process of constructing the hypothetical "distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions". However, the language of Article 7(2) goes on to require that the profits to be attributed to the PE must also be based on the hypothetical distinct and separate enterprise, "dealing wholly independently with the enterprise of which it is a permanent establishment". In some cases, it may therefore be necessary to carry out a functional and factual analysis of another part of the enterprise (of which the PE is a part) if the other part contributes to the functions being performed by the PE or undertakes activities in relation to the assets and risks attributed to the PE, or vice versa.

171. Continuing to follow, by analogy, the approach of the Guidelines, profits should be attributed to a PE by applying the traditional transaction methods (CUP, resale price and cost plus), or, where such methods cannot be applied reliably, the transactional profit methods (profit split and TNMM).

172. The question arises as to how to adapt the guidance of the Guidelines on transfer pricing methods to the PE context. In an Article 9 situation, there are "controlled transactions" between associated enterprises, and the transfer pricing methods apply by comparing those transactions with comparable uncontrolled transactions between independent enterprises. In the PE situation there are "dealings" rather than actual "controlled transactions" that govern the economic and financial relationships between the PE and another part of the enterprise.

173. The authorised OECD approach is to undertake a comparison of *dealings* between the PE and the enterprise of which it is a part, with *transactions* between independent enterprises. This comparison is to be made by following, by analogy, the comparability analysis described in the Guidelines. By analogy with the Guidelines, comparability in the PE context means either that there are no differences materially affecting the measure used to attribute profit to the PE, or that reasonably accurate adjustments can be made to eliminate the material effects of such differences. Principles similar to the aggregation rules of Chapter I of the Guidelines should also apply, to permit the PE's dealings to be aggregated, where appropriate, in determining the PE's attributable profit. The rest of this section looks at some of the issues identified above in a little more detail.

(ii) Recognition of dealings

174. There are a number of aspects to the recognition (or not) of dealings between a PE and the rest of the enterprise of which it is a part. First, a PE is not the same as a subsidiary, and it is not in fact legally or economically separate from the rest of the enterprise of which it is a part. Second, dealings between a PE and the rest of the enterprise of which it is a part normally have no legal consequences for the enterprise as a whole. This increases the scope for tax motivated transfers between the two and also acts to reduce the usefulness of any documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist. It therefore implies a need for a greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions between two associated enterprises and places the onus on the taxpayer to be able to demonstrate clearly that it would be appropriate to recognise the dealings.

175. This greater scrutiny means a threshold needs to be passed before a dealing is accepted as equivalent to a transaction that would have taken place between independents at arm's length, and should therefore be reflected in the attribution of profits under Article 7(2). In the associated enterprise situation it will usually be self-evident that a transaction has occurred, e.g. the transaction will have legal

consequences other than for tax. Even transactions between associated enterprises may not be recognised where they do not take place under the normal commercial conditions that would apply between independent enterprises (see 1.38 of the Guidelines which discusses the circumstances in which transactions between associated enterprises would not be recognised or would be restructured in accordance with economic and commercial reality). A dealing within a single legal entity is not something which is self-evident but is a construct, the existence of which is inferred solely for the purposes of determining an arm's length attribution of profit. Consequently, intra-entity dealings are perhaps more susceptible to being disregarded or restructured than transactions between associated enterprises.

176. The starting point for the evaluation of a potential "dealing" will normally be the accounting records of the PE showing the purported existence of such a "dealing". Under the authorised OECD approach, that "dealing" as documented by the enterprise will be recognised for the purposes of attributing profit, provided it relates to a real and identifiable event (e.g. the physical transfer of stock in trade, the provision of services, use of an intangible asset, a change in which part of the enterprise is using a capital asset, the transfer of a financial asset, etc). A functional analysis should be used to determine whether such an event has occurred and should be taken into account as an internal dealing of economic significance. And ultimately it is the factual and functional analysis which determines whether the dealing has taken place, not the accounting records or other documentation provided by the enterprise.

177. This will require the determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the "dealing". In transactions between independent enterprises, the determination of the transfer of risks, responsibilities and benefits would normally require an analysis of the contractual terms of the transaction. This analysis would follow the guidance on contractual terms found in paragraphs 1.28 and 1.29 of the Guidelines.

178. A dealing takes place within a single legal entity and so there are no "contractual terms" to analyse. However, the authorised OECD approach treats "dealings" as analogous to transactions between associated enterprises and so the guidance in paragraphs 1.28 and 1.29 can be applied in the PE context by analogy. In particular, as noted in paragraph 1.28, "The terms of a transaction may also be found in correspondence/communications between parties other than a written contract." So, by analogy, the "contractual terms" are the accounting records, together with any contemporaneous internal documentation, purporting to transfer risks, responsibilities and benefits from one part of the enterprise to another part. Further, paragraph 1.26 of the Guidelines notes that "in line with the discussion below in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties conduct should generally be taken as the best evidence concerning the true allocation of risk." Paragraph 1.27 goes on to note that "{a}n additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. In arm's length dealings it generally makes sense for parties to be allocated a greater share of risks over which they have relatively more control".

179. An analysis of the contractual terms of the transaction is part of the factual and functional analysis and can be used to examine whether the actual conduct of the parties conforms to the terms of the contract and is consistent with the economic principles that govern relationships between independent enterprises. Such an examination is considered necessary even where there are contractual terms between legally distinct, albeit associated, enterprises. Paragraph 1.29 of the Guidelines states that it will be necessary to, "examine whether the conduct of the parties conforms to the terms of the *dealing* or whether the parties' conduct indicates that the *terms of the dealing* have not been followed or are a sham." The paragraph goes on to note that in such cases, "further analysis is required to determine the true terms of the transaction." Such an analysis will be even more important in the PE context where any terms between the various parts of the enterprise are not contractually binding.

180. In summary, an accounting record and contemporaneous documentation showing a "dealing" that transfers economically significant risks, responsibilities and benefits would therefore be a useful starting point for the purposes of attributing profits, but would not be determinative where it was found to be inconsistent with the functional and factual analysis and therefore the economic reality of the dealing. Ultimately the authorised OECD approach relies on a factual and functional analysis to determine the economic reality behind any documented dealing relating to the attribution of risk.

181. Once the above threshold has been passed and a dealing recognised as existing, the authorised OECD approach applies, by analogy, the guidance at 1.36-1.41 of the Guidelines. The guidance is applied not to transactions but to the dealings between the PE and the other parts of the enterprise. So the examination of a dealing should be based on the *dealing* actually undertaken by the *PE and the other part of the enterprise* as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III of the Guidelines. Except in the two circumstances outlined at paragraph 1.37, tax administrations should apply the guidance in paragraph 1.36 when attributing profit to a PE and so "should not disregard the actual *dealings* or substitute other *dealings* for them."

(iii) Applying transfer pricing methods to attribute profit

182. Consider a PE that distributes a product manufactured by its head office. The PE's dealings that are at issue are the obtaining of the product from the head office, and the sale of the product to a third party customer. It is assumed that the third party sales price is at arm's length and so the transfer pricing examination would be focused on the dealings with head office. To determine the PE's attributable profit from these dealings, the transfer pricing methods would be applied in light of the PE's business activities and functions as a distributor. If, for example, the head office also sells the product to third party distributors, the CUP method might be used to determine the profit that the PE would have obtained had it been a "distinct and separate enterprise" within the meaning of paragraph 2 of Article 7. The amount of gross profit attributed to the PE would be determined as the difference between revenues received by the PE from third party customer sales and the price charged by the head office, adjusted, if necessary, to the arm's length price by reference to comparable transactions between third party distributors and manufacturers.

183. Where a CUP is unavailable, the PE's gross profit might be determined based upon a comparable resale price margin percentage applied to the third party customer sales revenues. Net profit would then be computed by deducting expenses incurred by the enterprise for the purposes of the PE, including appropriate reflection of compensation for any functions performed by other parts of the enterprise for the purposes of the PE. See Part D, below. This result is consistent with paragraph 17.3 of the Model Commentary on paragraph 3 of Article 7, which states:

> "Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods, it will normally be appropriate for the provisions of paragraph 2 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles."

The same approach would be used in applying the other methods described in the Guidelines. This approach determines the profit of the PE in the host country. It should be noted that the timing of profit recognition for the purposes of relieving double taxation in the home country will depend on the interaction between Article 23 and domestic law and may be different.

184. An issue arises where there is a dealing between the PE and another part of the same enterprise and there are costs related to that dealing that have been incurred by the other part of that enterprise. To the extent that the costs that have been incurred by the other part of the enterprise have been reflected in the arm's length price for that dealing, these costs should not be allocated to the PE. Moreover, care is needed with regard to the internal accounting for the costs attributed to different dealings, e.g., to ensure that costs covered in a dealing are not also claimed again under another dealing. For example, product testing costs relating to an arm's length CUP for a product "sold" to the PE may not also be claimed a second time as part of "services" charged to the PE under a cost-plus method. The issue is akin to the issue addressed by paragraph 7.26 of the Guidelines and the guidance in that paragraph will be relevant by analogy for the situation where there is a dealing between the PE and another part of the same enterprise.

185. When attributing profit to the PE, it may also be necessary, as mandated by Article 7(3) of the Model Tax Convention, to take into account expenses incurred by the enterprise for the purposes of the PE, where such expenses represent functions (performed by other parts of the enterprise) for which compensation would be charged at arm's length. Whether expenses incurred outside the PE need to be taken into account would be revealed by a functional and factual analysis of the relevant parts of the enterprise. Subject to the preceding paragraph, the method by which this is achieved may vary. Some countries prefer to take such compensation for functions performed by other parts of the enterprise into account, by adjusting the gross profit margin to reflect the performance of those functions. The actual amount of expenses incurred by other parts of the enterprise in performing those functions should not be deducted to arrive at the PE's arm's length net profit. Other countries prefer a two step analysis. First, the gross margin for the PE based on comparables would be determined, without taking into account compensation for the functions performed by other parts of the enterprise. Second, an appropriate compensation for the functions performed by other parts of the enterprise would be determined based on comparables and this amount would be deducted to arrive at the PE's arm's length net profit. Both methods should produce the same result. Section D discusses in more details the issue of the interpretation of Article 7 (3) in relation to Article 7 (2) of the Model Tax Convention.

186. The transfer pricing methods are intended to determine the arm's length compensation for the functions that the PE performs, taking into account the assets and risks attributed to the PE. As discussed in Section C-2(i) above, the functional analysis undertaken to construct the hypothesised distinct and separate enterprise would have already determined the characteristics and functions of the PE, including a determination of the assets used and risks assumed.

187. The risks assumed by the enterprise as a whole, which are not directly attributable to activities carried on by particular parts of the enterprise, may still need to be taken into account in some manner when attributing profit to the PE using the arm's length principle. Such risks might enter into the analysis of whether the conditions of the dealings between the PE and another part of the same enterprise are comparable with conditions of the transactions between independent enterprises.

188. Where the PE has dealings with other parts of the enterprise, those dealings (provided they pass the threshold test above) will affect the attribution of profits to the extent that the dealings are relevant to the functions performed by the PE and the other parts of the enterprise, taking into account assets used and risks assumed. For example, the PE may begin to use assets (tangible or intangible) belonging to the enterprise that were developed by the head office or purchased for the business of the head office or vice versa. The PE may use services rendered by the head office or vice versa. The PE may use cash earned by the head office or vice versa. Under the authorised OECD approach, internal dealings should have the same effect on the attribution of profits between the PE and other parts of the enterprise as would be the case for a comparable provision of services or goods (either by sale, licence or lease) between independent enterprises. However, the authorised OECD approach is based on the premise that the internal dealings are postulated <u>solely</u> for the purposes of attributing the appropriate amount of profit to the PE.

(iv) Comparability analysis

189. The Guidelines identify 5 factors determining comparability between controlled and uncontrolled transactions; characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies. The authorised OECD approach seeks to apply the same factors to ensure comparability between dealings and uncontrolled transactions. It is considered that all the factors, with the exception of contractual terms, can be applied directly to evaluate dealings as they are essentially based on fact. The concept of contractual terms is rooted in relationships between legally distinct, albeit associated, enterprises and so needs to be applied by analogy to dealings within a single legal entity (see discussion in Section C-3 (iii) as to how to apply, by analogy, the guidance on contractual terms at paragraphs 1.28 and 1.29 of the Guidelines). Once the “contractual terms” of the internal dealings have been determined, a comparison can be made with the contractual terms of potentially comparable transactions between independent enterprises.

190. The comparability analysis might determine that there has been a provision of goods, services or assets etc. between one part of the enterprise and another that is comparable to a provision of goods, services or assets etc. between independent enterprises. Accordingly, the part of the enterprise making such a “provision” should receive the return which an independent enterprise would have received for making a comparable “provision” in a transaction at arm’s length. In an arm’s length transaction an independent enterprise normally would seek to charge for making a provision in such a way as to generate profit, rather than providing it merely at cost, although there can be circumstances in which a provision made at an arm’s length price will not result in a profit (e.g. see paragraph 7.33 of the Guidelines in connection with the provision of services).

191. Another outcome of the comparability analysis might be that the PE and the other part of the enterprise dealing with the PE have structured their dealings in a comparable manner to economic co-participants in an activity corresponding to a cost contribution arrangement (CCA). If the PE and the rest of the enterprise are found to be economic co-participants in such an activity, the dealings would be treated in a manner similar to transactions between associated enterprises in a CCA.

192. The guidance in Chapter VIII on determining whether a CCA between associated enterprises satisfies the arm’s length principle can be applied, by analogy, in the PE context. A CCA is, like any other transaction between associated enterprises, an arrangement containing rights and obligations designed to achieve a given economic goal for its members. Notwithstanding the fact that the PE is not a distinct and separate legal entity from the rest of the enterprise, the same economic goals can nonetheless be replicated as between a PE and the rest of the enterprise as a notional construct to assist in the attribution of profits to a PE. Given the absence of contracts between parts of the same enterprise, however, the enterprise presenting certain activities as being the object of a notional CCA will need to meet a significant threshold in order to provide reliable evidence in support of its position. Therefore, the onus will be on the taxpayer to prepare and produce, where required, the type of contemporaneous documentation that would have been created to document an actual CCA structured in accordance with the Guidance of Chapter VIII of the Guidelines. Beyond the documentation of the notional CCA meant to reveal the intentions of the participants, a functional and factual analysis will be required that will determine the conduct of the participants and, thus, establish the true nature of the economic relationships between different parts of the enterprise.

193. For example, where a PE is claimed to be a participant in a CCA type activity within a single legal enterprise, there should be sufficient evidence available to enable the tax authority in the PE’s host country to evaluate whether the PE’s contribution to the “CCA” type activity is, as stated at paragraph 8.8 of the Guidelines, “consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to receive from the arrangement.”

Documentary evidence will be critical in making this evaluation, provided it reflects the real situation and any documented intentions are put into effect and followed during the life of the CCA activity.

194. Consistent with the earlier guidance on the recognition of dealings, an enterprise and its PE would not ordinarily be found to be acting in a manner consistent with a CCA where this was not the intent of the enterprise, as supported by relevant documentation. Likewise, given the extent of the documentation required to support the existence of a notional CCA, an enterprise could not claim after the fact the existence of the CCA where no contemporaneous documentation is available to support such a claim. In other words, the degree of sophistication of the notional construct that is required by an economic CCA between parts of a single legal enterprise precludes claims that are not backed by convincing contemporaneous documentation.

195. The comparability analysis may also result in other outcomes than those described in the previous paragraphs. Member countries are of the opinion that these other outcomes should be equally susceptible to analysis, by analogy, with the guidance contained in the Guidelines.

196. The current approach found in the Model Commentary is based on the nature of the property involved, for example by presuming that the supply of goods for resale creates a provision, whilst a supply of intangible property would not. This approach creates problems where different types of property are supplied as part of a package. One analytical tool currently used by Member countries to determine the effect of internal dealings on the attribution of profit is the "direct or indirect approach" outlined in paragraph 17.2 of the Commentary on Article 7. This approach is based on the premise that provisions should be postulated, and arm's length prices charged, in cases where the relevant functions contribute directly to the realisation of profit from external entities. However, this view requires a determination of which functions contribute directly, as opposed to indirectly, to the earning of profit. It is also considered that it may be extremely difficult to find objective criteria for making the determinations described earlier in this paragraph. Accordingly, the Working Party agrees that the authorised OECD approach is to reject the current approach based largely on the nature of the property or services involved and use of the "direct and indirect approach" in favour of applying the comparability approach, by analogy, based on the guidance in the Guidelines.

197. To summarise, where internal dealings take place, the factual and comparability analysis will attribute profit in respect of the dealings by reference to comparable transactions between independent enterprises. The guidance in the Guidelines on undertaking such analyses will be applied, by analogy, in light of the particular factual circumstances of a PE and as a result of testing the authorised OECD approach. Three particular circumstances are considered in this regard: use of capital assets, use of intangible assets, and the provision of internal services.

(a) Capital assets

Determining ownership of capital assets at the time of acquisition

198. Physical assets may be either owned or rented and there are commercial pros and cons associated with either option. The starting point of the analysis is to determine the nature of the risks related to the asset used in the PE. The nature of these risks will vary according to whether the asset is legally owned or not by the enterprise. So, if the asset is leased or rented from a third party, the PE would usually be considered to use a leased or rented asset and neither the PE nor another part of the enterprise could be found to be the economic owner of the asset. However, where the enterprise is a licensee its contractual

rights to use the leased, rented or licensed asset may themselves constitute an asset[7] owned by the enterprise. Where a physical asset is acquired by the enterprise as a whole and is located in, and used exclusively by, one PE, the question arises as to which part of the enterprise should be considered the economic owner of the asset.

199. Economic ownership of an asset belongs with the part or parts of the enterprise performing in particular the key entrepreneurial risk-taking functions in respect of that asset, as determined by the factual and functional analysis. This is why, in practice, the actual acquisition of an asset by one part of the enterprise is not determinative in assigning its economic ownership within the enterprise.

Change in use of a capital asset

200. The issue of determining which part of the enterprise should be considered the economic owner of an asset that is legally owned by the enterprise as a whole does not arise only at the time of acquisition by the enterprise. It can also become an issue when an asset is transferred from one part of the enterprise for use in another part of the enterprise. For example, the situation may arise in which the use of a capital asset by one part of an enterprise, e.g. the head office is changed to use by another part of the enterprise, e.g. the PE. For instance, if both the head office and the PE engage in a manufacturing function, and the head office no longer has need for a particular machine, that machine might be moved from the head office to the PE for use in the manufacturing business of the PE. After this removal, the factual and functional analysis of Article 7(2) would show the PE as using the asset, and accordingly the profits associated with the use of the asset would become attributable to the PE. The removal of the machine from the head office to the PE is a real and identifiable event, and so would constitute an internal dealing.

201. The question then becomes how to account for the acquisition and use by the PE of an asset, either acquired from a third party or transferred from another part of the enterprise, when computing the amount of profit that should be attributed to the PE. Should the PE be treated as having "bought" the capital asset from the head office? Should the PE be treated as leasing or renting the capital asset? Is it possible for the PE to be treated as a participant in a "CCA" type activity in respect of the capital asset? The answers to these questions raise issues owing to the special factual circumstances of a PE. If there had been a change of arrangement between two independent enterprises, the question as to whether the asset had been bought, leased or rented would have been determined by examining the contractual arrangements between the parties (provided their actual conduct followed the contractual arrangements, see paragraphs 1.28 and 1.29 of the Guidelines). A dealing takes place within a single legal enterprise, however, and so there are no "contractual terms". However, as noted in Section C-3 (iii) the guidance in paragraphs 1.28 and 1.29 can be applied by analogy so that the "contractual terms" may be the accounting records, together with any contemporaneous internal documentation, purporting to transfer risks, responsibilities and benefits from one part of the enterprise to another part.

202. Where a physical asset has been transferred from one part of the enterprise to another, such a transfer is clearly an economically significant event and will pass the threshold test for the recognition of an internal dealing. The question to be determined is the character of that dealing. An important factor in determining the character of the dealing is the documentation produced by the taxpayer at the time of the transfer. The dealing may be characterised in the documentation as a rental agreement, an outright sale or as the commencement of a "CCA" type of activity. As is always the case with intra-enterprise transfers, however, the documented characterisation of the dealing will only be respected for tax purposes if the documentation reflects the economic reality. Documentation which characterises the dealing as, for example, a rental arrangement, will only be recognised if, in fact, the original economic owner of the asset

7 . A right to use can become a liability over time, if the licence payment or rent exceeds the economic benefit derived from the right to use the asset

continues to bear the economic risk and take the key entrepreneurial risk taking decision in respect of that asset.

203. As already noted, economic ownership of an asset belongs with the part of the enterprise performing the key entrepreneurial risk taking functions in respect of that asset. Depending on the asset and the circumstances of its transfer, the key entrepreneurial risk taking decisions in relation to a transferred asset might include responsibility for organising serial use for short periods by different parts of the enterprise. In such circumstances, ownership of the asset would not be transferred to the PE which was intended to use the asset for a short time (it would be "renting" the asset, and that characterisation would override any documentation to the contrary) and the economic owner would bear the risk that the asset might not be needed by other parts of the enterprise and so may not generate sufficient income to cover the expenses of ownership.

204. On the other hand, a transfer might be documented as a "rental", but if in fact the PE is responsible for the regular maintenance of an asset for which maintenance is a significant cost or has to recruit personnel to perform unforeseen repairs, and if the PE has responsibility for deciding when to replace the asset rather than continue to maintain it, then it may be that the PE is assuming most of the risks associated with the ownership of the asset. In such circumstances economic ownership of the asset appears to have been transferred to the PE.

205. As indicated in paragraph 196, one must first establish whether the enterprise itself owns the assets, leases it or rents it from an independent enterprise. Where the enterprise itself rents the asset, it is hard to see how the factual and functional analysis could show that one part of the enterprise was performing key entrepreneurial risk-taking functions equivalent to being the owner of the asset, given that the enterprise itself had only assumed the risks of a licensee. Where the enterprise legally owns the asset, it may be relevant to know what independent parties making use of a similar asset under similar conditions would do. As noted in paragraphs 200-202 above, while the documentation of the arrangement will assist in the determination, if the conduct of the parties is inconsistent with this documentation, consideration must be given to the actual conduct of the PE and the rest of the enterprise in order to establish the true nature of the arrangement.

206. The determination of the nature of the dealing would be assisted by reference to the terms agreed between the parties (whether explicit or implicit), following, by analogy, the guidance given by paragraphs 1.28 and 1.29 of the Guidelines (see general discussion in Section C-3 (ii)). The compliance obligation of the taxpayer, then, is to document the transfer contemporaneously, and ensure that the documented characterisation is consistent with how the different parts of the enterprise subsequently behave.

207. If it is considered that the factual situation reflects the provision of a capital asset in a manner comparable to an outright sale between independent enterprises, the fair market value of the asset at the time of transfer would need to be established. Under the authorised OECD approach, where the asset is transferred from head office to the PE, the fair market value would provide the basis upon which an allowance for depreciation would be computed in the host country. The computation of the depreciation allowance would be made according to the domestic law of the host country for each year in which the asset is used by the PE.

208. Again, where the asset is transferred from the PE to another part of the enterprise, the fair market value of the asset at the time of transfer would generally be used as the basis upon which an allowance for depreciation would be computed in the country to which the asset had been transferred. The situation in the PE's host country will depend on its domestic law and the interaction between domestic law and Article 7.

209. The domestic law of many countries will recognise for tax purposes the transfer of the asset from their jurisdiction, for example by computing a profit or loss by comparing the fair market value of the asset at the time of transfer with its book value or its depreciated cost base for tax purposes (see paragraph 15 of the Model Commentary on Article 7). However, the domestic law of some countries will not permit the unrealised profit from such a transfer to be taxed, although a loss may have to be allowed under the provisions of an applicable tax treaty. It should also be noted that the authorised OECD approach only determines the attribution of profits to a PE under Article 7. The authorised OECD approach does not override domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets.

210. As indicated in Section B-2(i) differences in domestic law treatment between home and host country may give rise to double taxation due to an asymmetric treatment of the transfer of the asset. For example, if the asset is transferred to head office in a jurisdiction, which would not recognise the unrealised profit from the notional transfer, the taxpayer will not get immediate relief for any tax paid in respect of that transfer in the jurisdiction of the PE.

211. For the authorised OECD approach to apply in a completely symmetrical manner in this situation, the home country of the head office would need to recognise that the transfer into its jurisdiction gives rise to a disposition of the asset by the enterprise and an immediate reacquisition at fair market value. This would produce a profit or gain that could be taxed in the head office's home country, thereby permitting that jurisdiction to provide relief against that profit or gain for the tax paid in the host country of the PE in respect of the transfer. However, the absence of a right to tax the profit or gain under the domestic law of the head office's home country would mean that it is not possible to tax the profit or gain on the transfer and so provide for immediate double taxation relief.

212. The above situation is one where the authorised OECD approach could not be applied in a symmetrical manner without a change in the domestic law of the country of the head office. As discussed at Section B-2 above, remedying such a situation is beyond the scope of this Report. However, if the asset is ultimately disposed of by the enterprise at a profit or gain, partial or complete relief from double taxation may be achieved at that time, if the head office jurisdiction is a credit country and allows for the carryover of unused credits from the time of the transfer of the asset from the PE.

213. If it is considered that the factual and functional analysis reflects the provision of a capital asset in a manner comparable to a lease or a licence between independent enterprises, no profit or loss at the time of the transfer of the capital asset would have to be recognised. Instead, profits would be attributed between the parties to the notional transfer, based, for example, on a comparable transaction between independent enterprises (a lease or a licence). Therefore, when computing its taxable profits, the PE would be entitled to deduct an amount equivalent to the arm's length charge for the use of the lease or license that would have been agreed upon between independent enterprises had they entered into the same transaction. Whether the dealing representing the change of use of the asset was comparable to a lease as opposed to a licence would be determined described in paragraphs 198-202 above.

214. Another possibility might be that the PE and other parts of the enterprise have structured their dealings in a comparable manner to economic co-participants in a "CCA" type activity that contemplates serial use of a capital asset by different parts of the enterprise. Following, by analogy, the guidance given in Chapter VIII of the Guidelines there might not be a need in such cases to recognise any appreciation (or depreciation) at the time of the change in the use of the capital asset, if the asset were transferred between "participants" in a manner consistent with the contemplated serial use of the asset under the "CCA" type activity.

215. In other cases, there may still be a need to recognise any appreciation or depreciation in the value of a capital asset following a change of use, even where an asset is used pursuant to a CCA type activity. For example, the asset may no longer be used in the activity which is the subject of the "CCA" or because one part of the enterprise involved in the change of use has ceased to be a participant in the "CCA" type activity or because another part of the enterprise has started to use the asset and has become a new participant in the "CCA" type activity.

(b) Intangible property

Introduction

216. One of the most important commercial developments in recent decades has been the growth in the significance to an enterprise or an MNE group of its intangible property. The pace of technological change has meant that, more than ever before, the ability of an enterprise or MNE group to generate profits is linked to the specialised knowledge and processes at its disposal, while the revolution in communications has led to an ever-increasing emphasis on advertising and the value of brands and the creation of new ways of conducting business such as e-commerce in which reliance on physical capital may in certain cases be less significant.

217. These developments represent a major challenge for tax administrations and taxpayers who need to place a value on a company's intangible property or estimate the revenue it generates. Intangible property in various forms, including the company's name itself, can represent the main part of the substantial differences between the net asset value of many quoted companies and the market value of their shares. Therefore, it is vitally important that, in determining the profits attributable to a PE under the authorised OECD approach, due consideration is given to the treatment of intangible property. This is a complex area not least because unlike the situation involving other assets (considerations relating to CCAs aside), it is common for intangible property to be used simultaneously by more than one part of the enterprise. Significant issues may arise where there is some change of use in relation to intangible property.

Existing Guidance

218. There is little existing guidance on intangible property in the Commentary to Article 7. In the PE context, intangible property is mentioned in only two places; once in the Commentary on Article 5 in the context of establishing whether a PE exists; and once in paragraph 17.4 of the Commentary on Article 7, which represents the only discussion in the Commentary of the treatment of intangible property within a single enterprise operating through a PE. The general presumption in the 1994 Report was that notional payments are not recognised for the use of intangible property by one part of the enterprise, i.e. notional royalties, are not allowed. The position reached in the 1994 Report is reflected in the comments at paragraph 17.4 of the Commentary, which advise that:

> "Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprises without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development activity (e.g. the

responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate to a compensatory charge."

219. The discussion in paragraph 17.4 is deficient in a number of respects. It focuses on whether an internal "royalty" could be paid and is silent on other important issues such as the impact of intangible property on the comparability analysis, the allocation of a return to intangible property from third parties, the rewarding of the parts of the enterprise that may have performed the functions leading to the creation of the intangible, etc. Further the paragraph flags up the issues of allocating costs of development of an intangible and the risks of adverse consequences related to an intangible but without providing much in the way of guidance as to how to perform such an allocation. The rest of this section aims to provide guidance to remedy the current deficiencies.

Guidance on applying the authorised OECD approach to intangible property

220. It would be overly prescriptive to allow only one approach for dealing with the variety of ways in which intangible property can be exploited. Indeed, although the language of paragraph 17.4 of the Commentary (reproduced above) favours the cost allocation model, there is a clear implication that arm's length notional payments between different parts of the enterprise could be allowed if the costs of creation could actually be identified as having been, in practice, incurred by one part of the enterprise. Unfortunately, the paragraph does not explicitly distinguish between legal and economic ownership and this may have led to an overstatement of the difficulty in identifying which part of the enterprise has borne the costs and risks of creating and developing the intangible property in certain circumstances. Nor has it recognised that more than one part of the enterprise may have contributed to the development of the intangible property.

221. By contrast with the lack of guidance in a PE context, the Guidelines provide an entire chapter (Chapter VI) on the treatment of intangible property, which usefully distinguishes between marketing intangibles and other commercial intangibles (referred to as "trade" intangibles) and could be applied by analogy in the PE context. In particular, the concept of functional and factual analysis would be applied in order to determine which, if any, part of the enterprise could be identified as having performed the function of creating the intangible.

222. The possibility of using functional analysis to determine the economic "ownership" of assets has already been tested in one common situation where assets are created by the functions of the enterprise – namely the financial assets created by financial enterprises such as banks. As can be seen from paragraphs 10 and 11 of Part II, this determination was made on the basis of where the key entrepreneurial risk-taking functions were performed.

223. Clearly the determination of the economic ownership of intangible property created by an enterprise should also be based on similar principled grounds so as to rule out the possibility of the enterprise simply nominating one part of the enterprise as the owner (by booking the intangible assets there) irrespective of whether, for example, that part had the expertise and/or capacity to assume and manage the risks associated with the intangible property. The discussion below explores the extent to which it may be possible to attribute economic ownership of the intangible property to one part of the enterprise, in a way that is consistent with the general principles of Part I and the attribution of financial assets and risks described in Parts II and III.

224. The rest of this section provides guidance on three main issues. First, the determination of which part(s) of the enterprise is the economic owner of the intangible property. Second, the impact of intangible

property on the profits to be attributed to the PE. Third, any dealings between the part of the enterprise that is the owner of the intangible and another part(s) of the enterprise that uses the intangible.

1. Which part(s) of the enterprise is the economic owner of the intangible property

225. The discussion in this section focuses first on trade intangibles, then moves on to consider whether it is possible to apply the same approach to marketing intangibles. The following two situations are discussed:

- Where the intangible property is newly developed by the enterprise
- Where the intangible property has been acquired from another enterprise

The attribution of trade intangibles to a single part of the enterprise.

Internally Developed Trade Intangibles

226. The authorised OECD approach seeks to attribute profit to the PE by reference to a functional and factual analysis which determines the functions performed by, and the assets and risks, attributed to the PE. As noted under the first step of the authorised OECD approach it will be necessary to use a functional and factual analysis to determine what intangible property the PE uses and under what conditions, i.e. does it "own" the intangible either solely or jointly with another part of the enterprise. It may be that one part of the enterprise is a research centre for the enterprise and therefore has performed most or all of the functions by which a trade intangible, e.g. a complex software operation, has been created. However, that does not necessarily mean that one of the internal "conditions" of the research centre PE is that it is treated as the economic owner or joint economic owner of the intangible.

227. Between associated enterprises, one company may commission another to develop a particular piece of software in return for remuneration. The legal terms of the contract will determine their relationship, and in particular may define what risk, if any, is borne by the developer and what ownership rights the developer and the commissioning company will acquire in the finished software. In short, the performance of the development function(s) does not of itself determine the legal ownership. Rather the key issue is which enterprise acts as the entrepreneur in deciding both to initially assume and subsequently bear the risk associated with the development of the intangible property.

228. The decision to initially assume the development risk would appear to be similar to the concept of the key entrepreneurial risk-taking functions described in Parts II and III that are used to determine the economic ownership of financial assets. The economic ownership of newly developed intangible property would seem to be capable of determination under a similar factual and functional analysis. As noted in Section B-1 (iii) of Part II, "it will be important to identify not just what key entrepreneurial risk-taking functions are performed but also their relative importance. The key entrepreneurial risk-taking functions are those which require ***active decision-making*** with regard to the taking on and ***day-to-day management*** of individual risk and portfolios of risks" [*emphasis added*].

229. In financial enterprises, depending upon what business organisation model they use, the active decision-making and day-to-day management may often be devolved throughout the enterprise. An issue arises as to whether this is likely to be the same with regard to the development of intangible property or whether it is more likely that the key entrepreneurial risk-taking functions are undertaken at a high strategic level by senior management or whether by a combination of centralised and devolved risk taking functions.

230. Whether the degree of centralisation of the decision making process for the development of intangible assets is high will depend on the circumstances of the particular business, and so be dependent on the facts. However, it should be noted that there is no hard evidence that the decision making process for the development of intangible property is generally so centralised, especially as given the comments at paragraph 226 above, the focus for determining the key entrepreneurial risk-taker is on the active decision making and day to day management rather than on simply saying yes or no to a proposal. This suggests that, just as for financial assets, economic ownership may often be determined by functions performed below the strategic level of senior management. This is the level at which the day to day management of a program toward the development of an intangible would occur, where the ability to actively manage the risks inherent to such a programme lies. Further, as noted in paragraph 11 of Part II, such a determination must be made on a case-by-case basis as the key entrepreneurial risk-taking functions and especially their relative importance are likely to vary according to facts and circumstances.

231. The functional and factual analysis should therefore describe and evaluate the dynamics of the particular enterprise's research and development programme, and in particular the nature of the critical decision-making process and the level at which those decisions are taken. It is also suggested that the performance of such a rigorous functional analysis should protect against manipulation so that there should be no problem in accepting the case where genuinely all the decision-making process for the development of intangible property is centralised in one part of the enterprise such as the Head Office.

232. Parts II & III discuss at length the various types of risk associated with financial assets. With the development of intangible property the main risk is that the development is unsuccessful or is not successfully implemented for some other reason, thereby creating a financial loss (the researchers salaries and other costs not covered by income received form the successful development of the intangible). Depending on the type of intangible property there may also be other developmental risks, e.g. adverse side-effects caused in a trial of a new active ingredient for a drug. Under the authorised OECD approach the "developer" of the assets would have to bear such losses and would have sufficient capital attributed to it to support the risk assumed. With a financial asset the risks are assumed by the economic owners unless there is a recognised dealing which transfers risk (and economic ownership) to another part of the enterprise. Only the profits of the economic owner are affected by the crystallisation of risk assumed in the creation of financial assets.

233. The failure to develop an intangible asset on the other hand may affect not just the owner of the asset, but also the intended users of the intangible property. Financial assets are not generally used by other parts of the financial enterprise to the extent that intangible property is used by other parts of the enterprise. This raises a question as to whether use and intended use of an intangible should be a factor in determining economic ownership. The answer would seem to be that intended use per se does not determine the capacity in which the user subsequently uses the asset once developed, i.e. as sole or joint economic owner or licensee. Therefore it is not so much the intention to use the intangible per se that should be a factor in determining economic ownership of an intangible, but the extent to which the intended user performed the key entrepreneurial risk-taking functions, e.g. by taking (or taking part in) the initial decision to develop the intangible or undertaking the day to day management of the R&D programme. It may well turn out that the user of the developed intangible is, in fact, the party or one of the parties that has performed the key entrepreneurial risk taking decisions, precisely because the user stood to gain from it. And this can be as true for tangible assets as it is for intangible assets.

234. Again consistent with the position taken for created financial assets, an assertion that one part of the enterprise has the capital necessary to support the risks of development would not be a relevant factor. As already noted, capital follows risks and not the other way round so the part of the enterprise found to be the economic "owner" of the intangible property would be attributed the capital necessary to support the associated risks. In short, the key factor is whether the PE undertakes the active decision-making with

regard to the taking on and day-to-day management of the risks related to the creation of the new intangible.

Acquired Trade Intangibles

235. Although trade intangibles are commonly developed internally they are also acquired from other enterprises, either outright or through a licensing agreement as discussed in paragraph 196 above. The question arises as to how to attribute the ownership of such assets, once acquired. Again under the authorised OECD approach, the approach is to determining the key entrepreneurial risk-taking functions.

236. In some circumstances, this may be determined in exactly the same way as for internally created intangibles. For example, where an enterprise both acquires and develops similar trade intangibles the functional and factual analysis might show that ownership of both the acquired and internally created intangibles lies with the same part of the enterprise because the part(s) of the PE responsible for the key entrepreneurial risk taking decisions on developing intangibles are also responsible for the key entrepreneurial risk taking decisions on acquiring intangibles. This may not be that unusual given that two decisions are involved in making an acquisition of intangibles. The first is to determine whether that particular intangible is valuable to the enterprise's business. And secondly that it makes more sense to buy the intangible than to develop it in house. Such decisions may well be made by the same people who would decide whether it is better to develop the intangible internally.

237. In other circumstances, an important factor in determining the key entrepreneurial risk-taker might be intention to use the acquired asset. The reasoning behind this would be that when an existing intangible is acquired there is no risk that the development of the intangible will be unsuccessful (since it has already been successfully completed). Rather, the risks are that the acquired intangible will not be successfully used, say for example, there are practical difficulties in making the acquired software compatible with existing systems, or the improvements the intangible makes to existing products does not equate to an increase in sales commensurate with the cost of the acquired intangible. In such instances the risk associated with failure appears to fall more on the user, i.e. the user is the key entrepreneurial risk-taker.

238. A further consideration that the discussion may need to take account of is the fact that trade intangibles may be acquired at various stages of development. It could be that the acquired intangible is fully developed as assumed in the preceding paragraph. Or it might be that there is still some way to go before the intangible is fully developed. This may affect the analysis of the key entrepreneurial risk-taker.

Marketing intangibles

239. Similar issues arise in respect of marketing intangibles, in particular the name and logo of the company or the brand. Does the name of a well-known company belong equally to all parts of the enterprise, such that each PE can be said to share in the name by analogy with the fact that in Parts II & III it is said to share in the capital of the enterprise? Is it one of the internal conditions of the enterprise like creditworthiness? And if this is so what are the consequences?

240. It would appear more difficult under the first step of the authorised OECD approach to attribute the sole or joint ownership of the marketing intangibles to one part of the enterprise under a factual and functional analysis. This may be especially so where those marketing intangibles are global in nature. The connection between the performance of functions, the initial assumption and subsequent bearing of risks and the creation of a global marketing intangible may be more remote than for trade intangibles so that it may be more difficult to identify which functions and risks actually relate to the creation and ongoing maintenance of the global marketing intangibles. The key entrepreneurial risk-taking functions leading to

the decision to create a global marketing intangible may have been made a long time ago for well known brands or to be relatively unimportant compared to the ongoing costs of maintaining a global marketing intangible such as a brand. Moreover, brands generally require constant maintenance in terms of advertising and other promotional expenditures and, again, these activities may be dispersed within the enterprise. In terms of ongoing risk- management this may be dispersed within the enterprise or simply related to the sharing of advertising costs.

241. On the other hand, where the marketing intangible is specific to the PE's host country, it may be possible to determine the "sole or joint ownership" of the intangible. This is because the specific nature of the marketing intangible should make it easier to identify the key entrepreneurial risk-taking functions leading to the creation and ongoing maintenance of the specific marketing intangibles. Further, it should be easier to identify where these functions are performed as they are unlikely to be dispersed within the enterprise but are likely to be performed either in the PE or in head office.

242. In conclusion, the same principles should apply to determine the sole or joint "economic" ownership of marketing intangibles as trade intangibles. However, factual differences mean that it may not normally be possible to identify one part of the enterprise as the owner of the global marketing intangibles although it may be possible in some circumstances to identify one part of the enterprise as the owner of the marketing intangibles specific to the host country of the PE.

2. Impact of intangible property on the profits to be attributed to the PE

243. If it is determined under the functional and factual analysis that the PE has performed, at least in part, the function of creating the intangible or bears extraordinary marketing expenditure in relation to the intangible, the PE would be entitled to a comparable return to that of an independent enterprise performing a similar function. Where the functional and factual analysis attributes sole or joint ownership of the intangible asset to the PE the guidance in Chapter VI on special considerations for intangible property should be followed, by analogy, when making the attribution of profit to the PE performing that function, or the guidance in Chapter VII, in respect of any services provided in connection with the development of the intangible property.

244. The conditions under which the PE performs that function also need to be taken into account and, in particular, whether the PE is the "sole or joint owner" of the intangible. If the conditions were comparable to those of a contract researcher within the meaning of paragraph 7.41 of the Guidelines, the contract researcher PE would be attributed a profit consistent with that earned by independent enterprises performing a similar function as contract researchers and not as "owners". Another possibility might be that both the PE and other parts of the enterprise have jointly contributed to the development of the intangible property, for their joint purposes, in which case profit would be attributed between the contributing parties, based on what would happen between independent parties participating in a comparable "CCA" type activity. The guidance given in Chapter VIII of the Guidelines would be followed, by analogy. The rest of this section looks in more detail at some of the key issues in determining the impact of intangible property on the profits of the PE.

245. The return on intangible property is part of the overall return to the enterprise from its transactions with third parties and the issue is not to determine that return but rather to attribute the return within the enterprise in accordance with the arm's length principle. For example, the existence of a proprietary trading model may have enabled traders at a financial institution to generate more profits. The profit from the transaction with third parties that has been properly attributed to the PE as a result of functions performed by the PE (including use of intangible assets) may therefore already include an element relating to the return on the intangible property used by the PE. Therefore in such cases there would normally be no need to impute any additional return to intangible property, but rather the issue to be

determined will be whether the PE has recognised appropriate expenses associated with the creation, development or maintenance of the intangible that it has used.

246. The focus of Article 7 is on attributing profits to the PE and in the context of rewarding intangible property, the focus is on ensuring that the intangible owner is attributed an arm's length return. There are a number of ways of ensuring that the return to intangible property is appropriately attributed within the enterprise, only one of which that attributes the return in a manner similar to a royalty transaction between independent enterprises in similar circumstances. It must be noted, however, that in the context of the authorised OECD approach, the use of the word "royalty" is not meant to convey either an actual payment or a formal license agreement between two parts of the same enterprise but is intended to refer to the arm's length compensation that one would have had to pay (and deduct from income) for the use of the intangible if the provider of the intangible were a distinct and separate enterprise. The recognition of the notional royalty is relevant only to the attribution of profits to the PE and should not be understood to carry wider implications as regards withholding taxes, which are outside the scope of this Report. Between independent enterprises other ways of rewarding the owner of the intangible include incorporating the reward in the price of goods sold by the intangible owner, or by sharing part of the overall profit with the intangible owner, for example through a residual profit split method. If such arrangements were replicated in a PE situation, then the "royalty" issues discussed above would not be in point.

247. A PE of a well-known MNE which provides goods or services under the MNE's brand name but does not contribute to the MNE's reputation outside the host country would be fully remunerated for any share in the ownership of the name under the authorised OECD approach by receiving the third party income generated by the functions it performs less the expenses incurred in performing those functions, as the price paid by third parties would reflect the value of the name and the volume of third party sales would likewise be affected by that name. Therefore, in such cases there would normally be no need to impute any additional return to the marketing intangible but again the issue to be determined will be whether the PE has recognised sufficient expenses associated with the creation, development or maintenance of the marketing intangible that it has used.

248. However, there may be some circumstances in which an additional return might be justified. For example, it may be that the PE has carried out particular functions that have led to an increase in the value of the brand name <u>outside</u> the host country and these functions had not already received an arm's length reward. Further, if exceptionally it is found that another part of the enterprise is the "owner" of the brand name, then the guidance in Chapter VI of the Guidelines on marketing activities undertaken by enterprises not owning trademarks or trade names may be capable of application by analogy to the PE undertaking such marketing activities.

249. Importantly, if the PE has <u>not</u> contributed to the value of the brand name, but has benefited from global marketing costs outside the host country, it should compensate the other part of the enterprise through a sharing of the costs or otherwise in determining its profits to the extent that those costs are related to the use of the intangible in the PE's host country. This determination would have to be made on a case-by-case basis because of the different types of brands and different market conditions etc. Not all global brand names are valuable and nor do all global marketing campaigns benefit individual jurisdictions.

250. Additionally, whilst the existing Commentary focuses on royalty income from licensing intangibles and on cost sharing, it is also possible to attribute the return from intangible property without any internal "royalty" by means of a profit method. For example, if the intangible property is closely associated with an integrated global trading business which is remunerated via a profit split method, it would be possible to attribute the return to the intangible property within the profit split calculation either

explicitly by including it as a factor in its own right or implicitly by virtue of its impact on other factors. In this case there is therefore no need to calculate royalty income per se, or to infer the existence of a cost sharing agreement. In short, the objective of the analysis is to ensure the appropriate attribution of the return on intangible property, rather than on whether an internal "royalty" should be recognised.

251. Finally, where the PE is determined as the economic owner of intangible property, capital, including free capital is attributed to support any significant risks associated with the development of the intangible property. As discussed in the section dealing with the attribution of capital, it can be difficult to measure precisely the risk associated with the creation of intangible property, however the exercise should be performed where those risks are significant. Where the PE is determined not to be the economic owner of the intangible, but, say, a contract R&D service provider, it will still require funding to meeting researcher's salaries etc, but given that the significant risks lie with the economic owner, it will be attributed little free capital the funding being more in the way of stage payments from the economic owner of the intangible.

3. Internal dealings relating to use of an intangible

252. Just as in the case of capital assets, even more difficult questions can arise when an intangible property that is "solely owned", say, in head office, is provided to one or more of its PEs for use in its business. For example, a PE may begin to make use of a trade intangible developed in the past by activities in the head office, and exploited in the past by the head office. This situation commonly arises because of business changes, for example, the PE moving into a new business area. Under the authorised OECD approach, a functional and factual analysis of the situation might show that the PE should be treated as engaging in a dealing with the head office, in respect of that intangible property. Profit would be attributed in respect of this dealing by reference to comparable transactions between independent enterprises (e.g. a royalty) and would depend on a factual and functional analysis of the dealing, the type of interest obtained or notional rights acquired (exclusive or non-exclusive) etc. Guidance on these issues is given in Chapters VI and VIII of the Guidelines. It is worth reiterating that, as noted in the previous section, an "internal "royalty" is only one of a number of possible ways of rewarding intangible property.

253. As stated above, unlike the situation involving capital assets, it is common for intangible property to be used simultaneously by more than one part of the enterprise. Making an intangible asset available to a PE does not imply that other parts of the enterprise have ceased to be able to exploit that same asset or may not be able to do so in the future. Such a change in use could result in the PE being treated as having obtained not the intangible asset itself or an exclusive notional right to use the intangible, but rather a beneficial interest in that asset or a non-exclusive right to use the intangible. Thus, under the authorised OECD approach, the PE would be treated as having acquired an interest in the intangible or a notional right to use the intangible at the time of the change of function.

254. The value of the interest acquired (joint ownership, outright ownership or a beneficial interest) would be determined by reference to comparable transactions between independent enterprises. The PE might be treated as having acquired the intangible or an interest in the intangible at fair market value and so is entitled to depreciate/amortise the interest in the acquired asset using that value, subject to host country depreciation/amortisation rules. This would put the position of intangibles (where the facts and circumstances suggest that the treatment discussed in this paragraph should apply) on a par with that of tangible assets transferred for the use of the PE and not for resale.

255. Another possible outcome of the analysis of the dealing involved in making an intangible available to a PE could result in the PE being treated as having obtained a notional right to use the intangible property analogous to a licensing agreement. Depending on the factual circumstances and the comparability analysis, the PE might be entitled to deduct an amount equivalent to the arm's length charge

(notional royalty) for a license arrangement that would have been agreed upon between independent enterprises had they entered into a comparable transaction.

256. Similar principles to those discussed above apply to dealings recognised in respect of intangibles acquired by an enterprise through licensing from a third party. As discussed at paragraph 196, an enterprise's right to use an intangible under a license may constitute an asset whose economic ownership can be attributed to a part of the enterprise and can be the subject of a dealing with another part of the enterprise. Economic ownership of this asset is attributable to that part of the enterprise performing the key entrepreneurial risk-taking functions related to the right to use the licensed asset. Where the economic owner makes the licensed intangible available for use by another part of the enterprise so that a dealing between these parts is recognised, the factual and functional analysis will determine the character of that dealing, e.g. as an outright transfer or a licensing of those rights to use, for purposes of attributing profit from that use.

257. It should be noted that the analysis in the preceding paragraph deals only with the direct consequences of the transfer of the intangible asset itself or a beneficial interest in an existing intangible asset. In circumstances where an intangible developed by one part of the enterprise is to be further developed by the enterprise as a whole, it might be that such further development would be conducted in a "CCA" type activity to which the PE is a participant. In such circumstances the PE would be treated for tax purposes as if it had acquired an interest in the pre-existing intangible property (a buy in) and any subsequent dealings related to the further development of the intangible property would be determined by following, by analogy, the guidance given in Chapter VIII of the Guidelines. If, by following, by analogy, the guidance of Chapter VIII, the PE were found to have acquired only the notional right to use the pre-existing intangible that is subject to the "CCA" type activity and did not obtain a beneficial interest in the intangible property itself, a notional royalty may be attributed based, by analogy, on the guidance in Chapter VI.

(c) Internal services

258. A considerable head office support infrastructure is often necessary in order to carry out a business conducted through PEs. These can cover a wide range of activities from strategic management to centralised payroll and accounting functions. The existence of these support functions needs to be considered when attributing profit to the various parts of the enterprise.

259. The Commentary on Article 7 at paragraph 17.7, presumes that services which are related to the general management activity of the enterprise should normally be allocated at cost. The provision of a mark up (or more strictly an arm's length price) is restricted to certain cases (see the comments at paragraph 17.5 and 17.6), for example where it is the trade of the enterprise to provide such services to third parties or where the main activity of the PE is the provision of services to the enterprise as a whole and where those services are both a significant part of the expenses of, and provide a real advantage to, the enterprise.

260. In respect of this view, it is important to consider that the Guidelines have, since 1996, significantly updated the principles cited in the Commentary on Article 7 concerning the situations in which associated enterprises should be permitted to transfer property or services to each other without realising a profit. The Commentary on Article 7 uses an interpretation of the arm's length principle that pre-dates the Guidelines. Under the former interpretation, specific factual circumstances were established in which associated enterprises might deviate from the arm's length principle and transact with each other

at cost[8]. The factual circumstances related to whether the transaction involved goods/services offered regularly to third parties: the "direct or indirect approach". Chapter VII of the Guidelines have revised this interpretation, so that associated enterprises are now always required to comply with the arm's length principle.

261. One area where there is a difference between the authorised OECD approach and the existing position in the Commentary arises from the fact that under the authorised OECD approach, the arm's length principle is applied to determine the reward for performing that service. Application of that principle will take account not only of the price applied to the service but following the guidance in Chapter VII, whether, at arm's length, both parties would have contracted for the provision of the service. The tests at paragraph 7.6 of the Guidelines will prove helpful in resolving such issues. Moreover, application of the arm's length principle may indicate a price for the service rendered that is above or below the costs incurred by the head office in providing it (see paragraph 7.33 of the Guidelines).

262. The authorised OECD approach is to attribute profits to a PE in respect of services performed by the PE for other parts of the enterprise (and vice versa) by following, by analogy, the guidance given in the Guidelines, especially in Chapters VII and VIII, in order to determine whether, and if so, to what extent, the support functions should be rewarded. In some cases, the PE and the other parts of the enterprise can be considered as acting in a comparable manner to economic co-participants in a "CCA" type activity involving the provision of those services. The internal dealings within the enterprise would be treated for tax purposes in a like manner as a provision of comparable services between independent parties in a comparable "CCA" type activity, following, by analogy, the guidance given in Chapter VIII of the Guidelines. Most of the services provided by the head office of an enterprise are little different from those provided by the parent, or centralised service provider, of a MNE group. Similar techniques can be used as for associated enterprises. If CUPs are unavailable, cost plus methods may be particularly useful.

263. Finally, it is worth recalling paragraph 7.37 of the Guidelines which is reproduced below:

"While as a matter of principle tax administrations and taxpayers should try to establish the proper arm's length pricing, it should not be overlooked that there may be practical reasons why a tax administration in its discretion exceptionally might be willing to forgo computing and taxing an arm's length price from the performance of services in some cases, as distinct from allowing a taxpayer in appropriate circumstances to merely allocate the costs of providing those services. For instance, a cost-benefit analysis might indicate the additional tax revenue that would be collected does not justify the costs and administrative burdens of determining what an appropriate arm's length price might be in some cases. In such cases, charging all relevant costs rather than an arm's length price may provide a satisfactory result for MNEs and tax administrations. This concession is unlikely to be made by tax administrations where the provision of a service is a principal activity of the associated enterprise, where the profit element is relatively significant, or where direct charging is possible as a basis from which to determine the arm's length price."

(d) Documentation

264. The authorised OECD approach would also apply, by analogy, the guidance on documentation in Chapter V of the Guidelines. In particular, the same standards would apply to the documentation of dealings as currently apply to the documentation of transactions and the summary of recommendations at paragraphs 5.28 and 5.29 of the Guidelines should be followed. Compliance requires the non-resident enterprise to document contemporaneously the attribution of profit to the PE and ensure that the

8. See paragraphs 81-83 of the 1984 OECD Report, "Transfer Pricing and Multinational Enterprises - Three Taxation Issues; The Allocation of Central Management and Service Costs".

documentation is consistent with how the different parts of the enterprise subsequently behave, establishing the true nature of the economic relationships. In short, in the PE context, information on the attribution of profits to the PE in the home country should be readily available to the host country and vice versa.

265. However, as dealings have not always been recognised for the purposes of attributing profits to PEs, taxpayers may not be in the habit of documenting dealings to the same extent as they would document transactions with associated enterprises. This may explain some of the potential difficulties in applying the authorised OECD approach in practice that have emerged from the testing process. It may therefore be necessary for tax administrations to educate taxpayers in this matter so as to ensure that dealings are in fact adequately documented in accordance with the guidance in Chapter V of the Guidelines. Tax administrations and taxpayers should also follow the general guidance in Chapter V on these issues.

(v) Dependent agent PEs

Introduction

266. As already stated in paragraph 6, this Report does not examine the issue of whether a PE exists under Article 5 (5) of the Model Tax Convention (a "dependent agent PE") but discusses the consequences of finding that a dependent agent PE exists in terms of the profits that should be attributed to the dependent agent PE. It is worth emphasising at the outset that the discussion below is not predicated on any lowering of the threshold of what constitutes a PE under Article 5. However**,** certain business arrangements have facilitated the growth of business models that may meet the threshold conditions and so give rise to dependent agent PEs within the meaning of Article 5(5).

267. The current lack of guidance on how to determine the profits to be attributed to a dependent agent PE has created uncertainty as to the consequences of finding dependent agent PEs under Article 5(5). There is a concern from business that in the absence of such guidance a "force of attraction" rule may become the default position; so that, for example, the finding of a dependent agent PE would have the automatic effect of drawing in profits to the host country irrespective of whether those profits are generated by, or as a consequence of, activity undertaken by the dependent agent. This section is intended to remedy the current unsatisfactory situation by providing specific guidance on the attribution of profits to a dependent agent PE using the same principles that are applied to attribute profits to other types of PEs. Moreover, as will be seen below, the authorised OECD approach, grounded in a factual and functional analysis of the activities of the dependent agent and emphasising the importance of determining the key entrepreneurial risk taking functions, provides a measurement of the amount of profits attributable to a dependent agent PE that is consistent with the arm's length principle. Consequently, there is no presumption that a dependent agent PE will have profits attributed to it. In some circumstances, the functional and factual analysis may determine that the amounts to be attributed to the dependent agent PE is a negligible profit, nil or a loss.

268. The situation where global trading in financial instruments is conducted by a dedicated agent ("dependent agent enterprise") which is itself a wholly owned subsidiary of the global trading group and results in a dependent agent PE under Article 5(5) is discussed in detail in Part III of the Report. The example discussed below primarily focuses on situations where the dependent agent is an associated enterprise. However, the same principles are applicable to situations where the dependent agent is not an associated enterprise.

The authorised OECD approach for dependent agent PEs

269. In cases where a PE arises from the activities of a dependent agent, the host country will have taxing rights over two different legal entities - the dependent agent enterprise (which is a resident of the host country) and the dependent agent PE (which is a PE of a non-resident enterprise). In respect of transactions between the associated enterprises (the dependent agent enterprise and the non-resident enterprise), Article 9 will be the relevant article in determining whether the transactions between the associated enterprises, e.g. commission paid to dependent agent enterprise based on volume of product sold, were conducted on an arm's length basis.

270. In respect of the dependent agent PE, the issue to be addressed is one of determining the profits of the non-resident enterprise which are attributable to its dependent agent PE in the host country (i.e. as a result of activities which have been carried out by the dependent agent enterprise on the non resident enterprise's behalf). In this situation, Article 7 will be the relevant article. Finally, it is worth stressing that the host country can only tax the profits of the non-resident enterprise where the functions performed in the host country on behalf of the non-resident enterprise meet the PE threshold as defined under Article 5. Further, the quantum of that profit is limited to the business profits attributable to operations performed through the dependent agent PE in the host country.

271. Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. The answer is to follow the same principles as used for other types of PEs, for to do otherwise would be inconsistent with Article 7 and the arm's length principle. Under the first step of the authorised OECD approach a factual and functional analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand the dependent agent enterprise will be rewarded for the service it provides to the non-resident enterprise (taking into account its assets and its risks (if any)). On the other hand, the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident, together with sufficient free capital to support those assets and risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets, risks and capital. The analysis would also focuses on the nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes the key entrepreneurial risk-taking functions. In this regard an analysis of the skills and expertise of the employees of the dependent agent enterprise is likely to be instructive, for example in determining whether negotiating or risk management functions are being performed by the dependent agent on behalf of the non-resident enterprise. In general the factual and functional analysis focuses on the nature of the functions carried out and in particular whether key entrepreneurial risk-taking functions are carried out by the dependent agent enterprise on behalf of the non resident enterprise, such that the associated assets and risk of the non-resident enterprise should be attributed to its dependent agent PE (in which case the profits associated with those assets and risks would be taxable in the host country) rather than to another part of the non-resident enterprise (in which case the associated profits would not be taxable in the host country).

272. In practice the dependent agent enterprise may not perform key entrepreneurial risk taking functions and if it does not then the attribution of the assets, risks and profits to the dependent agent PE, are correspondingly reduced or eliminated. In particular, it should be noted that the activities of a mere sales agent may well be unlikely to represent the key entrepreneurial risk-taking functions leading to the development of a marketing or trade intangible so that the dependent agent PE would generally not be attributed profit as the "economic owner" of that intangible.

273. In calculating the profits attributable to the dependent agent PE it would be necessary to determine and deduct an arm's length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking into account its assets and its risks if any). Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm's length reward has

been given to the dependent agent enterprise. In accordance with the principles outlined above (and illustrated in the example below) the answer is that it depends on the precise facts and circumstances as revealed by the functional and factual analysis of the dependent agent and the non-resident enterprise. However, the authorised OECD approach recognises that it is possible in appropriate circumstances for such profits to be attributed to the dependent agent PE.

274. Before moving on to the example, it is worth first considering an alternative approach put forward by some commentators (referred to here as the "single taxpayer" approach), which contends that in all circumstances the payment of an arm's length reward to the dependent agent enterprise fully extinguishes the profits attributable to the dependent agent PE. The reasoning behind this approach is that the compensation to the dependent agent enterprise, if arm's length under Article 9, is considered to adequately reward the dependent agent enterprise for its functions performed, assets used and risks assumed, and since there are no other functions performed, assets used and risks assumed in the host country there can be no further profits to attribute. The functional and factual analysis may show that certain risks, for example, inventory and credit risks under a sales agency arrangement, belong not to the dependent agent enterprise but to the non resident enterprise which is the principal. Although it is agreed that the risks are legally borne by the non-resident enterprise, the difference between the two approaches is that under the "single taxpayer" approach, those risks can never be attributed to the dependent agent PE of the non-resident enterprise, whilst the authorised OECD approach would attribute those risks to the dependent agent PE for tax purposes if, and only if, the dependent agent performed the key entrepreneurial risk-taking functions in respect of those risks.

275. Whilst superficially attractive the "single taxpayer" approach in fact contains a number of fundamental flaws. Firstly, this approach would not result in a fair division of taxing rights between host and home jurisdictions as it ignores assets and risks that relate to the activity being carried on in the source jurisdiction simply because those assets and risk legally belong to the non-resident enterprise. Indeed, such an approach would go against one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises (including their assets and risks) in respect of their activities in the source jurisdiction. The "single taxpayer" approach simply does not consider that if the risks (and reward) legally belong to the non-resident enterprise it is nonetheless possible to attribute those risks (and reward) a PE of the non-resident enterprise created by the activity of its dependent agent in the host country.

276. A second problem with the "single taxpayer" approach is that if accepted it would mean the authorised OECD approach being applied differently depending on what type of PE was involved. For PEs other than dependent agent PEs, the authorised OECD approach attributes assets and risks to the PE that are created or economically owned as a result of functions carried on by the PE, and attributes profits accordingly, notwithstanding the fact the assets and risks legally belong, of course, to a non-resident enterprise. In contrast, under the "single taxpayer" approach outlined above, no profits would be attributed to a dependent agent PE in respect of the risks and assets of the non resident enterprise, even though they arise from activities carried out through the dependent agent PE. Such a distinction between enterprises carrying on business through dependent agent PEs and enterprises carrying on businesses through fixed place of business PEs, would seem inconsistent with Article 7 and the arm's length principle. Moreover, drawing a distinction along those lines may result in inconsistent application of the authorised OECD approach in the financial sector, given that where broker/dealers transact business in a local market through a PE they generally do so through a dependent agent PE, whereas banks in the same position generally do so through a fixed place of business PE.

277. Or to look at this issue from another perspective, the "single taxpayer" approach would lead to the same result in terms of profit attribution for dependent agent PEs, even where the facts are substantially different. The attribution of profits to a dependent agent PE would be the same in situations where the

factual and functional analysis demonstrated that the PEs activities generated risks and assets for the enterprise and in situations where the factual and functional analysis determined that the activities did not generate such risks and assets.

278. Finally, it is recognised that a basic principle of statutory interpretation is that the drafters of a statute (or treaty) intend every word to have a meaning and consequently, the text should not be interpreted in a manner that renders a portion of it superfluous. The "one taxpayer" approach to attributing profits, however, would mean that there would never be profit consequences resulting from the finding of a dependent agent PE, thereby making the Article 5 (5) largely redundant.

Practical illustration of the application of the authorised OECD approach - dependent sales agents

279. The following illustrations are intended to better explain the approach taken under the authorised OECD approach. It is recognised that in practice most situations will be significantly more complex and difficult to deal with. The objective however is to illustrate the principle that the host country's taxing rights are not necessarily exhausted by ensuring an arms length compensation to the dependent agent enterprise under Article 9 (the following example is one where the dependent agent is an associated enterprise).

280. Under a typical sales agency agreement, the dependent agent enterprise never takes title to the goods, which remain the property of the non-resident enterprise in whose name the contracts with customers are concluded. Thus where the dependent agent enterprise warehouses a stock of goods belonging to the foreign enterprise in order to fulfil the customer orders generated by the dependent agent's sales activities, the associated inventory risk is assumed by the non-resident enterprise. An arm's length agency fee paid by the non-resident enterprise to the dependent agent enterprise would not therefore include an element to reward the assumption of these risks – they are assumed by the non-resident enterprise.

281. The question is whether any of the reward for the assumption of inventory risk should be attributed to the dependent agent PE of the non-resident enterprise. As already noted, this will be determined by the identification of whether the key entrepreneurial risk-taking functions are undertaken by the non-resident enterprise itself or by the dependent agent enterprise on behalf of the non resident enterprise. This analysis should be undertaken on a case-by-case basis given the wide variety of risk management strategies used by different types of business. The creation and management of inventory risks may involve different entrepreneurial risk taking functions in different business sectors, and even different businesses within the same sector. Those functions may be undertaken in the non resident enterprise, or they may be undertaken by the dependent agent enterprise on behalf of the non-resident enterprise. Moreover, the result of some business models, for example "just in time" manufacturing, may be to eliminate such risks as inventory risk (though such business models may create new risks – the risk for example that the sale is lost because the goods are not available at the time the customer wants it).

282. Having said all this, and for the purpose of illustrating the application of the authorised OECD approach to a dependent agent, suppose that previously the enterprise operates as a full-fledged distributor (i.e. it buys and sells on its own account) and assumes and subsequently manages the inventory risk, including the risk that inventory may become obsolete. Suppose further that there is a business restructuring under which this enterprise converts into a dependent agent enterprise as described in paragraph 269 above. Assume finally that the functional analysis shows that the personnel that used to perform the key entrepreneurial risk taking functions in respect of inventory risk are still employed in the dependent agent enterprise and are still performing those functions, albeit now on behalf of the non-resident enterprise. This would mean that the "economic ownership" of the inventory and the reward for the assumption of the associated inventory risk are attributable under the authorised OECD approach to the

dependent agent PE. And, of course, under the authorised OECD approach, so is the associated profit or loss.

283. The above result is determined under the functional and factual analysis. There is no presumption that assets or risk should be attributed to the dependent agent PE. In other circumstances, the functional and factual analysis might show that the key entrepreneurial risk taking functions are now undertaken by people in the Head Office of the non-resident enterprise, and the former decision takers in the associated enterprise are either no longer employed by the dependent agent enterprise in the host country or do not carry out activities on behalf of the non-resident enterprise. In such circumstances the economic ownership of the inventory and the reward for the assumption of the associated inventory risk would not be attributable under the authorised OECD approach to the dependent agent PE of the non-resident enterprise but to its Head Office.

284. A similar analysis can be carried out on a case-by-case basis in respect of other types of risks, e.g. the credit risk in respect of the customer receivables of the non-resident enterprise. Again, under a typical sales agency agreement customer receivables and the associated credit risk legally belong to the non-resident enterprise, not the dependent agent enterprise and so the remuneration paid by the non-resident enterprise to the dependent agent enterprise should not reward the assumption of this risk. Once again the key question is whether any of the reward for the assumption of credit risk should be attributed to the dependent agent PE of the non-resident enterprise. As already noted, this will be determined by reference to the identification of where the key entrepreneurial risk-taking functions are undertaken, i.e. in the dependent agent or the non-resident enterprise.

285. Dependent agent PEs may well arise in situations where following a business re-structuring, MNE Groups have arranged their business in a way that seeks to convert a “full-fledged” operation to a “risk stripped” operations in the host jurisdiction. What emerges from the discussion above is that even where contractual arrangements successfully remove, “risks” from the dependent agent enterprise so that they belong to another enterprise – the non-resident enterprise - that does not assist in answering the key question – should any of the risks that have been “stripped” to the non-resident enterprise nevertheless still be attributed to its dependent agent PE in the host jurisdiction. The authorised OECD approach answers this question by undertaking a functional and factual analysis and, in particular, by identifying which enterprise is undertaking the key entrepreneurial risk-taking functions. In this context, it is worth recalling that under the authorised OECD approach it is not possible within a single enterprise to strip risks from the key entrepreneurial risk-taking functions that give rise to those risks.

Administrative matters and documentation

286. The danger of overlooking the assets used and risks assumed in the performance of the functions in the PE jurisdiction are minimised if the existence of the dependent agent PE is formally recognised so that it is clear that the host country has taxing rights over two different legal entities - the dependent agent PE and the dependent agent enterprise and an attribution of profit based on a functional analysis is made to the dependent agent PE on the basis described in this section. This should also ensure that any other tax consequences arising from different rules for PEs and subsidiaries in the PE jurisdiction are taken into account. One way to formally recognise the existence of dependent agent PEs is to require the filing of tax returns for all such PEs. However, nothing in the authorised OECD approach would prevent countries from using administratively convenient ways of recognising the existence of a dependent agent PE and collecting the appropriate amount of tax resulting from the activity of a dependent agent. For example, where a dependent agent PE is found to exist under Article 5(5), a number of countries actually collect tax only from the dependent agent enterprise even though the amount of tax is calculated by reference to the activities of both the dependent agent enterprise and the dependent agent PE. Such administrative matters

related to the taxation of dependent agent PEs are for the domestic rules of the host country and not for the authorised OECD approach to address.

287. Dependent agent PEs may sometimes give rise to documentation issues that are often not found in other types of PE. A fixed place of business PE, which is typically an economically distinct business unit, may have its own set of financial accounting records that provide a starting point for the attribution of profit for tax purposes. This may well not be the case with the dependent agent PE, particularly where the taxpayer has not set out with the intention of creating a dependent agent PE. Even without this complicating factor, difficulties can arise for tax administrations in trying to obtain the information necessary to determine the profits attributable to the dependent agent PE of the non-resident enterprise in the host jurisdiction. The non-resident enterprise may have no physical presence in the host jurisdiction and the dependent agent enterprise may ordinarily have little information about the operations of the non-resident enterprise. However, under the authorised OECD approach the non-resident enterprise would, just as for other types of PEs, be required to document how it has attributed profit to its dependent agent PE.

D. Interpretation of paragraph 3 of Article 7

288. In attributing profit to a PE in accordance with the arm's length principle, regard must be given to the wording of Article 7(3), which provides that:

> "In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere."

289. Article 7(3) is open to varying interpretations, and the Member countries have considered a range of possibilities. The perspectives on Article 7(3) tend to focus on two competing interpretations. One interpretation is that the provision is aimed primarily at ensuring expenses of a PE's activity are not disallowed for inappropriate reasons, in particular, because the expense is incurred outside the PE's jurisdiction, or is not incurred exclusively for the PE. The other view is that Article 7(3) modifies the arm's length principle articulated in Article 7(2), in that (1) costs allocable to a PE should be deductible even if they exceed what an arm's length party would incur, and (2) another part of the enterprise cannot recover more than its costs with regard to expenses incurred for the purpose of the PE, unless those expenses relate directly to dealings with third parties. In analysing these positions, regard has been given to the history of Article 7(3); to the original intent of the provision; to the practice of Member countries in applying the provision; and the views of Member countries as to the ideal role of the paragraph.

290. The history of Article 7(3) would tend to support the view that the original intent of the provision was simply to ensure that relevant expenses would be deductible against the income of a PE, and that no conflict with the arm's length principle was intended. Indeed, it appears from the history that Article 7(3) was not intended to modify the arm's length principle. Questions about the allocation of profit for head office activities were specifically mentioned in the League of Nations draft of 1933, many years prior to the origin of Article 7(3), so the issue was certainly known and could have been articulated in connection with the issuance of Article 7(3) had that been the intent. However, when Article 7(3) makes its first appearance in the 1946 League of Nations London Model, the expressed purpose is unrelated to the profit issue: "There are indeed in most enterprises with two or more establishments, certain items of expenses that must necessarily be apportioned in order to achieve the object of separate accounting, which is to place branches of foreign enterprises on the same footing as domestic enterprises."

291. Subsequently, the historical grounding of Article 7(3) was somewhat confused by efforts to address the profits attribution question in Commentary to the 1963 Draft Double Taxation Convention on Income and Capital. That Draft Commentary discussed aspects of the profit attribution issue under the caption of Article 7(3). The question addressed was whether the deductions allowed in computing the profits of a PE for particular kinds of expenses (e.g. internal "interest" and "royalty" payments) should be the actual costs incurred or arm's length prices. However, paragraph 14 of the Commentary qualifies that: "it is convenient to deal with them here", presumably because the general discussion on allocating expenses is found under the same heading. The original version of paragraph 13 of the Commentary demonstrates the limited role intended for Article 7(3): "This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. *It is valuable to include paragraph 3 if only for the sake of removing doubts* (emphasis added)." The wording of Article 7(2) was then changed in the 1977 OECD Model Double Taxation Convention on Income and Capital so as to make it: "subject to paragraph 3". This change helped create the misleading impression of a conflict of principle between Article 7(2) and Article 7(3).

292. The changes made in the Model Commentary in March 1994 tried to clarify the intention of Article 7(3) by stating in paragraph 17 that: "there is no difference in principle between the two paragraphs". It then went on to say that Article 7(2) should not be interpreted as requiring: "that prices between the permanent establishment and head office be normally charged on an arm's length basis whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual costs of those expenses." Unfortunately, the language from paragraph 14 of the Commentary to the 1963 Draft Double Taxation Convention on Income and Capital ("it is convenient to deal with them here") referring to the placing of the discussion, was lost in the changes.

293. In sum, it appears that the original intent of Article 7(3) was to ensure that expenses of a PE's activity could be deductible against a PE's attributed profits regardless where incurred (in the jurisdiction of the PE, of the head office or of another part of the enterprise). The original drafting does not appear to have contemplated a modification of the arm's length principle. However, given the wording of the Commentary to Article 7 and the proviso "subject to paragraph 3" that has been included in Article 7(2), it is possible to interpret Article 7(3) otherwise. In particular, the practice of some Member countries has been to interpret Article 7(3) to provide the two modifications to the arm's length principle of Article 7(2), namely that: (1) costs allocable to a PE should be deductible even if they exceed what an arm's length party would incur, and (2) another part of the enterprise cannot recover more than its costs with regard to expenses incurred for the purpose of the PE, unless those expenses relate directly to dealings with third parties.

294. All Member countries, including those that interpret Article 7(3) as requiring the above-named modifications to the arm's length principle, believe that it would be preferable if Article 7(3) did not result in modifications to the arm's length principle, which may in appropriate circumstances involve the sharing of costs. Accordingly, under the authorised OECD approach the role of Article 7(3) should be just to ensure that the expenses of a PE's activity are taken into account in attributing profits to a PE, in particular where the expense is incurred outside the PE's jurisdiction, or is not incurred exclusively for the PE. It will be noted from the discussion of Article 7(2) that the authorised OECD approach does not mandate an attribution of profit (see paragraph 245 above). Furthermore, the authorised OECD approach only determines which expenses should be attributed to the PE. It does not go on to determine whether those expenses, once attributed, are deductible when computing the profit of the PE. That will be determined under the domestic law of the host country.

E. Interpretation of paragraph 4 of Article 7

295. The OECD Model Tax Convention contains in Article 7(4), another provision for attributing profits to a PE:

> "Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article."

296. There is concern that the language of Article 7(4) does not require the use of the purely transactional profit methods authorised by Chapter III of the Guidelines and nor does it follow the hierarchy of methods outlined in that Chapter, as profit methods are allowed if customary, rather than as a last resort. Additionally, Article 7 (4) refers to "an apportionment of the total (added emphasis) profits of the enterprise to its various parts" and could therefore only be transactional in nature if the total profits to be split could be aggregated from individual transactions in accordance with the principles set out by Chapter I, Part C (iii) of the Guidelines. This is very unlikely unless the PE carries on the full range of activities conducted by the whole enterprise or the enterprise itself only carries on a single activity.

297. However, there are safeguards against too widespread an adoption of the Article 7(4) approach. The Commentary on Article 7 at paragraph 25 makes clear that such a method is:

> "not as appropriate as a method which has regard only to the activities of the permanent establishment and should only be used where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory."

298. This would appear to prevent it being applied by countries that have not used such methods to date or in new business areas. There also is an implication in the above language, which is borne out by the historical background, that the use of Article 7(4) has only become customary in areas where it has not proved possible to apply the distinct and separate enterprise approach of Article 7(2). The Commentary also makes clear at the end of paragraph 25 that in bilateral treaties the provision "may be deleted where neither State uses such a method."

299. The approach described by Article 7 (4) is also distinguishable from the global formulary apportionment method rejected by Chapter III of the Guidelines. This is because the last sentence of the provision makes clear that the result of an apportionment under Article 7(4) should be in conformity with the other principles in the Article. These include, amongst other things, the arm's length principle, as applied to PEs by Article 7(2). However, the fact that an attribution under this provision starts off from an attribution of total profits means that, in practice, it may be very difficult to achieve such a result.

300. Given the above caveats, its possible use in a very small number of cases should not weaken the commitment to transactional methods contained in Chapters II and III of the Guidelines. However, the Member countries are of the opinion that such an apportionment method is not consistent with the guidance on the arm's length principle in the Guidelines, or that it is extremely difficult to ensure that the result of applying that method is in accordance with the arm's length principle. Member countries are also of the opinion that methods other than an apportionment of total profits could be applicable, even in the most difficult cases. Accordingly, under the authorised OECD approach only paragraphs 1, 2 and 3 of Article 7 are needed to determine the attribution of profits to a PE. A possible exception to the above

conclusion, relates to the attribution of profit to a PE of an enterprise carrying on an insurance business. The Working Party has not yet finalised Part IV of the Report on the insurance industry but the view of most countries is that (given that under the authorised OECD approach only paragraphs 1, 2 and 3 of Article 7 are needed to determine the attribution of profits to a PE) there is no continuing need for Article 7(4).

F. Interpretation of Paragraph 5 of Article 7

301. Another example where there are problems in applying the "functionally separate entity" approach in the special situation of an enterprise carrying on its business through a PE, is described by Article 7(5) of the OECD Model Tax Convention, which prohibits an attribution of profits to a PE "by reason of the mere purchase of goods or merchandise for the enterprise." The Commentary at paragraph 30 states that the provision is concerned with a PE that "although carrying on other business, also carries on purchasing for its head office." The Commentary makes clear that all profits and expenses that arise from the purchasing activities will be excluded from the computation of taxable profits.

302. This does not necessarily accord with the situation that would occur where one independent enterprise "merely purchases" goods or merchandise on behalf of another independent enterprise. In those circumstances the purchaser would be remunerated on an arm's length basis for its services as a purchasing agent of the other enterprise. There also is a practical problem in deciding which expenses of the PE relate to the purchasing activities and so should be excluded. In addition, it is not clear why the restriction on attributing profits in Article 7 (5) is limited to the case where the PE merely purchases goods or merchandise. There seems little difference in principle if, instead of purchasing goods or merchandise, the PE carries on another of the activities mentioned in Article 5(4), such as the collection of information, which are not sufficient by themselves to create a PE.

303. The Working Party is of the opinion that Article 7(5) is not consistent with the arm's length principle and is not justified. The authorised OECD approach is that there is no need to have a special rule for "mere purchase". There should be no limit to the attribution of profits to the PE in such cases, apart from the limit imposed by the operation of the arm's length principle.