



Sándor Szmicssek
Tax Partner

The OECD Council has approved three tax instruments of major significance

On 22 July 2010, the OECD Council approved the new, revised versions of the Model Tax Convention together with its Commentaries and of the Transfer Pricing Guidelines, as well as a new document related to the above, the Report on the Attribution of Profits to Permanent Establishments. The shared characteristic feature of these three documents is that they provide consensus-based principles, frameworks and a common basis for interpretation in the area of international taxation.

The Model Tax Convention

The most important change in the OECD Model Convention is its revised Article 7, which provides that in case the tax administration of one country adjusts the profits attributed to a permanent establishment (and thus also the tax base for that country), then the tax base must be also adjusted in the other country in order to avoid double taxation. If the other country does not agree with the adjustment, it is necessary to conduct negotiations. As a result of this change, the principle of the avoidance of double taxation is more effectively followed. Other new elements in the Model Tax Convention include the avoidance of double taxation with respect to the income of collective investment vehicles, the application of tax treaties to state-owned entities, tax treaty issues relating to telecommunications transactions involving several countries, and new rules in the area of international taxation governing employees sent to work for a short duration in a foreign country.

Transfer Pricing Guidelines

Under the first three chapters of the revised Transfer Pricing Guidelines, the hierarchy between the traditional methods (i.e. comparable prices method, the cost plus method and the resale price method) and the transactional profit methods (namely the transactional net margin method and the transactional profit split method) for determining the arm's length price was

eliminated. This step was necessitated by the practice, due to the fact that even though the original Guidelines suggested the use of the latter group of methods as a last resort only, in the decisive majority of the cases both the taxpayers and the tax authorities chose these same methods. Consequently, the revised chapters contain more detailed and practical guidance than before on how to apply the transactional profit methods. Further, readers can also find detailed guidance on how to prepare comparability analyses; in other words, what steps should a company take in order to determine the arm's length price of inter-group transactions. Further annexes were also added to the revised document with the aim of illustrating with examples what can be done to make the data pertaining to an independent and an associated enterprise comparable.

The Guidelines obviously cannot provide an answer with respect to all possible transactions that may occur in reality, but there have been many for which guidance was badly needed. These include business restructurings in multinational enterprise groups, in the course of which functions, risks and assets are restructured across borders. The new Chapter IX of the Guidelines discusses this issue.

Report

The significance of the third document is that it sets forth detailed rules on how to determine the corporate taxable income of permanent establishments. In the framework of the above, it defines the assets, risks and capital that are to be attributed to the permanent establishment in the course of the functional analysis. The approach adopted in the Report – which is the real novelty – is that it treats permanent establishments (e.g. branches) as separate, independent enterprises, and it addresses not only the issue of determining the incomes and expenses related to the given activity, but also the assets and capital necessary for the activities of these hypothetical enterprises (permanent establishments). After the determination and detailed interpretation of the basic principles, the 241-page document deals in separate chapters with the special application of these principles to branches of banks, to the global trade of financial instruments and to subsidiaries of insurance companies.

Opinion

In issues of international taxation, the OECD documents include the uniform and consensus-based principles and interpretations accepted by the OECD member countries, and in the course of the application of the Hungarian regulations these must be taken into account. This is particularly true with respect to issues of transfer pricing. Since 2003, documentations with strictly defined content must be prepared also in Hungary concerning the arm's length prices of transactions between associated enterprises. The preparation of these documentations places much burden on taxpayers, not only because obtaining the necessary information is often problematic, but also because there was no practical guide that would have "taught" how exactly the documentations should be drawn up, what the individual methods mean, how the one to be used should be selected and applied, or how the

comparability analysis should be prepared. Over time, a relatively efficient model with respect to the comparability analyses was established that served as the basis of the transfer price analyses; meanwhile, however, questions and doubts did arise on numerous points concerning the version of the Guidelines in effect, as well as transactions had to be evaluated (requiring guidance) from the point of view of the arm's length principle of which the Guidelines made no mention. It became essential, therefore, that the Guidelines be updated, which in the case of the first three chapters meant for the largest part the detailed codification of the prevailing practice. The current revision creates an international standard for the preparation of transfer pricing documentations, and therefore, from now on there will be uniform requirements related to the preparation of the same. Furthermore, the document is also an international standard that is guiding for tax administrations, which can follow, control and enforce it.

A third document was added to the formerly two basic instruments of international taxation. This new document discusses issues related to permanent establishments, which increased, by way of its detailed principles and interpretations for theory and practice, the level of consensus in the area of international taxation. Of special value is the fact that it specifically deals with banks, insurance companies and the global trade of international financial instruments, since these areas always raise special questions. This third document is the more detailed explanation of Article 7 of the Model Tax Convention, the basis of which in turn is the Transfer Pricing Guidelines; therefore, the three documents are organically linked to each other. Since international banks operating in Hungary are branches of their foreign parent companies, the new document on the rules governing permanent establishments has particular significance concerning the determination of the corporate taxable income of these bank branches.

Sándor Szmicsek is the editor of the Hungarian editions of the Model Tax Convention and the Transfer Pricing Guidelines. Preparations are under way for issuing the Hungarian editions of the new documents, which are expected to be published by the end of the year by the Training Centre of the Chamber of Hungarian Auditors.

Should you have any questions in respect of any topic in our Newsletter, please feel free to contact us.

Sándor SZMICSEK

Tax partner

Mazars Kft.

1074 Budapest, Rákóczi út 70-72.

+36-1-429-30-10

sandor.szmicsek@mazars.hu

www.mazars.hu

www.mazars.com

Note: The information contained in our Newsletter is for information purposes only. Such information should not be regarded as substitute for professional advisory services nor used as basis for decisions or actions without prior consultation with your advisers.