Memo

To	Tax Treaties, Transfer Pricing and Financial Transactions Division OECD/CTPA
From	KPMG International
cc	Manal Corwin and Mark Martin, Washington National Tax, KPMG in the US
Date	May 27, 2021

Comments on Proposed Changes to Commentaries in the OECD Model Tax Convention on Article 9 and on Related Articles

Professionals in the member firms of KPMG International ("KPMG") welcome the opportunity to comment on the March 29 consultation document describing proposed changes to the Commentaries in the OECD Model Tax Convention (the "Convention") with respect to Article 9 and related articles.

The OECD's work to revise the Commentaries to the Convention to reflect updates to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("Transfer Pricing Guidelines"), which supplement the Commentary on Article 9 by providing detailed guidance on the application of the arm's length principle, is of great importance to taxpayers, tax practitioners, and tax administrations around the world. By ensuring that the Commentaries and the Transfer Pricing Guidelines are aligned, the OECD can provide clear guidance with respect to transfer pricing matters and forestall disputes that might otherwise arise in unclear areas.

Conversely, if the Commentaries and the Transfer Pricing Guidelines are not fully aligned, taxpayers and tax administrations alike may be forced to navigate apparent contradictions, which may expose them to potential whipsaw effects through no fault of their own.

KPMG believes that the proposed revisions detailed in the consultation document would generally be helpful in conforming the Commentaries to recent revisions to the Transfer Pricing Guidelines with respect to the treatment of financial transactions. However, we are concerned that, without additional revision to provide appropriate context, the inclusion of proposed paragraph 3.1 (relating to the role of domestic law in determining deductibility) would be misleading and ultimately harmful.

In many jurisdictions, tax authorities may choose among multiple ways to challenge intercompany transactions. For example, the issues may be characterized as transfer pricing issues, or they may be characterized – depending on the jurisdiction – as issues related to whether payments are nondeductible expenses or non-business (and therefore nondeductible) donations. In the United States, for instance, the IRS has historically challenged what are in substance transfer pricing issues under sections 61 (gross income) and 162 (trade or

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business expenses)[1] of the Internal Revenue Code (the "Code"). However, the IRS has more recently determined that, as a policy matter, these alternative theories should not be pursued, and the underlying issues should instead be addressed under section 482 of the Code (transfer pricing).[2]

This is a laudable policy. Tax authority examiners, by selecting among a number of equally applicable characterizations for an issue, should not be able to affect whether the issue is eligible for resolution via the mutual agreement procedure ("MAP") under a bilateral tax treaty. Wherever an issue can be properly characterized either as a transfer pricing issue or as another issue, the issue should be regarded as a transfer pricing issue for purposes of determining whether Articles 9 and 25 apply. That is, regardless of whether the tax authority asserting an adjustment elects to proceed under the transfer pricing characterization, the Commentaries should specify clearly that the issue falls within the scope of Article 9 and is eligible for MAP under Article 25. Applying this rule would allow the treaty partners to resolve characterization disputes in MAP, and would prevent tax authorities from limiting access to the MAP through the characterization of adjustments.

One area in which disputes frequently arise relates to the benefits test. KPMG is aware that, in cases where disputes arise concerning whether a taxpayer in one jurisdiction receives a benefit from services provided by a related taxpayer in a second jurisdiction, a number of tax authorities take the position that this is a domestic deductibility issue, and that denial of a deduction does not result in taxation not in accordance with an applicable tax treaty based on the Convention and thus is not eligible for consideration under the MAP article. In our experience, the countries asserting such arguments have generally conceded that the issues are appropriate for resolution in MAP, but only after significant expenditure of time and resources by the taxpayer, the tax authority of the jurisdiction proposing the adjustment, and the competent authority of the counterparty jurisdiction. In our January 8, 2021 comments in response to the recent consultation document on BEPS Action 14, we recommended that the Action 14 minimum standard be updated to expressly clarify that access to MAP must be permitted in situations such as the one described above.

Whether an intercompany activity provides a benefit, and thus rises to the level of a service for which compensation must be paid under the arm's length principle, is a fundamental part of the transfer pricing inquiry under Article 9,[3] as is the question of whether an allocation under the indirect charge method of Chapter VII exceeds the benefit, and the Commentaries should be revised to clearly reflect this. Similarly, issues of whether a benefit has been adequately documented are properly characterized as transfer pricing disputes within the scope of Articles 9 and 25. More broadly, as noted above, the Commentaries should clearly reflect that any issue that can be characterized as a transfer pricing issue – regardless of whether alternative characterizations are available or are asserted by a tax authority – is covered by Articles 9 and 25. Failure to take a clear position in this area would improperly incentivize tax authorities to frame adjustments with the goal of excluding eligible issues from MAP, and would result in unfair and arbitrary treatment for taxpayers.

Accordingly, we recommend that the proposed revisions to the Commentary on Article 9 be revised as shown below. **Bold text** is used to indicate incremental revisions in addition to the new language proposed in the consultation document, which is shown as plain text:

> 3.1 Once the profits of the two enterprises have been allocated in accordance with the arm's length principle, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed, as long as there is conformity with the requirements of other provisions of the Convention. **Except as noted below,** Article 9 does not deal with the issue of whether expenses are deductible when computing the taxable income of either enterprise. The

[1] *See* R.T. French Co. v. Comm'r, 60 T.C. 836 (1973).
[2] *See* GCM 38676; 1996 FSA LEXIS 354. An exception is made for excessive employee compensation cases, which the IRS believes are better addressed under the specialized body of law adopted for that purpose.
[3] *See* Transfer Pricing Guidelines, Chapter VII, section B.1.1.

> conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 4 of Article 24. Paragraph 30 of the Commentary on Article 7 makes an equivalent statement for the application of Article 7. Examples of domestic rules that can deny a deduction for expenses include certain rules on entertainment expenses and on interest such as those recommended in the final report on Action 4 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project.[4]
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> **3.2 Tax authorities in some jurisdictions possess the ability to challenge related party transactions under transfer pricing rules or under other (i.e., non-transfer pricing) domestic rules (e.g., depending on the jurisdiction, by treating amounts as nondeductible expenses or nondeductible donations, or by treating the taxpayer as failing to satisfy domestic documentation requirements). Notwithstanding the prior paragraph, where an issue (other than domestic law limits on interest deductibility) is properly characterizable either as a transfer pricing issue or in another manner, that issue falls within the scope of Article 9, regardless of the characterization or grounds chosen by a tax authority in making or proposing an adjustment. As noted in the Commentary to Article 25, access to the mutual agreement procedure is available for such issues.**
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> **3.3 For example, in the context of intercompany services, a fundamental step in the allocation of profits in accordance with the arm's length principle is the application of the benefits test, as laid out in Chapter VII to the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. The determination of whether and to what extent a benefit exists falls squarely within the scope of Article 9, and accordingly any dispute arising with respect to the existence or nonexistence of a benefit is eligible for the mutual agreement procedure under Article 25.**

To conform to this clarification, we recommend that a new paragraph 12.2 be added to the Commentary on Article 25:

> **12.2 As noted in the Commentary to Article 9, issues that are susceptible of characterization as either transfer pricing or non-transfer pricing (e.g., domestic deductibility) issues fall within the scope of Article 9, regardless of what characterization is imposed on the issue by a tax authority making or proposing an adjustment. For the same reasons, these issues are, irrespective of their characterization by one or more tax authorities, eligible for resolution using the mutual agreement procedure. Allowing tax authorities to exclude transfer pricing issues from the mutual agreement procedure based on the availability of an alternative non-transfer pricing characterization would frustrate the aims of Articles 9 and 25 and would hamper the effectiveness of treaty-based dispute resolution.**

We appreciate the OECD's commitment to updating the Commentary to Article 9 and related articles, and we applaud the proposed changes' clear recognition of the importance of the Transfer Pricing Guidelines in applying Article 9. The additional changes recommended above will eliminate an area where the proposed Commentary could be read in a manner inconsistent with the Transfer Pricing Guidelines. We believe these changes will also increase tax certainty with respect to benefit issues and thereby reduce unnecessary strain on the global treaty-based dispute resolution framework.

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[4] OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. http://dx.doi.org/10.1787/9789264241176-en.

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