

TAXREP 92/08

Discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention

Memorandum submitted in December 2008 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to the discussion draft document published in July 2008 by OECD

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INTRODUCTION

1. We welcome the opportunity to comment on the discussion draft published by OECD on 7 July 2008 at <http://www.oecd.org/dataoecd/37/8/40974117.pdf>
2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

GENERAL COMMENTS

3. We welcome the discussion draft which represents a more internally consistent interpretation of Article 7 and the July 2008 Report on the Attribution of Profits to Permanent Establishments.
4. We are, however, concerned that the proposed Commentary does not make it absolutely clear that the purpose of the Model Tax Convention is to eliminate double taxation. There is a potential lack of symmetry between the view taken by the host country, where the permanent establishment is based, and the home country, and that asymmetry could lead to double taxation.
5. This is explicitly recognised in paragraph 28 of the Commentary.
6. We would therefore recommend the OECD to formally adopt the additional paragraph inset at paragraph 53, or the paragraph inset at paragraph 67, as part of the new Article 7.
7. These would encourage Member States to give corresponding adjustments for the potential double taxation that would otherwise arise.
8. To the extent that an adjustment is required in accordance with paragraph 59 it would be helpful to confirm that the adjustment will be dealt with via the competent authorities and then subsequently arbitration in those cases concerning treaties between EU Member States or between states that have adopted arbitration in their (extant) treaties.
9. The Commentary also recognises that prices determined for transfer pricing purposes could legitimately be within a range of acceptable values. But when it comes to double taxation agreements, and the elimination of double taxation, it is imperative that the two contracting states arrive at a consistent, agreed position as to the specific amount of income and expense to be properly allocated to a permanent establishment.
10. Our other concern is that moving to a full arm's length price for services, rather than an allocation of costs, will give rise to a considerable number of difficult issues, particularly when the permanent establishment is in a low cost location.

RISK AND FUNCTIONS

11. We do not believe it accurately reflects commercial reality to suggest that the correct principle is always that risks must be attached to functions. For instance it is common practice for large multi-national corporations to outsource some of their functions to other jurisdictions, e.g. payroll preparation, but if a mistake is made in the payroll work then the responsibility will remain in the hands of the multi-national corporation. It is just not correct to say that by outsourcing the function the risk will inevitably go to that outsourced function.

NOTIONAL PAYMENTS

12. We fully endorse the approach in paragraph 26, and the note, not to include in the new Commentary the text of an alternative provision that could be used by States wishing to provide for the source taxation of notional payments.
13. We would nonetheless urge the OECD to more actively discourage source states such as South Korea from exacting withholding tax on, for example, notional interest payments deemed to arise on assumed Head Office / Permanent Establishment 'debt' between a South Korean Permanent Establishment and the Head Office of the non-resident company of which the Korean Permanent Establishment forms part, even when such 'debt' is only a dealing i.e. does not represent the on-lending of external debt raised by the Head Office.

TYPOGRAPHICAL COMMENTS

14. The following typographical errors should be amended:
- In the penultimate line of paragraph 71 the word 'the' is superfluous between 'to' and 'these' so that it should read '...as to which Article should apply to those categories of income'.
 - In the second line of paragraph 76 the word 'character' is spelt incorrectly.
 - In line 8 of the same paragraph, the third word should be 'used' so that it reads '....concepts of permanent establishment, as used in Article 7,'.

IKY
19 December 2008

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.
3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 10,000 members of the ICAEW who pay an additional subscription.
4. To find out more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as **TAXGUIDE 4/99**; see <http://www.icaew.co.uk/index.cfm?route=128518>.