Source Country (BRICS) Model Treaty Posture and Planning for the Future

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Of all the international tax issues on the agenda today, perhaps the most difficult for both tax administrations and multinational entities (MNEs) is the tension between Organisation for Economic Co-operation and Development (OECD) member countries and the rest of the world with respect to transfer pricing (TP) principles. MNEs find themselves in the middle, producing a material danger of double or multiple taxation.

There are at least six groups with distinct voices in this area of tension:

OECD, TRADITIONALLY COMPOSED OF DEVELOPED COUNTRIES

1. United Nations (UN), often assisting developing or emerging markets
2. World Bank, non-governmental organizations (NGOs) and others
3. International Chamber of Commerce (ICC)
4. Brazil, Russia, India, China and South Africa (BRICS) and developed source countries, not happy with the principles of either the OECD or UN, and certainly no longer emerging markets
5. MNEs, stakeholders in the debate over taxing jurisdiction

There are many voices within each group, which can result in tension.

Many question how the OECD/UN model treaty policy arose and why it has developed in the manner it has. In 1920–1923, the ICC commenced a process to develop a model income tax treaty in the immediate aftermath of World War I. This period was the source of today’s model treaties. This work has been lost as the world has evolved and is instructive with respect to the current tax policies being espoused by source countries.

The Post-World War I World (1920–1923)

In the past, the paradigm of commerce and international taxation was a developed country (for example, England) and a country that was a colony of England (such as India). A global war ended, leaving England with enormous war debt. There was a material flow of commerce between England and India. For the most part, England transferred to affiliates in India capital, technology and access to global markets. India responded with commodities and produced goods. England was a creditor and India a debtor.

The policy issue for consideration was how income from these activities should be shared between “resident” and “source” countries.

ICC Proposal in 1923

In its interim report in 1923, the ICC proposed what would be called today a profit split or formulary allocation methodology to address income allocation between residence (creditor) and source (debtor) countries. The proposal was similar to the combined income methodologies typically used today to resolve major Competent Authority process under treaty mutual agreement procedures (CA) cases between countries with an MNE in the middle, and also similar to the methodologies for evaluating intangibles in the 2012 OECD discussion draft.

League of Nations (1923–1928)

In 1923, the ICC work was taken over by the League of Nations, which took an entirely different approach. It formulated five principles:

1. Source country (India) should tax local operations, including property or other pertinent matters.
2. Residual income should be earned by the country of residence, which provided the knowledge and capital for the business.

3. Presence of an interim holding company should be treated as a residence country. It was expected that all countries would adopt a common model.
4. Subsidiaries should not be treated as a PE.
5. TP is to be evaluated on a consistent basis.

The model treaties that eventually became the OECD model, and subsequently the UN model, are based on these five principles. The net impact of these principles was a system that allowed source countries to earn a routine return; residence countries to receive residual income; and interim holding companies to be treated as residence countries, even if they were located in a low-tax country.

MNE Tax Planning Strategies

Not surprisingly, the international tax and effective tax rate (ETR) strategies of MNEs evolved based on this treaty model. Common structures included what are described today as global/regional principal; centralized risk-taker, intangibles owner; and limited risk activities in high-tax countries.

ETR strategies are often based on easily applied one-sided TP methodologies, which typically test the earnings of source country affiliates.

These strategies are precisely the focus of the League of Nations' work, which is the model of OECD/UN model treaties.

Today, MNEs are commonly pilloried for base stripping source countries. Whether this criticism is appropriate or not, it is apparent that this behavior was encouraged by the League of Nations model. At the time, it may have been intended to facilitate repatriation of revenue to residence countries to repay war debts.

The role of MNEs is to seek the most efficient means of conducting business within the global tax framework that is established for their operations, as they do with intellectual property, competition or other standards. Their competitors, of course, have the same incentives.

The world has changed dramatically. In many cases, so-called source countries have become the creditors, and former residence countries have become debtors.

Posture of the Parties in Connection with the "Model" Tension

The relative posture of the parties that creates so much tension with respect to TP in the world of today is roughly as follows:

SOURCE COUNTRIES

1. Model treaty structure, one-sided TP methodologies and common planning paradigms do not create a level playing field in terms of global income allocation.
2. Efforts to defend their tax bases are often aggressive (such as India's posture on a variety of matters, including the general anti-avoidance rule, or Brazil's idiosyncratic tax framework).
3. UN model treaty is more generous to source countries than the OECD model (for example, in the PE article).
4. UN should declare that OECD guidelines are for guidance only in applying the arm's length standard, or develop its own guidelines.
5. There is debate over whether there should be a new source-country-oriented model treaty.

OECD

1. Broadening of PE concepts
2. Global Tax Forum (outreach and expansion)

3. Cooperation with UN
4. Declarations concerning tax-base stripping and “double non-taxation”

UN

1. Focus on source countries
2. Transfer Pricing Manual (aims to ensure that developing market perspectives, priorities and examples are fully reflected in official materials, and to adapt the complexities of the OECD guidelines to the realities of business conditions and administrative examination capabilities in developing markets)
3. Discussion of country-by-country MNE TP reports (which set out effective tax rate and related matters for review by tax authorities or other parties, such as certain non-governmental organizations)

WORLD BANK AND NGOS

1. Agendas often involve criticism of MNE behavior, without focusing on actual treaty history.

MNES

1. ETR strategies are defended in the face of serious challenge from all tax authorities, often with genuine threats of double taxation.
2. The situation involving source countries is especially troublesome, as they often pay lip service to the OECD guidelines as they make material deficiency assessments on principles that can be perceived as contrary to the concepts of the guidelines and Model Treaty Commentary.

REALITIES FOR MNE PLANNING FOR THE FUTURE

1. No one benefits from the tension that is growing in the TP world.
2. All parties would benefit from updating the model treaties.
3. The actual history of tax treaty policy is different than may be commonly understood, which goes to the core of the current tension.
4. The world has changed dramatically since these policies were designed. Debtor countries of that time have become creditors, and prior creditors are now debtors. Technologies of business are equally different. Yet the treaty paradigm has not kept pace.
5. Rather than criticizing business, it is time to invest that energy in developing policies that are consistent with the realities of the current world. This could be one element of facilitating global growth.
6. In evolving MNE effective tax rate planning, these realities (including how to adjust for potential rejection of current planning models in BRICS and other Source Countries (via bilateral agreement, domestic foreign tax credit, or otherwise.

For more information, please contact your regular McDermott lawyer, or:

Cym H. Lowell: +1 713 653 1777 clowell@mwe.com

For more information about McDermott Will & Emery visit www.mwe.com