PART THREE

SUGGESTIONS RELATING TO THE APPLICATION OF THE ARTICLES OF THE UN MODEL CONVENTION AND PROCEDURAL ASPECTS OF TAX TREATY NEGOTIATIONS

I. PROCEDURAL ASPRST.622523(S)9.8..3738.

suitable for transmission. In addition, the other competent authority may find it burdensome merely to process a volume of data routinely transmitted by the first competent authority. Moreover, a tax-

may be willing to let the taxpayer decide when to invoke the process and thus they may stand ready to have the process invoked at any point starting with the proposed adjustment.

At a minimum, taxpayers must be informed when they

large number of initial adjustments. The requirement that the initial adjustment conforms to an arm's length standard, however, may provide a sufficient safeguard against overly aggressive initial adjustments.

To be effective, a treaty with a correlative adjustment provision must provide that any procedural or other barriers to the making of the c

reducing or eliminating the adjustment also would seem unwarranted. It might be appropriate, however, for a State to allow deferral of payment of tax in hardship cases as long as interest at a market rate was payable currently, appropriate security for payment was established, and the related persons were required to adopt a consistent method of accounting, under which a deduction for the royalty due but not paid would be deferred until the deferred tax payment was made.

E. Operating procedures

Taxpayer participation. All Contracting States are likely to favour some degree of taxpayer participation in the competent authority procedures. At a minimum, the States would allow taxpayers to present relevant information to the competent authority of their State of residence and to respond to requests for information from their competent authority. Some States may be prepared to allow taxpayers to present legal briefs or even to make an appearance before the competent authority.

Taxpayers have sometimes sought the right to be involved directly in the actual consultations between the Contracting States. Allowing this degree of taxpayer participation is likely to extend and distort the consultative process. It will extend it because taxpayers are likely to want a solution that minimizes their current and future taxes, whereas the interests of the Contracting States may be in achieving an appropriate policy framework for settling the current matter and related future matters. It may distort the process by converting it into a quasi-judicial procedure in which alleged rights of the taxpayer are being vindicated. A tax treaty, however, is an agreement between sovereign States and should be interpreted to advance the tax policy goals of the States, not the private interests of particular taxpayers.

The competent authorities ought to require taxpayers, as a condition for invoking the competent authority procedure, to submit the relevant information needed to decide the matter. In addition, some competent authorities may require, where appropriate, that data furnished by a taxpayer be prepared as far as possible in accordance with internationally accepted accounting standards so that the data provided will have some uniformity and objectivity. Progress has been made in developing uniform international accounting standards, and the work of competent authorities should be aided by this development.

Timing issues. If a time limit on the invocation of the competent authority procedure is to be imposed, the limit should be promulgated, and the point at which the time begins to run should be defined. Article 25, paragraph 1, provides that a case "must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention." This paragraph establishes the notification date as the starting point and sets three years as the time limit. In bilateral negotiations, the Contracting States might wish to give the competent authorities the power to waive these limits in appropriate cases. The three-year limit may be inappropriate if the Contracting States want taxpayers to exhaust domestic remedies before invoking the competent authority mechanism.

Methods of consulting. The competent authorities must decide how their consultation is to proceed. Presumably, the nature of the consultation with respect to a particular case will depend on the character of the case and the likelihood that similar cases are forthcoming. The competent

authorities should keep the consultation procedure flexible and should leave every method of

otherwise to assist in the resolution of an extremely difficult case or a case that has reached an impasse. These experts might be persons currently or previously associated with other tax administrations and possessing the requisite experience and technical competence.

Effect of agreement. In developing their competent authorities procedure, States must decide on the legal effect of a taxpayer's invocation of that procedure. In particular, they must determine whether a taxpayer is bound by the decision of the competent authorities in the sense that it gives up rights to alternative review procedures, such as recourse to domestic administrative or judicial procedures. Some competent authorities may desire that their actions be binding because they do not want to go through the effort of reaching agreements with their counterparts in the other State only to have the taxpayer reject the result if he feels he can do better in the courts or elsewhere. Other competent authorities may not want to bind taxpayers because they think that taxpayers might respond by unduly delaying the invocation of the competent authority process for strategic reasons. If the competent authorities want their procedure to be exclusive and binding, they must establish the necessary rules under the general delegation of authority granted to them in article 25, paragraph 4. In particular, they might require the taxpayer to waive recourse to alternative domestic procedures as a condition for invoking the competent authority procedure.

In some cases, a State wishing to make competent authority decisions final may not be in a position to do so under domestic law. Article 25, paragraph 4 gives competent authorities the power to "develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure." A State may consider, however, that its domestic law requires a more explicit statement of authority to permit the competent authority procedure to be binding. For example, the State may view article 25, paragraph 1, referring to remedies under national laws, as requiring it to give effect to those remedies if they exist. Or it may interpret its prior practices as settling the interpretation of article 25 in favour of a preservation of domestic appeal rights. In that event, the State may wish to negotiate specific language in article 25 that makes clear that it does have the authority to make the determinations of the competent authorities final. In some cases, a change in domestic legislation also may be required.

F. Publication of competent authority procedures and determinations

The competent authorities should make public the procedures they have adopted with regard to their consultation procedure. The description of the procedures should be as complete as is feasible and at the least should contain the minimum procedural aspects discussed above.

Where the consultation procedure has produced a substantive determination in an important area that can reasonably be viewed as providing a guide to the viewpoints of the competent authorities, the competent authorities should develop a procedure for publication in their countries of that determination or decision with sufficient detail to make the published decision useful to taxpayers confronting similar issues. Of course, some aspects of a competent authority procedure must be kept confidential, to protect, for example, commercial secrets. The legitimate rights of taxpayers to confidentiality with respect to their business affairs and the right of the public to understand the developing body of law can be balanced by lagging publication by some months and by editing out unnecessary details.

The competent authority procedure should not become a vehicle for developing a private body of tax law. A basic requirement of a fair legal regime is that taxpayers be informed of the laws under which they are governed. An excessive privacy with respect to the decisions of the competent authorities can result in only a favoured few understanding important aspects of the relevant tax law. In addition, excessive secrecy can create an environment in which corruption can flourish.

II. SUGGESTIONS FOR TRANSFER PRICING[1]

From a financial perspective, transfer pricing is perhaps the most important tax issue in international taxation. Over 60 per cent of intern

acceptable to a State if the various errors from us

United States of America. Only in the 1960s, however, did countries develop a systematic approach towards transfer pricing in the international arena.

The verbal formula used in a tax statute to authorize use of an arm's length standard is not very important, for it is the detailed implementation rules that actually give substance to that standard. The various statutory approaches followed by countries fall into the following four categories, namely:

1. Countries which have included a specific reference to the arm's length principle (or to open market prices), and to adjustments in case of deviations, in their tax laws, e.g., Australia refers to considerations less than arm's length considerations (Section 136 AD Income Tax Assessment Act) and the United Kingdom mentions "the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length" (Section 770 Income and Corporation Tax Act 1988 — formerly section 485).

2. Countries which permit prices to be adjusted in case of associated enterprises, without explicit references to the arm's length principle, for example, France (Article 57, General Tax Code

property is, by nature, unique. Patent licenses between unrelated persons may not provide a good indication of an arm's length royalty for a license of a particular patent between associated enterprises because it may not be possible to establish that the usefulness and profit potential of the

CUP method, the arm's length price for a transaction among associated enterprise (controlled transaction) is the price charged in comparable transactions among unrelated persons (uncontrolled transactions). Under the resale price method, whic

3. Role of form chosen by associated enterprises

Normally, tax administrations, in testing controlled transactions, should accept the form of those transactions. For example, if a parent corporation makes a sale to a subsidiary of all rights to a patent, and the price for the sale is a lump sum payable at the time of the sale, the sale format should usually be accepted, and a tax administration should not re-characterize the transaction as a license or as a sale in exchange for a series of payments contingent on the revenues generated by the patent or the subsidiary's use of it.

However, if the structure chosen by the associated enterprises differs from the substance of the transactions, that form may be disregarded, and the transactions may be re-characterized consistently with their substance. For example, a transfer from parent corporation to subsidiary, which the parties have characterized as a loan, may be re-characterized as a capital contribution if the substance of the transaction is equity, rather than debt.

The OECD Committee on Fiscal Affairs has also identified a second circumstance justifying disregard of the structure chosen by associated enterprises:

> "where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate tran . of n che av(r)-7of

4. Arm's length ranges

In some situations, several comparable uncontrolled transactions can be identified, and the prices at which those transactions took place differ. Such an arm's length range may occur because various sellers charge different prices in essentially identical transactions due, for example, to their relative skill in bargaining. Indeed, in a market where buyers and sellers have imperfect information about each other, some range of prices is to be expected. A range of prices also can result from the fact that the uncontrolled transactions are not identical, either with the controlled transaction or with themselves. For example, the goods or services may differ in small ways or other terms of the transactions may not be identical.

When faced with an arm's length range, a tax administration might first ask whether the range can be narrowed by refining comparability standards excluding, for example, all uncontrolled transactions other than those most comparable to the controlled transaction and making adjustments to the terms of the uncontrolled transactions to enhance comparability. Once the range has been sufficiently narrowed, the controlled transaction should be accepted as having occurred at arm's length if it falls within the range. If the controlled transaction is outside the range, an adjustment is appropriate to bring it within the range. This might be done, for example, by restating the price in the controlled transaction at the median of the prices in the uncontrolled transactions. If the circumstances suggest that the taxpayer, in setting its prices outside the range, had not acted in good faith, the tax authorities might set the arm's length price at a point within the range that would be least beneficial to the taxpayer.

Ct

reported by that enterprise. It may be also relevant whether the goods or services sold by the enterprise are at the beginning, middle or end of a product cycle.

Facts and circumstances from later years might also be relevant. However, tax administrations must be careful not to apply the arm's length principle unfairly by hindsight, basing decisions on facts and circumstances that could not reasonably have been anticipated when the controlled transactions were made. In some cases, nevertheless, hindsight may be used to set prices if it appears from the facts and circumstances that uncontrolled persons would have made use of hindsight in setting the price. Assume, for example, that Company P, a parent corporation, transfers intangible property to Company F, its foreign affiliate, at a time when the value of that property is nearly impossible to determine. It is determined that uncontrolled parties engaged in a comparable transfer would avoid the difficult pricing problem by entering into an arrangement that made the compensation for the intangible property a function of the profits derived from its future use. In that event, a price set by hindsight would be the arm's length price.

C. Traditional methods

insurance and other delivery costs that are included in the controlled price, but not the uncontrolled price.

The CUP method is often not useable if the price in the controlled or uncontrolled transactions is materially affected by intangible property used in producing or marketing the goods or services (e.g., a patent or a trade mark). For example, a sale of branded goods is not comparable to a sale of unbranded goods unless the brand has no material value or is owned solely by the purchaser of the goods. Similarly, a sale of goods under one trade name is not usually comparable to sales under other trade names because each trade name is unique.

However, the OECD Committee on Fiscal Affairs states:

"The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method. Practical considerations

subsidiary's customers. More generally, comparability is importantly affected for purposes of this method by the assets used, risks assumed, and other material factors relating to the functions performed by the controlled and uncontrolled buyer/resellers.

The resale price method is most appropriate if the purchaser in the controlled transaction resells the goods or services without further manufacture or other transformation. If the functions performed by the purchaser go substantially beyond resale, it is not likely that the taxpayer or the tax administration can identify uncontrolled transactio

fixed quantities of irons each month, whereas Company A maintains an inventory of finished goods and is subject to the vagaries of market demand, the companies' operations are not comparable because Company A has assets and risks that Company B does not have. Company B may not be used as an uncontrolled comparable for Company A's transactions unless reliable adjustments can be made for these differences.

The relative efficiencies of the controlled and uncontrolled producers are an important consideration in this context. For example, if Com

those regulations, there is no formal priority of methods. The selection of methods is made under the so-called best method rule. Under that rule, a controlled taxpayer must use the transfer pricing method that provides the "most reliable measure" of an arm's length result under the taxpayer's particular facts and circumstances. In selecting a method, two important factors must be considered: compatibility and the quality of data and assumptions. Methods relying on uncontrolled transactions with the highest degree of comparability are to be preferred.

The difference in the approach of the United States of America and the approach advocated by the OECD may not be very different in practice. The OECD guidelines provide that the newer methods may be used only as a last resort, whereas the United States of America would apply a newer method whenever it constitutes the best available method. In practice, the newer pricing methods are mostly used in the United States of America in cases involving valuable intangible property. In those cases, the traditional methods are usually difficult or impossible to apply. If the traditional methods cannot be applied, the application of a newer method would be, in the OECD formulation, a "last resort."

t5T89(s)-G.746S(T)ED064R7(A)N.GE789(-)5956B3E4T5W40EEN COMPETENT AUTHO04(o)-0.956417(u)8564

The items covered under a routine transmittal or exchange of information may extend to regular sources of income flowing between countries, such as dividends, interest, compensation (including wages, salaries, fees and commissions), royalties, rents and other possible items whose regular flow between the two countries is significant. It should be recognized, however, that at present many countries are not in a position to supply routine information of this type because their tax collection procedures do not provide the needed data. In most respects, information routinely provided is likely to be far more valuable to the receiving country if it is provided in electronic form.

b) Transactions involving taxpayer activity

A routine exchange of information may cover certain significant transactions involving taxpayer activity.

(i) Transactions relevant to the treaty itself:

- Claims for refund of transmitting country tax made by residents of receiving country;
- Claims for exemption or particular relief from transmitting country tax made by residents of receiving country.

(ii) Transactions relevant to special aspects of the legislation of the transmitting country:

- Items of income derived by residents of the receiving country that receive exemption or partial relief under special provisions of the national law of the transmitting country.

(iii) Transactions relating to activities in the transmitting country of residents of the

ntry

- Developments affecting the taxation in the transmitting country of regular sources of income flowing between countries, especially as they affect the treaty,

information are radically reduced. If the receiving country is accustomed to dealing mostly with electronic data, it may have difficulty making good use of certain information provided in paper form, especially if much of that information is not particularly useful.

3. Factors to be considered by the transmitting country

The transmitting country should consider factors affecting its ability to fulfil the requirements of a routine exchange of information. Such a consideration should lead to a more careful selection of the information to be routinely exchanged, avoiding exchanges of information that will be of little practical use to the receiving country.

Among the factors to be considered is the administrative ability of the transmitting country to obtain the information involved. This ability is a function of the general effectiveness of its administrative procedures, its utilization of withholding taxes, its utilization of information returns from payers or others and the over-all costs of obtaining the information, and the extent to which its reporting agents provide information in electronic form.

4. Factors to be considered by receiving country

The receiving country should consider factors affecting its ability to utilize the information that could be received under a routine exchange of information, such as the administrative ability of the receiving country to use the information on a reasonably current basis and effectively to associate such information with its own taxpayers, either routinely or on a sufficient scale to justify the routine receipt of the information. The ability to link information routinely exchanged with particular taxpayers will depend to a considerable degree on the form (electronic or paper) in which that information is transmitted.

B. Transmittal on specific request

A widely used method of exchange of information is that of a request for specific information made by one treaty country to another. The specific information may relate to a particular taxpayer and certain facets of his situation or to particular types of transactions or activities or to information of a more general character. The following are various aspects that the competent authorities should focus on in developing a structure for such exchanges.

1. Items covered

(a) Particular taxpayers

The information that a receiving country may want from a transmitting country is essentially open-ended and depends on the factors involved in the situation of the taxpayer under the tax system of the receiving country and the relationship of the taxpayer and his activities to the transmitting country. A detailed enumeration of the types of information that may be within the scope of an exchange pursuant to specific request does not seem to be a fruitful or necessary task. The agreement to provide information pursuant to specific request may thus be open-ended as to the range, scope and type of information, subject to the over-all constraints to be discussed herein.

Specifically requested information may consist, for example, of:

(i) Information needed to complete the determination of a taxpayer's liability in the receiving country when that liability depends on the taxpayer's worldwide income or assets; the nature of the stock ownership in the transmitting country of the receiving country corporation; the amount or type of expense incurred in the transmitting country; or the fiscal domicile of an individual or corporation;
(ii) Information needed to determine the accuracy of a taxpayer's tax return to the tax administration of the receiving country or the accuracy of the claims or proof asserted by the taxpayer in defence of the tax return when the return is either regarded as suspect or under actual investigation;
(iii) Information needed to determine the true liability of a taxpayer in the receiving country when it is suspected that his reported liability is wrong.
(iv) Information needed to determine whether a taxpayer has reported facts regarding a transaction involving both countries in a consistent manner.

(b) Particular types of transactions or activities

The exchange on specific request need not be confined to requests regarding particular taxpayers but may extend to requests for information on particular types of transactions or activities, including:

(i) Information on price, cost, commission or other ssntoii

Since items in this category, such as the volume of exports between the countries, are presumably not regarded as secret to the tax authorities in the transmitting country, they may be disclosed generally in the receiving country, as article 26 provides.

2. Rules applicable to the specific request

The competent authorities should develop rules for the transmission of specific requests by the receiving country and the response by the transmitting country. Although the rules may be general in character in the sense that they set standards or guidelines governing the specific request procedures, the rules should also permit discussion between the competent authorities of special situations that either country believes require special handling.

The rules should specify:

(a) The amount and nature of detail that the receiving country must include in the request,

countries may feel that article 26 permits joint consultation where all three countries are directly linked by bilateral treaties. However, the languag

should also recognize its responsibility to try to change its domestic laws to strengthen the domestic authority of its own tax administration and to enable it to respond to requests from other countries.

(c) The competent authorities should also weigh the effects of a possible imbalance growing out of divergences in other aspects of tax administration. For example, if country A cannot respond as fully to requests as country B can because of practical problems of tax administration in country A, should the level of the exchange of information be geared to the position of country A? Or, in general or in particular aspects, should country B be willing to respond to requests of country A even though country A would not be able to respond to similar requests of country B? This matter is similar to that discussed in the preceding paragraph and a similar response is appropriate.

(d) Article 26 authorizes a transmitting country to utilize its administrative procedures

3. Periodic consultation and review

The competent authorities should establish efficient and expeditious provisions for consultation to address the inevitable differences that will arise on the interpretation and application of Article 26. The consultation should extend both to particular situations and problems and to periodic review of the operations under the exchange of information provision. The periodic review should ensure that the process of exchange of information is working with the requisite promptness and efficiency, that it is meeting the basic requirements of treaty implementation and that it is promoting adequate compliance with treaty provisions and the national laws of the two countries.

IV. PROCEDURAL ASPECTS OF TAX TREATY NEGOTIATIONS

The procedural aspects of negotiating a tax treaty include the identification of the need for a treaty, the establishment of contracts with a potential treaty partner, the appointment of a delegation, the preparations for negotiations, the conduct of the negotiations and procedures for bringing the treaty into force.

Empiezas

A. Identification of need for a treaty

In determining whether a need exists for a tax treaty with a particular country, a country should examine the nature and extent of the existing economic relationship between the two countries as well as the potential and desire for growth in that relationship. In particular, there should be an intelligent assessment of the nature of future economic relationship. For example, a country should consider the likelihood of foreign direct or portfolio investment from the country concerned, the possibility of the country's technical or managerial personnel coming for employment, and the likelihood that residents of the other country will set up branches, offices or subsidiaries within its territorial jurisdiction. In addition, the country should examine whether the interrelationships between the tax systems of the two countries are inhibiting economic relationships. These inhibiting effects may, for example, be the results of excessively high levels of tax on international income flows, inadequate statutory relief from double taxation, and conflicting definitions of terms or concepts. Finally, a country should attempt to determine whether, to what extent and for what reasons the tax systems of the two countries result in double taxation on residents of the two countries.

B. Initial contacts

Once a country has identified the need for entering into a treaty with a particular country, it must communicate to that country its desire to open negotiations. As a general rule, such contacts are made initially through diplomatic channels. When a personal relationship exists between tax officials in the two countries, however, it may be helpful to utilize that relationship. In that event, the official diplomatic contacts should be supplemented by informal contacts through these personal channels.

When necessary, this initial contact phase may be the appropriate time to request information or other materials on the tax system and tax treaties of the other country.

C. Appointment of a delegation

A delegation typically consists of three to five individuals, although this number by no means reflects a hard and fast rule.

The leader of the delegation should be a senior official with tax policy responsibility who has the authority to make independent policy decisions, at least on a tentative basis.

At the conclusion of the week's discussions, it is useful to prepare an agreed statement of the open issues and, if possible, to schedule the next meeting.

2. Between the first and second rounds of the negotiations

It should be agreed at the conclusion of the first round that one side will prepare a draft showing agreed language and, by use of brackets and alternative language or other suitable symbols, the open issues. This document should be the discussion draft for the second round.

It is important that the notes of the discussions be recorded and distributed to members of the delegations as quickly as possible, while memories are still fresh, particularly if there is more than one treaty under negotiation at the time.

Between the two rounds, the heads of the delegations should correspond in order to exchange drafts, to indicate tentative conclusions on major open issues and to confirm the schedule for the next round of discussions.

3. Second round of negotiations

It is important to maintain both momentum and continuity in treaty negotiations. Thus, the time between rounds should be minimized and, to the extent possible, the composition of the delegations should be retained.

Before resuming the article-by-article or issue-by-issue review of the draft, there should be a brief discussion of changes, if any, in the tax laws of either country between the first and the second rounds.

The review of the common working draft should continue, further narrowing any differences which remained at the beginning of the second round. Although it is generally best not to reverse prior decisions, this possibility should not be ruled out if either side considers it necessary. All decisions at this stage are made subject to policy review.

On occasion, agreements are reached in the course of negotiations that do not readily lend themselves to inclusion in the treaty but that should be made public at some time. There may be, for example, an agreed interpretation of a treaty provision, that is too detailed to go into the treaty text. This interpretation may be spelled out in an exchange of letters to be signed at the same time as the treaty. Such letters of understanding normally would not be subject to ratification, but would form part of the public record.

If full agreement has been reached by the conclusion of the second round, the treaty should be

Finally, experience has shown that social contacts between delegations during the negotiations often are most helpful in maintaining a high level of good will between the delegations. The value of such social contacts is in no way correlated with their elaborateness or cost.