

# **SEMINAR - MAY 19-20, 2011 OECD UPDATE**

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# CLARIFICATION OF THE MEANING OF "BENEFICIAL OWNERSHIP" IN THE OECD MODEL TAX CONVENTION

- On April 29, 2011, WP1 of the Committee on Fiscal Affairs of the OECD released a discussion draft of the meaning of "beneficial ownership" in the OECD Model Tax Convention.
- Purports to clarify the meaning of "beneficial owner" in Article 10 (dividends), Article 11 (interest) and Article 12 (royalties) through revised Commentary to these Articles.
- Reduced withholding tax by source state where the recipient of the payment in the residence state is the beneficial owner of the payment.
- · Beneficial owner does not have the meaning that it has under trust law.
- A recipient who receives the payment as an agent or nominee, or is a conduit company acting as a
  fiduciary or administrator, is not the beneficial owner of the payment.
- Beneficial owner has the full right to use and enjoy the payment and is not constrained by a contractual
  or legal obligation to pass the payment to another person.
- A contractual or legal obligation will normally derive from relevant legal documents, but may also be found on the basis of facts and circumstances showing that, in substance, the recipient does not have the full right to use and enjoy the payments.

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# CLARIFICATION OF THE MEANING OF "BENEFICIAL OWNERSHIP" IN THE OECD MODEL TAX CONVENTION

- Withholding tax reductions on payments of dividends, interest and royalties should not be granted in cases of abuse.
- However, abusive situations such as conduit companies and treaty shopping situations are not intended to be restricted by the concept of "beneficial owner".
- Rather, abusive situations are intended to be dealt with by specific treaty anti-abuse provisions, general
  anti-abuse rules and substance-over-form or economic substance approaches, discussed in the
  Commentaries under Article 1 of the MTC.

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# TRANSFER PRICING AND INTANGIBLES OECD PROJECT

## **Background**

- WP6 of the Committee on Fiscal Affairs on the Taxation of Multinational Enterprises will carry out a new project on the transfer pricing aspects of intangibles through a Special Session established for this purpose.
- Preliminary to the start of this project, in July 2010, public comments were invited to identify issues and shortfalls in the existing TPG. 50 written submissions were received and a consultation was held in November 2010 by WP6.
- On January 25, 2011, the Committee on Fiscal Affairs released a scoping paper outlining the objectives
  of this project.
- Although many of the issues addressed in the revised 2010 TPG are relevant to intangible transactions, a number of issues specific to intangible transactions were not addressed in the 2010 revisions.
- These issues have led to uncertainty and complex disputes. This project is intended to develop clearer
  and consensus-based international guidance on the transfer pricing aspects of intangibles in order to
  limit uncertainty and dispute risks.
- It is expected that a first draft of the results of this project will be released towards the end of 2013.

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#### TRANSFER PRICING AND INTANGIBLES OECD PROJECT

#### **Definitional Aspects**

- The TPG do not currently define "intangibles" for transfer pricing purposes. Paragraph 6.2 contains an
  illustrative list of intangibles including rights to use industrial assets such as patents, trademarks, trade
  names, designs or models as well as literacy and artistic property rights and intellectual property such as
  know-how and trade secrets.
- · The definitional issues include:
  - (i) the meaning of language used in Chapter IX (Business Restructurings) related to the payment for transfers of "something of value" in the context of transactions involving intangibles (see section D.2 of Part II and Examples D.2 and D.3 of Part IV of Chapter IX);
  - (ii) the relevance of the usefulness of definitions of intangibles used in other disciplines such as accounting, law, financial valuations, etc.;

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- (iii) identification of factors to be considered in determining whether an intangible is used or transferred and if so, what is the arm's length compensation? Factors to be considered related to compensation would include the availability of legal protection and the ability to produce economic benefits to a business;
- (iv) consideration of the relevance and usefulness of categorizing intangibles for transfer pricing purposes, such as the use of the terms marketing and trade intangibles, routine and non-routine intangibles, etc.

# **Specific Categories of Intangibles**

- The project defines 4 categories of transactions involving intangibles, namely, (1) contract research
  and development activities, (2) differentiation between intangible transfers and services, (3)
  marketing intangibles, and (4) other intangibles and business attributes.
- The TPG contain 3 examples of contract R&D transactions that the scoping paper suggests raise
  questions about the appropriate transfer pricing method (paragraphs 2.55, 7.41 and 9.26 of the
  TPG) to be applied to the facts described in those examples.

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# Paragraph 2.55

- This is an example of a transaction for which the cost plus method is appropriate.
- Company A, a company in a MNE group, carries out contract R&D for Company B, another group company.
- Company B bears the risk of failure of the research, owns all of the resulting intangibles, and therefore also has all of the profit opportunities resulting from the research.
- The mark-up may reflect how innovative and complex the research is.

#### Paragraph 7.41

- This example provides a more qualified endorsement of the cost plus method.
- This example is one of contract R&D involving highly skilled personnel of the research company. In this
  example, the research company is insulated from financial risk since all expenses are reimbursed
  whether or not the research is successful.

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- In addition, the principal owns all of the intangible property derived from the research and the risks relating to the commercial exploitation of that property are not assumed by the research company.
- On these facts, the TPG states that the cost plus method may be appropriate, subject to the principles in Chapter II of the TPG.

#### Paragraph 9.26

- This example concerns an R&D contract in which the principal may be regarded as controlling the service provider.
- The principal bears the risk of failure and is the owner of the outcome of the research. In addition, in
  order to control its risk, the principal is responsible for making a number of decisions respecting the
  research including its objectives, budgeting, etc.
- Although the example does not mention which transfer pricing method is appropriate, the principal's
  control of the service provider and the fact that the principal bears the risk of failure and owns the results
  of the research suggests that the cost plus method is appropriate.

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### Discussion

- Each of these examples involves contract R&D which is a high value service contract in which the
  principal bears the financial risk of the research and owns the results of the research.
- Although the cost plus method should be the appropriate transfer pricing method for all three examples, as mentioned, the second example is subject to the caveat that "the cost plus method may be appropriate, subject to the principles in Chapter II".
- This caveat raises the issue of what other methods (such as the profit split method) may be applicable to high value contract R&D transactions and in what circumstances?
- · Accordingly, additional guidance in this area is invited.

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## <u>Differentiation Between Intangible Transfers and Services</u>

- The project will consider the issue of how to distinguish transfers of intangibles, such as where the right
  to use a trademark is licensed, from services involving intangibles such as a service provider using
  valuable know-how to provide a service to a principal without an explicit transfer of rights.
- Generally, the profit split method applies where there is a transfer of rights and the cost plus method applies where there is a provision of services.
- In practice, there is usually a mixture of services and transfers of rights and therefore guidance is needed to determine the appropriate transfer pricing method in these circumstances.

### Marketing Intangibles

· No specific work will be conducted in respect of marketing intangibles.

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# Other Intangibles and Business Attributes

- There is uncertainty as to whether certain types of intangible business attributes should be regarded as compensable intangibles.
- Examples are workforce in place, goodwill, going concern, value drivers and first mover advantage.
- The project will review the relevance of these business attributes in the context of transfer pricing including their valuation.

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## Intangible Transfers

Although, as stated above, the project will establish guidance on whether an intangible has been transferred or whether the value of intangibles has been transferred through services, the recharacterization of transactions regarding intangibles will not be directly reviewed.

#### Right of an Enterprise to share in the return from an Intangible that it does not own

- Where an intangible (i.e., patent or trademark) is owned by an enterprise, but an associated enterprise incurred expenses related to its development or the enhancement of its value – should the associated enterprise be entitled to share in any additional return over the normal return generated by the intangible?
- This question can be rephrased as the attribution of economic benefits to the "economic owner" of the intangible.
- The project will consider whether clearer guidance can be developed in this context.

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# TRANSFER PRICING AND INTANGIBLES OECD PROJECT

# **Cost Contribution Arrangements**

- OECD guidance on CCAs is found in Chapter VIII of the TPG.
- · CCAs are sometimes involved in the ownership and development of intangibles.
- Issues have arisen relating to the existing TPG guidance on the ownership and development of intangibles by CCAs including issues related to the characterization of intangibles transfers and the valuation of contributions made to CCAs by their participants.
- The project will review the existing guidance in Chapter VIII of the TPG on CCAs related to the sharing of the costs and risks of developing, producing or obtaining intangibles (rather than services).
- Chapter VI of the TPG deals with intangibles. The review will begin with revising Chapter VI and then
  extend to CCAs in Chapter VIII to conform the guidance in Chapter VIII with any revised guidance made
  to Chapter VI (as well as in the new Chapter IX on business restructurings).

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# TRANSFER PRICING AND INTANGIBLES OECD PROJECT

## **Valuation**

- The project will also provide guidance on the following valuation of intangibles issues:
  - consideration will be given to the application of financial valuation methods, including whether the Discounted Cash Flow method should be given greater recognition in the TPG;
  - (ii) whether the existing guidance related to the aggregation of intangibles for valuation purposes requires clarification;
  - the use of post-transaction and post-filing information when the transfer of intangibles is highly uncertain (mindful of using hindsight);
  - (iv) valuation gaps in respect of intangibles that exist from the perspectives of the transferor and transferee and how to resolve such gaps.

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# NEW PROJECT ON THE ADMINISTRATIVE ASPECTS OF TRANSFER PRICING

- This project will attempt to review administrative simplification measures developed by countries in the transfer pricing area such as safe harbours and reduced documentation for small transactions or for small or medium-sized enterprises, streamlined dispute prevention processes, etc.
- Purpose of the project is to balance the development of sophisticated guidance for complex transactions with the cost-effective use of taxpayers' and tax administrations' resources for improved compliance and enforcement.
- OECD is reviewing the existing safe harbour guidance in Chapter IV (Administrative Approaches to Avoiding and Resolving Transfer Pricing Disputes) of the TPG with a view to updating it.
- OECD is seeking comments before June 30, 2011 from interested parties on this topic.

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### **ISSUES REVIEW**

- WP6 is conducting an "Issues Review" to promote a more consistent application of the arm's length principle and the TPG.
- As part of this Issues Review, WP6 is currently reviewing the position of countries on the use of post transaction/post filing data and the issue of using hindsight for transfer pricing.
- WP6 is also reviewing the main transfer pricing issues encountered in Mutual Agreement Procedures.

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#### **DIALOGUE WITH NON-OECD MEMBERS**

- WP6 is strengthening its dialogue with non-OECD countries through various initiatives, including the creation of an Annual Meeting on Transfer Pricing under the auspices of the Global Forum on Tax Treaties and Transfer Pricing.
- The first meeting is scheduled to take place in November 2011 and is expected to attract representation from 60-80 countries.

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### **EXCHANGE OF INFORMATION**

- · Article 26 of the MTC provides rules for the exchange of information between treaty partners.
- The rules in paragraph 26 establish the obligation to exchange information and the circumstances under which this obligation exists.
- The main forms of information exchange are on request and automatic and spontaneous exchanges.
- There are certain exceptions from the obligation, but the grounds for declining a request cannot be based on bank secrecy or the absence of a domestic tax interest in the information – reservations on these two points have been withdrawn by all OECD and non-OECD countries that previously held such reservations.

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#### ASSISTANCE IN TAX COLLECTION

- Generally, tax authorities cannot take collection action for taxes beyond their own borders the "Revenue Rule".
- Accordingly, an article on tax collection is now included in the MTC as new Article 27.
- The Convention on Mutual Administrative Assistance in Tax Matters also provides for tax collection assistance as well as exchange of information for a wide range of taxes.
- The Convention is a multilateral as opposed to a bilateral instrument developed jointly by the OECD and the Council of Europe. Canada has signed the Convention, but has not yet ratified it.

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### TRANSFER PRICING GUIDELINES 2010 UPDATE

## General

- OECD released its revised version of the TPG in July 2010.
- New Chapter III of the TPG reaffirms the central importance of comparability analyses and provides detailed guidance on how to perform them.
- The 2010 TPG removed transactional profit methods as methods of "last resort".
- There is no longer a hierarchy of the five transfer pricing methods the method selected should be "the
  most appropriate to the circumstances of the case".
- The 2010 update contains new guidance on the application of transactional profit methods, addressing
  the application of the profit split method (e.g., determining the combined profit to be split and how to split
  it, and analyzing issues in applying the transactional net margin method, e.g., the standard of
  comparability and the selection of the net margin indicator).

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#### TRANSFER PRICING GUIDELINES 2010 UPDATE

# Chapter IX - Business Restructurings

- Business restructurings involve the cross-border redeployment of functions, assets and/or risks between associated enterprises which affect the profit and loss potential in each country.
- Business restructurings frequently involve cross-border transfers of intangibles.
- More typically, restructurings reflect the conversion of full-fledged distributors into limited risk distributors
  or commissionaires for a related party that acts as a principal, or the conversion of full-fledged
  manufacturers into contract manufacturers or toll manufacturers for a related party that operates as the
  principal.
- The update to the 2010 TPG contains new Chapter IX which deals with business restructurings.
- Chapter IX includes a detailed discussion of the transfer pricing aspects of risk transfers and risk bearing, including the extent to which contractual allocations of risks are to be respected.

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### TRANSFER PRICING GUIDELINES 2010 UPDATE

- Chapter IX also discusses the role of comparables and the role of the notions of "control over the risk" and of "financial capacity to assume the risk".
- Includes a discussion of the circumstances where the restructuring would be compensated if it were at arm's length.
- Chapter IX clarifies that the arm's length principle and the TPG should apply in the same way to transactions that result from restructuring and transactions that are so structured from the start.
- Guidance is also included in those circumstances where a tax administration may not respect the transactions as structured for transfer pricing purposes.

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# COLLECTIVE INVESTMENT VEHICLES – 2010 UPDATE TO ARTICLE 1

- In May 2010, the OECD released a Report entitled "Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles".
- The Report dealt with the issues of whether the CIV itself or its investors were entitled to treaty benefits.
- The Report discusses the technical questions of whether a CIV should be considered a "person", a
  "resident of a Contracting State" and the "beneficial owner" of the income that it receives under treaties
  that do not have a specific provision dealing with CIVs (as is the case in the vast majority of treaties).
- The Report includes proposed changes to the Commentary on the Model Convention which were included in the 2010 Update to the Model Convention (paragraphs 6.8 to 6.34 in the Commentary to Article 1).

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#### MODEL TAX CONVENTION COMMENTARY ISSUES

- 1. Clarifying the Permanent Establishment Concept (Article 5 of MTC)
- Work has commenced on interpretative issues respecting the scope of the dependent agent as a
  permanent establishment concept.
- Work has also commenced on the issue of when premises are "at the disposal" of an enterprise for the purposes of the Commentary to Article 5.
- 2. Taxation of Services (Articles 5 and 17 of MTC)
- Generally, Article 5 does not permit source taxation of services unless the services are attributable to a
  permanent establishment in the source country.
- An alternative treaty provision in paragraph 42.23 of the Commentary to Article 5 permits countries who
  seek to tax services performed in their country otherwise than through a PE in that country, to treat the
  performance of services within their country beyond a minimum time threshold as a PE.
- Work is continuing on the scope of Article 17 (Artistes and Sportsmen) to particular situations and this
  work will be clarified in a future update to the Commentary.

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#### MODEL TAX CONVENTION COMMENTARY ISSUES

- 3. <u>Tax Treaty Policy Implications of the Communications Revolution</u>
  (Articles 4, 5, 7 and 12 of MTC)
- New Commentary on tax treaty issues relating to telecommunications, including an examination of the treatment of transponder leases, roaming payments, broadcasting payments and spectrum licences is included in the 2010 Update of the MTC (see, for example, paragraphs 9.1, 9.2 and 9.3 of the Commentary to Article 12).
- 4. Employment Services Provided on Short-Term Foreign Assignments (Article 15 of MTC)
- A non-resident employee who performs services in a country on a short-term assignment is, in certain circumstances, not subject to tax on that income by that country (less than 183 days, etc.).
- Certain arrangements between the individual's formal non-resident employer and the local enterprise
  in the country where the services are performed raise issues as to whether the individual is an
  employee of the local enterprise and thus taxable on employment income by that country.

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#### MODEL TAX CONVENTION COMMENTARY ISSUES

## Employment (Cont'd)

- A discussion draft of these issues was released by the OECD in April 2004 and a further report was released by the OECD in March 2007.
- The Commentary in Article 15 has been updated in 2010 with the conclusions reached in the March 2007 report
- 5. Non-Discrimination (Article 24 of MTC)
- WP1 is giving consideration to the issue of whether new or alternative non-discrimination provisions should be included in the MTC.
- 6. <u>Guidance on Attribution of Profits to Permanent Establishments</u> (Article 7 of MTC)
- The 2008 Report on the Attribution of Profits to Permanent Establishments described how the arm's length principle applied to allocate an enterprise's profits between its permanent establishment in one country and its operations in another country (e.g., the home office).
- The Report's conclusions were incorporated into the Model Tax Convention in a two-step process.

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#### MODEL TAX CONVENTION COMMENTARY ISSUES

- The Commentary to the pre-existing version of the text of Article 7 was included in the 2008 update to
  the MTC and took into account those aspects of the 2008 Report that did not conflict with the
  Commentary as it read before the adoption of the 2008 Report.
- In 2010, the Committee on Fiscal Affairs adopted a further revised version of the 2008 Report and the MTC adopted a revised text of Article 7 and a revised accompanying Commentary.

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### **AGGRESSIVE TAX PLANNING**

- In February 2011, the Committee on Fiscal Affairs released a Report entitled "Tackling Aggressive Tax Planning Through Improved Transparency and Disclosure".
- This Report reviews a number of initiatives adopted by various countries to deal with aggressive tax planning.
- · The strategies adopted are:
  - a) mandatory early disclosure;
  - b) additional reporting;
  - c) questionnaires;
  - d) co-operative compliance;
  - e) rulings; and
  - f) penalty linked disclosure.
- In Canada, mandatory disclosure is reflected in the tax shelter rules and in the proposed aggressive tax planning reporting requirements.
- The purpose of these strategies is to provide timely, targeted and comprehensive information to tax authorities.

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