

# Base Erosion and Profit Shifting (BEPS)

COMMENTS RECEIVED ON  
PUBLIC DISCUSSION DRAFT

## BEPS Action 7

### Additional Guidance on the Attribution of Profits to Permanent Establishments Part I

8 September 2016





## Table of Contents

ACCA.....	5
Andrea Lupini (Dr).....	7
ANIE Federazione.....	9
Association of British Insurers.....	12
BDI.....	16
BEPS Monitoring Group .....	22
BIAC.....	39
Bundessteuerberaterkammer KdöR .....	81
BusinessEurope .....	90
CBI .....	95
Chartered Institute of Taxation.....	96
CMS .....	98
Confédération Fiscale Européenne.....	102
Confederation of Swedish Enterprise .....	105
Duff&Phelps Ltd. ....	108
DWVA.....	113
Eleonore Ronge (Prof. Dr.) .....	118
European Business Initiative on Taxation .....	122
EY.....	126
Fédération Bancaire Francaise.....	139
FIDAL .....	141
Flick Gocke Schaumburg .....	145
FTI Consulting.....	151
Global Federation of Insurance Associations.....	155
Grant Thornton .....	160

International Chamber of Commerce .....	169
IFA Grupo Mexicano, A.C. ....	172
Insurance Europe .....	180
International Alliance for Principled Taxation .....	182
InterContinental Hotels Group .....	213



ACCA is a global accountancy body with many of our members operating within small businesses and practices. In addition to this I am the Chair of the Tax Group of pan-EU small business group UEAPME. As such we would be keen to participate in the public consultation meeting in October.

Our brief comments revolve around the deep concerns we have that by changing the paragraph 4 exemptions within Article 5 will create vast levels of uncertainty and the unintended creation of a PE together with its inherent tax consequences in a state where the SME is purely seeking the help of a third party to put the final touches to an item in order to make it fit for that specific market. In addition an SME may quite often have no choice but to warehouse in the other state due to the less streamlined nature of its business processes. Again this will like lead the unintended creation of a PE. We cannot and should not expect an SME to be able to navigate around the proposed new rules which set out to capture the activities of MNCs.

In addition the SME will likely find that it is not only susceptible to a direct tax obligation it will also be liable to VAT which is dependent upon the rules around fixed establishment.

The overall compliance burden for an SME will be a “deal breaker” in their being able to conduct business outside their home state borders. It is difficult enough as it is for SMEs and this will compound their problems even more finally end their internationally endeavours.

## **ACCA response to OECD's Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments**

The BEPS Action 7 amendments to Article 5 of the OECD Model Tax Convention in respect of the exemption for independent agents and preparatory or auxiliary activities will give rise to an increase in deemed permanent establishments. While in principle, we welcome the OECD's revision of Article 5 to reflect the modern economy, the amendments increase the risk of differences in interpretation by tax authorities, thus significantly increasing uncertainty for businesses. The Discussion Draft provides some clarification, but we would urge the OECD to issue further clear and pragmatic guidance and take all reasonable steps to minimise administrative burden on businesses.

The changes with respect to the definition of independent agents in Article 5(5), in particular, are likely to impact SMEs and entrepreneurial businesses, which would have previously been protected from the narrower definition of the conclusion of contracts. In order to mitigate uncertainty and disproportionate administrative burden to SMEs, we encourage the OECD to consider the inclusion of an exemption for SMEs or de minimis limits on low values of sales to resident customers.

Given the divergence in profit allocation methodology that has started to emerge among tax authorities in different countries, the OECD must take robust steps to ensure that the definition of permanent establishments, and the Authorised OECD Approach ('AOA') is applied consistently by all participating jurisdictions.

## Comments on Example 1 in the Public Discussion Draft – BEPS ACTION 7

*“Additional Guidance on the Attribution of Profit to Permanent Establishments”*

by Dott. Andrea Lupini (Commercialista ed Esperto Contabile – Italy)

- 1. Commentators are invited to express their views on whether the order in which the analyses are applied under article 9 of the MTC and article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.**

I agree with the “two steps analysis”, first article 9 and secondly article 7 as general rule.

Though that, the analysis could be conducted in line with the theory of “independent rules” (Sydney Roberts).

In particular, in a world where each Fiscal Administration considers separately article 5(6) from article 5(5) with the following order: first article 5(6) [maybe specifying that “any other agent of independent status” could be anybody, any person (corporate or physical) with territorial link?] then article 5(5). Then, the PE of independent status could be allocated profit straightforward from the article 7 of the MTC.

As a fact of the matter, the OECD par.20 Guidelines 2010 precises that the degree of capacity to make decisions to take on by the local Agent as well as its financial capacity can influence the level of attributable risks.

Therefore, in the case there is non-independent status and low capability to freely exercise the management by the local agent, like when the agent seeks approval from the foreign enterprise in respect of the manner in which they perform the work whatever risks are allocated as assumed in the example 1, the PE shall be read through article 5(5) attributing the risks based on people functions analysis, therefore starting with article 9 for allocating profit to the non resident company and allocating profit to DAPE with article 7 OECD Model Tax Convention.

- 2. Do you agree with the functional and factual analysis performer in example 1 under AOA ?**

*The annex 1 of the public discussion draft under comment is sufficiently well described. Said that, one flag among the others is my concern, and I would like to emphasize hereto by answering at the next question.*

- 3. DO YOU AGREE WITH THE CONSTRUCTION OF THE PROFIT AND LOSSES OF THE DAPE in Ex.1 under AOA ?**

The nowadays economical and business world is driven by “clients”. These are the “breath” for the market survival of either multinational or group of enterprises at lower level.

Let's focus on the “**marketing sales strategy and budgeting**” functions. Certainly here what it matters is who is bearing advertising and marketing costs. Even when such advertising and marketing costs are paid in advance by the Agent SELLCO and secondly refunded by the non resident company PRIMA, we do not assume a full financial capacity risk to PE Agent SELLCO. It is likewise that the PE Agent uses funds of the principal. This is not a significant function.

However from a marketing stand point of view (and from a multinational perspective) the function “identification of customers, soliciting and placing orders and processing orders with Prima” is a key activity for the effectiveness of the sales strategy set out by Prima. On the other hands, without such a key-marketing-activity that works smoothly, the overall sales in the source country could be zero and NO INCOME WOULD BE GENERATED AT SOURCE.

Another point is that **“working capital”** accounted in the assets of SELCO – receivables – is coming from the source based country, and secondly it turns into cash available to banks. The outcome of such a **“working capital”** is income sourced in the country where SELCO operates.

This to evidence that the function “identification of customers, soliciting and placing orders and processing orders with Prima” is **significant**, it is vital activity for the benefit of the non-resident enterprise (Prima) even though that SELCO Agent is acting in the ordinary activity.

Even assuming a low level of performance by SELCO, it is undeniable true that as associated company SELCO represents a commercial reality for the non resident company and it must be applicable the article 9 of the OECD by attributing a premium risk for such a significant function – finding clients, order, get money !!!

As long as we are in the case of related parties, an issue would be whether the sales commission fees paid in 5% were arm's length remuneration or not. But still it could be questioned, as in this comment, that an additional profit might remain in SELCO due a significant function that SELCO plays for the non resident.

As regarding the application of article 7 to allocate profit at the DPE SELCO, it shall be considered (instead of what it looks like in the document that allocate “0”) an additional **“marginal degree of profit”** to be allocated at the DAPE SELCO as such as a fact of the matter the SELCO is associated company – non independent – it has a physical presence in the source country and moreover by contractual agreement is engaged by Prima to act whatever “on behalf of Prima” ... “in Prima's interests” or “in the name of Prima” so with a dependent status. Though we are under article 5.5 OECD model tax convention, a **“marginal degree of profit”** shall be allocated at SELCO for the significant function attributable to identify and find new clients. This could be found by using the weighted average calculation.

4. **What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied ? If the conclusion is different, what would be the differences ?**

See comment to question n°3

5. **In the types of Ex 1, is it appropriate to conclude that, where under the functional and factual analysis under article 7, the dependent agent enterprise does not perform significant people function on behalf of the non resident enterprise, there will be no profit attributable to the DAPE after the payment of an appropriate fee to the DAE under article 9 ?**

See comment to question n°3

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**RE: Additional Guidance on the Attribution of Profit to Permanent Establishments**

Dear Sirs,

*Federazione Nazionale Imprese Elettrotecniche ed Elettroniche* ("ANIE") thanks the OECD for the opportunity to provide comments in response to the OECD Centre for Tax Policy and Administration's Discussion Draft on Additional Guidance on the Attribution of Profit to Permanent Establishments (the "Discussion Draft").

ANIE greatly appreciates OECD Working Party No. 6's work on providing additional guidance on the attribution of profit to permanent establishments. This letter comments on certain aspects of the Discussion Draft and suggests areas for further enrichment and clarification. We hope that our comments may be useful in enhancing the effectiveness of the new proposed guidelines, with particular regard to the practical issues that may arise from their application.

**General Comments** Based on the wording of the Discussion Draft, we understand that the intention of the OECD is to maintain the Authorized OECD Approach (the "AOA") set out in the 2010 Report on the Attribution of Profit to Permanent Establishments (the "2010 Report") as the basis for attributing profits to permanent establishments, and that the OECD sees no need for substantive modifications to the existing rules and guidance and to the 2010 Report (e.g. see paragraphs 3 and 18).

However, there seems to be some tension between the approach illustrated in the Discussion Draft, in particular Example 2 and Example 4, and the content of the 2010 Report, in particular regarding whether the existence of control over risk/significant people functions in the Dependent Agent Enterprise (DAE) would result in the attribution of risk and assets to the DAE or to the Dependent Agent Permanent Establishment (DAPE). Therefore with reference to question n. 9 to public commentators, the current wording of 2010 Report may not be fully supported by the examples.

The current guidelines in the 2010 Report, in particular paragraph 230 to 245, seem to indicate that under the AOA, when the DAE performs the significant people functions relevant to the assumption and/or subsequent management of certain risk and/or the significant people functions relevant to determining the economic ownership of certain assets and are performing those functions on behalf of the non-resident principal, risk and assets would be attributed to the DAPE. Conversely, the Discussion Draft, referring to Section D of Chapter 1 of the Guidelines and the control over risk, would attribute the risks and assets to the DAE in this scenario.

Several paragraphs of the 2010 Report, in particular Section D5, seem to support the attribution of risk/assets to the DAPE rather than to the DAE and may need to be aligned to the Discussion Draft. For example:

- Paragraph 232 "... On the one hand the dependent agent enterprise will be rewarded for the service it provides to the non-resident enterprise (taking into account its assets and its risks (if any)). **On the other hand, the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident**, together with sufficient "free" capital to support those assets and risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets, risks and capital."
- Paragraph 235 "...The functional and factual analysis may show that certain risks, for example, inventory and credit risks under a sales agency arrangement, belong not to the dependent agent enterprise but to the non-resident enterprise which is the principal. Although it is agreed that the risks are legally borne by the non-resident enterprise, the difference between the two approaches is that under the —single taxpayerll approach, those risks can never be attributed to the dependent agent PE of the non-resident enterprise, **whilst the authorised OECD approach would attribute those risks to the dependent agent PE for tax purposes** if, and only if, the dependent agent performed the significant people functions relevant to the assumption and/or subsequent management of those risks."
- Paragraph 241 "...**An arm's length agency fee paid by the non-resident enterprise to the dependent agent enterprise would not therefore include an element to reward the assumption of these risks** – they are assumed by the non-resident enterprise."
- Paragraph 242 "Assuming the activities performed by the dependent agent enterprise on behalf of the non-resident enterprise create a dependent agent PE under Article 5(5), **the question is whether any of the reward for the assumption of inventory risk should be attributed to the dependent agent PE of the non-resident enterprise. ...**"
- Paragraph 243 "Having said all this, and for the purpose of illustrating the application of the authorised OECD approach to a dependent agent, suppose that the personnel that perform the significant people functions relevant to the assumption and/or subsequent management of inventory risk and the significant people functions relevant to determining the economic ownership of the inventory are employed in the dependent agent enterprise and are performing those functions on behalf of the non-resident enterprise. **This would mean that the "economic ownership" of the inventory and the reward for the assumption of the associated inventory risk are attributable under the authorised OECD approach to the dependent agent PE.** And, of course, under the authorised OECD approach, so is the associated profit or loss."



- Paragraph 245 "A similar analysis can be carried out on a case-by-case basis in respect of other types of risks, e.g. the credit risk in respect of the customer receivables of the non-resident enterprise. Again, under a typical sales agency agreement customer receivables and the associated credit risk legally belong to the non-resident enterprise, not the dependent agent enterprise and so **the remuneration paid by the non-resident enterprise to the dependent agent enterprise should not reward the assumption of this risk. Once again the key question is whether any of the reward for the assumption of credit risk should be attributed to the dependent agent PE of the non-resident enterprise.** As already noted, this will be determined by reference to the identification of where the significant people functions relevant to the assumption and/or subsequent management of the risk are undertaken, i.e. in the dependent agent or the non-resident enterprise."

In the light of the above, ANIE invites the OECD to provide further clarification on the interaction between the Discussion Draft and the existing guidance on the attribution of profit to permanent establishments, and in particular the 2010 Report.

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We hope that the OECD will find our comments useful and trust that you will not hesitate to contact us should you wish to discuss the issues we have raised in more detail.

For further information, please contact **Laura Beretta** ([laura.beretta@prysmiangroup.com](mailto:laura.beretta@prysmiangroup.com)) and **Gianni De Robertis** ([gianniderobertis@kpmg.it](mailto:gianniderobertis@kpmg.it)), who have assisted ANIE in preparing this submission.

Yours sincerely,

Maria Antonietta Portaluri



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#### About ANIE

The *Federazione Nazionale Imprese Elettrotecniche ed Elettroniche* (ANIE) is one of the major industry associations in Italy, representing electrical engineering and electronics companies. It was founded in 1945 and is a member of Confindustria. It has more than 1,200 members, with a combined workforce of 410,000 and a combined turnover of €56 billion at the end of 2013.

ANIE brings together very large multinationals as well as small and medium-sized Italian enterprises; 65% of its member enterprises have less than 50 employees. Its members place high importance on research and innovation and account for over 30% of private Italian investment in research and development.

Nationally and internationally, ANIE and its network of members seek to encourage and strengthen entrepreneurial values, promoting their development in pursuit of the general interest of the country and acting to ensure transparent rules. ANIE is part of the European Engineering Industries Association.



## The UK Insurance Industry

The Association of British Insurers (ABI) is the leading trade association for insurers and providers of long term savings. Our 230 [members](#) include most household names and specialist providers who contribute £12bn in taxes and manage investments of £1.9trillion.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

## Introduction

1. The ABI continues to support the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment and we are grateful for the opportunity to comment on the discussion draft<sup>1</sup>. Our comments reflect our desire to ensure that the guidance is workable, well targeted, and proportionate in the context of the efficiency of commercial insurance operations.

## Response

2. Although the additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in the Report<sup>2</sup> apply particularly outside the financial sector, we are concerned about the potential inadvertent impacts on insurance operations.
3. As we explained in our responses to the two discussion drafts<sup>3</sup> on Preventing the Artificial Avoidance of Permanent Establishment (PE) Status a widened definition of what constitutes a PE is likely to create a plethora of insurance PEs (but not regulatory) where no or minimal profit would be attributed, thus creating an unnecessary administrative burden for business and tax authorities.
4. We are pleased that paragraph 104 of the discussion draft acknowledges that there will be situations where the profits attributed to the PE are nil, but disappointed that no solution has been identified to avoid the disproportionate compliance burden that would be placed on insurers in these circumstances with the consequent impact on tax administration resources. The discussion draft suggests that the creation of a Dependent Agent PE for corporation tax

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<sup>1</sup> Discussion draft on OECD BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments released 4 July 2016.

<sup>2</sup> Report on Action 7 of the BEPS Action Plan (Preventing the Artificial Avoidance of Permanent Establishment Status) 5 October 2015

<sup>3</sup> Discussion drafts on OECD BEPS Action 7 (Preventing the Artificial Avoidance of PE Status) released 31 October 2014 and 15 May 2015.



purposes, even where no profit is attributable, could give rise to “other tax liabilities”. In an insurance context we believe that this is generally not the case.

5. The circumstances where the widened definition of PE could potential create new insurance tax PEs are as follows:
  - Sales and marketing of insurance products – it is acknowledged in 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) (“Part IV”) that sales and marketing is only one of the functions in the insurance business value chain and that such functions are unlikely to be a Key Entrepreneurial Risk-Taking (KERT) function.
  - Routine non-KERT functions performed by an in-house service company, such as back office processing of applications, claims handling, investment management, administrative support and /or consultancy services.
  - Where Delegated Underwriting Authorities (DUAs) (see Appendix 2 of our response to the original discussion draft released on 31 October 2014 for a description) are in place, and the third party agent acts exclusively or almost exclusively for the insurer. In these circumstances the authority granted under a DUA could be strictly limited and if so there would be no KERT function undertaken by the agent.
  - A third party unconnected agent acting exclusively for an insurer who is performing non-KERT functions.
  - An agent connected with the insurer is performing regulated (non-KERT) activities in the same territory as the customer and is rewarded directly, on arm’s length terms, by the customer this should not necessarily lead to the creation of a PE. This could, for example, relate to a broker distributing insurance products where the broker is rewarded through a fee charged to the customer independently from any fees charged by the provider of the insurance products. There are some insurers that will potentially have numerous PEs in these circumstances.
6. Although tax PEs would be created in the circumstances outlined in paragraph 5 above, the correct application of Part IV would result in nil or minimal profit attributed as the functions being performed are non-KERT<sup>4</sup> and would already be rewarded commensurate with the duties performed. Furthermore, we do not believe that generally there will be “other tax liabilities”.
7. We believe that now the OECD has undertaken the further work on attribution of profits to PEs and as part of this work has recognised that there will be situations (in the case of insurers, numerous) where the profits attributed to a PE are nil that a solution should be found to avoid the needless creation of PEs and the disproportionate compliance burden created.

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<sup>4</sup> The 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) explains the Key Entrepreneurial Risk-Taking (KERT) function of insurance is the assumption and management of risk/business by appropriately skilled employees, with the capital that is required to be held against these risks.

8. We are also disconcerted by paragraphs 36-38 relating to example 1 of the discussion draft and the implications as it could apply to insurers. It appears to be a straightforward example where all of the economically significant risks are with Prima in country A and the sales agent in country B is receiving an arm's length commission. Therefore, whilst a PE is created, there is no profit attributable to the PE in country B. However, paragraph 36 states that under Article 7, the sales income obtained in country B is attributable to the (Dependent Agent Permanent Establishment) DAPE in Country B. In order to ensure zero profit, the cost of goods sold (COGS) (payable back to the Country A) is a balancing figure.
9. In the insurance context, applying the approach in example 1 to a very limited DUA in Country B, where all the economically significant risks (i.e. KERTs) are with the insurer in country A, would require the entire premium obtained from Country B to be attributed to the PE even though there are no KERT functions in that country. This would conflict with Part IV. Furthermore, it would also be illogical to try to construct the equivalent of a balancing figure COGS in an insurance P&L to get the residual underwriting profit back to Country A the home location, unless you were deeming there to be internal reinsurance between the branch and head office, which is explicitly not allowed under Part IV.
10. Therefore, whilst we understand the need for the construction of a notional P&L to arrive at the profits/losses of the DAPE we do not agree with the statement that the sales revenues associated with a dependent agent are by default attributable to the DAPE in view of the potential conflict with Part IV (questions 3 and 6 of the discussion draft).
11. We therefore believe that to avoid the risk of notional P&Ls being constructed inappropriately in the insurance context that it is essential that Part IV, which provides comprehensive guidance which defines and discusses risks, risk management and allocation of risk in the context of insurance businesses, is referenced in the Commentary on Article 5(5) and 5(6) as it sets out the facts and circumstances of the insurance business value chain. A suitable place to include such a reference would be in paragraph 39 of the Commentary.
12. Currently there is nothing in the Commentary on Article 5 that suggests the facts and circumstances of the business value chain should be taken into account as part of the determination of whether there is a PE. We believe that the Commentary would benefit from such an addition as it would reduce the PEs being created where nil or minimal profit would be attributed.
13. An alternative approach would be for tax authorities not to require tax filings where no profits are attributable, with business being required to notify the tax authority of the existence of a PE. This notification process should satisfy disclosure concerns.



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*Page*  
1 of 6

**BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments**

Dear Sir or Madam,

We highly appreciate OECD's invitation to comment the discussion draft "BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments". We thank the authors for the work they have done, and also we would like to thank the OECD for continuing the work on this topic. In our opinion the current discussion about allocation of profits (regarding the lowered threshold for deemed PEs) in general still needs to ensure:

- Clarity,
- legal certainty and
- simplification of administration.

Considering the above, OECD's guidance should provide clear rules about the respective allocation, mitigating discussion and disputes between taxpayer and tax authorities as well as between the countries involved.

**General comments**

The BDI considers it to be important to limit the compliance obligations, in particular for the case that no profit will actually be allocated to the deemed permanent establishment (PE), e.g. due to the lack of significant people functions (SPF) or economic ownership to be allocated to a deemed PE. Otherwise the lowered thresholds for a deemed PE will only result in inefficiencies and unnecessary administrative burdens for both, tax payers and tax authorities.

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Therefore we suggest to introduce an exemption rule under which a non-resident enterprise (Prima) would not be obliged to file a separate tax return in Country B if the profit of the dependent agent permanent establishment (DAPE) is nil. This would not affect the tax revenue of the affected countries, but both countries would have full transparency over the activities of the dependent agent. Further explanation on this will be given in the comments to example 1.

### **Specific comments**

Question 1) Can the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC affect the outcome

The order in which the analyses are applied under Article 9 of the Model Tax Convention (MTC) and Article 7 of the MTC can affect the outcome. If Article 9 is applied isolated first, the application of the arm's length principle would not be applied to dealings as outlined in the OECD 2010 Report on the Attribution of Profits to Permanent Establishments, paragraph 172 et seq. (hereinafter referred to as the "Authorized OECD Approach" or "AOA"), which is based on Article 7 paragraph 2 of the MTC 2010. Instead, the arm's length conditions would only be reviewed on the level of the non-resident enterprise ("Prima") only for the controlled transaction between Prima and Sellco, but not for dealings between Prima and its PE. After the application of the arm's length principle on the level of Prima, the profit would be allocated to the PE according to Article 7 of the MTC.

In our view, Article 9 has to be applied twice: First to the controlled transactions between Prima and Sellco, and a second time for dealings recognized between Prima and the PE to which the arm's length principle has to be applied. This is also in line with the AOA, which rules that dealings have to be at arm's length, meaning that there first needs to be a dealing, on which Article 9 of the MTC then can be applied. Summarizing, in our view Article 9 needs to be applied first between Prima and Sellco, then Article 7 needs to be applied to attribute the profits before Article 9 is applied to the dealings to achieve an appropriate profit sharing between Prima and its PE.

In the following we would like to comment on the examples given in the discussion draft and the respective questions.

#### **Example 1**

Answer to question 2) In the functional and factual analysis of Example 1 the role of the dependent agent with respect to the conclusion of contracts should be included as this is one of the core functions actually to be performed by the dependent agent to constitute a DAPE.

Answer to question 3) Yes, the construction of the profits or losses of the DAPE is correct.

Page  
3 of 6

In this context it is very doubtful that a DAPE should be obliged to file a tax return. In fact – assuming the sales commission to Sellco being at arm's length – this would not affect the tax revenues arising in either of the countries involved. Instead, for Prima, the obligation to file a tax return (and related to this, to perform functional and factual analyses) would mainly create a significant administrative burden which would in relative terms be considerably higher than for a legal entity. Considering the fact that usually a dependent agent is engaged in situations where the local business (here in Country B) is not large enough for Prima to establish a separate legal entity, it is inappropriate to load this administrative burden to Prima for this relatively small business. In some cases this obligation may even result in an investment obstacle for Prima. In any case the administrative costs would be tax effective resulting in a decreased overall income of Prima and also lowering the tax revenue of the countries involved.

It also has to be considered that in big international groups, the number of DAPes will be significantly high due to the wording of Article 5 paragraph 5 and 6 of the MTC as proposed in the Final Report to BEPS Action Item 7. Due to this fact the administrative costs – from a group's perspective – would be unreasonably high.

In consequence the BDI considers it as very important that an exemption rule is established under which Prima would not be obliged to file a separate tax return in Country B if the profit of the DAPE is nil. This would not affect the tax revenue of both affected countries. Nonetheless both countries would have full transparency over the activities of the dependent agent. Actually, in Example 1 it is key that the sales commission paid to Sellco is at arm's length, which has to be documented in the Transfer Pricing Documentation of Prima and of Sellco. This way both countries gain transparency that there is a dependent agent and whether the remuneration is at arm's length.

A possible solution could be an exemption rule like it is included in the protocol to the double tax treaty between Germany and Austria, where it is laid down (for the current wording of Article 5 paragraph 5 of the MTC) that – notwithstanding the wording of the treaty – no DAPE needs to be assumed if the remuneration of the dependent agent for its activities is at arm's length. Summing up, such an exemption rule would have no negative impact to the affected countries but would relieve Prima from a significant administrative burden.

Answer to question 4) The administrative burden to determine the income of the DAPE would be reduced as no full functional and factual analysis (in line with the AOA) would have to be performed. The result, a nil profit for the DAPE, would remain.

Answer to question 5) Yes, this assumption is correct as there are no additional functions, risks or assets to be attributed to the DAPE.

Page  
4 of 6

## Example 2

Answer to question 6) No, the construction of the profits and losses of the DAPE and Sellco is not correct. The mere fact that the Dependent Agent Enterprise (DAE; here: Sellco) exercises functions on behalf of Prima (i.e. manages risks about inventory and credit to customers as outlined in the description of Example 2) cannot lead to the conclusion that Sellco economically bears the risks. If, for example, the dependent agent conveys a deal for Prima and the respective receivable has to be waived that will not be reflected as a loss in the books of Sellco but in the books of Prima instead and Prima will not get remunerated by Sellco for this loss. Apart from that it has to be distinguished between the mere administration of the risks which can be outsourced to Sellco (by Prima) and decision making. In most cases Sellco may be assigned the administration of receivables and customer's payments, but has no decisive power (for example if the receivable is waived). In this case, Sellco needs to receive an additional remuneration (as a service fee) for administering the receivables, but the risk (and the resulting loss) has to be attributed to Prima.

Even if the decision power is with Sellco this still does not lead to the conclusion that Sellco also economically bears the risk for bad debts. Instead this risk has to be attributed to the DAPE and would lead to an additional service fee for Sellco and a risk premium on the level of the DAPE. In this case the DAPE would have an individual profit and also has to bear the loss in case of bad debts.

Answer to question 7) Question 7 is not commented as in Germany the AOA has to be followed in any case.

Answer to question 8) As we do not agree that Sellco economically bears the risk the question whether Sellco has the financial capacity to bear those risks is irrelevant.

Answer to question 9) As mentioned above we do not agree that the inventory and credit risks should be allocated to Sellco. The view taken in the Discussion Draft is also not in line with paragraph 232 of the 2010 Attribution of Profits Report where it is stated that the DAPE "will be attributed the assets and risks of the non-resident enterprise [Prima] relating to the functions performed by the dependent agent enterprise [Sellco] on behalf of the non-resident [Prima]". To meet the obligations resulting from those risks the DAPE needs to be attributed an appropriate free capital instead.

Answer to question 10) No, the construction of the profits and losses of the DAPE in Example 3 is not correct. Given that 4.5% is the appropriate remuneration of the DAPE according to the functions performed, risks borne, and assets assumed it is reasonable that this operating margin also includes risk premiums for the risks borne by the DAPE (inventory and credit risk). As the economic ownership of the inventory and receivables is attributed to the DAPE and the facts give no indication that decisions about risks are taken by Prima those risks have to be attributed to the DAPE. In this specific example the construction of the profits and losses of the DAPE would result in a risk-free distribution function performed by DAPE which contradicts the risk allocation. Thus if an operating margin of 4.5% is found appropriate the operating profit of DAPE has to be determined without considering bad debt losses and inventory losses. Instead only the salary of Employee (20) and the warehousing costs (6) have to be considered resulting in costs of goods sold (COGS) of 165 and an operating profit of 2. If there is no bad debt loss and no inventory loss the operating profit is 9.

As the inventory and credit risks are attributed to the DAPE according to the functional and factual analysis it is impossible to consider the DAPE being risk-free. If the operating profit of 2 is found inappropriate for a year when the bad debt and inventory losses occur like in Example 3. The conclusion should be that the operating margin of 4.5% is inappropriate considering the functional profile of the DAPE.

Answer to question 11) See comment on question 7.

#### Example 4

In this example it is stated that the facts are identical to Example 2. We conclude from the example that, in deviation from Example 2, warehousing is no relevant fact in Example 4.

Answer to question 12) Given the assumptions made in this example the construction of the profits or losses of the DAPE is correct. However, it should be mentioned that this example seems to be very theoretical as the service fee indicates that Sellco only performs routine functions and may have a certain degree of control over credit risks. Additionally it is doubtful that Sellco would as a third party bear significant credit risks on its own, acting as an agent. This is even more true as Sellco only manages 25% of the risks (given the assumption in the example), but finally bears 40% of the risks. This way Sellco would bear risks which it does not have any control over.

Answer to question 13) In general, this statement is true but it indicates that the contractual agreement between Prima and Sellco might not be at arm's length (even if this is assumed). If it was, this would demonstrate a lack of the AOA as under the AOA the DAPE shall be treated like it was a separate legal entity and where dealings should work equally like contractual agreements between separate legal entities. Considering this the



result for the profit sharing between Prima and Sellco on the one hand and Prima and DAPE on the other hand should come to the same result (proportional). The mere fact that this is not the case shows that Sellco contractually takes over more risks (proportional) than it controls while risk is attributed to DAPE proportional to the fraction it controls.

Page  
6 of 6

Please do not hesitate to contact us if you have any questions.

Yours sincerely



Dr. Karoline Kampermann



Ralph Brügelmann

# The BEPS Monitoring Group

## Comments on the Public Discussion Draft on

### ADDITIONAL GUIDANCE ON ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

These comments have been prepared by the [BEPS Monitoring Group](#) (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Jeffery Kadet, with contributions and comments from Tommaso Faccio and Sol Picciotto.

#### SUMMARY

This discussion draft (DD) deals with attribution of profits to a host country resulting from changes to the taxable presence requirement in the definition of a permanent establishment (PE) in BEPS project's Action 7. Although generally clear and well reasoned, it is of limited usefulness in our view, for two main reasons. These comments explain these shortcomings and suggest how they could be corrected.

First, it applies only to the 2010 version of the OECD model convention, which introduced the 'authorised OECD approach' (the AOA) for attribution of profits to a PE. The AOA attempts to extend to PEs as far as possible the independent entity principle as applied to associated enterprises within a multinational enterprise (MNE). A number of OECD countries have not accepted the AOA, and it has also been generally rejected by developing countries. One reason for this is that the independent entity principle is especially inappropriate for a PE, which by definition is part of the same legal entity. Hence, few actual treaties are based on the AOA, and this is also true for most national tax law rules which would apply to entities resident in non-treaty countries. States, especially developing countries (whether or not they decide to join the Inclusive Framework for BEPS), should not be pressurised into adopting the AOA. Instead, the UN Committee of Tax Experts, in liaison with the OECD, should develop its own revisions to the commentary to the UN treaty model consequent on the changes to the PE definition introduced by Action 7. Further work is clearly necessary, by a wider range of countries, and adopting a broader approach, to produce guidance that would be of use to tax payers and tax authorities, especially in the bulk of cases where the AOA is not applicable.

Secondly, the examples provided in the DD adopt a very restricted approach, which assumes that all or most significant people functions take place in the non-resident entity, and hence attribute only limited profits to the PE. They include some illustrations of when aspects of inventory and credit risk management may take place in a PE, but significantly the examples

include no discussion of other sales-related functions such as marketing and advertising, which are instead assumed to be controlled by the non-resident entity, with no relevant local input. Similarly, the examples are silent regarding core business functions conducted in host countries that are often found in modern MNE business models. These simple examples may be relevant to relatively small firms based almost entirely in their home countries, which employ a foreign sales agent. But they are entirely unrealistic in relation to most large MNEs and their modern business models, which aim to be both global and local. No MNE can operate effectively by centralising virtually all its significant people functions and all its core business functions at a distance from its customers and suppliers, as is assumed in the examples provided here. Indeed, there are many well known examples of MNEs which employ significant staff in host countries engaged in both customer-facing and many core business functions. The failure of this DD to discuss such situations suggests a lack of consensus on how to deal with them, which may regrettably exacerbate the likelihood of conflicts even between OECD countries.

As the DD is now drafted with its focus on the AOA and its unrealistically simple examples, its effect is to strengthen the BEPS mechanisms used by many MNEs. This contradicts the mandate for the BEPS project, which is to align taxation and value creation.

## **GENERAL REMARKS**

### **Status of these proposals**

1. This discussion draft (DD) proposes some consequential measures resulting from the proposals under Action 7 of the BEPS Action Plan. These Action 7 proposals resulted in some changes to the definition of a Permanent Establishment (PE) in article 5 of the OECD Model Tax Convention (the Convention), which specifies when a foreign resident company may be treated as having a taxable presence in the host country. These changes essentially concern (a) when a legal person (including a related entity) acts as a dependent agent by regularly being involved in concluding contracts on behalf of the foreign company (a dependent agent PE, or DAPE), and (b) when the foreign company maintains a stock of goods, e.g. in a warehouse for delivery. This DD concerns the appropriate attribution of profits to these types of PEs, under article 7 of the Convention.
2. This DD addresses only the methodology for such attribution of profits under what is known as the Authorised OECD Approach (AOA). The AOA was introduced only in 2008, with the support of a majority of OECD countries, resulting in extensive changes to article 7 of the Convention and to its Commentary of 2010. Nevertheless, some OECD countries (Chile, Greece, Mexico, New Zealand, Portugal and Turkey) reserved their right to continue to use the previous version, as did non-OECD countries (Argentina, Brazil, China, Hong Kong-China, Indonesia, Latvia, Malaysia, Romania, Serbia, South Africa and Thailand). The AOA was not accepted by the UN Committee of Tax Experts, so that the 2011 version of the UN Model Double Taxation Convention treats the attribution of profits to a PE in a significantly different way from the 2010 OECD Convention.
3. These are not minor differences, but reflect a fundamental difference in approach, which is long-standing. The AOA introduced a significant strengthening of the independent entity principle, by aligning the methods for attribution of profits to a PE under article 7 with those for associated enterprises under article 9. These are based on analysing the ‘functions performed, assets used and risks assumed’ by the various portions of the non-resident taxpayer in the host country and elsewhere as if they were separate legal entities, treated as elaborated in the OECD Transfer Pricing Guidelines. The changes introduced by the AOA

involved a significant reduction of host country rights to tax business profits generated partially or wholly within the host country, in favour of the country of residence.

4. The BEPS Action Plan stated clearly that:

‘While actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.’

In our view this commitment has not been fully respected; the selection of measures to strengthen source or residence taxation in the BEPS project outcomes has generally tended to disfavour source taxation. In particular, the changes to the Transfer Pricing Guidelines have emphasised the functions of ‘control’ of activities such as R&D, and of risk. The changes to the PE definition in Action 7 go the other way, by strengthening taxation at source, although not to any great extent. However, their impact would be limited much further if countries are required to apply the AOA for the attribution of profits.

5. It should be made very clear that the proposals in the current DD affect only the 2010 version of the Convention and its Commentary. Although specific questions have been included in the discussion draft concerning non-AOA approaches to determining the profits of a PE or DAPE, all examples and discussion assume that the AOA is applicable. The changes, therefore, by their terms, apply only to treaties based on the 2010 version of the Convention. Countries and specific bilateral treaties that do not use that model should not be committed to applying this DD’s approach to article 7, though of course some of the concepts introduced in this DD may have applicability to applying non-AOA approaches.

6. On a broader note, countries should not be considered as accepting a commitment to introduce the AOA, or in any way be pressurised to do so. This is particularly important for developing countries which may join the Inclusive Framework as BEPS Associates. They are joining at a late stage of the process, which will inevitably limit the extent to which they can ensure that their concerns are taken into account. However, they have been assured that they can contribute on an equal basis to the continuing processes of standard setting, which includes the current DD.

## **2. Further work required.**

7. While attribution of profits under the AOA is the focus of the discussion draft, the vast majority of future situations confronting taxpayers and tax authorities will not involve the AOA. Rather, where a treaty is applicable, it will likely have in effect some pre-AOA version of Article 7. Further, many MNEs, whether through normal tax planning or complicated profit-shifting structures, make sales and perform services through companies resident in low-tax jurisdictions which have no treaty applicable, so that their PEs and DAPes would come under local law within host countries. Where there is no applicable tax treaty, of course, the AOA will again be inapplicable.

8. With this situation in mind, we suggest two things:

First, we suggest that the applicable OECD Working Groups liaise with the UN Committee of Experts on International Cooperation in Tax Matters, which should review its version of article 7 and commentaries, in light of the changes to article 5 resulting from Action 7.

Second, in conjunction with the UN Committee of Experts, we suggest that consideration be given to providing broader principled guidance and examples that

would be of use to taxpayers and tax authorities, no matter whether a treaty is involved or not and no matter whether the AOA or a pre-AOA approach is applicable.

9. In regard to the need for more and broader guidance, we note that many host countries, even where a tax treaty is applicable, have only vague rules at best for making PE profit calculations. This will be especially true for DAPes. Recognizing this, the OECD Commentary could in many cases provide important background and guidance to tax authorities attempting to apply their vague rules on determining the profits of a PE or DAPe. With this in mind, it would be a great benefit for all countries, and especially the less sophisticated developing countries, if more examples could be included in the Commentary that will focus on the significant people functions that do in fact occur within source countries for some of the common MNE business models. Such examples would be of great assistance to taxpayers in calculating the PE and DAPe profits that they will declare and to tax authorities attempting to review the reasonableness of such declared profits. In our view it is regrettable that, perhaps because this DD focuses on the AOA, the examples it provides reflect some of the content of the 2008 report that gave rise to the AOA. That report, which reflects business models now ten to fifteen years old, tends to stress simple examples which assume that the PE or DAPe does not have significant people functions. Today in the real world, such simple examples will most typically be factually untrue.

10. For instance, there are many MNE businesses where core business functions are conducted through service agreements with local related party group members. Providing some examples with fact patterns that include various significant people functions that are typically found would be very helpful. We of course understand that the present examples have been drafted in a limited and simplified fashion to assist the Working Groups in the drafting of new Commentary and to encourage comments from interested parties. This has resulted in the restrictive assumptions in Examples 1 through 4 which give limited functions to the DAPe in the host country in relation to inventory management and extension of credit to customers. It is also notable that these examples assume that other sales-related functions such as marketing and advertising, which add significant value to sales, are controlled by the non-resident entity, and merely implemented locally by the sales entity. From a guidance perspective, though, it is critical that future Commentary amendments take a much broader approach within the examples and reflect many of the significant people functions that are typically conducted within host countries within commonly used MNE business models. The absence of such examples in this DD does not reflect the way many MNE businesses operate, and suggests a lack of consensus among OECD countries, which will regrettably lead to conflicts.

11. The Example 5 warehouse case with its three Scenarios is excellent. However, what would be very helpful for many countries, and could apply to numerous MNEs, would be a warehouse and local support example that reflects the manner in which many MNEs conduct internet-based businesses. For example, the many MNEs that sell hard and soft products and that provide various services through internet platforms maintain extensive local operations to provide both customer support and quick delivery of physical products. These local activities are so much a part of the core business being conducted that such MNEs will have a PE or DAPe in many host countries. These local activities are not in any way preparatory or auxiliary to the overall business activity of the enterprise. Regarding attribution of profit to such PEs and DAPes, examples and discussion should mention not only the attempt to identify arm's length answers under the traditional transactional methods (CUP, resale, and cost-plus), but also the use of transactional profit methods (TNMM and profit-split method). There should also be discussion of formulary approaches where an applicable treaty allows it (or no treaty applies) and it is customarily used in the particular country, as allowed in the

pre-AOA para 4 of Article 7, which is widely applicable in treaties especially those of developing countries.

12. Whereas the warehouse in Example 5 Scenario B is owned by WRU, we suggest that a similar example be included for an internet-based business that involves a host country subsidiary that is performing these core functions for the overseas MNE parent or other group member, so that the example involves a DAPE.

### **3. Highly Subjective Situations**

13. Whether it is the more complex case of Example 4, involving inventory and credit management functions, or Example 5 that involves know-how, software, and various home office services benefiting the PE, there are many situations where any allocation will be very subjective and subject to considerable risk of taxpayer/tax authority disputes. Recognizing this, guidance regarding two approaches would be very helpful.

First, guidance should be provided for application of the profit-split method to determine the profit attributable to the PE or DAPE. We believe that there will be many subjective and complex cases where the profit-split method will be most appropriate transfer pricing method under the circumstances.

Second, many existing treaties in pre-AOA para 4 of Article 7 allow in certain circumstances the application of an apportionment formula to an enterprise's total profits to determine profits attributable to the PE or DAPE. Guidance should be provided here as well. (See further comments in our response to question 4.)

### **4. Inclusion of Examples that Reflect Actual MNE Conduct of Business**

14. The very simplified examples in this discussion draft seem to be relevant only for relatively small firms based almost entirely in one country, which may employ an agent to facilitate foreign sales. They are frankly largely inappropriate for most MNEs by not addressing the reality of how such firms are in fact operating. If this simplistic approach finds its way into the Commentary and other guidance, then taxpayers will prepare tax filings and unsophisticated tax authorities will review them with these simplified examples in mind.

15. Examples 1 through 4 assume that Prima is an operating company. In contrast, many MNEs record their revenues not within real operating group members but through cashbox and tax haven companies, having few employees or operations of their own. These companies often rely on intercompany service agreements with operating related parties for many of their core business functions. Guidance should be provided to consider such situations so that taxpayers can more appropriately prepare tax filings and tax authorities in source countries will be able to review those filings and approach these issues more intelligently and knowledgeably.

16. The basic facts for Example 1 include that 'there are no significant people functions performed by Sellco on behalf of Prima in Country B relevant to the attribution of Prima's assets and risks to the DAPE'. This is not only an oversimplification, it will be factually wrong in most cases. Yes, maybe the final analyses and decisions regarding worldwide marketing and production strategies will be made by management in Prima's home country, but they will in virtually all cases receive important contributions of information, analysis, and support from DAE personnel in Country B. The DAE personnel are also typically the people who are conducting these various business functions and in direct contact with customers, suppliers, etc. Further, it will commonly be the case that Prima management personnel will periodically travel to Country B where they learn more 'on the ground' that adds to their ability to develop and implement their marketing strategy. They may also be

involved in major customer presentations and in maintaining customer relationships or be involved in major transactions during their visits. To ignore all this and simply say in the example that the MNE group as a whole has no significant people functions conducted in Country B is simply wrong. No MNE can operate effectively by centralising its main significant people functions at a distance from its customers and suppliers.

17. Example 2 in para 48 states, in part: ‘The functional and factual analysis under Step 1 of the AOA shows that Sellco undertakes all the functions involved in identifying customers, soliciting and placing orders and it also implements locally the marketing and advertising strategy devised by Prima.’ Then, in para 51, regarding activity attributed to the DAE, there is no mention of these Sellco functions and activities. Only the inventory and credit functions and the necessary capital needs are discussed. This apparent ignoring of all these Sellco functions simply understates their importance and the value of their activities in many of today’s MNE business models. We suggest that the example specifically include these functions within para 51 and other appropriate portions of the example.

18. Further, the artificial contractual allocation of risk through the Prima/Sellco service or other intercompany agreement defining the relationship of Prima and Sellco does not define the various activities and risks that the MNE as a whole is taking with respect to Country B. That these can be different is of course emphasized in the respective Article 9 and Article 7 analyses and discussions for each example. However, the emphasis on the Article 9 analysis takes attention away from the more important Article 7 analysis.

19. With this in mind, the MNE has invested money and energy in setting up the DAE and employing and training its personnel. The MNE is selling products through the DAE’s efforts and extending credit to Country B customers. As a unified group, the MNE is conducting a full risk-bearing business in Country B and not only the artificially limited risk undertaken by the DAE through the intercompany agreements. Example 1 should be changed to show this and to result in some appropriate level of DAE income that reflects the full risk-bearing business nature of its activities and therefore cannot in any realistic circumstances be zero.

20. For example, regarding sales and credit risk, there may be a high-level person in the home country approving sales and making final credit decisions, but there will be personnel in the local country who identify and decide which local customers are worth pursuing for possible sales. These personnel will likely meet with and interview many of the local prospective customers, making local decisions on which of them are solid enough to consider offering to Prima as potential customers. These DAE personnel will also select information to communicate to the home country management both on overall local conditions and on specifics with respect to each potential customer. This is all part of control and implementation of the MNE’s sale of products and assumption of credit risk. The risk undertaken and the potential benefit to the MNE as a whole are not limited to the usual ‘limited risk’ and cost-based service fee defined in the intercompany agreement between the non-resident and the DAE. Example 1 or some additional example to be added must reflect this reality and not some imaginary simpleton situation that would virtually never be found in real life.

21. Examples 1 through 4 include as fact that the local dependent agent (whether Sellco or an employee) does ‘not create any local marketing intangibles in Country B. Sales channels are generic and not specialised.’ The background that has caused the G20 to initiate the OECD managed BEPS project has been the extraordinary success of MNEs in shifting profits from the countries in which value is created, whether through innovation, production, or customer sales and services. Many of these MNEs conduct proprietary businesses that involve both new technologies and business models that are anything but generic and unspecialized.

22. Considering this, assuming for all examples that there are no local marketing intangibles in Country B and that the sales channels are generic and not specialized serves to terribly restrict the relevance of these examples. These examples must be amended to reflect the reality that most MNEs' local country marketing, sales, and support operations do significantly reflect and apply the proprietary technologies, proprietary business models, and proprietary product/service knowledge of their well-trained and experienced personnel, some of whom are local and some of whom may have been transferred from the home country or other countries where the MNE conducts major operations. These operations not only reflect significant profit-earning people functions, but they also result in the creation of local marketing intangibles (e.g. customer list, know-how, etc.) and their impact on the attribution of profits to permanent establishments must be recognised and addressed in this guidance.

## **SPECIFIC COMMENTS**

***1. Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.***

### **Response:**

We believe that accurately delineating the actual transaction between the non-resident enterprise and the DAE under Article 9 as a first step is absolutely the wrong approach. The primary reason is that it takes focus away from the much more important issues and calculations of how the MNE is conducting business within the applicable host country. A secondary, though no less important, reason is that the Article 7 analysis on an MNE-wide basis allows the analysis to focus solely on actual activities of group personnel and agents and real third-party contracts and dealings, ignoring the normally tax-motivated intercompany agreements on which intercompany transactions are based. This first step can often be completed relatively expeditiously and avoids in many cases getting bogged down in the terribly subjective analysis of an Article 9 intercompany pricing analysis. As indicated below, in many cases, by conducting the Article 7 analysis first, tax authorities will determine that no Article 9 analysis is needed.

Regarding the primary reason, MNEs are operated as centrally managed worldwide businesses. It is a mere legal fiction that their activities are attributed amongst a number of related group members, since such attribution is generally based on tax-reduction objectives rather than on any real commercial or non-tax legal objectives.

With this in mind, we believe that placing the analysis of the related party transaction as the first step takes away from the more important steps of determining what activities the MNE is conducting in the host country and the overall profits from all of that MNE's activities that occur with respect to that host country where it has either an actual PE or a DAPE. We therefore strongly recommend the following steps in this specific order:

Step One: An analysis of the business conducted and the activities performed in the host country of all MNE group members ignoring legal entity lines. This analysis would reflect the centralized manner in which MNEs generally manage their business. This analysis is not only important for ultimately determining attribution of profits under Article 7, but it also provides a big picture perspective for each host country tax authority to identify non-resident MNE group members that might not appear in isolation to have either a PE or a DAPE. Thus, it is an important step to achieving one of the goals of the Action 7 Final Report, which is to prevent the avoidance of PE status through the splitting up of contracts to take advantage of the exception of paragraph 3 of Article 5.



Step Two: The determination of the worldwide profits attributable to the combined activities of all MNE group members for the relevant products and services sold into or provided to customers in that host country or that otherwise relate to activities in that country.

Step Three: The determination of the MNE's profits attributable to the MNE's business and activities actually conducted in the host country. This determination would reflect the AOA approach, but applied to the MNE as a whole and not to any one group member.

Step Four: An Article 9 analysis of the activities of each group member so as to determine the arm's length charges necessary to determine the respective profits of the one or more DAEs and the deduction allowed to the PE or DAPE of the non-resident group member(s).

As for the second reason, Example 4 is an excellent demonstration of the importance of focusing first on the MNE as a whole. In Example 4, both Prima and Sellco conduct significant people functions regarding credit terms, the extension of credit, and the recovery of customer receivables. Attempting to determine a specific answer regarding the relative contributions and values applicable to each group member will be very subjective and likely be a matter of contention between tax authorities and MNEs. (See para 73 on page 23 to illustrate the subjectiveness and consequential potential for disputes.)

By focusing first on the MNE as a whole and the respective activities of MNE personnel and agents in the host country and elsewhere, a tax authority may be able to minimize the subjective areas of serious potential dispute as they delineate the nature of the MNE's presence in the host country and attach relative values to the actual functions performed. (See paras 80 and 81.) Further, the tax authority can determine the extent of any potential Article 9 issue by simply comparing the MNE's profits from its business and activities actually conducted in the host country (Step Three above) with the profits already reported by the DAE that relate to its activities conducted on behalf of the DAPE. If the difference is found to be immaterial or otherwise insufficient to merit the extensive and resource-intensive transfer pricing audit procedures that would be required, then the tax authority can choose to not conduct any Step Four Article 9 analysis. This would save considerable time and expense both for tax authorities and for MNEs.

As a further point on this, assume that the Step Three analysis yields a profit of 100 when the DAE has reported profits of 75, so that in the absence of any Article 9 adjustment the DAPE profit will be the remaining 25. In deciding whether to initiate analysis under Article 9 to arrive at the most theoretically correct respective DAE and DAPE profits, the applicable host country tax authority might appropriately consider what tax differences will arise where the 75/25 profit split changes to, say, 100/0, 90/10, or 65/35. Assume, for example, that the host country applies the same income tax rate to both resident and non-resident taxpayers and also imposes a branch remittance tax that places branch profits in the same economic position as a local subsidiary's earnings that are subject to a dividend withholding tax. In such a case, the local country tax authorities may appropriately choose to refrain from making any Article 9 analysis and simply impose tax on the DAPE's 25 of profits and the DAE's 75 of profits. On the other hand, if there is no branch remittance tax imposed on the DAPE's profits or if the effective tax rates differ for some reason, the tax authorities may choose to initiate an Article 9 analysis.

It may of course be added that there will be some cases where an MNE has contractually limited the risk of a DAE and provided a service fee based on a cost-plus or similar arrangement that protects the DAE from loss. Where the MNE has not been as profitable as expected, it may well occur that the DAE profits will exceed the Step Three profits, thereby

causing a DAPE loss. In such situations, tax authorities will seldom see any need to initiate an Article 9 analysis to adjust the relative incomes of the DAPE and the DAE.

***2. Do you agree with the functional and factual analysis performed in Example 1 under the AOA?***

**Response:**

We do not believe that the functional and factual analysis performed in Example 1 is reasonably representative of reality within centrally managed MNEs. As such, we believe that its assumptions not only cause an incorrect answer, but they are seriously misleading and will result in a continuation of BEPS tax motivated structuring.

From para 24: ‘Prima selects the sales agent, monitors its performance and makes decisions on whether to continue, adapt or terminate the relations with the sales agent.’ These activities from para 24 are then used as part of the rationale in para 30 and are also found in Table 1 within Annex 1.

While it may be factually true that a parent company like Prima will always have a choice to form its own subsidiary to house certain functions or alternatively to identify and hire an unrelated party for such functions, this is truly meaningless in related party situations. As such, this right and authority in the hands of Prima should be ignored in any analysis. By pointing it out as a separate fact in para 24 and in Table 1 in the Annex, and especially including it as a factor in para 30, the example implies that this is an important factor that should affect the Prima/Sellco transfer pricing analysis. We believe that it is misleading to give any importance to this. It should be eliminated as a factor.

From para 24: ‘Sellco is responsible for identifying customers, soliciting and placing customer orders and processing customer orders with Prima.’ Sellco, though, is not performing the functions of setting sales strategy and sales targets nor is it setting pricing policy. These top-level functions, which are performed by Prima, are an important part of the overall conclusion of Example 1 that there are no significant people functions performed by Sellco on behalf of Prima. (See para 34.)

True, many MNEs operate with management centralized in the home country or in regional headquarters making major company-wide or region-wide decisions that are then implemented in each country. However, these centralized managements do not operate in a vacuum sending their decisions out from the center. They have continual day-to-day dialogue and reporting from personnel in each country who contribute to the bases of data and other information on which they make their decisions. The local country subsidiaries’ employees, including both local management and other personnel, contribute significantly in gathering data and information, applying judgment on what data and information will be relevant, and providing their local knowledge and insight. They also, on a daily basis, are implementing the centrally made policy decisions through their judgment in identifying potential customers, determining how to approach these prospects, and then using their product and other skills and knowledge to close sales and provide services. It is also the information they gather and their own professional judgment that will be the basis for the ultimate sales and credit decisions that personnel at Prima will make.

It may be added that the legal, cultural, and business practices differ to a greater or lesser extent within each country. The local country subsidiaries’ employees without doubt make judgments and recommendations to decision makers overseas regarding how central company policies and business models should be set and implemented for their respective countries. This is not mere information gathering by a clerk without thought or analysis; it is rather an

important and significant people function that cannot be ignored in either the Article 7 or Article 9 analyses.

For the above reasons, Example 1 is misleading in suggesting that the situation as described will result in no significant people functions being performed by Sellco in its DAE capacity on behalf of Prima's DAPE. Example 1 should be rewritten to reflect at least a few of the real people functions that are being performed within the host country with a resulting amount of DAPE profit.

In making the above comments, we recognize that the 2010 Report on the Attribution of Profit to Permanent Establishments comments in para 233:

In particular, it should be noted that the activities of a mere sales agent may well be unlikely to represent the significant people functions leading to the development of a marketing or trade intangible so that the dependent agent PE would generally not be attributed profit as the "economic owner" of that intangible.

This comment, however, which was included in this 2010 update of the 2008 report, was likely written in the course of work conducted over the previous several years such that it is based on knowledge of business practices that are now ten to fifteen or more years old. Current practices of MNEs and the business models they use require realistic examples that will provide real guidance to taxpayers on how to calculate income attributable to PEs and DAPes, as well as to tax authorities on the factors and matters they must include in their review of such PEs and DAPes.

It should be added that in some situations, of course, the personnel at Prima are truly making these sales and credit decisions. However, in many cases, if not a majority of cases, whilst contractual agreements between Prima and Sellco would require Prima to approve every sale to customers made in Country B through the review of the customer's creditworthiness, the Prima personnel in reality are merely rubber-stamping the 'recommendations' made by Sellco.

Since determining whether mere 'rubber-stamping' is occurring is very difficult for any local tax authority, we strongly recommend that Example 1, when used in future finalized guidance, assume that "rubber-stamping" is the case and that the burden of proof is on the MNE to factually demonstrate that its sales and credit approval functions are truly occurring outside the country of sales.

We note that there are also cases where only certain types of sales are effectively reviewed by Prima (e.g. where the sale value exceeds a set amount). We consider that specific guidance should be provided to address these situations.

In addition to the above, we believe that the real commercial risk of an MNE group with respect to its activities in a host country is not being adequately reflected whenever a local commissionaire, agent, or other service provider earns a relatively lower commission or service fee due to limited risks being included in the applicable agreements. An example will help explain this concern.

Say that an MNE, resident and headquartered in country A, has separated its centrally managed operations amongst its group members so that the group member (X) making product sales to customers in country B has no local activities or employees of its own in country B. To support its sales to country B customers, X contracts with Y, another group member resident in country B, to provide various support operations. These various support functions could include, for example, marketing activities, sales support efforts, local warehousing and delivery, etc. Further, Y could be legally a commissionaire, an agent, or

only a service provider. Under the contractual relations between X and Y, Y is at limited risk so that the commissions or service fees it receives are relatively low reflecting its low level of assumed risk. Assume for purposes of this discussion that the commissions or service fees are at arm's length.

Assume that, under the current Article 5 definition of PE, X has no PE in country B, but will have a DAPE under the future expanded Article 5 definition. For both simplicity and to clearly illustrate a key point, assume that X's DAPE is considered to include solely the activities that Y is conducting for X.

Y will of course be taxable in country B on its own profits, which as noted above are based on its arm's length commissions and/or service fees received.

Before the expansion of the Article 5 PE definition, X as an overseas seller has no PE and will be free of any country B tax. After the Article 5 expansion, X will have a DAPE and will be taxable in country B, but on what?

Y's level of profits from its activities reflect its contractually lowered assumption of risk. Assume that in this particular case Y will get paid at least its expenses incurred plus a limited profit element no matter whether its services result in any sales for X or whether it inventories, warehouses, or delivers any of X's products, since it contractually bears very limited risks. On the other hand, X's profits from those same activities conducted by Y reflect X's full commercial business risk. If X sells insufficient product to recoup its local expenses in country B (i.e., the commissions and services fees paid to Y), then X will have a loss. If X sells plenty of product, then X will be the sole beneficiary with Y receiving no additional commission or service fees.

Clearly, X is in business to make profits. It believes that paying for Y's activities will allow it to make sales and a profit on sales to customers in country B. The point of course is that the value of Y's local activities to X, an overseas seller, is much higher to X since X is taking the business risk of paying Y for these local support operations irrespective of how many local sales are made. The portion of X's profits (assuming of course that X has made some sufficient level of profits) that will be attributable to its DAPE cannot be the same as the limited risk commissions and service fees earned by Y under its artificial limited-risk position. Commercial business risks, even if only the efficiency and competency of how Y conducts its business activities, are being factually undertaken within country B through the actions of the Y personnel and must be recognized in the AOA Article 7 DAPE analysis. There will be no efficiency or competency risk issue for Y since Y will receive its cost-plus income irrespective of how it conducts its business. On the other hand, X's DAPE will fully benefit from Y's efficiency and competency or will suffer from the lack thereof. Thus, there clearly are risks attributable to the DAPE.

***3. Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?***

**Response:**

For the reasons expressed in the response to question 2 above, i.e. that there are factually significant people functions being conducted in any typical MNE situation by Sellco in the host country and that there are DAPE commercial risks in excess of those assumed by Sellco, we do not agree with this approach of showing no profit or loss within the DAPE.

***4. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

**Response:**

Example 1 makes no reference to home office services or IP used by the DAPE. Accordingly, there is no issue of any notional payment under the AOA that would not be appropriate under the pre-AOA methods. However, the pre-2010 OECD Model Tax Convention and many existing treaties do include the following para 4 in Article 7:

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

For those many countries that have customarily applied an apportionment formula to an enterprise's total profits, this paragraph of course continues to allow its application.

Since relatively few countries have instituted the AOA approach, and many tax treaties still include this para 4, for guidance to be relevant to most MNE taxpayers and countries, it should reflect the application of formulae that are appropriate for commonly used business models. In our view, this should be developed by the UN Committee of Experts, which is the custodian of the older, and still more widely used, version of article 7. However, we do encourage the OECD, with its expansion of BEPS Associates, to provide useful and appropriate guidance.

The BEPS Monitoring Group submitted detailed comments on 6 February 2015 regarding the profit-split method and how it could be simplified for commonly used business models. This BMG recommended approach is also appropriate for the Article 7 analysis where this para 4 applies. We recommend that this approach be explained in future Commentary amendments with the inclusion of appropriate examples.

***5 In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?***

**Response:**

For the reasons expressed in the response to question 2 above that there are factually significant people functions being conducted in any typical MNE situation by Sellco in the host country country, we do not agree that showing no profit or loss within the DAPE is appropriate. Further, even if the DEA were to perform no significant people functions, as explained in the response to question 2, the DAPE's commercial risks in excess of those assumed by Sellco again require that there be at least some DAPE profits where the DAE operates under an intercompany agreement that limits the risks it undertakes.

***6. Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?***

**Response:**

We agree that the AOA is being applied to the stated facts in Example 2. However, we believe that the example is not consistent with reality, and is thus misleading for taxpayers and tax authorities for the reasons expressed in the above response to question 2. There are

additional factually significant people functions being conducted in any typical MNE situation by Sellco in the host country that are in addition to those significant people functions described in Example 2 for inventory and credit matters. We recommend that the Example should include these significant people functions

***7. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

**Response:**

See above response to question 4.

***8. In your opinion, what would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?***

**Response:**

As a first comment, this question 8 provides an excellent example of why our response to question 1 strongly recommends that the Article 7 analysis be made first on an overall MNE basis without regard to which group member is doing what.

By performing first an overall MNE Article 7 analysis to determine the group-wide profits attributable to the MNE's business and activities actually conducted in the host country (Step Three as described in the response to question 1), the analysis is made without any need to address such subjective and difficult to determine matters such as this 'financial capacity' issue. Rather, a tax authority can simply compare the results of this Step Three with the actual profits reported by the DEA and can decide if any difference is worth the additional work of an Article 9 analysis.

Now we focus on the specific issue raised in this question 8 regarding what, if any, consequences arise if Sellco does not have the financial capacity to assume the inventory and credit risks. (Example 2 in para 42 states with respect to both inventory risk and credit risk: 'On the assumption that Sellco has the financial capacity to assume the risk, ...')

We believe that in the context of the Example 2 factual situation there are no consequences at all to the various analyses and tax results from Sellco's lack of financial capacity.

While it is entirely appropriate to treat a "cashbox" company as having no financial capacity within a transfer pricing analysis, in the case of a group member like Sellco in Example 2 that is conducting real activities through its own personnel, the fact must be recognized that Prima, as the controlling parent of the MNE, has full power to create whatever financial structure it desires for Sellco and to place as little or as much assets and risks as it desires within Sellco. Given this taxpayer control, tax results must be based on actual activities and physical assets and not on what is artificially controllable through MNE decisions and agreements that have primarily tax-motivation and little or no legal or operational motivation or effect.

With the above in mind, we recommend that the para 32 phrase, 'on the assumption that Sellco has the financial capacity to assume the risk', be eliminated from any BEPS guidance as articulated in future amendments of the Model Tax Convention and its Commentary and the Transfer Pricing Guidelines in situations like this. It must be made clear in this type of circumstance that financial capacity of the company that is factually performing the activities will not affect the transfer pricing analysis.

***9. What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?***

**Response:**

We are not concerned by the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco are also taken into account, under Article 7, as the significant people functions that result in the attribution of economic ownership of assets to the DAPE. We are also unconcerned about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE.

Our reading of the guidance in the 2010 Attribution of Profits Report, in particular of paragraphs 230 to 245, is that the conclusions in Example 2 are founded on the example's too simplified fact pattern. As explained in our response to question 2, we are concerned both that significant people functions commonly found to occur in host countries in common MNE business models are treated as if they do not exist and that actual business risks attributable to the DAPE may be ignored in some limited-risk Sellco situations. We strongly recommend that expanded examples in future guidance confront and clarify these issues as explained in our response to question 2.

***10. Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?***

**Response:**

We agree with the construction of the profits and losses of the DAPE within the limited factual situation of Example 3.

***11. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

**Response:**

See above response to question 4.

***12. Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?***

**Response:**

We agree with the construction under the AOA of the profits or losses of the DAPE within the limited facts of Example 4.

The discussion in para 81 assumes an appropriate sharing of credit risk based on the sharing of significant people functions measured by the respective contributions to credit management costs for Country B customers. Where there are such significant people functions both within the host country and outside it and there is an absence of reasonable objective bases for sharing specific risks such as those risks considered in this Example 4, it

would be helpful to indicate in this example or a similar example in future guidance that the profit-split method is an alternative which should be considered.

***13. Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?***

**Response:**

We agree that profits or losses within the DAPE will arise because of contractual allocation of risk within intercompany agreements that differs from the actual activities of the DEA and the non-resident. See our comments on this issue in the response to question 2 above.

***14. Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?***

**Response:**

We agree that the construction of the profits or losses of the PE in Scenario A of Example 5 is in accordance with the AOA. However, given that most treaty situations will not involve the AOA, plus many Scenario As may occur where there is no treaty in effect, some discussion and guidance of the pre-AOA approach and of the possible application, where appropriate, of the profit-split method would be very helpful to many.

In particular, with the differing treatment under the AOA and pre-AOA approaches of payments for know-how and software and the fees for services that will include profit elements, such additional guidance is particularly importance. We believe that the OECD should not, so to speak, merely keep its head in the sand and ignore the fact that the AOA will seldom be applicable.

***15. Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?***

**Response:**

Same response as for question 14, except for the following with respect to Scenario C.

In the response to question 2, there is discussion regarding situations where real commercial risk attributable to host country significant people functions is not being adequately reflected in the price paid to the local commissionaire, agent, or other service provider because of a relatively lower commission or service fee resulting from contractually limited risks. In such cases, there could well be additional profits attributable to the PE.

***16. In particular, do you agree that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?***

**Response:**

Yes, under normal circumstances, there should be an appropriate return for any assets, whether tangible or intangible, that are factually a part of the PE or DAPE. The nature of the return and the calculation of the amounts of return would depend on the facts.



We can imagine that there might be occasional exceptions to this. For example, if WRU lost all its customers in Country W and continued only minimal activities in Country W to maintain its owned facilities and seek out new customers, then there should normally be no return recognized by the PE from these assets.

***17. Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?***

**Response:**

In general, we agree. We understand, though, that the streamlined approach refers only to return from the physical asset. In the case of Scenario B where there are activities, even if only routine activities, there would also be attributed to the PE appropriate return for those routine services. Thus, the total profits of the PE in Scenario B would reflect both the routine activities and the ownership of the warehousing facility, the return from which would be determined under the streamlined approach.

For Scenario C, the arrangement with Wareco would determine whether there might be any additional profit attributable to the PE in addition to the return on the property. See response to question 15 regarding risk attributable to host country significant people functions not being adequately reflected in the price paid to Wareco.

***18. Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.***

**Response:**

We do not agree, since significant people functions performed by commissionaires, agents, and other service providers such as Wareco will most typically be compensated in a manner that does not provide either the benefits or the risks of the non-resident's business. See the responses for questions 2 and 15.

***19. Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits to the PE of WRU?***

**Response:**

The comments in our responses to questions 2, 15, and 18 apply here. With Wareco earning a cost-plus fee for services, the commercial business risk related to all functions performed by Wareco personnel is born by WRU. As such, there would be additional profits to attribute to the PE of WRU.

***20. What would the conclusion [be] if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

**Response:**

With the exception of the possible application of a formula apportionment approach, we do not see for Scenario C any significant differences between the AOA approach and other approaches. See our response to question 4.

***21. Do commentators have suggestions for mechanisms to provide additional co-ordination for the application of Article 7 and Article 9 of the MTC to determine the profits of a PE, taking into account the considerations expressed above?***

**Response:**

We believe that the ordering approach suggested in our response to question 1 is the best approach to achieve simplification (since that will mean that in many cases no Article 9 analysis will be required) and to focus both taxpayers and tax authorities on the overall relationship of the MNE with the host country, thereby resulting in more accurate voluntary reporting of profits and better and more efficient reviews of taxpayer's operations and reported profits.

**William Morris**

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**September 5, 2016**

**Ref: DISCUSSION DRAFT: BEPS ACTION 7 – “ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS”**

Dear Jefferson,

Thank you for the opportunity to comment on the Discussion Draft: BEPS Action 7 – *Additional Guidance on the Attribution of Profits to Permanent Establishments* issued on 4 July 2016 (“the discussion draft”).

As we have made clear from the beginning of the BEPS process, we understand that many governments had concerns about the Permanent Establishment (PE) rules. Concerns over the contract conclusion test for dependent agent PEs (DAPE), the preparatory and auxiliary rules, the independent agent rules, and time-related thresholds, were combining to make governments both more sceptical about the benefits of tax treaties, and more aggressive in their interpretation of those treaty provisions. That, in turn, was leading to more disputes between countries. As a result, BIAC made clear that it understood, for example, that the contract conclusion test for DAPE was likely to change to a different, lower threshold. But we also made clear that the overwhelming benefit of the current test was the certainty that it gave taxpayers (and many countries). Therefore, we requested that any replacement threshold be as clearly defined, and that definition be as widely agreed to, as the current rule.

As anticipated, the Action 7 report released in October 2015 substantially lowers the PE threshold and, consequently, there will be a significant increase in the number of PEs in territories where taxpayers already have established legal entities. The guidance the OECD provides must be robust enough to provide certainty to taxpayers (and countries) as to its interpretation in the multitude of cases where it will now apply. Without sufficient guidance, we are at risk of creating a proliferation of disputes and a

mountain of administrative work, to the detriment of cross-border trade, and without significant benefit to tax authorities.

The attribution of profits to PEs is a notoriously difficult area and we commend the OECD for providing this draft guidance, which is directionally very encouraging. However, the discussion draft does not seem to fully recognise the complexities of profit attribution in a post-BEPS environment, implying that although there will be an increase in the number of PEs, the principles behind the attribution of profits have not changed. We are not sure that this is entirely correct. Furthermore, it is important to note that many MNEs that will be impacted have not had the volume of experience in applying profit attribution guidance in practice. In fact, many MNEs have historically gone to great lengths (e.g. setting up local legally incorporated entities) to ensure that the complexities of the Profit Attribution guidance are not something that they have to face. The significant lowering of the PE threshold, alongside fundamentally more complex guidance on the application of Article 9, leaves taxpayers feeling that room for different interpretation – and tax uncertainty – has grown dramatically.

BIAC has four main recommendations that we believe would facilitate the successful implementation of this guidance alongside revised Article 5 of the Model Tax Convention (MTC):

1. Additional guidance is required in relation to the revised Article 5 threshold before it is possible to provide comprehensive comments on the correct approach for attribution.
2. A prerequisite of adopting the Article 5 changes must be commitment to the Authorised OECD Approach (AOA) under Article 7.
3. The interpretation of Article 9 should be restricted to the consensus agreement reached in October 2015 in relation to BEPS Actions 8-10.
4. Additional clarity is required in respect of the application of OECD's proposed approach under Article 7.

In this response, we have provided significant detail in relation to these points, together with appendices outlining business models that may be helpful in developing and finalising the profit attribution guidance. We have also, of course, provided more detailed responses to the specific questions posed in the discussion draft. We would welcome the opportunity to provide more detail wherever you may find it useful.

Again, we thank you for the opportunity to comment on this discussion draft.

Sincerely,



Will Morris, Chair  
BIAC Tax Committee

## Introductory comments

1. BIAC strongly endorses pro-growth tax systems which facilitate cross-border trade and investment, enhancing economic growth and efficiencies in the international market place. The guidance on the attribution of profit to PEs should support cross-border trade and investment by clarifying which jurisdiction has the right to tax income, thus ensuring that income is not subject to double taxation.
2. Under the pre-BEPS Article 5, businesses appreciated the certainty that activity exemptions and contract conclusion tests provided. If the new profit attribution guidance is not implemented in a clear and consistent way, cross border investment as a whole will become more administratively complex, more uncertain, and ultimately more costly.
3. As a result, businesses may seek to modify business models or limit cross border investment in order to have certainty over the taxes due (and to mitigate the risk of double taxation).
4. Many aspects of the discussion draft are encouraging. The interplay with actions 8-10 and allocation of risks to dependent agent entities (DAEs), i.e. undertaking an Article 9 analysis and subsequently undertaking an Article 7 analysis, is the most sensible approach in our view. It is also useful to have numerical examples with a P&L in order to demonstrate how the guidance is applied (albeit with simplified fact patterns).
5. While we accept that the OECD's final recommendations on threshold are not technically within the scope of this consultation, we have concerns that both tax authorities and businesses will struggle to deal with the majority of new PEs that stem from it. The interplay between the new Article 5 and the new Transfer Pricing Guidelines (and thus attribution of profits under Articles 7 and 9) remains complicated and untested.
6. During the BEPS consultation, BIAC (along with several other commentators) noted that a move away from the clear "contract conclusion" test in the pre-BEPS MTC Article 5, which limited the number of PEs that could theoretically be created where ultimately limited or no profits would ever be allocated. The threshold revisions could lead to an enormous compliance burden for all MNEs as an unintended consequence of addressing the attribution of profits in the limited number of business models that the OECD considered to be posing a BEPS risk.
7. The examples in the Discussion Draft appear to confirm BIAC's concerns, and it is imperative that clear guidance is provided (and practice developed) both within and beyond the PE profit attribution workstream to ensure that taxpayers and tax authorities have a clear understanding of where PEs exist, the profits subsequently attributable to them, and the compliance burden that will arise. Tax authorities should be encouraged to consider these three areas together in development of domestic rules and practices to ensure that an appropriate balance is struck.
8. Developing clear, pragmatic guidance that helps reduce this enormous burden is paramount, and we remain committed to assisting the OECD in any way required in order to ensure that the profit attribution element of the BEPS PE reforms are successful in delivering a reduction in

the complexity and compliance burden that the new threshold brings. We recommend that the discussion draft be developed further to:

- a. Mitigate the potential for differences in interpretation (in relation to Article 5, Article 7, and Article 9), and
  - b. Be practical enough for businesses to comply with (noting that, in its current form, MNEs will not have the resource to perform the requisite analysis in the increased number of cases to comply with this profit attribution guidance).
9. Overall, BIAC believes the solution to the BEPS risks that Action 7 attempts to address, such as the artificial avoidance of PEs through commissionaire arrangements and similar strategies, ought to be much more precisely targeted. The recommendations offered in the discussion draft place a significant compliance burden on taxpayers and will greatly increase tax uncertainty for all businesses operating cross-border, to the detriment of international trade and investment<sup>1</sup>.
10. With this in mind, we have four main areas of comment on PEs (the first of which relates generally to the issue of PEs, and the latter three of which relate specifically to the topic of attribution):
- a. Without a clearer agreement and understanding of when the threshold for a PE has been breached, it is very difficult to develop or comment on precisely how the attribution rules should be applied.
  - b. Without a commitment from all participating countries to adopt the AOA, there are many cases where the work on the attribution of profits to PEs will not be useful, potentially creating further confusion.
  - c. The interpretation of Article 9 in the discussion draft goes beyond the consensus agreed in October 2015 in relation to BEPS Actions 8-10.
  - d. While we agree with the OECD's proposed approach to Article 7 in several areas, given the complexity of global value chains and modern business models, we believe that additional work is required to reduce the risk of double taxation, minimise compliance burdens and to develop practical approaches to circumstances where the recognition of a PE is not expected to generate additional tax for a territory.

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<sup>1</sup> With respect to Commissionaire arrangements in particular, there are several non-tax reasons why businesses may want to retain the existing structure, rather than transitioning to (for example) a Limited Risk Distributor (LRD) model. For example, legal entities being required to manage receipts and payments carry reporting and other legal obligations. Whilst we understand the OECD's concerns with the pre-BEPS taxation of commissionaire structures, in reality, the functions, assets and risks of a commissionaire are not as extensive as an LRD, and accordingly we would recommend that the total margin in the commissionaire territory (under Article 7 or a combination of Articles 9 and 7) should never exceed that of an LRD.

These areas are elaborated below.

11. We also have several specific comments on the examples outlined in the discussion draft. These are also elaborated below.
12. Finally, we have several more generic comments on process and scope:
  - a. While we understand why the scope was limited to addressing DAPE and warehousing scenarios, as set out in paras 5 to 13, we consider that additional guidance is essential on how the future commentary will address PE profits in light of other BEPS changes. This is acknowledged in paragraphs 10 and 11 but there is disappointingly little reference to the Transfer Pricing Guidelines (TPG) amendments in the examples.
  - b. It would be helpful for the OECD to explain what the exact output of this consultation is expected to be, as no amendments to the commentary to the MTC have been proposed as part of this work to date. BIAC's view is that the guidance contained in the OECD paper should be inserted into the commentary on the MTC and the AOA to ensure its legal standing.
  - c. It would also be useful to understand how this work will be coordinated with the multilateral instrument to amend existing treaties.
  - d. The Article 9 analysis allocates returns for risks to the Agent (Sellco) in Example 2 and (partially) in Example 4. In doing so, it assumes that the Agent would be allowed to deduct bad debt and inventory losses. In reality, deductions by Sellco may be subject to local country rules, many of which prescribe deduction only by a legal owner of the debts/ inventory. The OECD should encourage participating jurisdictions to change local tax rules where they would otherwise result in effective double taxation.

### **Clear guidance on threshold (under revised Article 5)**

13. The OECD's final recommendations on Action 7 released in October 2015 departed from the thresholds that had previously been included in discussion drafts during the BEPS Project. While this is particularly true in relation to the definition of DAPE, business would also welcome clarity over the meaning of terms that apply to the Article 5(5) exemptions. In particular, we believe there is ambiguity around the following concepts (which more detail is provided on below):
  - a. "plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification";
  - b. "artificial splitting up of contracts" ; and
  - c. "preparatory and auxiliary activities".

14. We believe that it is not possible for stakeholders to provide comprehensive comments on the attribution of profits (or for participating countries to accept the resulting guidelines) until these thresholds are understood more clearly.
15. Additionally, businesses see these threshold issues as a far more fundamental concern in relation to the potential compliance burden and risk of double taxation than the attribution guidance.

*“Principal Role”*

16. The Action 7 Final Report provided limited guidance on the meaning of the term:

*“The phrase must be interpreted in the light of the object and purpose of paragraph 5, which is to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, i.e. where that person acts as the sales force of the enterprise. The principal role leading to the conclusion of the contract will therefore typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise”*

17. This guidance is helpful in a scenario where only one salesperson prepares all relevant offer/tender documents, decides about the content and convinces one representative of the customer to accept a contract. However, in real life scenarios the complexity of modern business models (including in particular the ease of global communications and travel) mean that deal teams (rather than a simple sales individual) are generally quite dispersed.
18. Appendix II outlines several business models provided by BIAC members which demonstrate this complexity. The key concerns identified are:
  - a. Can the “principal role” be undertaken by a group of individuals, or is there only one individual that can play the “principal role” on any deal?
  - b. If a group of individuals can play the “principal role”, and they operate in different countries, does this mean that a PE is created in each country (and if so, how should profits be allocated between them)?
  - c. If only a single individual can play the “principal role” on a deal, how should it be determined which individual this is?
  - d. If only a single individual can play the “principal role” on a deal, is it the individual, or the employer who needs to be behaving “habitually” in any country in order to create a PE?
  - e. In either the case of an individual or a group of individuals, if an individual travels between several countries to habitually meet customer(s), is a PE created in all of the



countries to which that individual travelled (and if not, in which country/countries are PEs created)?

- f. In either the case of an individual or a group of individuals, if an individual habitually communicates from different countries, with customers from different countries (e.g. over a period of months via telepresence, telephone, email or letter), is a PE created in all of the countries in which they worked on the deal (and if not, in which country/countries are PEs created)? Additionally, is there a difference in application caused by different methods of communication?
- g. Where there are several distinct legal “contracting parties” within a group (e.g. one selling an asset and the other providing ongoing services such as maintenance or financing), will this result in several PEs in the same country?
- h. Finally, we think a clearer definition of the term “principal” would be helpful. We assume that for most sales activities, the “principal” role in leading to the conclusion of contracts would be the salesperson.

#### *Splitting-Up of Contracts and Fragmentation*

19. We believe that additional guidance is required in terms of the new fragmentation clause, notably its limitation to those activities which constitute complementary functions and are part of a cohesive business operation. Even though we believe that the attribution principles as laid out in example 5 would also apply here, we would welcome a clear statement that merely being part of a cohesive business operation does not necessarily equate to value being attributable to the new deemed PE. The profit attribution to complementary activities should rather be determined by an analysis of the relevant facts and circumstances (i.e. the activities of the Significant People Functions (SPFs)).
20. Additionally, the final report on BEPS Action 7 contains various ambiguities in respect of the splitting up of contracts. Without greater clarity (e.g., by providing a list of circumstances in which non-tax reasons would be assumed or accepted<sup>2</sup>), the guidance will create uncertainty in respect of non-abusive commercial arrangements.
21. We would also welcome detailed clarification of the consequences of an abusive structure being asserted. For example, it would be helpful if the example does concluded on which entity would actually be deemed to have a PE (and importantly which would not).
22. In addition, the proposed changes to paragraph 18 of the OECD Model Commentary on paragraph 3 of Article 5 leave many questions unanswered, on which clarification would be

<sup>2</sup> For example, where a customer has requested specific contractual terms, or where the scope of work must be split due to location of requisite expertise.

welcomed to provide context and a greater degree of certainty to the way in which profits should be allocated:

- The term “connected activities” (which determines whether different periods of time should be combined) requires clear illustrative examples since the guidance provided in the Final Report regarding the definition of which activities should be considered to be connected is vague and subjective.
- It is stipulated that connected activities which are carried on at the same building site or construction or installation project during different periods of time by one or more enterprises closely related to the first-mentioned enterprise should be added together. More guidance is required to understand whether also a closely related enterprise (which is tax resident of the country in which the building site or construction or installation project is being executed) shall be considered for these purposes even if the profits out of its activities are fully taxable in its country of residence (i.e. country of activity).
- Example A: Company A (resident in Country A) commissions the supply and installation of machinery Unit 1 of Customer C’s factory in Country S (duration of 2 months). The DTA between Country A and Country S is aligned with the MTC. Ten weeks after the installation, has been completed, Customer C orders the supply and installation of a second identical machine in Unit 2 of the same factory from Company S (a wholly-owned subsidiary of Company A) which is resident of Country S. Company S will execute the installation in Country S (duration 14 months) but subcontracts Company A for the equipment supply, only. According to the group structure and group’s sales policy Company S is responsible to serve the market in Country S.
- Based on our understanding, this scenario should not result in the combining of the commissioning activities provided by Company A with the installation activities provided by Company S as (i) the decision to conclude the contracts was taken independently and separately and (ii) the entire profits related to the activities provided by Company S are taxed in Country S (i.e., no loss of tax base in Country S).
- Example B: The same facts as in Example A, however as two supervisors (employees of Company S) are currently working in another project, Company S requests personnel from Company A based on an intra-group hiring out of personnel agreement for an arm’s length price.
- We are of the view that Example B should result in the same conclusion as Example A. The entire profits related to the commissioning and installation activities are taxed in Country S via Company S (i.e. no loss of tax base in Country S).
- The mere fact that personnel of Company A are performing services under the sole functional guidance/ instruction of Company S (intra-group employee secondment, i.e. hired out from Company A to Company S) should not lead to “connected activities” since the taxable profits of the installation and commissioning activities of Company S would not

change (the tax deductible personnel costs would be equal to the situation where Company S deploys its own personnel instead given they are at arm's length).

23. In the Discussion Draft it is noted that no further guidance will be required on the profit allocation since the respective regulatory framework already exists. However, considering that the AOA approach has not been adopted uniformly by all countries (see Appendix I), and given the numerous open questions on the interpretation of the newly introduced anti-avoidance rules in connection with the splitting-up of contracts, we believe that clear guidance and explanatory examples on which profits would then be attributable to such PEs are required.

#### *Preparatory and auxiliary*

24. Whilst it is not our intention to challenge the OECD's Action 7 recommendations made in October 2015, we believe that clarification of the recommendations is required as a result of the OECD's follow up work on profit attribution to PEs.
25. The changes to paragraph 4 of Article 5 of the MTC require the listed activities to be preparatory and auxiliary in nature. This will lead to an increase in the number of PEs in excess of those where there is a tax-avoidance motive (and in particular an increase in the number of PEs where there are no or very low profits attributable to them).
26. The listed activities which currently do not constitute a PE are well understood and, subject to the modifications proposed to paragraph 5 of Article 5 of the MTC, should still constitute valid exclusions from the PE requirement. However, clarifying the meaning of "preparatory and auxiliary" in the MTC Commentary in the context of the revised Article 5 would provide welcome confirmation of this. For example, a foreign entity which maintains a stock of merchandise for delivery, where there is no related party commissionaire arrangement in place, and where contracts were never negotiated in the host country, may now be caught as a result of this modification.
27. As is noted in paras 104 (and 105) of the Discussion Draft, circumstances can arise where there would *prima facie* be a DAPE by virtue of the Action 7 extensions, but where no profits are attributable to that PE- thus merely resulting in incremental compliance burdens rather than incremental tax. We would suggest that if the predictable/forecast outcome of such an attribution would be of nil or negligible DAPE profits then that should be taken as *prima facie* evidence that the activities conducted by the DAE on behalf of the DAPE should be viewed as preparatory or auxiliary functions so that PE recognition and filing is not required. This could for example be framed as indicative guidance that if the forecast Net Present Value of DAPE taxable profits are less than, say, 5% of the NPV of combined DAE and DAPE profits then the DAE activities should be viewed as Preparatory or Auxiliary under the general Article 5(4)(e) exclusion (as extended into Article 5(5)).
28. Further, it would be useful if the OECD provided further guidance on how to distinguish a separate aftermarket business line from a main business line. For example, a business selling

equipment may also have an additional service line selling spare parts, which is likely to have relatively limited value (e.g. less than a third of the value of the main business). It is unclear how this would be dealt with in the context of the new guidance and whether such a service line would be considered merely auxiliary.

#### *Corporate tax administrative burden*

29. There is no practical solution offered to ensure the administrative complexity involved in applying the arm's length principle to the large number of PEs that will be created as a result of the revised Article 5 definition (which, even putting aside the MLI, is, in practice, likely to be applied beyond those treaties where it has been formally adopted).
30. Without clear guidance on threshold (and consistency in interpretation of attribution) it will often be the case that taxpayers lack the budget and resource to reliably interpret and apply the standards and consequently will struggle to comply, which will be to the detriment of both themselves and tax administrations. The SME community will struggle in particular to navigate these new rules.
31. In addition, as is clear from the examples in the discussion draft (and the number of potential PEs highlighted in the examples in Appendix II), there will be a vast number of PEs under the new threshold to which no (or very little) profit is ultimately allocated. In such instances, governments should take a sensible approach to domestic legislation, balancing the potential compliance burden (to both taxpayers and tax authorities) with the expected tax to be collected, and the benefits of investment and cross border trade to their economies more generally.
32. For example, an MNE produces 10 distinct and independent product lines from 10 legal entities located in 10 different countries. The products are sold via a sales network of 5 legal entities, each located in the MNE's 5 leading markets. The sales services provided by the 5 sales entities are priced on arm's length terms in accordance with Article 9 of the MTC and no SPFs are performed that would give rise to an allocation of profits to a PE of the non-resident producer. In this scenario, each of the 5 sales entities would submit a tax return as normal but, a further (10 x 5) 50 tax returns may also need to be filed for the non-resident PEs that would be created under the increased threshold. This reality is in contrast to the examples in the discussion draft where the burden of filing a single additional tax return is multiplied many times over.
33. BIAC believes that the solution to these issues is twofold. Firstly, the OECD must offer clear and practical guidance which can be applied to complex scenarios (as part of the ongoing process of which this consultation forms part). Secondly, participating countries must be pragmatic in their domestic implementation.

34. We believe that the OECD must take the lead in providing participating countries with innovative, pragmatic, and consistent solutions regarding domestic implementation. The OECD is ideally suited to do this. We would welcome the opportunity to discuss this further, but an initial survey of our members suggested the following options:

- a. De minimis thresholds where sales to resident customers are low (or nil).
- b. Exemptions for SMEs.
- c. Article 7 safe harbours (such that no detailed TP analysis is required).
- d. The ability to discuss and agree with the tax authority (and obtain acceptance by the other State tax authority) the “overall” compensation that would be due under Article 9 and 7<sup>3</sup>, leading to either (i) amendment of the contracts such that the DAE legally takes on the deemed risks and received the appropriate compensation of the DAPE, or (ii) a TP adjustment in the DAE to the same effect. In this case, in lieu of filing tax returns each year, the non-resident company could file an annual self-declaration to confirm if there is any change to its business model as well as its risk, function and assets arrangements. No administrative requirements should be applied before the completion of the PE profit attribution analysis.

35. The proposed “safe harbour” requirement could be as follows. Where it is clear that the following four conditions are met, there should not be a requirement to review the position further or to file a nil tax return for the non-resident entities:

- i. The transfer pricing policy sufficiently rewards the parties to the controlled transaction based on the functions performed, risks assumed and assets owned/utilised;
- ii. The controlled transaction is accurately delineated;
- iii. The transfer pricing outcome is aligned with the economic activity that produced the profits (including SPFs), rather than the contractual allocations; and
- iv. The transactions are sufficiently documented in accordance with Action 13.

In addition to removing the burden of filing additional tax returns, a safe harbour would also mitigate potential confusion over additional (and unintended) VAT/GST obligations.

36. Finally, the OECD should comment on how taxpayers and tax authorities will deal with the auditing of the potentially greatly increased number of PEs. The taxable basis of a PE is not easy to define and, in order for any PE to be properly audited, management accounts must be used. Although we note that the link between management accounts and local accounts is not always easy to demonstrate, it is important that the OECD makes clear tax administrations

<sup>3</sup> We have used the term “State” authority, but we note that where local group entities and PE governed by different tax authorities in the same country (e.g. province, federal, or different tax administration divisions), these bodies coordinate properly to ensure taxpayers do not face double taxation.

should not seek to audit the entire P&L of an entity when only a small part of that entity gives rise (or potentially gives rise) to a PE.

*Administrative burden caused by PE changes in respect of Non-Income taxes*

37. As previously mentioned in BIAC submissions on PE status, BIAC urges the OECD also to consider the likely indirect tax impacts which will result from lowering the PE threshold, in particular the potential consequences for VAT as well as for Personal Income Tax (PIT) obligations (PAYE, wage tax, etc).
38. The creation of new PEs will likely lead to additional required VAT registrations, especially in countries where corporate tax and VAT registrations are automatically linked. This will add significant cost and complexity for business and tax authorities in terms of compliance and tax collection, as well as increasing the risk of disputes and instances of double taxation. This is due to the lack of legal certainty in the context of conflicting establishment definitions, force of attraction/collection rules where all supplies to local customers become subject to local VAT charged by the supplier even where the local PE does not intervene in the transaction (i.e. customer reverse charge not applicable), and challenges from tax administrations where there are apparent but totally legitimate mismatches between the PE's corporate tax return and VAT return. Lowering the PE threshold has similar consequences for PIT registrations: the Head office becomes liable to PAYE and wage taxes for the employees from the first day the PE has been constituted.
39. The consistent implementation of the OECD's International VAT/GST Guidelines should help mitigate such issues but we would also encourage the OECD to include explicit language in its proposals to highlight the fact that the term "permanent establishment" as used in the OECD Model Income Tax Treaty is a distinct concept from the "VAT establishment" term used in the International VAT/GST guidelines, such that the existence of one should not automatically result in the other. Such language already exists in the OECD International VAT/GST guidelines (footnote 24) and in the OECD BEPS Action 1 2015 Final Report (paragraph 337), however, there is a case for further strengthening this key point.

## **Commitment to the Authorised OECD Approach (AOA)**

*Adoption of the AOA*

40. While comments are invited regarding its application to situations where the AOA is not followed, the discussion draft itself only provides guidance on situations where the relevant jurisdiction has adopted the approach taken in the 2010 Report on the Attribution of Profit to Permanent Establishments (i.e. attribution of profit under the AOA).



41. The changes to the MTC and Report on the Attribution of Profits to Permanent Establishments (the Report) in 2010 sought to introduce the AOA into all future treaties based on the MTC. However, for treaties entered into before this date (and in the application by non-OECD members) there remains significant divergence in how and when the AOA is applied. These changes were the culmination of a significant amount of work and were agreed upon by the vast majority of OECD countries; there is still some way to go to ensure they are widely applied.
42. The evidence suggests that the non-AOA approach results in tax authorities (and courts) applying a number of different methodologies (including, particularly, global formulary apportionment), which are incompatible with the arm's length principle.
43. Appendix I outlines a number of countries/cases where BIAC members have observed that tax authorities do not adopt the AOA in their calculations of attribution of profit to PEs. In *Rolls Royce India*, for example, the Indian Revenue attributed 75%-100% of the profit from the Indian contracts to the Dependent Agent PE (DAPE) in India. The Tax Tribunal and High Court attributed 50% of the global profit to manufacturing, 15% to R&D and the remaining 35% to sales/marketing. The entire 35% of the sales/marketing profit was attributed to the DAPE in India.
44. While we appreciate the reservations that some countries had made in to the application of the AOA to the pre-2010 Articles 5 and 7, business is anxious for the approach to be as consistent as possible going forward. The BEPS revisions to Article 5 of the MTC and the corresponding changes to the guidance on the allocation of profits to PEs provide an opportunity to address this existing inconsistency.
45. We note that while not all elements of the "BEPS Package" were minimum standards, the transfer pricing and PE threshold changes were a *package* of measures that are only coherent when taken together. This is critical when considering the interaction between the revised Chapter 1 of the OECD Transfer Pricing Guidelines (i.e. "the Article 9 analysis" for the purposes of this workstream), the revised definition of PE as per the 2016 MTC as recommended by the OECD BEPS Action 7 Final Report, and the output of the current work on the attribution of profits to these new PEs (i.e. "the Article 7 analysis") alongside the Article 9 analysis.
46. Consequently, we believe that if countries wish to adopt the revised threshold as outlined in the BEPS Action 7 Final Report, either under domestic law or treaty interpretation (which that tax authorities may feel compelled to do whether or not the wording of the relevant law/treaty Article 5 has been updated), then these countries should also be required formally to adopt the AOA.
47. Inasmuch as the existing guidance on the AOA (i.e., the 2008 Report relevant to the pre-2010 Article 7 and the 2010 Report relevant to the 2010 Article 7) is the subject of an OECD Council Recommendation (i.e., Council Recommendation C(2008)106), BIAC hopes that the new guidance on the application of the AOA to PEs will effectively become a supplement to the

existing guidance and that the Council Recommendation will be updated to reflect the incorporation of the new guidance into the existing guidance.

48. While OECD Council Recommendations are not legally binding, the OECD indicates that “practice accords them great moral force as representing the political will of Member countries and there is an expectation that Member countries will do their utmost to fully implement a Recommendation.” Such an approach would provide desired certainty to taxpayers, at least in respect of OECD Member country tax administrations, regarding the manner in which the AOA will be applied to the new PEs, thereby minimising risks of double taxation. BIAC would also greatly welcome a similar expression of political commitment on the part of non-OECD countries to the agreed application of the AOA to the new PEs.
49. We consider that changes to Article 7 (including a commitment to the AOA) should be included as a minimum standard in the Multilateral Instrument (MLI), although we appreciate that this may be difficult for the OECD to mandate at this stage in the process. However, we would expect that no country should be able to adopt changes to Article 5 through the MLI without also committing to the AOA under Article 7.

#### *Additional guidance on application of AOA*

50. More specifically relating to the discussion draft, the analysis under the AOA within the Article 7 sections of the examples lacks some necessary detail. The complexity of step 1 of the AOA, and the pricing analyses required under step 2 seem not to be fully appreciated.
51. Under the AOA, step 1 requires hypothesising the PE and identifying its dealings with the rest of the enterprise. This entails a disciplined functional analysis to determine where the relevant SPFs take place. Once the functional analysis has been done, the “dealings” between the head office entity and the PE need to be constructed. Step 2 of the AOA is determining the most appropriate transfer pricing method, and is based on the analysis under step 1. In the discussion draft both steps appear to have been assumed. In reality, identifying the appropriate functions, assets, risks, and SPFs (and then pricing them) is an enormously complicated exercise, and should be given due consideration in the examples.
52. In the discussion draft, the functional analysis is essentially replaced by factual assumptions, which is necessary given that these are examples. However, the next step – construction of the dealings – is also omitted. In performing the analysis under Article 7, the dependent agent permanent establishment (DAPE) examples all start with 100% of the sales income in the DAPE without any analysis of why that approach is correct. This may be a holdover from the “old” DAPE definition under which the DAPE had to conclude contracts on behalf of the non-resident. In that case it might make sense to conclude that the “dealing” was a sale by the head office entity to the DAPE followed by a sale by the DAPE to the third party customer. If that was appropriate under the prior definition of a DAPE, it is no longer necessarily



appropriate under the new definition. The dealing needs to be defined based on the functional analysis and the dealing will not always be a sale by the head office entity to the DAPE, followed by a sale by the DAPE to third parties. In some cases, the most appropriate characterisation of the dealing between the head office entity and the DAPE may be a sale to a limited risk distributor. In other cases, we believe that the most appropriate characterisation of the dealing between the head office entity and the DAPE would be the provision of a service and the payment of a commission to a service provider.

The discussion draft similarly does not cover the choice of the most appropriate transfer pricing method. Even if this is to be assumed, it is important for the choice of method to be articulated as it is a fundamental part of the analysis.

### **Interpretation of Article 9**

53. While it is not intended to focus primarily on Article 9, the discussion draft is the first example of how the new TPG (as approved by the OECD Council in June 2016, plus further conforming amendments expected to be approved later in 2016) will work in practice. Although the discussion draft does not represent a consensus position of OECD/G20 countries, it could be seen as compelling evidence in the more general application of the revised TPG, even where PEs are not in point.
54. The examples (and in particular example 2) suggest that the Article 9 analysis requires an allocation of both the income and costs associated with bad debt, inventory management and warehousing.
55. We do not believe that this is in line with the output of BEPS Actions 8-10. Instead, we consider that in such examples the entity's headline compensation should be adjusted to reflect the functions, assets and risks undertaken by the tested party. It would also be helpful in example 2 if the first entry in the Sellco table labelled "Income from sales commissions" be renamed to include three lines (e.g. sales commission 10, inventory management 10, credit analysis 10)
56. Whilst we understand that an Article 9 approach should seek to identify an appropriate remuneration for an entity by "delineating the actual transaction", we do not believe it necessarily follows that this should require an analysis of the profit and loss account, based on the "combined" profits. This is a more appropriate methodology when undertaking an Article 7 analysis but should not be relevant for calculating the arm's length remuneration for a tested party based on its functions, assets, and risks. In particular, paragraph 45 of the Discussion Draft includes an explanation of total profits, which lends itself to the implication that a profit split is an appropriate methodology. If this approach is followed, it should be made explicit that this is not the intended implication.
57. We believe the language and analysis of Example 2 should accordingly be reconsidered as it pertains to Article 9. To recall that Example, it involves a company, Prima, that manufactures

products and sells the products through a network of sales agents (paragraph 21). With respect to one of its sales channels, Prima decides to delegate responsibility for inventory management and customer credit decisions to its sales agent, Sellco.

58. However, Example 3 makes clear that these activities could just as easily have been performed by Prima using a single employee. That Prima employee, by performing those functions, would not be taking on the inventory obsolescence or customer credit default risks personally, of course. The same conclusion would apply if Prima outsourced the same functions to an independent person, e.g., a former employee. In either case, the only risk the employee or independent party would be taking is the risk of being fired for not performing his or her job well. (This is the same risk that paragraph 28 recognises Sellco is taking with respect to the performance of its basic sales function).
59. We believe the Article 9 result for Prima should be the same whether it delegates the performance of the functions to an independent party (e.g., to a former employee) or to Sellco as a sales agent. Example 2 should be modified, accordingly, to explain why the Article 9 analysis as applied to Sellco in Example 2 reaches a result that is seemingly at odds with the result that would apply if the employee in Example 3 were to continue to perform his or her functions but as an independent enterprise.
60. We believe the conclusion in Example 2 would be more supportable if the Example were changed to assume that Prima delegated to Sellco decision-making authority with respect to inventory and credit management and allocated *to a second affiliate* the economic risk of inventory obsolescence and customer credit default – an affiliate not in a position to perform the oversight functions itself (as Prima does in Examples 1 and 3), i.e. if Prima had contractually transferred the risk to a second company; so the control functions in Sellco would transfer it back to Sellco.
61. At a minimum, the assumptions in Example 2 should be supplemented to include a statement that the agreement between Prima and Sellco is not consistent with arm's length or marketplace practice. The Article 9 Guidelines have no authority to upset conditions that would be agreed between independent enterprises; Example 2 should make plain that it is not seeking to do so here.
62. The terminology in paragraphs 20 and 42 pertaining to Example 2 should be changed. Both paragraphs refer to inventory and customer credit risk as being “contractually allocated to” Prima, implying that the contract is the event that gives rise to Prima’s risk in these areas. This misrepresents the facts. Prima is a manufacturer that sells its goods through a network of sales agents. Since the goods originate with Prima, inventory and customer credit risks are with Prima from the outset. They may be contractually allocated *away* to the sales agents but the contract does not allocate those risks *to* Prima in any meaningful sense. The text in paragraphs

20 and 42 should recognize that the risks are borne by Prima by virtue of its role as the originator of the goods and not attribute that fact to Prima's contract with Sellco.

63. Regarding Example 4, we consider it would be helpful if the language in paragraph 72 be amended to make clear that the compensation arrangement described there does not reflect any sort of normative view that this is the compensation structure one would expect. Currently the paragraph says the applicable guidance makes clear that Sellco's compensation "may" have an element of profit or loss participation. We believe that the intent of this language is to convey that such an arrangement is permissive, not presumptive or prescriptive, and ask only that this be made clear to avoid any implication to the contrary. We highlight this point because we believe the compensation arrangement described in the example would be unusual in the marketplace. Sellco's role described in paragraph 69 is modest and while performance of its functions may indeed have an "effective influence" (see footnote 12) on Prima's realisation of bad debt risk (just as many things may influence that risk), it should not be assumed that a party performing Sellco's role would take on the risk embodied in the compensation arrangement described.
64. For avoidance of confusion, we suggest the text in the third bullet point of paragraph 73 be amended to make clear (as Example 4, Scenario B later does) that there may be situations under the arrangement described in which Sellco's compensation is reduced to reflect losses. Accordingly, we would strike the phrase "such that Sellco receives a fee equal to 40% of the difference" and substitute in its place "such that Sellco receives a fee (or suffers an expense, as the case may be) equal to 40% of the difference ...."

## **Attribution under Article 7**

### *Welcome developments*

65. We support the use of Distributor Return as a proxy for allocation of returns for sales, contract conclusion and inventory related functions/risks in Example 3. In addition to Example 3, we consider that the Distributor return proxy be explicitly specified in Examples 2 and 4.
66. The discussion draft implies that generic sales channels do not lead to the creation of local marketing intangibles, which BIAC agrees is correct. However, the draft should be worded more clearly to ensure that in the case sales channels are not generic that there still will not be local marketing intangibles in every case, only when an analysis of the relevant facts and activities suggests that they have been created.

### *Complexity of different businesses (general)*

67. For some sectors (for instance banking and insurance), it has long been recognised that applying the profit attribution guidance in a consistent way is incredibly complicated, with

enormous potential to arrive at different conclusions based on the same facts. Consequently, additional specific guidance has been provided by the OECD for these industries.

68. For other industries, however, there is currently not a solution for managing this complexity in a post-BEPS environment. We are concerned that in reality, different (non-FS) industries carry on significantly different business models and have significantly different capital structures. We do not believe that this point has been sufficiently recognised by the OECD or tax authorities to date. Indeed, the discussion draft seems to suggest that although there will be an increase in the number of PEs, the principles behind the attribution of profits has not changed, and therefore, significant additional guidance is not necessary.
69. Although this may well be correct from a theoretical perspective, as a practical matter once a PE is established, tax authorities often seek to attribute (excess) profit to it. Furthermore, it is important to note that many MNEs outside of the FS sectors mentioned above (or tax authorities) have not had the same volume of experience in applying profit attribution guidance in practice to non-FS MNEs. The significant lowering of the PE threshold, alongside fundamentally more complex guidance on the application of Article 9 could dramatically increase disputes and tax uncertainty.
70. A common concern for a warehouse operation PE is that the tax authority may erroneously use the anti-fragmentation concept when determining the profit attribution to the PE, especially those operating under complex business models. According to Action 7 and the additional guidelines, the anti-fragmentation rules should be used to determine the existence of PE only. If the PE has been recognised, the approaches quoted in the additional guidelines should be followed and no anti-fragmentation rules should be further applied. The discussion paper addresses this indirectly by stating that "although there will be an increase in the number of PEs, the principles behind the attribution of profits have not changed" but we believe it would be worthwhile to specifically clarify this point. The expected proliferation in the number of PEs that will arise under the new Article 5 definition increases the importance of this guidance, as it will now be used by a much larger number of businesses.
71. While we appreciate the resource constraints, and, indeed, the time pressures that the OECD is required to work to, we consider that in order to be most useful, the OECD should consider the development of more industry-specific guidance to alleviate the subjectivity and uncertainty that non-FS businesses face. BIAC is, of course, ready to help with this in any way that it can.

*Simplicity of examples vs complexity of modern global trade*

72. Appendix II outlines some business structures provided by BIAC members, and demonstrates the significant complexity of global business models and the corresponding variation in the locations (and number of locations) in which various functions will be undertaken by various individuals (many of whom will cross borders as they undertake these functions).

73. While we appreciate that this is the first discussion draft in this area (and that of course it will develop over time), and while we recognise the importance of guidance that covers simple scenarios that can be built upon, we are concerned that it overlooks the enormous difficulties that tax authorities and businesses will face in applying to subjective standards (Article 9 and Article 7) to highly-complicated transactions.
74. In particular, the guidance must include further detail on how split SPFs should be addressed. Our preference is that this be dealt with in a pragmatic manner, with clear thresholds that minimise the need to undertake analyses that cover many countries, and to then file returns with very low (or nil) profits in each country.
75. Additionally, while the discussion draft offers guidance on how the profits/losses arising from credit risk could be attributed, we note there is no indication of how to deal with entities that may take on pricing risk, or have developed local marketing intangibles.
76. Example 3 of Appendix II considers the factors involved in the valuation/allocation of pricing risk. We would welcome a more detailed example from the OECD to explain how pricing risk assumed by a Dependent Agent PE should be dealt with under the AOA.
77. Example 2 in Appendix II considers the example where there will be a multiplicity of PEs in one country in respect of a single transaction. This is another area of complexity where further explanation in the draft guidance would be very welcome.
78. We further suggest the OECD includes additional examples to address commonly used complex business models such as warehousing operation PE under a toll-manufacturing arrangement. The more comprehensive the examples available, the less likely it is that disputes will arise in respect of real world complex business models.

*Assumption that PE exists*

79. While the business models identified and outlined in the examples used in the discussion draft are simplified, they will still be relevant for some existing business models, and, to the extent that they identify the level of activity that can be undertaken with minimal attribution of profits, this provides some comfort to taxpayers wishing to structure the location of their people and functions such that they do not cross lines that would result in significant attribution of profits to PEs and the corresponding administrative burden that would apply.
80. However, we are concerned that in every example (however simplified) it is assumed that a PE exists and a profit attribution calculation must be performed. We believe this is a fundamental departure from the previously held practice that companies could opt to incorporate local subsidiaries and undertake robust transfer pricing analyses to limit the risk of PE challenge when operating overseas. It would be helpful to have a threshold example or, at least, an example showing exactly where a PE would not exist for the purposes of this guidance.

81. We do not believe that creating PEs wherever a subsidiary exists was the intention of the revised wording for Article 5 of the MTC, and would welcome additional examples of where a related enterprise does *not* create a PE in order to remove uncertainty in this respect. This is important given that Article 5.7 establishes that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company (par. 40 Commentaries on Art. 5.7).
82. Further, it is noted in the commentary that, “however, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude contracts in the name of the parent (see paragraphs 32, 33 and 34 above), unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article applies” (par. 41 Commentaries on Art. 5.7). We note that this paragraph has not been proposed to be amended by BEPS Action 7, potentially creating inconsistencies with the proposed new attribution of profits to PE guidance.

### **Additional comments on draft examples provided**

#### *General comments*

83. The basic functional and factual analyses and application of step 1 of the AOA are critical to the usefulness of examples, particularly where the examples represent relatively simplified business models, but then must be applied to more complex business models in practice. We request that the functional and factual analyses for each example are, therefore, given more focus.
84. In particular, we propose that the tables for Examples 1 and 2 are integrated into the discussion of each example rather than relegated to Annexes, and a table on a consistent basis is inserted in relation to Example 4.
85. Additional guidance would be helpful with respect to the two key concepts “SPFs” and “Free Capital” in order to ensure that there is no ambiguity in understanding them.
86. The OECD make a number of assumptions in the paper which are applied to the practical examples presented. They concern:
- i. Assumptions regarding the facts that give rise to the creation of a PE, specifically in Example 1, (and taking into account the wording in the MTC Commentary on Art. 5(7)-40), providing that no additional functions, assets and risks were attributed to DAPE;
  - ii. Assumptions regarding Remuneration of the Related Parties / Head Office/ PE (e.g. incentive fee); and



- iii. Assumptions regarding Proportion of Attribution of risk to Head office and PE (e.g. 75%, 25%).

87. Whilst we appreciate that it is necessary to make certain assumptions for the purposes of providing examples, as there is no detail on how these assumptions were reached, we believe there is a risk that they could be misinterpreted as rules / official OECD positions. The OECD should be clear that these assumptions are not indicative of the most appropriate way to identify functions, assets and risks, nor to apportion profits to PEs, but are specific to the facts of these examples.

88. BIAC would also appreciate the OECD undertaking further work on aligning the analysis under Article 9 and Article 7 of MTC to reduce the risk of conflicting interpretations. Article 7 of the MTC is based on similar assumptions to Article 9 (under step 1 of AOA, PE should be treated as a separate and independent entity enterprise, and remunerated based upon a comparability analysis using by analogy the guidance on TP methods).

#### *Example 1*

89. We believe that the Article 9 summary at paragraph 45 would be better expressed as the allocation of income and expenses between Prima and Sellco. Such an analysis is the proper outcome of the analysis and a delineation of the allocation between Sellco and Prima would be the clearest starting point for the subsequent Article 7 analysis allocation of profit or loss between Prima's Head Office and DAPE. The same point applies to Examples 2 and 4.

#### *Example 2*

90. In Example 2, Sellco undertakes additional functions and risks that will be compensated by an increase in the expected return. We found it difficult to understand the calculation of the Sales commission in the amount of “30”, until we reached Example 3, paragraph 66: “in accordance with the assumptions in Example 2 should, if it were a separate and independent enterprise, earn an operating margin of 4.5%”. The explanation on the calculation of the Sales commission should be included in Example 2 (or alternative reasoning included if it is not the same as Example 3).

91. We believe that footnote 10 is somewhat confusing in this example. While the OECD has made clear in the 2010 Report on Attribution of Profits to Permanent Establishments that it does not adopt a “single taxpayer approach”, the footnote seems to apply that this approach should be used, i.e. by stating that “when the analysis under Article 9 has already been performed to allocate risk to Sellco, the analysis under Article 7 will not attribute the risk to the DAPE”. Clarification on this point would be welcomed.

#### *Example 4*

92. We found the explanation of SPFs and free capital, and the rationale for the amounts attributed, difficult to follow in this example.
93. In addition, more guidance for determining whether a PE is appropriately capitalised would be welcomed.

*Example 5*

94. We would welcome it if the OECD could clarify its position on the attribution of the income derived from the selling of parts to third party customers. BIAC's understanding is that such sales would not be attributed to the PE (Warehouse), but we believe that this should be explicitly stated in order to mitigate the risk of disagreements between taxpayers and tax authorities on this point.



## Questions in the draft

### *GUIDANCE ON PARTICULAR FACT PATTERNS RELATED TO DEPENDENT AGENT PERMANENT ESTABLISHMENTS (“DAPE”)*

**1. Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.**

- BIAC agrees with the basic premise that if there is a DAE: (i) undertake an Article 9 analysis to determine the income and expenses of Company A and Company B, then (ii) undertake an Article 7 analysis to determine the income and expenses of Company A and Head Office and Company A DAPE.
- This should be clearly stated in the final guidance to avoid any uncertainty regarding the order of application.
- Additionally, as noted above in our general comments, we have reservations regarding the calculation of the Article 9 analysis, and request that the OECD take a proactive approach in encouraging solutions that could reduce the administrative burden.
- The discussion draft does not adequately address the risk of double taxation in a host country where articles 7 and 9 overlap (in particular where the risks are not contractually allocated, but are delineated and allocated to the DAE under the Article 9 Analysis, and they are also managed through SPFs that are relevant for Article 7 Analysis). This should be addressed specifically in the guidance.
- We believe that this sequencing not only provides the most clarity, on a basis consistent with the Action 7 objectives and principles, but may also be either necessary or of assistance, if local consolidated filing options are to be pursued.
- As a practical matter we would suggest starting with a functional analysis of what is done in Country B and whether, within the context of the extended Action 7 PE concepts, that should be viewed as a domestic Article 9 supply to a DAPE which is thereby created, or as a cross-border supply to Country A (i.e. one which creates income in country B and expense solely in Country A, rather than expense in a Country B DAPE of the Country A host). It is not clear to us that there cannot be the “mirror image” domestic to domestic Country B supplies from the DAPE to the DAE (because local functions are carried on by the DAE) ,but if there can be such mirror image domestic functions, then those should also be identified. We would suggest that a logical sequence to subsequently follow is:

(i) Make all Article 9 charges other than these domestic Country B to Country B charges;

- (ii) Make an Article 7 determination as to what taxable profits are, in aggregate, properly attributable to Country B before considering domestic Article 9 charges within Country B. For this purpose all functions performed in Country B are treated as if they are performed by the Company for whom the Article 7 analysis is being performed; and
- (iii) Make Article 9 charges within Country B so as to separate local taxable profits/losses between local entities or presences.

- Alternatively, before the order re Article 9 and 7 analyses are considered, it may be worth providing taxpayers with the option of the performance of a broader functional analysis of DAE/DAPE (potentially leveraging the presumed Article 5 analysis). This analysis could be beneficial in terms of both efficiency and consistency (i.e. if no activities/risks were attributed to DAPE there would be no need for any Article 7 analysis and if activities/risks were attributed to DAPE it could be ensured that they differed from those attributed to DAE). The aim would be to avoid double counting of activities and/or risks in Country B and ensure that the activities/risks of DAPE are rewarded under Article 7 and those of DAE are rewarded under Article 9.

#### EXAMPLE 1

### 2. Do you agree with the functional and factual analysis performed in Example 1 under the AOA?

- The analysis appears reasonable based on the limited facts of the example. The DAPE is not attributed risks because there are no SPFs performed by the DAPE on behalf of the non-resident enterprise; the DAPE is not attributed economic ownership of assets because there are no SPFs performed by the DAPE on behalf of the non-resident enterprise relevant to the attribution of economic ownership of such assets; there are no risks or assets attributable to the DAPE, so no capital is attributable to the DAPE.
- However, the final guidance should provide clear direction and detail on the appropriate analysis that should be performed to reach these conclusions. In particular, the AOA does not rely on SPFs to attribute the economic ownership of tangible assets but instead presumes that the place of use should be “the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view.”<sup>4</sup>
- Since inventory is a tangible asset, attributing the economic ownership of inventory based on SPFs seems on its face to be inconsistent with the 2010 Report. It appears that the OECD is proposing a different rule for inventory. If this is the case, we believe

<sup>4</sup> Paragraph 75 of the 2010 Report.

it would be helpful to explicitly articulate it. This difference may be based on the fact that any value attributable to inventory is not attributable to its “use” in a conventional sense, but rather is attributable to decisions concerning what levels of inventory should be held, where it should be stored and at what price it should be resold. Thus, these SPFs are more important to the value of inventory than the place of “use”. BIAC agrees with this implied analysis. In order to avoid different interpretations, it would be useful to articulate this as a special rule for inventory. Otherwise countries may take different positions based on existing paragraph 75 and this example. Such inconsistencies could lead to double taxation.

**3. Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?**

- While we appreciate that the end result is (in practice) that the DAPE is allocated a return equivalent to a sales agent (using distributor margin as a “proxy”), the DAPE activities outlined in paragraph 36 are clearly those of a sales agent. We do not believe that this is an appropriate basis for actually attributing economic ownership of the products being sold under a technical analysis under step 2 of the AOA, which is consistent with Article 7, given that neither sales nor cost of sales would be attributed to the DAPE if it was a distinct and separate enterprise performing sales activities.
- Furthermore, with regards to the remuneration of Sellco, we would like to highlight that in some situations with a similar fact pattern it would be appropriate that Prima pays Sellco for the services it performs on a cost plus basis instead of a commission fee. In particular, this would be the correct transfer price in the cases where Sellco is not that enterprise which decides whether to accept an offer. This scenario should be reflected in the final guidance accordingly.

**4. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

- This, naturally, depends on the wording of the relevant treaty and the interpretation used in practice by the tax administration of the country of the PE. Generally, there is a concern that the country would use the method referred to in Article 7(4) of the older MTC and apportion some of the profit of the enterprise to the PE. This is particularly true of in Example 1, where zero additional profit is attributed to the PE but a non-AOA approach could attribute a higher profit.

- We refer to paragraphs 40 - 52 of our response regarding the limitations of the application of the discussion draft to countries who have not adopted the AOA and a request for all participating countries to do so.
- BIAC believes that countries should be required to commit to the AOA<sup>5</sup> if they are going to be permitted to change their treaties to adopt the new, broader definition of a PE as part of the multilateral instrument.

**5. In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?**

- Based on the facts provided and the absence of any SPFs, this is the correct answer and it is a positive sign from the OECD that this is used as the first example, because many DAPes created by the changes arising from Action 7 will result in no additional profit arising, but additional unnecessary administrative burden for taxpayers and tax authorities. These scenarios could be more adequately handled by ensuring that an arm's length transfer pricing between Prima and Sellco is established either via a commission fee or a cost plus remuneration.

**EXAMPLE 2**

**6. Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?**

- We are concerned that the example does not appropriately delineate the transaction that is being priced under Article 9, construct the dealings that are being priced by analogy under Article 7, or identify the most appropriate method for determining the transfer price by analogy under Article 7.
- Several of the activities identified in paragraph 42 as Risk Control Functions (RCFs) for attribution of profits or losses to Sellco are then also identified in paras 49-50 as SPFs for the attribution of the same risks to DAPE (Footnote 10 appears inconsistent on this point). We suggest that this "double count" should be addressed by appropriate delineation and pricing under Article 9 to ensure that Article 7 analysis is only required where there are real, evident activities performed by Sellco on account of Prima and without such activities there would be no profits or losses attributable to the PE.

<sup>5</sup> Whether this would be the full or partial AOA would depend on which version of Article 7 is contained in the bilateral treaty that is being amended.

- It follows from the Article 9 analysis that all Sellco activity is performed on its own account as part of its service provision to Prima. It could thus be interpreted that there is no need for any Article 7 analysis, because following the delineation no additional functions have been performed on account of Prima. In those cases where the Article 9 analysis did identify Country B functions as being performed on account of Prima: (i) the Article 9 delineation would be a provision of staff by Sellco to Prima and the performance of the function by Prima; (ii) the consequential Article 7 analysis would then attribute Prima profits or losses to the DAPE based on those functions.
- At the same time, it should be recognised that this Article 9 analysis would involve a delineation of Sellco's activities as a high value credit management service provider to Prima, which entitles it to a premium fee while exposing it to an obligation to make good credit losses suffered by Prima.
- We refer to paragraphs 40 - 52 of our response regarding the limitations of the application of the discussion draft to countries who have not adopted the AOA and a request for all participating countries to do so.

**7. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

- This, naturally, also depends on the wording of the relevant treaty and the interpretation used in practice by the tax administration of the country of the PE. Generally, there is a concern that the country would use the method referred to in Article 7(4) of the older MTC and apportion some of the profit of the enterprise to the PE.
- We refer to paragraphs 40 - 52 of our response regarding the limitations of the application of the discussion draft to countries who have not adopted the AOA and a request for all participating countries to do so.

**8. In your opinion, what would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?**

- The answer should be determined by reference to the revised Chapter I of the TPG if the AOA is followed, and using that guidance, the risk should be allocated to the entity that actually manages and has the financial capacity to assume the risk. This may or may not be Prima in the example, as there is insufficient information to make the determination; this could result in a reduction in the fee to Sellco and an adjustment to the profit of the DAPE.

9. What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?

- A degree of complexity in Example 2 arises from attribution of the same functions to Sellco and to Prima. The same activities identified at Paragraph 42 as the RCFs for attribution of profits or losses to Sellco are then identified at Paras 49-50 as the SPF for the attribution of the same risks to DAPE (Footnote 10 appears inconsistent on this point). We suggest that this "double count" should be addressed by appropriate delineation and pricing under Article 9 to ensure that Article 7 is only in point where there are other activities (i.e. those not appropriately remunerated under Article 9) performed by Sellco on account of Prima and without such activities there would be no profits or losses attributable to the PE.
- For Example 2, it would follow from the above Article 9 analysis that all Sellco activity is performed on its own account as part of its service provision. There would be no need for any Article 7 analysis in the absence of any functions performed on account of Prima.
- In addition to the above, we have set out below a point on the simplification of this example. The OECD looks at the fact that there are SPFs relating to inventory risk and credit risk in the local affiliate and none at the Head Office. Based on that fact, it is suggested that the contracts with the local affiliate should be recharacterised, placing all the inventory risk and credit risk return (except for the funding return) into the contract, even where it was not in the actual legal contract. The Discussion Draft then infers that the controlling SPFs pull in (a) higher compensation for the local affiliate and (b) the assets and risks of the non-resident entity related to inventory and credit into the PE, but limit the return at the PE to a funding return. This could either (a) create a double counting of the funding return (where it is assumed that the local affiliate has the capacity to bear those risks) or (b) irrationally segregate the funding return when it should have gone to the local affiliate with everything else, leaving nothing in the PE. If the contract were to be recharacterised, we believe that the appropriate simplification would be to recharacterise it by transferring both the economic return on the specified risks and the funding return, leaving zero at the PE.

### EXAMPLE 3

#### 10. Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?

- In this example there appears to be no incorporated entity in the host country<sup>6</sup>, but an employee who operates in the host country is responsible for inventory decisions, credit terms and approving sales.
- BIAC agrees that in this instance it is clear that no Article 9 analysis is required. BIAC also agrees with the approach taken in respect of the Article 7 analysis; the DAPE is remunerated the arm's length price that would be paid to a third party agent, which is calculated as a reasonable target operating margin of 4.5% with all other profits remaining in the head office.
- However, BIAC is concerned that the examples neither construct the dealings nor identify the most appropriate method for determining the transfer price by analogy.

#### 11. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

- This, naturally, also depends on the wording of the relevant treaty and the interpretation used in practice by the tax administration of the country of the PE. Generally, there is a concern that the country would use the method referred to in Article 7(4) of the older MTC and apportion some of the profit of the enterprise to the PE.
- We refer to paragraphs 40 - 52 of our response regarding the limitations of the application of the discussion draft to countries who have not adopted the AOA and a request for all participating countries to do so.
- Per our response to question 4, BIAC believes that countries should be required to commit to the AOA if they are going to permitted to change their treaties to adopt the new, broader definition of a PE as part of the multilateral instrument.

### EXAMPLE 4

#### 12. Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?

<sup>6</sup> BIAC would welcome confirmation that there is no incorporated entity in the host country as it is not clear. The OECD commentary mentions that "Prima does not engage Sellco as its sales agent in Country B"; however, it is not clear from the OECD wording whether Sellco actually exists.



- In this example, Sellco takes on some of the credit risk and is given incentive payments for managing receivables and is remunerated accordingly under Article 9. But then under the Article 7 analysis, the DAPE is allocated a share of the risk return in proportion of its risk management costs under the proposed recharacterisation of the contract. Accordingly, it ends up with much higher profits (or losses) than where no risks are taken on. This is broadly in line with the ALP. However, the conclusion that Sellco's compensation may take the form of sharing in the potential upside and downside should not necessarily be the case.
- The Discussion Draft uses proportionate risk management costs to allocate the risk return between the principal and PE, which assumes that cost is directly representative of return. However, cost does not account for significance of decisions that are made, or whether the PE is implementing the principal's risk control strategy in a perfunctory way (pay differential may capture some of these disparities). The Example should make it clear that adjustments may be made for relative risk control rather than determined by cost alone.
- Example 4 also shows that a loss should also be allocated in the same way (under both Articles 9 and 7).

**13. Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?**

- In the case of Example 4, a similar argument applies to the Article 9 analysis as in relation to Example 2. Here, the fact of the incentive fee being based on credit performance is itself consistent with characterisation of the activity as being performed on Sellco's own account as a service.
- Additionally, as in Example 2, the Article 9 analysis would be a delineation of Sellco's activities as a high value credit management service provider to Prima which entitles it to a premium fee while exposing it to an obligation to make good credit losses (under the recharacterisation of the contract per the Discussion Draft).
- BIAC would welcome additional guidance on this example because, although the functions performed by Sellco in Example 4 are less extensive than the functions performed in Example 2, the profit attributed to the DAPE is much higher. This may be due to the difference between Article 7 and Article 9 on how to allocate risks, but this is not clear.



- Additionally, we would like to note that although we agree with the OECD's explanation, it is of some concern to business, as it creates a significant incentive for countries to find that SPFs are performed locally. Given the difficulty of performing the factual and functional analysis to the level of detail that may be required, it may be difficult for taxpayers to reach certainty and countries may assert profits attributable to SPFs when the taxpayer was of the view that those functions were not significant.

*GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS ARISING FROM ACTIVITIES NOT COVERED BY SPECIFIC EXCEPTIONS IN ARTICLE 5(4)*

*EXAMPLE 5*

**14. Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?**

- The language of the example does not make it clear that the AOA was properly applied to reach this result. BIAC's concern is that the general principle of the AOA is that the rewards of economic ownership are generated by SPFs. There is no reason to suppose that WRU is not continuing to exercise such functions in relation to the warehouse, albeit not in Country W, for example, in its selection of Wareco as a partner and its ongoing oversight of the Wareco contract. The dealings between the Head Office and the PE, as required by the AOA, have not been clearly set out in this example. Given the context, it is not clear why the PE is treated as having received all the customer revenue; if all the controlling functions are in Country A, the Head Office ought to receive all of the customer revenue.
- The Discussion draft states that the principle is to impute a return to the PE that is equivalent to the economic ownership of the warehouse. This makes the analysis that examines the principal's sales and cost of goods sold irrelevant, and therefore it should be excluded; the analysis in the Example should be limited to that of an arm's length return for owning a warehouse asset.
- Finally, the examples ought to point out that that the warehouse may not be in the country where the inventory is sold. In that case, the warehouse would not create a PE in the country of sale, and sales in another country cannot be attributed to that PE.

**15. Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?**

- A profit and loss statement in respect of these examples, as is provided for examples 1-4, would be welcomed.

- If assets should be attributable to the location of the SPFs, there is no rationale for treating tangible property differently from intangible property, in which case any “funding” return for the warehouse should appropriately go to WRU in Country A.
- In Scenario C, there are not even any routine people functions in Country W, let alone any SPFs. However, assuming that the warehouse is owned by WRU and used in its business, that would seem to constitute use for purposes of paragraph 75 of the 2010 AOA Report. In this case we would agree that the PE should receive a funding return for ownership of the warehouse. This should result in a smaller return to the PE compared to 5A or 5B. That difference is directly attributable to the profit received by the third party.
- We assume that there is no funding return on the inventory assets for the reasons described in our response to question 2. If so, this should be clarified when the guidance is finalized.
- The meaning of the word “streamlined” in paragraphs 97 and 101 is not clear and we request that the OECD clarifies this terminology.

**16. In particular, do you agree that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?**

- Whilst BIAC does agree, we believe that an *investment* return should be limited to situations where the principal is the legal owner of the warehouse and there are affiliated risk controlling SPFs in the country.
- If there is tangible property in the PE country which is used by the PE, then we would agree that, pursuant to paragraph 75 of the 2010 AOA Report, there can be a *funding* return on those assets even if there are no personnel of the non-resident enterprise operating in the PE.
- See below (response to question 17) regarding concerns on the differences between *funding* and *investment* returns.

**17. Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?**

- The simplicity of the streamlined approach in this example is welcomed, but its basis appears inconsistent with the AOA. The streamlined approach attributes an investment return to the PE as a reward for the economic ownership of the warehouse and has

parallels with the attribution of a risk free return to a party for the passive provision of capital.

- If this is intended to be an approach that can be used to limit administrative costs, identifying an investment return based on comparable asset ownership investments could be considered.
- With respect to the quantification of the “return” on the tangible assets, the draft uses the phrase “investment return” in some places and “funding return” in other places. The difference between the two phrases is not clear. Whilst we agree that the PE should receive a funding return on its assets and a routine return service fee for the services rendered. If the active decision making is not in the PE country, the PE country should be limited to a funding return and not an investment return. Additional guidance on the difference between these concepts would be welcomed and help to reduce misunderstandings.
- Further, it should be highlighted that it might be the case that no profit should be attributable to the PE, as in Example 1.

**18. Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.**

- If there is no operational link between the SPFs carried out by other parties acting on their own account and the activities of the PE, then it is correct that there should be no attribution of profit under the AOA and assuming the wording and normal interpretation of Article 5(7).

**19. Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits to the PE of WRU?**

- There would not be a difference. This is a useful confirmation that a subsidiary or PE that provides a service at a fee that is arm's length is not entitled to any additional profit simply because of its related party status with another business within the overall enterprise.

**20. What would the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

- This, naturally, depends on the wording of the relevant treaty and the interpretation used in practice by the tax administration of the country of the PE. Generally, there is a

concern that the country would use the method referred to in Article 7(4) of the older MTC and apportion some of the profit of the enterprise to the PE.

- We refer to paragraphs 40 - 52 of our response regarding the limitations of the application of the discussion draft to countries who have not adopted the AOA and a request for all participating countries to do so.

#### *EXPLORING ADDITIONAL APPROACHES TO CO-ORDINATE THE APPLICATION OF ARTICLE 7 AND ARTICLE 9 OF THE MTC*

##### **21. Do commentators have suggestions for mechanisms to provide additional co-ordination for the application of Article 7 and Article 9 of the MTC to determine the profits of a PE, taking into account the considerations expressed above?**

- As noted above, the arm's length principle can be applied to SPFs, as this would be the case if the functions were outsourced to an unrelated party. This should mean the SPFs can be included, in many cases, in the Article 9 analysis where they are performed by a related party, which is the appropriate mechanism for allocating profit in related party dealings (thereby relieving Article 7 so that there is nil profit attributed to the PE).
- Where the SPFs are identified and remunerated under Article 9, and no amount is attributed to the PE, the principal should be able to disregard the existence of the PE and not be required to file a tax return (see comments above re a safe harbour exemption). Similarly, de minimis amounts that fall within Article 7, (and not squarely within Article 9), should be capable of being addressed through Article 9 if the principal chooses to avoid filing requirements and potential unintentional VAT/GST/wage tax consequences.

## Appendix I: Examples of cases where non-application of the AOA has led to a departure from the arm's length principle

### Specific Examples

Countries *explicitly* not following the AOA

In 2016, WTS Alliance<sup>7</sup> undertook a survey of 62 countries<sup>8</sup> approach to permanent establishments. It found that even before examples of “in practice” departures from the AOA are considered, a significant number of countries have not formally adopted the AOA (some of which are OECD/G20 countries):

- Austria
- Azerbaijan
- Bahrain
- Indonesia
- Iran
- Kuwait
- New Zealand
- Oman
- Qatar
- Russia
- Serbia
- Thailand
- Trinidad & Tobago
- United States of America
- United Arab Emirates
- Venezuela
- Vietnam

#### *Rolls Royce (India)*

The Indian Revenue attributed 75%-100% of the profit from the Indian contracts to the Dependent Agent PE (DAPE) in India. The Tax Tribunal and High Court attributed 50% of the global profit to manufacturing, 15% to R&D and the remaining 35% to sales/marketing. The entire 35% of the sales/marketing profit was attributed to the DAPE in India.

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<sup>7</sup> WTS Alliance is a global network of tax advisory firms, with a presence in more than 90 countries.

<sup>8</sup> [http://www.wts.de/en/content/global\\_wts\\_pe\\_study.php](http://www.wts.de/en/content/global_wts_pe_study.php)



Rolls Royce - Delhi  
High Court.pdf



Rolls Royce - Delhi  
Tribunal.pdf

### *Dell (Norway)*

The Norwegian Revenue asserted that 60% of the profits attributable to Norwegian sales should be allocated to the DAPE in Norway.



Dell DAPE Norway  
Ruling.pdf

### *Zimmer (France)*

While the French Revenue did not win the case, this was on the ground that under existing rules, the PE threshold had not been passed for a commissionaire structure. However, the French Revenue had argued that a profit split methodology should be used to allocate profits to the PE in this case.

## **Members' Anecdotal Evidence**

### *China*

It is expressly stated under the Chinese tax laws that deemed profit allocation methods can only be used when the AOA cannot be applied due to the lack of accounting materials etc. Nevertheless, in practice most PEs are taxed on the deemed profits allocating 15% to 50% of gross revenue to China.

The reasons for such a tendency are various: i) most PEs do not keep sound book accounts; ii) tax authorities tend to adopt a simpler method to tax PEs to reduce their administration costs; and iii) even taxpayers may tend to use deemed profit method to reduce their admin costs, in particular for those short-term projects with relatively high profit level.

## Appendix II: Example Business Models

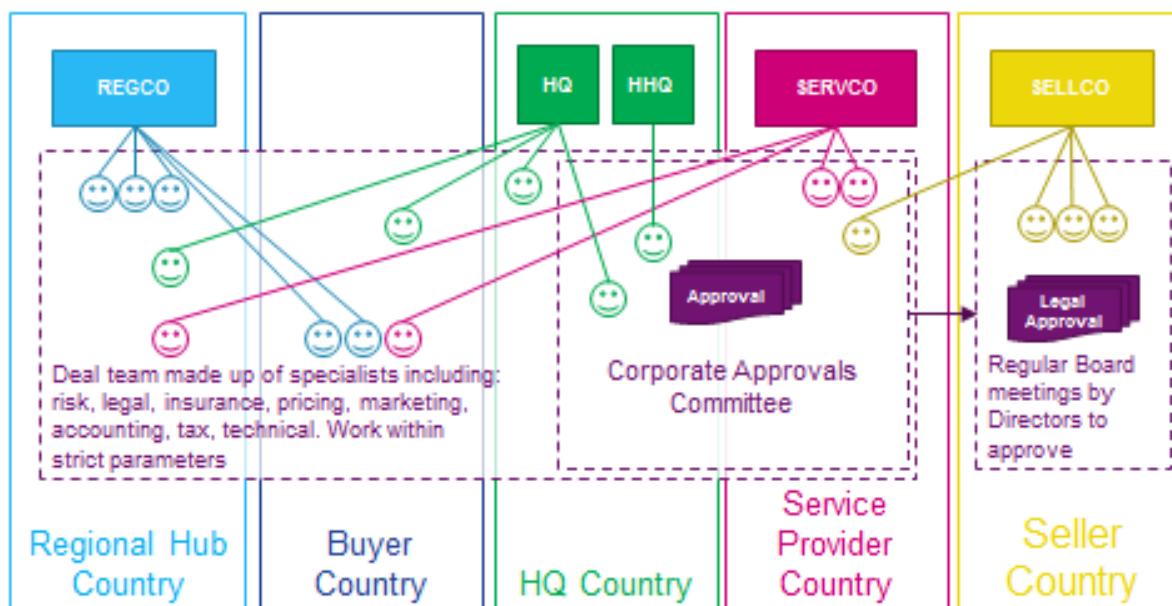
### Example 1

This example highlights the difficulty of identifying in which countries the “principal role” is played in contract negotiations.

#### *Background and overview*

- In this example, employees from several companies will act in concert to negotiate the deal with the customer, although it will always be within parameters designed in advance with input from the business line Headquarters (HQ), the global group headquarters (HHQ), and a company employing specialists to determine appropriate specific deal terms (ServCo). All of these parameters were designed by individuals who were not travelling when setting the parameters.
- However, the negotiation is undertaken across several countries and involves a deal team made up of employees from a regional sales company (REGCO), the company that is actually selling the asset (SELLCO), HQ, and SERVCO. Approval (but not negotiation) is also required from HHQ on large contracts.
- These employees may be in any of a number of countries while negotiating the deal, including the country of the customer, the country where REGCO is incorporated, the country where ServCo is incorporated, the country where HQ is incorporated, or potentially any other country (for example in the country where the seller has its own PE). These functions may be undertaken remotely, via video or phone conference, or in person meetings with each other and/or the customer.

*Locations of employees during deal negotiation*

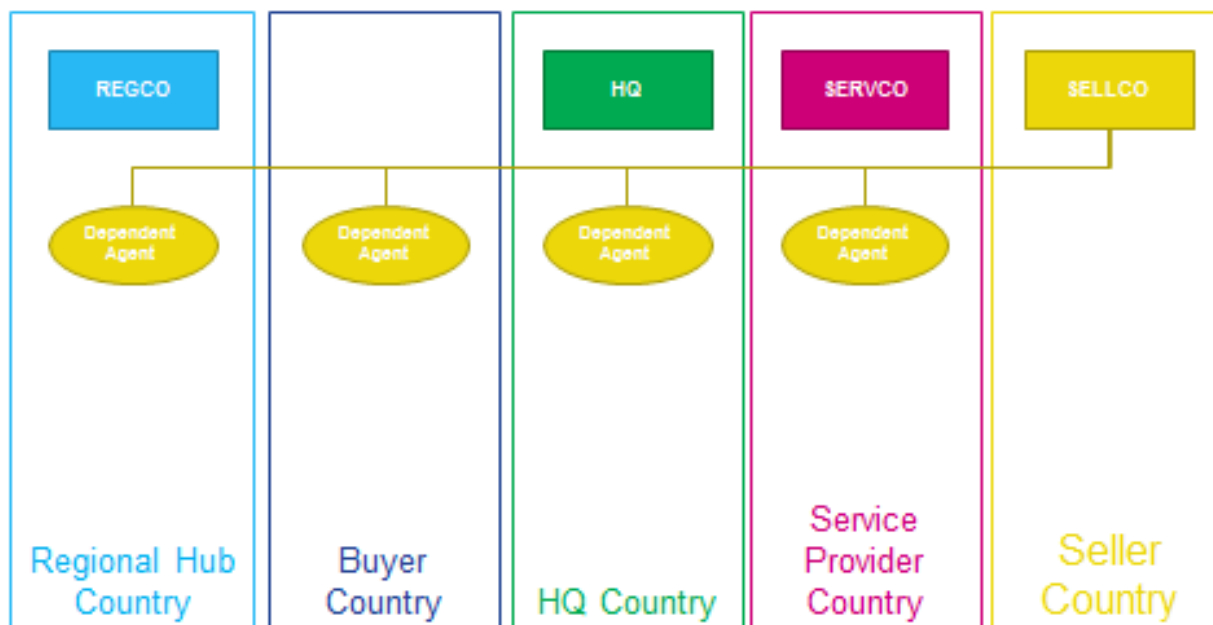


*Locations (and entity) from which activities are undertaken*





*Potential PE's under revised Article 5*



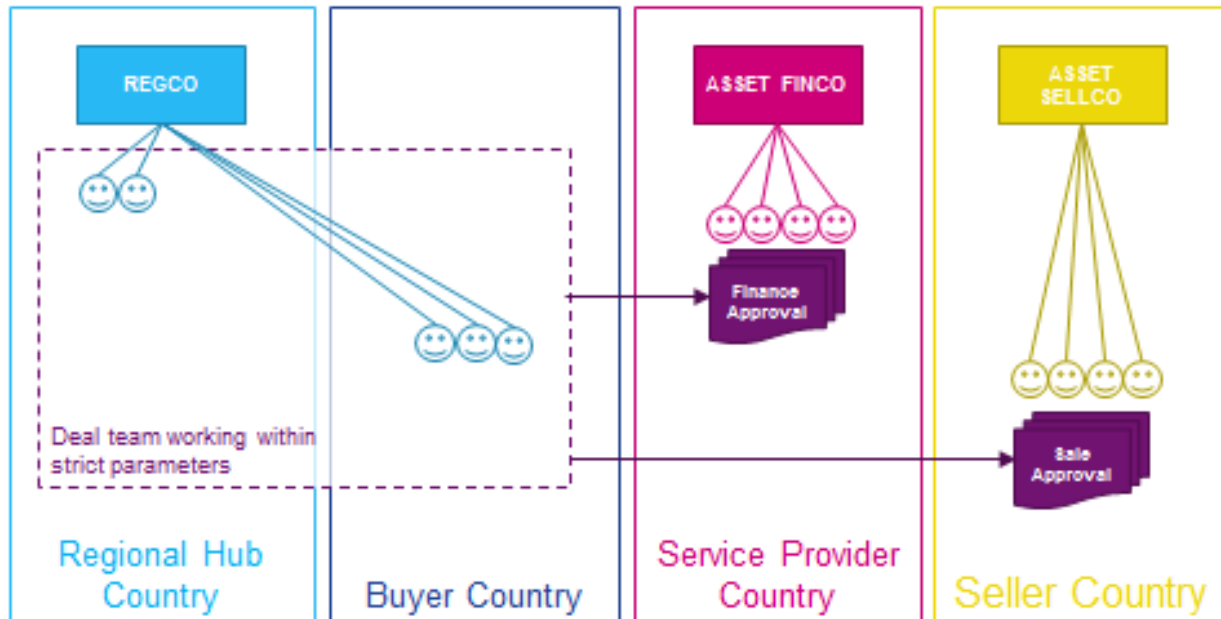
**Example 2**

This example highlights how multiple PEs within multiple countries could be created in relation to the same deal.

*Background and overview*

- In this example, an MNE sells assets, and also provides financing service to its customers. For regulatory and commercial reasons, one entity manufactures and sells assets (ASSET SELLCO), and another entity provides financing (ASSET FINCO).
- ASSET SELLCO and ASSET FINCO have developed strict parameters through which deals can be agreed, and undertake significant functions in their home countries to support deal completion. However, to ensure that the customer only has to deal with one party in their own country, sales and marketing activities are carried out by a regional sales company (REGCO) who contracts with both ASSETCO and FINCO for provision of marketing and sales services (currently remunerated on a cost plus basis).

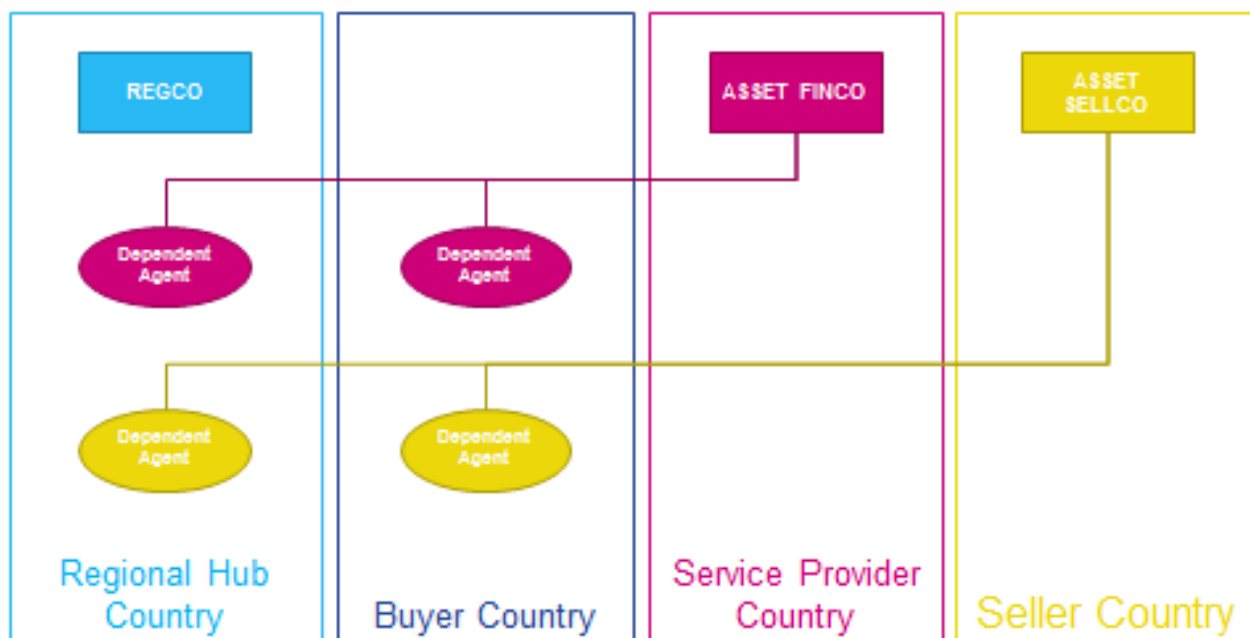
*Locations of employees during deal negotiation*



*Locations (and entity) from which activities are undertaken*



*Potential PE's under revised Article 5*



### Example 3

This example highlights the complexity in valuation / allocation of pricing risk.

#### *Background and overview*

- FCO manufactures heavy engineering, high technology products in Country X.
- SCO (100% subsidiary of FCO in Country Y) supports sale of FCO products in Country Y functioning as a Sales Agent.
- Sales and Marketing activities are undertaken by SCO though it only has range bound authority on some terms and conditions.

#### *Decision making matrix*

Key Terms and Conditions	FCO	SCO	Commercial Rationale
Price ... Discounts < 15% of List Price		✓	
Price ... Discounts > 15% of List Price	✓		Decision impacted by global demand, factory capacity utilization
Payment Terms up-to 90 days		✓	
Payment Terms >90 days	✓		Negative impact on Working Capital due to mismatch between FCO's receivables and FCO's vendor payables
Liquidated Damages = contract price		✓	
Liquidated Damages > contract price	✓		Can have financial impact disproportionate to the Contract
Delivery Schedule	✓		No Manufacturing, Supply Chain resources in SCO since product manufactured by FCO
Performance Guarantee	✓		No Engineering resources in SCO; co-located at manufacturing facility in FCO
Warranty Period/ Scope	✓		No Engineering, Manufacturing resources in SCO

#### *Potential issues*

- If SCO is regarded as DAPE, how should profit be attributed to such DAPE, excluding return for functions and risks attributed to FCO outside Country Y?

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5. September 2016

**Public Discussion Draft on Additional Guidance on the Attribution of Profits to  
Permanent Establishments**

Dear Mr. VanderWolk,

Thank you for the opportunity to comment on the Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments (hereinafter referred to as: "the Discussion Draft") issued on 4 July 2016.

The German Federal Chamber of Tax Advisers (hereinafter referred to as: "Bundessteuerberaterkammer") represents the interests of more than 95,000 tax advisers in Germany vis-à-vis the Bundestag, the Bundesrat, the Federal Ministries, the top echelons of the civil service, the courts and the institutions of the EU and OECD.

The objectives and competencies of Bundessteuerberaterkammer include inter alia facilitating public discussions on tax matters, analysing and giving opinions on draft tax legislation and all other legislative areas that affect the tax profession in Germany and exchanging information about tax laws and professional law.

We would be pleased to discuss any questions you have on our comments and would welcome the opportunity to contribute to the discussion as part of the public consultation meeting in October.

Yours sincerely,

i. V. Claudia Kalina-Kerschbaum  
Geschäftsführerin

i. A. Cornelia Metzging  
Referentin

Encl.



**Bundessteuerberaterkammer**  
KÖRPERSCHAFT DES ÖFFENTLICHEN RECHTS

**Enclosure**

**Public Discussion Draft:**  
**Additional Guidance on the Attribution of Profits to**  
**Permanent Establishments**

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5. September 2016

## **I. General Remarks**

Bundessteuerberaterkammer welcomes that the OECD is consulting with public on its profit attribution guidance. Clear guidance will assist tax authorities and taxpayers as well as their advisors applying the AOA to the revised PE definition. Further, we support the objectives of the discussion draft to illustrate how the rules for the attribution of profits to permanent establishments apply, taking into account both the changes made by the Report on Action 7 and the changes made to the Transfer Pricing Guidelines. However, it is critical that any guidance given by the OECD is workable and tax authorities in all countries and taxpayers take a consistent approach. Furthermore it may be useful if the examples were expanded.

Although the OECD expects the revised definition of PE to be enacted through its Multilateral Instrument, it is likely that tax administrations will begin to attempt to apply any new Commentary as soon as it is finalised. In that context, aligning the work on the Commentary and profit attribution guidance would promote consistency.

## **II. Questions for Consultation**

### **1. Order of application and guidance on this order**

From our perspective, the order in which the analyses are applied should not affect the outcome; no guidance on this order appears to be necessary.

### **2. Agreement with the factual and functional analysis in Example 1**

We agree with the functional and factual analysis under Article 9 and Article 7 and step 1 of the AOA, and in particular with the conclusion that there are no risks or assets attributable to the DAPE and that there is no need to attribute capital to the DAPE. It appears to us, however, that allocating the sales income to the DAPE under step 2 is not in line with the functional and factual analysis under step 1, since the sales activities performed by Sellco for Prima are limited to identifying customers, soliciting and placing customer orders, and processing customer orders with Prima. Recall that there are no significant people functions performed by Sellco on behalf of the non-resident enterprise (Prima) in Country B relevant to the attribution. In particular, “the DAPE has not been attributed the economic ownership of any assets (inventory, marketing intangibles, or receivables)”.

### **3. Agreement with the construction of profits or losses in Example 1**

In principle, agreed; we wonder, however, if it is in line with the proper application of the authorized OECD approach to attribute the sales committed by the DAE to the DAPE despite the fact that no significant people function is carried out in this DAPE.

Besides running counter to the basic principle that assets, risks, capital, and third party transactions are attributed to the permanent establishment carrying out significant people functions, attributing both the sales volume and, thus, the costs of goods sold would imply that the sales margin is earned in the DAPE (and passed on to the DAE). In our understanding, the profit and loss account of the DAPE in example 1 should take the following form:

+	Commission income	10
=	Gross profit	10
-	Commission to Sellco	(10)
=	Operating profit	0

Having said that, it would be interesting to see how the OECD would attribute the assets and the capital involved to the head office and the DAPE in this example. One may say that where the goods are sold to the third party customer, no assets and capital would remain to be allocated to the DAPE. However, if the “balance sheet” for tax purposes is set up according to proper bookkeeping principles, recording cost of goods sold would require that the goods themselves are recorded as assets to be attributed to the DAPE. Moreover, showing the goods as assets of the DAPE would also imply that the company records a goods dealing between the head office and the DAPE which would have to be taken into account at the market price (arm’s length price) of the goods.

#### **4. Conclusion if in Example 1 an approach other than the AOA applied**

No other conclusion would have to be drawn if the attribution of profits to permanent establishments followed the Relevant Business Approach.

#### **5. No profits attributable to the DAPE in Example 1**

Yes, in our understanding it is indeed appropriate to conclude that there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9.

In this regard, we would like to point out that despite there being no change in the allocation of taxable income taxpayers will face a significant increase of compliance and associated costs.

Further, we are concerned that the fact that a DAPE is established under the revised definition tax authorities may perform the analysis not consistently and allocate a taxable income to the DAPE. There are concerns that dissenting interpretations by tax authorities in different countries may lead to an increased risk of double taxation for taxpayers and to increased tax compliance costs for dispute resolution.



## **6. Agreement with the construction of profits or losses in Example 2**

In principle, agreed; please note, however, that the facts and circumstances in Example 2 do not make it perfectly clear whether the “responsibility” of Sellco indeed gives rise to reporting sales and cost of goods sold in the DAPE.

First, the facts tell us that Sellco is responsible for warehousing the inventory and determining and monitoring the appropriate inventory levels. The presentation of the facts, however, does not make clear the terms and conditions of Sellco’s responsibility on which Prima and Sellco would have reached agreement in a third party context. Moreover, the presentation of the facts does not go into the question of where this warehouse is located. Since it is said that the facts in Example 2 are the same as those in Example 1, there is good reason to believe that this warehouse is operated in Country A.

Second, the analysis of the controlled transaction between Sellco and Prima under Article 9 is based on the assumption that Sellco has the capacity to determine warehouse arrangements and the stocking levels, and actually performs the decision-making functions about inventory levels required for sales in Country B. Moreover, it is said that, contrary to the contractual agreement, Prima does not take such decisions and produces to Sellco’s orders. Here, the presentation of the facts is silent on whether Sellco’s capacity is that of a service provider or that of a principal company (even if the OECD concludes that Prima produces to Sellco’s orders, i.e., deeming that Sellco operates in the capacity of a principal company).

Third, the facts make it clear that Sellco carries out comprehensive functions with respect to customer credit including the collection of customer receivables. Here again, the presentation of the facts does not elaborate on whether Sellco’s functions are those of a financial service provider, those of a principal company, or those of, for example, a factoring company.

Having said that, regarding the analysis of the controlled transactions between Prima and Sellco under Article 9 it is somewhat unclear precisely what type of risk is allocated to Sellco. Recall that the inventory ownership is with Prima until title passes directly to the customers and the warehouse may be operated in Country A. Where ownership of inventory and receivables belong to Prima, inventory losses and bad debt losses can hardly be allocated to Sellco. This holds even more so as/if the warehouse is operated in Country B (although there may well exist some kind of compensation claim on the part of Prima vis-à-vis Sellco). By the same token we do not understand, how, from the accounting perspective, commission income fits with bad debt losses and inventory losses where the receivables and the inventory are reported in the financial statement of Prima (even if it is taken into account that the commission income includes some risk premium).

As far as the analysis under Article 7 and step 1 of the AOA is concerned, the significant people functions of DAE on behalf of Prima give rise to the allocation of inventory and receivables to the DAPE.

We do not think, however, that we should go so far as to say that such significant people functions constitute “economic ownership” for the DAPE in inventory and receivables since the concept of economic ownership may vary among the OECD countries, and we should take into account that legally, the DAPE forms part of Prima, which is the (legal) owner of these assets.

Under Article 7 and step 2 of the AOA it should be taken into account that, where inventory and receivables are allocated to the DAPE, this permanent establishment should also be allocated the possible inventory losses and bad debt losses (taking into account possible compensation claims vis-à-vis the DAE). Such representation of the DAPE P/L does not have to lead to different results. Therefore, depending on the precise type of risk allocated to Sellco, we agree on the conclusion that the DAPE reports sales return, COGS, and sales commission to Sellco and is allocated a funding return from its functions in relation to its inventory assets.

## **7. Conclusion if in Example 2 an approach other than the AOA applied**

If the attribution of profits to permanent establishments followed the Relevant Business Approach, there would be no significant people function to advocate the attribution of inventory and receivables to the DAPE. Therefore, leaving aside the fact that Article 9 now requires additional income remunerating possible risks allocated to the DAE (which is outside the scope of the AOA or RBA), no funding return from DAPE’s functions in relation to its inventory assets and receivables would be allocated under the RBA. However, it should be noted that proper attribution of income based on the causation principle should result in no different allocation of profits to a DAPE.

## **8. Consequences if in Example 2 Sellco does not have the financial capacity to assume the inventory and credit risks**

Allocating risks under Article 9 requires that the company needs to control the risk and has the financial capacity to assume the risk. Where no associated enterprise can be identified that both exercises control over risk and has the financial capacity to assume the risk, the OECD/G20 BEPS report on action items 8- 10 proposes to perform a rigorous analysis of the facts and circumstances of the case in order to identify the underlying reasons and actions that led to this situation. Since such an analysis is not possible in the case at hand, it is difficult to come up with a ready-made solution. However, if the case may be that Sellco’s activities regarding inventory and credit to customers take the form of an outsourced service on behalf of Prima, according to which Prima sets the objectives of the outsourced activities, assesses whether these objectives are met, and has the power to hire or fire the service provider, Prima would exercise control over inventory risk and credit risk. If it is found that Sellco performs significant people functions on behalf of Prima in relation to inventory (warehousing and establishing inventory levels) and credit to customers (parameter setting, sales approval based on review of customer’s creditworthiness and collection of customer receivables), for purposes of Article 7 and the AOA, inventory, receivables, inventory and credit risk would have to be attributed to the DAPE.

This is because Sellco performs the significant people functions relevant to the attribution of inventory, receivables and the corresponding risks on behalf of Prima in Country B.

**9. Views relating to the fact that in Example 2 the same functions that are considered under the Article 9 analysis are also taken into account under Article 7**

It appears somewhat puzzling that the inventory and credit risk is allocated to both the DAPE and the DAE. This holds even more so as Prima is the owner of the corresponding assets, effectively carries the risk, and, due to the lack of any contractual agreement, has no legal means to claim for any compensation. The reason for this atypical outcome lies in the discrepancy between the allocation of asset ownership to Prima on one hand and the allocation of risk of bad debt and inventory losses to the agent (Sellco) on the other (see above answer to question number 6). Whereas the allocation of both ownership and ownership risk to the DAPE is a matter of fact leaving the legal attribution unchanged (i.e., it stays with Prima), carrying “ownership risks” in economic terms requires a legal instrument on the basis of which such risks may materialize on the part of the “economic owner” (for example on the basis of an insurance contract). Where such legal means are missing, it should be necessary to identify the missing legal relationship in order to be in line with what third parties do. Abstaining from such identification of the (possible) legal relationship underlying the transactions between third parties may adversely affect the analysis of risks in commercial and financial relations in terms of transparency and traceability.

**10. Agreement with the construction of profits or losses in Example 3**

Agreed

**11. Conclusion if in Example 3 an approach other than the AOA applied**

If the attribution of profits to permanent establishments followed the Relevant Business Approach, there would be no significant people function to advocate the attribution of inventory and receivables to the DAPE. Therefore, leaving aside the fact that Article 9 now requires additional income remunerating possible risks allocated to the DAE (which is outside the scope of the AOA or RBA), no funding return from DAPE’s functions in relation to its inventory assets and receivables would be allocated under the RBA. However, it should be noted that proper attribution of income based on the causation principle should result in no different allocation of profits to a DAPE.

**12. Agreement with the construction of profits or losses in Example 4**

Agreed

**13. Agreement with profits and losses in Example 4 over and above the fee payable to Sellco**

From our perspective, in Example 4 allocating profits and losses resulting from credit risk and bad debts under Article 9 and Article 7 and step 1 AOA appears not to be contradictory (see the “whereas” in question 13). In the first case, the allocation is made on the basis of the (possible) contractual agreement between Sellco and Prima (i.e., head office plus DAPE), which according to the OECD’s assumptions for this example is in line with the arm’s length principle (were this not so, in case of doubt a different allocation basis would have to be found). The second case, however, is a matter of allocation between the head office and the DAPE, which in the (inevitable) absence of any contractual basis takes place based on the sharing of significant people functions measured by the respective contributions to credit management cost for Country B customers. This is what was assumed for purposes for the example, although it is possible to assume otherwise (in Germany, for example, this risk would in principle have to be allocated to the head office since this permanent establishment of Prima takes on the main responsibility, and is in charge of the main decisions, in this respect). In any case this latter allocation of profits and losses to the head office and the DAPE must also be in line with the arm’s length principle.

**14. Agreement with the construction of the profits or losses in Scenario A of Example 5 under the AOA**

Agreed; again, the question is, however, whether “economic ownership” (here, of the warehouse) can be allocated to the permanent establishment as part of a company which is the legal owner. We would prefer to talk about attribution of the warehouse in terms of significant people functions.

Moreover, a future revision of 2010 Report on the Allocation of Profits to Permanent Establishments should consider placing the focus more generally on “people functions” when attributing assets (as is the case, for example, in the context of attributing assets based on the place of use) and risks.

**15. Agreement with the conclusion reached in Scenarios B and C of Example 5 under the AOA**

We agree with the conclusion reached in Scenario C.

However, in relation to Scenario B we have the following comments. We understand that warehousing is not the core business of WRU and the warehouse PE operates as a cost centre. As the employees only perform routine functions on behalf of WRU, there is only a limited base for allocating taxable (sales) income to the PE. Further, we think the PE should be allocated a service fee which basically equals the cost of workforce and running expenses. Where warehouse operates as a cost centre and only routine functions are performed by its employees there should be no (additional) fees payable for know-how or services related to inventory usage. In this context the provision of know-how etc. are auxiliary means.

Therefore, taxpayers should be spared the complex determination of a transfer price for a sheer internal provision of auxiliary services.

**16. Agreement with the attribution of an investment return where no personnel of the non-resident enterprise is operating in the PE**

Agreed, since the warehouse is run by a service provider under a service level agreement.

**17. Agreement with the streamlined approach in this example (no functions performed in the PE); how would you identify the investment return?**

Basically yes. Please note, however, that in scenario B and C (to which this question refers) the warehouse is run by employees or a service provider on behalf of the non-resident company in the PE country. From an accounting perspective, the company would have to report the remuneration for routine services and the cost of workforce or the fee to Wareco for operating the warehouse in its P/L. Where the non-resident enterprise would be subject to the obligation of setting up a financial statement for its PE in Country W, no simplification would arise from such streamlined approach for tax purposes. In order to identify the investment return, the return on assets of selected leasing companies for property could serve as appropriate comparables.

**18. Agreement with attributing no profits to the PE where the non-resident enterprise has no personnel operating at the fixed place of business PE and significant people functions performed by other parties on their own account do not lead to the attributions of assets and risks to the PE**

Agreed

**19. Any difference in the outcome in the attribution of profits if Wareco were a related enterprise**

We do not see any difference.

**20. Conclusion, if in the applicable tax treaty an approach other than the AOA is applied; what would be the differences?**

If the attribution of profits to permanent establishments followed the Relevant Business Approach, there would be no people function to advocate the attribution of the warehouse to the PE since WRU's asset is used in Country W. However, immovable property creating a permanent establishment is always attributable to this PE since according to DTC's the taxing rights on immovable property are allocated to the country hosting the permanent establishment. As a consequence, we would see no difference.



2 September 2016

### **BUSINESSEUROPE POSITION ON THE PUBLIC DISCUSSION DRAFT ON BEPS ACTION 7: ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS**

Through its members, BusinessEurope represents 20 million European small, medium and large companies. BusinessEurope's members are 41 leading industrial and employers' federations from 35 European countries, working together since 1958 to achieve growth and competitiveness in Europe.

BusinessEurope is pleased to provide comments prepared by the members of its Tax Policy Group, chaired by Krister Andersson, on the OECD Discussion Draft entitled "BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments" (hereinafter referred to as the Draft).

BusinessEurope fully supports an objective of providing additional guidance and clarity on the appropriate methodology that should be applied in determining the profit that should be attributed, but is disappointed that the Draft is very restricted in scope and is effectively limited to two basic scenarios. Paragraphs 5-13 of the Draft give some explanation of why the guidance is being limited to two scenarios, and why there is no amendment to guidance on deemed PEs under Article 5(5) and other common PE scenarios. However, the approach taken seems to be overly restricted in addressing only DAPes and warehousing and it would have been preferable for some additional guidance to be provided on how the future commentary will address PE profits in the light of the other BEPS changes, which are acknowledged in Paragraph 10. However, it appears that the objectives set out in Paragraph 11 have not been achieved, as there is little reference to the TPG amendments in the examples. BusinessEurope would encourage the OECD to add additional examples and provide more comprehensive guidance on other scenarios where the Action 7 recommendations result in the creation or recognition of PEs under Articles 5(4) and 5(5).

It would also be helpful to understand the intended output of the consultation. There are no draft amendments to the commentary to the Model Tax Convention proposed in the Draft, and without that context, it is difficult to comment appropriately on the proposals. It has been acknowledged that part of the urgency of this work is driven by the need to have suitable wording for the Multi-Lateral Instrument ("MLI") to amend existing treaties, or at least commentary on the interpretation of treaties that can be included in the MLI. As the relationship between this draft and the MLI is not clear, it would be helpful to have some indication of the timetable for drafting and any consultation on the MLI text.





The first step in establishing a consensus position would be developing an AOA which is internationally consistent and provides legal certainty for the parties involved and where the associated compliance burdens do not exceed an administrable level. It is clear that the AOA, which introduces the concept of “Significant People Functions” will require the preparation of additional documentation (to cover facts not included in the Transfer Pricing functional analysis) for taxpayers operating through Permanent Establishments (DAPE in this case). The administrative burden and costs that such preparation requires will in some cases far exceed any additional taxes derived from this complex exercise.

It is apparent from the draft that the Authorised OECD Approach (“AOA”) is not, or at least not yet, the standard interpretation of the attribution of profits to PEs. In addition, the approach has been specifically rejected by the UN in 2010. It seems that many countries remain opposed to the AOA based on its complexity, the unlimited recognition of deductible notional expenses and the fact that it is not clear that it improves the avoidance of double taxation, which is one of the main objectives of tax treaties. The lack of consensus or a common interpretation of article 7 is likely to lead to increased double taxation. Countries applying different or asymmetrical approaches on the determination of the profit attributable to PE are the main concerns of the business community.

BusinessEurope is also concerned that there is a risk that the recommendations that will be made on this subject will be of limited use or may have unintended consequences when applied to existing double tax treaties that do not use the 2010 model. We therefore request that the final guidance, including any guidance that forms part of the MLI, specifically addresses how treaties that do not include the 2010 model article ought to be amended and interpreted following the Action 7 recommended changes to PE thresholds, and the other BEPS changes.

In the Dependent Agent Permanent Establishment (“DAPE”) examples, (Examples 1-4) fact patterns are selected to illustrate the principles of the guidance, and it is understandable why the facts include in Example 2 the statement that :

*“..the Article 9 analysis results in the allocation of risk not to the party contractually assuming the risk, but to the party that has control over risk and has the financial capacity to assume the risk. This example intends to illustrate the impact that such allocation of risk may have for the analysis under the AOA”*

However, BusinessEurope is concerned that, because the facts are not further elaborated, nor a detailed link to the revised TPG made, that the substitution of an alternative allocation of risk and reward to a DAPE is, or could be, seen as a standard process that tax administrations could or should follow.

BusinessEurope considers that the order of application of analyses under Articles 9 and 7 taken in the 5 examples, where the Article 9 analysis is conducted first, is the correct one on the assumption that Article 7 is in the 2010 MTC format and the AOA is utilised.

The functional and factual analysis performed in the examples seem to be reasonable, based on the limited facts made available, but BusinessEurope recommends that any



final guidance provides clear direction that the appropriate analysis should be performed and assumptions should not be made about the activity or purpose of a PE.

For all of the examples, the question is asked whether there would be a different conclusion if the AOA approach was not followed and what the difference would be. This question is difficult to answer, as in many cases it would depend on the wording of the relevant treaty and the interpretation used in practice by the tax administration of the country of the PE, but generally BusinessEurope's concern is that the country where the PE is located would use the method referred to in Article 7(4) of the older MTC and apportion some of the profit of the enterprise to the PE. Particularly in example 1 where zero additional profit is attributed to the PE there is a risk that the non-AOA approach would attribute a higher profit.

While BusinessEurope recognises that the examples are intended to illustrate particular principles, it is recommended that examples in final guidance are expanded to give more practical guidance and to set reasonable expectations of the level of analysis and detail that would be expected in practical situations. Paragraph 72 is only one example where the statement is made that: *"In practice, such compensation is likely to be subsumed in the determination of the appropriate profits for Sellco, but for the purposes of the example..."* it would be of great practical assistance if the final guidance made a clear distinction between expectations for practical implementation and the explanation of theoretical principles.

BusinessEurope considers that the attribution of zero profit to the PE in example 1 is correct. Based on the facts provided and the absence of any significant people functions, this is the appropriate answer and it is a positive sign from the OECD that this is used as the first example, emphasising a major concern of business that many DAPes created by the changes arising from Action 7 will result in no additional profit arising.

Examples 1-4 all show a simplified P&L account for the DAPE where the turnover of Prima is shown as sales income of the DAPE. It is not clear whether the OECD is recommending that this should be the expected format of the local reporting for the DAPE. If so, it should be recognised that this could be a significant change from what is currently reported, and could create a greater divergence between local GAAP and VAT reporting which will require transitional arrangements and additional explanations and potential misunderstandings.

BusinessEurope considers that the answer to question 8, relating to example 2, should be determined by reference to the revised Chapter I of the TPG if the AOA is followed, and using that guidance, the risk should be allocated to the entity that actually manages and has the financial capacity to assume the risk. This may, or may not be Prima in the example as the facts only state that Sellco lacks financial capacity to assume the risk and there is insufficient information to allocate the risk elsewhere within the group. This may result in a reduction in the fee to Sellco and an adjustment to the profit of the DAPE.

In example 4 it is assumed that Sellco would agree to bear a loss (paragraphs 72 to 77), but even if Sellco can be considered as sharing the SPF we do not believe that in





practice, Sellco would bear a risk of loss greater than its profit opportunity. In addition the allocation of the profit/loss between Prima and Sellco is something very difficult to objectively determine and BusinessEurope considers that this only creates uncertainty. Furthermore the allocation of remuneration between Prima HQ and Prima DAPE described in paragraphs 80-84 seems overly complex and far from the practical experience of most international business. The different interpretation of the SPF for the application of article 7 and 9 creates great potential complexity in interpretation and we would encourage the OECD to simplify the analysis in the final recommendations.

In the examples relating to warehousing, addressing the attribution of profit to PEs which would, before the Action 7 recommendations, have been subject to an exception under Article 5(4), the overall conclusion of the three scenarios that the PE is entitled to a compensation appropriate to the routine functions performed and an appropriate return on the investment in assets is welcomed, reinforcing the existing position that limited functions and risks carried out and managed by a PE should receive only a reward for those functions and risks and not a share of the enterprise profit.

In principle the streamlined approach is welcome and, if this is to be an approach that can be used to limit administrative costs, identifying an investment return based on market rates of comparable asset ownership investments, if this is available, should be considered.

BusinessEurope would agree that, it is correct that there should be no attribution of profit to a PE, using the AOA and the wording and normal interpretation of Article 5(7) if the non-resident enterprise has no personnel operating at the fixed place of business PE, in the circumstances where any significant people functions are performed by other parties on their own account in the jurisdiction of the PE, and the significant people functions performed by those other parties should not lead to the attribution of risks or assets to the PE.

BusinessEurope, considers that under scenario C of Example 5, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, there would be no difference to the outcome of the attribution of profits to the PE of WRU and welcomes the confirmation that a subsidiary or PE that provides a service at a fee that is arm's length is not entitled to any additional profit simply because of its related party status with another business within the overall enterprise.

BusinessEurope welcomes the confirmation at paragraph 104 that the existence of a DAPE for corporation tax purposes may arise even when there are no profits attributable to the DAPE, and the recognition that, even where there is no attributable profit, there may nonetheless be other local filing requirements and this may give rise to other tax liabilities. The Draft, at paragraph 105, goes on to refer to administratively convenient ways of collecting the appropriate amount of tax from DAPes and therefore appears to anticipate that filing will always be required by an MNE where a DAPE exists, even where there are no attributable profits. This would impose an additional compliance burden for both tax administrations and tax payers, while also creating other filing requirements without any incremental tax liabilities. As an illustration, in the scenarios used in the examples, Prima would, in many cases, have no VAT registration in country B, if its sales to customers in that country were exclusively business to



business transactions and where a domestic reverse charge mechanism applied. If Prima were then required to register a DAPE and record all its country B turnover through that PE as in the examples, BusinessEurope is concerned that this would create additional costs for all parties and increased risk of inappropriate VAT assessments.

BusinessEurope would suggest that, in addition to investigating whether there may be administratively convenient ways of recognising the existence of a DAPE and collecting the appropriate amount of tax resulting from the activity of a Dependent Agent Enterprise through mechanisms that could ensure additional co-ordination of the application of Article 7 and Article 9 to determine the profits of a PE, there should be serious consideration to an agreement on de minimis thresholds below which it is recognised that the cost to both taxpayer and tax administration of registering, reporting and accounting for negligible or zero amounts of tax greatly outweigh the amount of taxes that would be collected and the BEPS risk, if any, that could arise from these activities.

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Tax Treaties, Transfer Pricing and Financial Transactions Division  
OECD/CTPA

5 September 2016

Submitted by email: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

**CBI RESPONSE TO THE OECD PUBLIC DISCUSSION DRAFT “ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS”**

As the UK’s leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

The CBI has supported the OECD BEPS project since its inception and recognises the need to update international tax rules to address base eroding and profit shifting activity.

We have reviewed the response prepared by BIAC in respect of the OECD discussion draft “Additional Guidance on the Attribution of Profits to Permanent Establishments for public review ” and agree with the key points and conclusions set out in the BIAC response.



Chartered  
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Taxation  
Excellence in Taxation

Ref: IT

5 September 2016

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By e mail: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

Dear Sirs

**BEPS Action 7 – Additional Guidance on the Attribution of Profits to Permanent Establishments (PEs)**

We refer to the Discussion Draft published by the OECD on 4 July 2016 on *BEPS Action 7 (Additional Guidance on the Attribution of Profits to Permanent Establishments)* which builds on the work on Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status – and in particular the conclusion that additional guidance is required as to how profits should be attributed to PEs. This is acknowledged to be a difficult and controversial area.

The CIOT is an educational charity and one of our key aims is to work for a better, more efficient tax system for all affected by it. We strive for a tax system which provides greater simplicity and clarity, and also greater certainty for taxpayers. The CIOT responded to the OECD consultations on Action 7 published in October 2014 and May 2015 and continues to support the aims of the OECD to tackle artificial avoidance of PE status in the areas identified.

The already announced changes to the definition of a PE significantly lower the threshold at which a PE is considered to exist. This is highly likely to result in substantially more PEs. Many of these will be low value, non-abusive cases, which will nonetheless result in increased administration costs for tax authorities and an increased compliance burden for taxpayers. This is a particular concern for companies trying to expand in difficult markets.

Most multinationals outside of the financial sector have limited experience of dealing with profits attributable to PEs and many tax authorities will also have little experience in this area. Taxpayers and tax authorities also have to absorb the significant changes to the Transfer Pricing Guidelines (as approved by the OECD

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UK REPRESENTATIVE BODY ON THE  
CONFEDERATION FISCALE EUROPEENNE

Council in June 2016) implementing BEPS Actions 8-10 which affect the attribution of profits discussion.

We are also concerned that the Discussion Draft uses the Authorised OECD Approach (AOA) in its analysis of the fact patterns presented in circumstances, when this is an approach with which some countries disagree.

We suggest that the OECD should consider proposing a de minimis monetary threshold, for profits and/or sales, below which a company having no physical presence in a territory would have a zero profit attribution, even if under the revised Article 7 a PE would be created. Alongside a very limited filing requirement, this could alleviate the administrative burden on tax authorities and taxpayers.

We also suggest that if countries wish to adopt the lower threshold of a PE as outlined in the Report on Action 7, it should at least be recommended that they formally adopt the AOA.

Yours faithfully

Joy Svasti-Salee  
Chair, International Tax Committee

### **The Chartered Institute of Taxation**

The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 17,600 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

**REPLY TO THE OECD’S REQUEST FOR COMMENTS ON THE  
“PUBLIC DISCUSSION DRAFT ON BEPS ACTION 7 – ADDITIONAL GUIDANCE ON  
THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS”  
FROM CMS**

**CMS is a European Economic Interest Grouping that coordinates an organisation of independent law firms:**

CMS Adonnino Ascoli & Cavasola Scamoni (Italy)  
CMS Albiñana & Suárez de Lezo (Spain)  
CMS Bureau Francis Lefebvre (France)  
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**Contacts for follow-up. This contribution was prepared by the CMS Transfer Pricing Group and, in particular, by the following experts:**

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Do you authorize the OECD to publish your contribution on the OECD website? Yes

1. We would like first to welcome the OECD initiative to consult companies and practitioners in the framework of the additional guidance provided on the attribution of Profits to Permanent Establishments. We were very interested in reviewing, in light of Action 7 of the Action Plan on Base Erosion and Profit Shifting, the “*Public Discussion Draft On BEPS Action 7 – Additional Guidance on the Attribution of Profits to Permanent Establishments*” released on 4 July 2016 (further referred to as the “Discussion Draft”). Our observations are the following.

### **General observations**

2. In order to perform a relevant analysis of the attribution of profits to a permanent establishment (“PE”) according to Article 7 of the OECD Model Tax Convention (“MTC”), it is necessary to assume that the dependent agent enterprise (“DAE”) is remunerated at arm’s length, as per Article 9 of the MTC. We note in this respect that this assumption is systematically made for all examples proposed in this Discussion Draft – leaving only the question of the application of Article 7 of the MTC.

3. On the question of how to articulate Articles 7 and 9 of the MTC, we do not believe that the order of application of the two articles would have any major impact on the final result. Indeed, Articles 7 and 9 of the MTC should be applied following similar rules (i.e. those recommended by the OECD Transfer Pricing Guidelines), the only notable difference between the two being that the transactions in an Article 9 analysis are generally supported by contracts (between two related parties), whereas transactions in an Article 7 analysis are not (the transaction being between a company’s head office and its PE). As a result, where an Article 9 analysis relies on contracts, an Article 7 analysis focuses on significant people functions (“SPFs”).

4. Furthermore, following the final report on BEPS Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation* (and specifically, the section on Guidance for Applying the Arm’s Length Principle, Revisions to Section D of Chapter I of the Transfer Pricing Guidelines), Article 9 analyses focus significantly more on the actual allocation of functions, risks, and means to exercise and control said functions and risks, and may allocate them to a party in contradiction with the contractual allocation if the facts justify it<sup>1</sup>. This is very similar to the SPF analysis of Article 7. Analyses according to either article should lead to the same conclusions, regardless of the order they are performed in.

5. The core objective of Article 9 of the MTC is to allocate to Sellco the remuneration it would have perceived had it not been related to Prima. If Prima had entered into a similar transaction with a third party instead of Sellco, that said transaction led to the existence of a DAPE and that a tax audit occurred, it would be extremely unlikely that the tax administration

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<sup>1</sup> Final report on BEPS Actions 8-10, *Aligning Transfer Pricing Outcomes with Value Creation*, § 1.98: “If it is established in step 4(ii) that the associated enterprise assuming the risk based on steps 1 – 4(i) does not exercise control over the risk or does not have the financial capacity to assume the risk, then the risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.”

would reduce the revenue of the independent third party to attribute it to the DAPE. To summarize, the fact that the functions that are considered under an Article 9 analysis to allocate risks to Sellco and under Article 7 to attribute economic ownership of assets to the DAPE should not lead to any profit being taken from Sellco and allocated to the DAPE; any profit allocated to the DAPE should come from its principal, Prima.

### **Observations on Example 1**

6. We agree with the functional and factual analysis performed in Example 1 under the AOA, and with the conclusion that the DAPE should not be attributed any profits or losses. Furthermore, we believe the guidance should address the issue of documentation of such cases, as well as the issue of whether to file a tax return for such entities. We believe that requiring companies to prepare documentation or file a tax return for entities to which no profit is attributable creates a significant burden which would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention. As such, further guidance clarifying whether or not tax returns and documentation are necessary when there are no profits to be attributed to the PE would be useful.

7. In general, we agree with the principle that when the DAE does not perform significant people functions on behalf of the non-resident enterprise, there should be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9. Moreover, we believe it should be stressed that this is a general principle, i.e. that when the Article 9 functional analysis proves that the DAE does not exercise any significant functions nor bear any significant risks, it may automatically concluded that there is no profit left to attribute to the DAPE. We believe this – in addition to non-documentation of DAPes to which no profit is attributable – would help reduce the administrative burden on companies without creating or increasing any risks of profit shifting.

### **Observations on Example 2**

8. Example 2 does not make it sufficiently clear whether the goods are physically located in country A or in country B.

- If the assets are physically located in country B, then we agree with the allocation of a funding return to the DAPE.
- If the assets are physically located in country A, however, we disagree with such an allocation. Indeed, we do not believe that, in such a context, Article 7 should trump Article 9 and lead to the funding of an asset owned and actually located in country A to an entity located in country B.

9. The logical consequences of Sellco not having the financial capacity to assume the inventory and credit risks should lead to these risks being attributed to the group company which would effectively support the risk if it materialized (in this example, we assume this is Prima). It would appear logical that, in the event part of the inventory is lost or damaged, or in the event a sale leads to a bad debt loss, and assuming Sellco does not have the financial



capacity to deal with these events, Prima would effectively support the costs. It is difficult to split the risk between:

- (i) the functions performed by Sellco
- (ii) the legal ownership and financial capacity to bear the risk held by Prima, and
- (iii) economic ownership of the assets by the DAPE.

For practical reasons, we are of the opinion that the corresponding compensation should be attributed to Prima. As a result of this, a funding return should only be attributed to the DAPE if Sellco does not have the financial capacity to assume the risks.

#### **Observations on Example 4**

10. We believe this example is overly complicated, and do not understand the choice of the profit split method between Sellco and Prima to begin with. Indeed, the example clearly states that Prima bears the credit risk; as such, the profit split method does not seem appropriate here. We therefore suggest this example be removed.

#### **Observations on Example 5**

11. We do not agree with the construction of the examples. The intangibles used are routine intangibles, which can be sufficiently remunerated *via* the Cost Plus Method. This is equally true for all three examples.

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12. We thank you for giving us the opportunity to share with you our comments and would be pleased to provide you with any additional detail you would be interested in.

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For CMS,

Bruno Gibert: Partner  
Stéphane Gelin: Partner  
Arnaud Le Boulanger: Partner, Chief Economist  
Xavier Daluzeau: Partner



**Opinion Statement FC 13/2016**

**on the OECD Discussion Draft (BEPS Action 7)**

**Additional guidance on the**

**attribution of profits to permanent establishments**

**Prepared by the CFE Fiscal Committee**

**Submitted to the OECD in September 2016**

*The CFE (Confédération Fiscale Européenne) is the umbrella organisation representing the tax profession in Europe. Our members are 26 professional organisations from 21 European countries with more than 200,000 individual members. Our functions are to safeguard the professional interests of tax advisers, to assure the quality of tax services provided by tax advisers, to exchange information about national tax laws and professional law and to contribute to the coordination of tax law in Europe.*

*The CFE is registered in the EU Transparency Register (no. 3543183647-05).*

*We will be pleased to answer any questions you may have concerning CFE comments. For further information, please contact Piergiorgio Valente, Chairman of the CFE Fiscal Committee, or Rudolf Reibel, CFE Tax Policy Manager, at [brusselsoffice@cfe-eutax.org](mailto:brusselsoffice@cfe-eutax.org).*

## Introduction

This Opinion Statement relates to the OECD Discussion Draft *"Additional guidance on the attribution of profits to permanent establishments"*<sup>1</sup> released on 4 July 2016 on BEPS Action 7 (*"Preventing the artificial avoidance of permanent establishment status"*).

Please note that this is a preliminary version. The final version of this Opinion Statement will be published on the CFE website in the course of the next days or weeks: <http://www.cfe-eutax.org/node/5544>.

## Statement

1. The Confédération Fiscale Européenne welcomes any initiative by the OECD to clarify application of a complex exercise such as the attribution of profits to permanent establishments as a result of the development of Action 7 of the BEPS Action Plan.
2. However, CFE is of the view that the approach of the Discussion Draft is erroneous, as the Draft does not shed light on the fundamental issue, which is, in our view, the coordination of the Authorised OECD Approach –AOA–, (which has not been accepted in its entirety by all countries), with the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing. This is recognised in Paragraph 10 and again in Paragraph 103 of the Discussion Draft. Instead of looking for general principles that could apply to most situations, the document just focuses on two fact-patterns, those of the Dependent agent PE (DAPE) and Warehouses as fixed places of businesses. In the case of DAPE four examples are given, three of which look at a situation where the DAPE is an already related enterprise and one (example 3) where an employee of the company performs selling activities in the country of the associated enterprise. No examples are given of cases where the DAPE is neither an associated enterprise nor an employee (i.e. other representative, as mentioned in Paragraph 7 of the Draft). Only one example of Warehouse, divided into three different scenarios is given but in this case without the extensive quantitative analysis given in the case of DAPE.
3. Even if the Discussion Draft is trying to draw some general conclusions from the commentaries to the examples, the approach seems wrong, as the examples given contain some contradictions, and the questions have been worded to lead in a certain direction.
4. CFE would very much like, however, to participate in the public consultation, as the Permanent Establishment issue and the profits attributed to it are a key issue for almost all businesses with an international activity.

## Further comments:

5. The examples do not seem related to the new threshold PE resulting from Action 7 of the BEPS action plan. Most of the cases were already a PE previous to the suggested amendment of Article

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<sup>1</sup> <http://www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-attribution-of-profits-to-permanent-establishments.pdf>

5 of the OECD Model Convention. Therefore, they can hardly produce clarification for the new PE situations but, instead, for older pre-existing ones.

6. The examples mainly focus on the impact of Actions 8-10 on the AOA corresponding to the new Article 7 of the OECD Model Convention incorporated in 2010 which, by the way, has had little acceptance in treaty negotiations and has been hardly incorporated in treaty practice. There is a total lack of clarification of the impact of the new Actions 8-10 on the attribution of profits to PEs that result from Article 7 included in the vast majority of tax treaties and in the OECD Model Convention versions prior to 2010.
7. Conclusion for example 1 (paragraphs 37,39) is inconsistent by concept. A PE exists to the extent that profits 'can' be attributed and in the example the PE exists and no profits result in attribution to it. If no significant people functions can be identified in a PE situation no PE should arise. If a PE exists, on the contrary, the attribution of profits rules should enable some profit to be attributable.

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## Confederation of Swedish Enterprise - Comments on the OECD Public Discussion Draft entitled: "BEPS Action 7 Additional Guidance on the Attribution of Profits to Permanent Establishments" 4 July - 5 September 2016

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The Confederation of Swedish Enterprise is Sweden's largest business federation representing 49 member organizations and 60 000 member companies in Sweden, equivalent to more than 90 per cent of the private sector.

The Confederation of Swedish Enterprise is pleased to provide comments on the OECD Discussion Draft entitled "BEPS Action 7 Additional Guidance on the Attribution of Profits to Permanent Establishments" 4 July - 5 September 2016 (hereinafter referred to as the Draft).

The Confederation of Swedish Enterprise appreciates the efforts by the OECD to provide additional guidance on the attribution of profits to permanent establishments (PEs). Unfortunately the Draft falls short in some regards and does not deliver the level of guidance we had expected. The scope of the Draft is limited to two scenarios, namely dependent agent permanent establishments and warehouses. It is said that these two scenarios were found to be of particular need of additional guidance. While the guidance for these two scenarios are welcomed, we request additional guidance on how the commentary will address PE profit allocation in light of other BEPS changes.

We also request information on what the output of the consultation will be since there are no draft amendments to the commentary to the Model Tax Convention proposed in the Draft. In addition, it would be helpful to have some clarity on the relationship between this Draft and the work on the Multilateral Instrument.

One issue identified in the Draft that needs additional attention is the lack of support for the Authorized OECD Approach (AOA). Since the AOA has been rejected by the UN Committee of Experts on International Cooperation in Tax Matters, we are

concerned that the recommendations, which are based solely on the application of the AOA, will be of limited use in relation to the many treaties that do not include the 2010 model article 7. The Confederation of Swedish Enterprise would appreciate additional guidance on how such treaties ought to be amended and interpreted, following the recommended Action 7 changes to PE thresholds as well as other BEPS changes.

For all the examples the question is posed whether there would be a different conclusion if another approach than the AOA would be applied. This is difficult to answer since it depends on the wording in the treaty being applied and how it is interpreted by the tax authority in the PE country. However, the Confederation of Swedish Enterprise does see a general risk that the country where the PE is located would use the older method in article 7(4) and in doing so apportion some of the profit to the PE. This concern is most relevant in example 1, where no additional profit is attributed to the PE under the AOA. We believe that the attribution of profits in example 1 is correct. It is welcomed that example 1 addresses a concern for many businesses that DAPes created by changes by action point 7 will result in no additional profit arising.

We find the functional and factual analysis used in the examples to be reasonable. We also find that the order of application of the analysis is conducted in a correct manner. The analysis under article 9 should be conducted first, provided that article 7 is in the 2010 MTC format and the AOA is utilized.

The Confederation of Swedish Enterprise welcomes the examples about warehousing. The general conclusion from these are that the PE is entitled to a remuneration for the routine functions performed and an appropriate return on investment in assets. These examples reinforce the position that limited functions and risk carried out and managed by a PE should only receive reward for those functions and risks.

In order to keep administrative costs down, the streamlined approach is welcomed. It does however require that an investment return based on market rates of comparable asset ownership investments is available.

The Confederation of Swedish Enterprise agrees that if the non-resident enterprise does not have any personnel operation in the country where the PE is established, and the significant people functions are performed by other parties, then those people functions should not lead to attribution of risk or assets to the PE.

We believe that a de minimis threshold should be carefully considered, below which it is recognized that the cost to both taxpayer and tax administration of registering, reporting and accounting for negligible or zero amounts of tax greatly outweigh the amount of taxes that would be collected and the BEPS risk, if any, that could arise from these activities.

On behalf of the Confederation of Swedish Enterprise

September 1, 2016

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5 September 2016

Submitted by e-mail: TransferPricing@oecd.org

**Commentary on the BEPS Public Discussion Draft containing Additional Guidance on the Attribution of Profits to Permanent Establishments (Action 7)**

**Andrew Cousins, Richard Newby; Duff & Phelps Ltd.<sup>1</sup>**

We welcome the opportunity to comment on the OECD's discussion draft containing additional guidance on the attribution of profits to permanent establishments, issued 4 July 2016. In our response we have followed the numbering of the questions in the discussion draft.

***Question 1: Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.***

There seems no technical reason why the order of performing the analyses under Article 9 and Article 7 should affect the outcome, so long as the principles outlined and the facts are applied consistently under each analysis.

Practically however, to the extent that the calculation of the arm's length profit of the DAE feeds into the analysis of the DAPE to determine the arm's length fee deductible in the DAPE regarding the function of the DAE, it would appear more efficient to perform the Article 9 analysis before performing the profit attribution analysis to the DAPE under Article 7.

***Question 2: Do you agree with the functional and factual analysis performed in Example 1 under the AOA?***

The functional and factual analysis performed under the AOA is as defined in the 2010 paper. The Discussion Draft does not change this but rather applies the existing AOA in the context of the new guidance in the OECD Guidelines, in particular the new guidance

<sup>1</sup> The opinions and views expressed in this letter are those of the authors and not necessarily those of Duff & Phelps or its clients.



on risk. The functional and factual analysis in Example 1 appears consistent with the approach adopted in the 2010 paper.

***Question 3: Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?***

We agree that there should be no additional profit attributed to the DAPE where there are no significant people functions (SPFs) in Sellco relevant to the assumption of risks or the attribution of assets to the DAPE.

***Question 4: What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

This question does not lend itself to consideration in the abstract. Reference to the wording of the specific tax treaty and the differences from the OECD Model Tax Treaty are required to assess what differences in conclusion may result compared with the AOA.

***Question 5: In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?***

Logically, if under the AOA SPFs are the determining factor for attribution of risks and assets and therefore capital, when there are no SPFs relevant to the assumption of risks or the attribution of economic ownership of assets, there are no risks or assets attributable and therefore no capital or profit.

To avoid creating an unnecessary compliance burden on multinationals it may be worth clarifying that where there are no relevant assets or risks attributable to the DAPE based on SPFs performed by the DAE on behalf of the non-resident enterprise and appropriate profit has been allocated under Article 9 there is no need for a DAPE profit attribution analysis.

***Question 6: Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?***

We agree with the construction of profits/losses in Example 2.

***Question 7: What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

We refer to our response to Question 4 above.

***Question 8: In your opinion, what would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?***

This is a transfer pricing issue so the funding return will need to be adjusted to reflect the fact that Sellco does not have the financial capacity to assume the risk. In addition to the inventory funding return to Prima, Sellco would pay an additional fee to compensate Prima for retaining additional capital as a safeguard against further risks arising.

Presumably the SPFs still require the attribution of risks to the DAPE, if the SPFs remain the same. The attribution of capital to the DAPE would therefore follow from this. Under the Article 9 analysis the fee payable to Sellco would reduce, leaving more profit attributable to the DAPE under the Article 7 analysis.

***Question 9: What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?***

Following the principles of the AOA to their logical end, it is hard to see what other conclusion could be reached. The 2010 paper is the first to recognise that the hypothesis by which a PE is treated as a functionally separate and independent enterprise is a mere fiction.

***Question 10: Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?***

We agree with the construction of profits/losses in Example 3.

***Question 11: What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

We refer to our response to Question 4 above.

***Question 12: Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?***

We agree with the construction of profits/losses in Example 4.

**Question 13: Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?**

We agree with the statement.

**Question 14: Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?**

We agree with the construction of profits/losses in Example 5.

**Question 15: Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?**

We agree with the conclusions reached in Scenarios B and C.

**Question 16: In particular, do you agree that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?**

Under the AOA, yes, there can be such an investment return.

**Question 17: Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?**

Yes; no doubt some form of benchmarking would be available for the investment return.

**Question 18: Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.**

We agree with the analysis.

**Question 19: Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits to the PE of WRU?**

It appears to us that there would be no difference in outcome.

***Question 20: What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

We refer to our response to Question 4 above.

***Question 21: Do commentators have suggestions for mechanisms to provide additional co-ordination for the application of Article 7 and Article 9 of the MTC to determine the profits of a PE, taking into account the considerations expressed above?***

The performance of a separate Article 7 and Article 9 analysis in the case of each PE is burdensome and complete convergence of the two analyses based on the arm's length principle would be desirable, so as to avoid the need for duplicative and sometimes contrary analysis in respect of a single relationship.



**Andrew Cousins**  
Director, Transfer Pricing  
Duff and Phelps



**Richard Newby**  
Managing Director, Transfer Pricing  
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**DWVA**  
TAKING CARE OF BUSINESS

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Monday, September 05, 2016

Dear Mr. VanderWolk,

**RE – Comments on the Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments**

De Witte-Viselé Associates (hereafter “DWVA”) welcomes the opportunity to comment on the additional guidance on the Attribution of Profits to Permanent Establishments issued on 4 July 2016.

We are pleased to provide you hereby with our comments with respect to some of the questions raised in this discussion draft and hope our contribution can help in reaching a consensus on the additional guidance on the attribution of profits to Permanent Establishments.

Leslie Van den Branden  
Partner  
DWVA

Stephanie De Coster  
Transfer Pricing advisor  
DWVA



## 1. Comments regarding the guidance on particular fact patterns related to dependent agent permanent establishments (“DAPE”)

**Question 1** – Express your views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application

In our view the order in which the analyses are applied should not give rise to any differences, if conducted appropriately, considering that both analyses are based upon facts, functions performed, risks assumed and assets employed by the concerned parties.

This being said, it makes more sense to apply the Article 9 analysis first, followed by Article 7. Indeed, it makes more sense to first look to the controlled transaction(s), the related parties involved and their respective functions, risks and assets and subsequently the arm's length remuneration for the controlled transaction(s). Following this analysis one should then look whether or not the functions performed, assets used and risks assumed by one of the parties give rise to a Permanent Establishment in the other party's jurisdiction. Only then the Article 7 analysis comes into play.

Moreover, the scope of Article 7 is that of determining the appropriate level of profits to be allocated to a Permanent Establishment. According to the logic of things, this can only occur once all transactions – in which the concerned entity is involved in – are correctly defined, delineated and remunerated. One cannot allocate profits without having a full picture of all transactions and flows which may have an impact thereon.

However, if some differences would occur, this would rather be the case in such circumstances where the contractual allocation of risks does not match with the economic ownership thereof. Depending on which Article is applied first, one could discuss if the remuneration for the economic ownership should be covered in the determined arm's length remuneration between the related parties (application of Article 9) or should it rather be allocated to the Permanent Establishment (application of Article 7)<sup>1</sup>.

For such purposes, it would make some sense for the OECD to include a formal guidance on the preferred order in which the analyses are applied in its final report 'Additional Guidance on the Attribution of Profits to Permanent Establishments'. This would avoid any misunderstandings and lead to a common harmonised approach.

## 2. Example 1

**Question 2** – Do you agree with the functional and factual analysis performed in Example 1 under the AOA?

Taking into account the provided facts and circumstances, we do agree with the conducted functional analysis and the conclusions that were reached based upon the functional analysis, being that:

- (i) Sellco, as a limited risk sales agent, is entitled to an arm's length commission, reflecting its low risk profile, for its sales activities; and,

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<sup>1</sup> See also comments provided further below on example 2 of the discussion draft.

- (ii) No additional profits should be allocated to the dependent agent Permanent Establishment.

**Question 3** – Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?

We partially agree with the construction of the profits or losses of the dependent agent Permanent Establishment.

As mentioned here above, we do agree with the fact that no additional profits should be allocated to the dependent agent Permanent Establishment. However, we do have a comment with respect to the allocation of costs between Prima's Head Office and the dependent agent Permanent Establishment. Considering that the cost of the commission paid to Sellco for its sales activities is being allocated to the dependent agent Permanent Establishment, we would have expected that also the reimbursement of advertising expenses incurred by Sellco would have been allocated to the dependent agent Permanent Establishment. The reimbursement – like the commission – also relates to the sales agent activities Sellco performs for Prima and should therefore, in our view, also be allocated to the dependent agent Permanent Establishment.

As such, it does not have any impact on the results (operating profit) whether the reimbursement is allocated to Prima's Head Office or to the dependent agent Permanent Establishment, considering that the profits attributable to the dependent agent Permanent Establishment is nihil. However, this being said, discussions/conflicts may arise in the event that tax authorities in Country A (Prima's Head Office jurisdiction) would make the same assumption and therefore not apply the Authorised OECD Approach ("AOA") as outlined in the discussion draft and subsequently reject the cost deduction of "7" in Country A.

This comment is relevant for all examples provided throughout the discussion draft, considering that in all examples the reimbursement of costs has been retained at the level of Prima's Head Office.

**Question 5** – Is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?

We find it indeed appropriate, considering that the actually conducted activities by Sellco in Country B are already compensated through the commission paid by Prima. It would not be appropriate to allocate any additional profits to the DAPE, because by doing so, the same activity would be compensated and taxed twice, leading to double taxation.

### 3. Example 2

**Question 6** – Do commentators agree with the construction of the profits or losses of the DAPE in example 2 under the AOA?

We have some remarks/concerns with respect to the profits or losses of the DAPE and therefore do not fully agree with the results as provided in the discussion draft. Our remarks/concerns mainly result from the interaction between Article 9 and Article 7 in such circumstances where the contractual allocation of risks does not correspond with the actual allocation of risks.



Our remarks relate to the allocation of the economic ownership of the inventory risk and the credit risk. We fully understand the reasoning behind the reached conclusion that Prima, although it contractually assumes the risks, does not exercise control over the inventory and credit risk and subsequently the economic ownership thereof should be reallocated. However, it is not quite clear why this economic ownership is reallocated to the DAPE rather than to the DAE Sellco, who is performing the functions and bearing the risks from an economic perspective. Moreover, we do not fully agree with the translation of the reached conclusion into the numerical illustration for following reasons:

- Although the economic ownership of the inventory and credit risk – according to the example as provided in the discussion draft – is being allocated to the DAPE, all the costs related to bad debt losses and inventory losses are deducted at the level of the DAE Sellco and therefore its arm's length remuneration under application of Article 9 should already cover the economic ownership. If the economic ownership is to be allocated to the DAPE, there is somehow double use between DAPE and DAE. Indeed, Sellco – who has an increased functional profile and increased risk profile compared to example 1 – receives a higher commission for its sales activities in order to reflect this increased profile. Sellco is therefore, through the increased commission, remunerated for the economic ownership of the inventory and credit risk and not the DAPE; and,
- Sellco is the one bearing the funding return cost in order to compensate Prima for its legal ownership of the inventory and therefore the funds Prima has laid out for the inventory. Under paragraph 43 of the discussion draft we understand that the remuneration of "2" (funding return) has as objective to compensate Prima for its legal ownership of the inventory and therefore the funds it lays out for it. However, when reading paragraph 54 of the report it seems that the "2" rather represent the remuneration for the economic ownership of the assets to be allocated to the DAPE. In our view those are completely two different things, separate from each other. We have therefore the feeling that both paragraphs are contradicting each other, which creates confusion and uncertainty on how to interpret the example. We would therefore suggest to reword or clarify the purpose of the "2" funding return in order to avoid any misunderstandings. Taking the assumption that the funding return of "2" is indeed the compensation for Prima's legal ownership of the inventory, we were surprised that it was reallocated to the DAPE in the example as a reward for economic ownership. By doing so, we have the feeling that the envisaged concept is not to allocate income to PEs based on economic ownership but to exclude any taxation rights of legal ownership rewards in the 'home' country in case economic ownership is located elsewhere. One may reconsider the wording or providing additional guidance on the topic in the event this is not supposed to be the case.

In our view, only if based under the application of Article 9 Sellco is not rewarded for its economic ownership, it makes sense to allocate part of the (too high) remuneration of Prima for its legal ownership to DAPE. In addition, a full allocation of reward for legal ownership to DAPE systematically assumes full allocation of the underlying capital linked to the assets to the DAPE.

**Question 8** – What would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risk? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?

With respect to this question, we would like to provide a general comment, independent from the raised question itself. Namely, though we understand that the scope of the examples provided in this report is only to illustrate how to apply the guidelines with respect to profit allocation to PEs, we are of the opinion that the examples are missing the asset and capital allocation aspect. Especially considering the



increased importance of the determination whether or not an entity has the financial capacity to bear the risks it is supposed to bear following the final BEPS report action 8 – 10. This would also allow to assess the 'financial capacity to bear risks' criteria as well and what to do in cases where a party does actually control the risks but does not have the financial capacity.

Coming back to the actual question, if Sellco would not have the financial capacity to bear the risks it controls, it will most likely be Prima who will bear it, in its role of principal. It is indeed in Prima's best interest to provide financial support to Sellco in case of potential bad debt losses or inventory losses in order to avoid Sellco to go bankrupt. However, between unrelated parties such financial support would have an influence on the agreed pricing arrangement. Therefore, following the arm's length principle, the commission payable to Sellco will have to take this aspect into consideration. This would most likely result in a lower commission fee payable to Sellco.

The impact for the profits attributable to the DAPE would be very limited, as the financial support provided by Prima to Sellco does not give rise to any additional significant people functions performed by Sellco – for the account of Prima – in Country B. However, one could discuss if, the fact that Sellco does not have the financial capacity to bear the inventory and credit risk, it means that the economic ownership also does not longer lies at the level of the DAPE (in example 2). In such case, the impact in example 2, as currently outlined in the discussion draft, would be that the "2" funding return would not be attributable to the DAPE anymore, resulting in a nihil end result for the DAPE.

Prof. Dr. Eleonore Ronge

Wiesbaden, September 4th, 2016

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OECD/CTPA

Tax Treaties, Transfer Pricing and Financial Transactions Division

**Re : Public Discussion Draft BEPS ACTION 7 - Additional guidance in the Attribution of Profits to Permanent Establishments**

Dear Madam,

Dear Sir,

In the following I would like to comment on the questions raised in the Public Discussion Draft in the order mentioned therein.

**Ad question 1**

In some of the cases the Discussion Draft describes Art 9 and Art 7 apply because an associated enterprise constitutes a PE for the non-resident enterprise in the other contractual state. If in these cases transfer pricing issues arise in order to determine profits and losses of the PE Art 9 must apply first for logical reasons. This relates, however, only to the determination of the appropriate transfer price(s). It does, in my opinion, not imply that the analysis under Art 7 must necessarily adopt other conclusions of an analysis under Art 9 like e.g. the allocations of assets and risks. In this Art 7 and the analysis following its principles should prevail over Art 9.

**Ad question 2**

Example 1 seems to be contradictory because the specified activities performed by Sellco for Prima can constitute either an independent or a dependent representative under Art 5. Assuming a PE in this case seems - at least from a German prospective - doubtful. Nonetheless, if according to the facts a PE is assumed, there is in my opinion no room for an analysis according to Art 9 which would require transactions between two related companies i.e. an independent agency and no PE. Therefore, only an analysis under Art 7 should be applicable.

The other question is whether a PE needs own personnel or Sellco 's personnel acting performing sales functions for Prima is sufficient. If the latter alternative applies, at least the customer base in Country B should be allocated to the PE as Sellco provides in this respect significant people functions. It is, therefore, inconsistent that there are no risks or assets attributable to the PE. Accordingly, it seems adequate to allocate profit to the PE. On the other hand, I do not think that the „sales

commission” to be paid to Sellco should include a share in the profit but a mere refund of costs incurred. Otherwise, and as the example shows clearly, the difference between a PE and an independent agency tends to disappear.

#### **Ad question 3**

See answer to question 2 above.

#### **Ad question 4**

Under the regulations existing prior to the implementation of the AOA the results should not differ substantially.

#### **Ad question 5**

If at all a PE exists in the case described in the Discussion Draft it will be, as explained above, not appropriate to allocate no profit to it. Sellco performs significant people functions in behalf of Prima which must be allocated to the PE, in particular, a customer base in Country B. Accordingly, there must be a profit share.

#### **Ad question 6**

I doubt whether it is possible to allocate the inventory risk to Sellco and keep the title in the goods with Prima as this risk is linked to the legal/economic ownership in the inventory. If the inventory risk is transferred to Sellco the economic ownership in the inventory should pass to Sellco simultaneously. Sellco’s financial capacity is irrelevant.

As regards the credit risk, the risk reflects the possibility that the customer does not pay the outstanding purchase price. This risk is in my opinion inevitably borne by the legal owner of the underlying receivable and cannot be transferred separately. Sellco’s activities may have an influence on the possibility to collect the receivables but this is not sufficient to transfer the credit risk which remains with Prima.

#### **Ad question 7**

No differences to be expected.

#### **Ad question 8**

There are no consequences to be expected as the financial capacity has no influence on the result. Both risks have to be attributed to Prima anyhow, see answer to question 6. Sellco has in my opinion no share in the profit and is merely refunded costs incurred with respect to its activities on behalf of Prima.

#### **Ad question 9**

As already explained I find it difficult to apply Art 7 and Art 9 to transactions simultaneously because it contradicts the system of Art 5 of the Model Convention. The inventory risk and the credit risk are initially with Prima as a result of legal ownership. In addition, I miss an explanation on how the economic ownership is transferred to Sellco, respectively to the PE, in the example and possible tax effects of such a transfer.

As regards the funding return allocated to the PE there is no necessity for it. Furthermore, said funding return does not correspond to annot. 235 et seq. of the 2010 Attribution of Profits Report. The Report does not provide for such a payment but merely deals with the allocation of free capital to a PE. There is unfortunately no indication in the Discussion Draft on how Prima is funded.

**Ad question 10**

I agree with the conclusions.

**Ad question 11**

In comparison with older German DTC the result would be most likely similar.

**Ad question 12**

I do not agree with the construction of profits or losses of the PE for the reasons explained in the answers to questions 6 to 9 above.

**Ad question 13**

The reason lies indeed in the allocation of risk between two separate entities in comparison to the allocation of risk within the same entity. The result of the Discussion Draft is not convincing because under the arm's length principle the taxable profit should not depend upon whether or not a related person is involved in business transactions.

**Ad question 14**

In essence, I agree with the construction of profits and losses of the PE.

**Ad question 15**

Scenario C is a critical case of a PE. It is doubtful whether it should be treated as a PE at all. In any case, under German tax law there is no provision dealing with hypothetical „investment income“ in connection with real estate which is owned and used by the enterprise itself. There is of course a difference comparing ownership of real estate with a tenancy. The financial effect is, however, not calculated separately but indirectly part of the overall profit of the entity.<sup>1</sup>

**Ad question 16**

Generally speaking, it seems to me that PE without own personnel do not generate substantial profit. This is in line with the AOA which allocates profits according to significant people functions. Therefore, I feel that, as a rule, own personnel in the PE state should be a requirement for a PE.

**Ad question 17**

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<sup>1</sup> Wassermeyer, Doppelbesteuerungsabkommen, Art 6 OECD-MA, annot.97.

I do not agree with the Discussion Draft in this respect because it tends to expand the definition of a PE to a simple investment in the other contractual state. Germany does not provide for a taxation of such hypothetical income at all, there is merely an indirect effect on the overall profit of the enterprise. Thus, hypothetical income of this sort can hardly be the basis of taxation. The more so, since the complexity of such calculations for the taxpayer and the tax administration will exceed by far any positive effects on tax revenues.

**Ad question 18**

As already mentioned, I think that own personnel should be a requirement for the assumption of a PE. In addition, there is hardly a reason for assuming a PE if no profit can be allocated to it.

If, contrarily to that, significant people functions performed by another party were allocated to a PE, it would be consistent to attribute risks and assets to it. There may be compensations/refunds to be paid to the other party with respect to costs incurred or services rendered but the profit of the PE can then not be nil.

**Ad question 19**

Under the arm's length principle there should be no difference.

**Ad question 20**

The requirement of own personnel for a PE in the other contractual state was already discussed under former versions of the OECD Model Convention and prior to the implementation of the AOA. Under older DTC there would of course be no allocation of hypothetical investment income for the warehouse. Most likely the profit allocated to the PE would be small or nil in case no own personnel is employed by the PE.

**Ad question 21**

It may be useful to provide for a priority of Art 7 over Art 9 in case of diverging results of profit allocation to a PE. Further, it may be useful to provide for arbitration proceedings in case of deviating results of profit allocation in the contractual states.

Yours sincerely,

Prof. Dr. Eleonore Ronge

# **European Business Initiative on Taxation (EBIT)**

**Comments on OECD Public Discussion Draft on BEPS Action 7:  
Additional Guidance on the Attribution of Profits to Permanent  
Establishments**

EBIT's Members at the time of writing this submission: AIRBUS, BP, CATERPILLAR,  
CONSTELLATION BRANDS, DEUTSCHE LUFTHANSA, DIAGEO, GSK, HUAWEI, INFORMA,  
INTERNATIONAL PAPER, JTI, PEPSICO, RELX, ROBECO, ROLLS-ROYCE, SAMSUNG,  
SCHRODERS, SHV, TUPPERWARE, UTC.

**EBIT comments on OECD Public Discussion Draft on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments**

Submitted by email to: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

Brussels, 5 September 2016

Dear Mr VanderWolk,

EBIT is grateful for this opportunity to comment on the OECD Public Discussion Draft on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments (the “Discussion Draft”) dated 5 July 2016.

EBIT has a number of general concerns with the Discussion Draft which are set out below.

- EBIT welcomes the recognition in the Discussion Draft that there may be PEs, especially under the lower thresholds recommended in Action 7, to which little or no profit should be attributed.
- There has been to date little consistency of approach by tax authorities in relation to attribution of profit. There are different interpretations of the authorised OECD approach (AOA) and many authorities adopt methods which could not be described as falling within the AOA. Additional clarity in the AOA and greater and more consistent adoption by tax authorities would ease the compliance burden considerably. Where tax authorities do not follow the AOA, fees for intangibles like know-how and software might not be deductible in the PE and that no margin would typically be allowed on fees for services to the PE.
- The processes for assessing transfer prices under Article 9 and PE profit attribution under Article 7 would be more greatly coordinated in the case of a dependent agent PE (DAPE) if the compliance activities of the agent and the PE were either handled by the same tax authority compliance officer/ team or there were active collaboration between respective officers/ teams resulting, where necessary, in a single tax audit. EBIT has experienced separate enquiries and audits being carried out by different officers/ teams putting forward conflicting arguments. In one case a transfer pricing audit of a subsidiary providing local marketing and support services to its head office concluded that the service fee was not arm’s length. Additional income was subsequently attributed to the subsidiary by the Tax Officer. Independent of the transfer pricing audit the Tax Authority deemed the subsidiary to constitute a DAPE of the head office and apportioned some of the profits on local sales derived by head office to the DAPE. As the two audits were carried out in isolation, profit apportionment to the DAPE gave no consideration to the additional service fee income apportioned to the subsidiary following the transfer pricing audit. This resulted in the same profits being taxed twice in the subsidiary country with no permitted credit in the head office’s country of residence.
- We do generally agree that the Article 9 analysis should be carried out first and then the Article 7 analysis should follow, but in practical terms this has not always taken place. That is also vital to the proper operation of intra-country transfer pricing arrangements and transactional taxes like VAT as well as cross-border withholding taxes.
- Having a PE with a zero profit attribution is not the same as not having a PE. It can, for example, mean ~~we~~ that companies would need to sort out payroll withholding from day one for business visitors, and in some territories there would be a presumption that a fixed establishment for VAT or other taxes had been created. Therefore, we would urge the OECD to discourage territories from speculatively claiming the existence of a PE where the ultimate analysis is likely to lead to a low or zero profit attribution to the PE.

**EBIT comments on OECD Public Discussion Draft on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments**

As the OECD recognises elsewhere, the recording and reporting of the activities of a PE creates administrative cost for both MNEs and tax administrations: this is particularly burdensome where the profit attributable to the PE is zero or very small. Consideration should therefore be given to establishing a de minimis threshold below which the activity of a PE would not need to be reported, and the related administrative burdens and exposure to other taxes and reporting obligations avoided.

- This is particularly important where a PE would not have arisen but for a broad interpretation of the new anti-fragmentation rules. For example, new paragraph 22.3 of the commentary on Article 5 (as set out in the 2015 Final Report on Action 7) gives the example of an independent logistics company in State S, operating a warehouse in which it maintains a stock of goods belonging to an enterprise of State R. The commentary states that in some circumstances the enterprise of State R may have a sufficient level of access to the building for the purposes of inspection that this constitutes a fixed place of business of that enterprise. That right of inspection may be required for regulatory reasons. In most commercial situations – particularly where facts differ from the online retailer example in new paragraph 22 – the enterprise of State R could analyse those activities as preparatory or auxiliary, such that subparagraph 4(b) of Article 5 exempts it from PE status. However, Example B of new paragraph 30.4 of the Commentary appears to state that if a subsidiary of RCo is distributing products in State S, and taking delivery from the warehouse, then the exceptions of paragraph 4 cannot apply – and a PE exists regardless of how minimal the activities are. This seems to apply even in the present case where (unlike in paragraph 30.4) RCo does not own or operate the warehouse. The Discussion Draft suggests – rightly in our view – that zero profit would be allocated to that PE. This is by analogy to Scenario C, where a return commensurate with economic ownership of the warehouse is contemplated, noting that in the present case the warehouse is not owned by RCo. Regardless of this, however, PE obligations would have been created.
- The practical implications of setting up a branch outside the territory of residence of the head office, which may be mandatory in the overseas territory when a PE is created, should not be underestimated. Registration and filing/ reporting requirements are often quite extensive. In the case of a dependent agent PE (DAPE), the position could be greatly simplified if the dependent agent were able to fulfil these administrative requirements on behalf of the PE and in the course of its own tax compliance. The information could then be shared with the head office's tax authority under the relevant treaty or tax information exchange agreement, etc.

More specifically in relation to the five examples included in the Discussion Draft:

- It is important to note that the overly simplistic 'binary' examples set out in the Discussion Draft do not reflect the reality of what EBIT members have experienced. Many situations are far more complex, with an entity potentially have a large number of PEs and a particular dealing constituting a PE of more than one entity.
- A clear distinction should be made in the case of different kinds of warehousing. Many businesses will need to use warehouses for a range of purposes relating to a wide variety of inventory risk issues. Where a warehouse does in these circumstances constitute a PE (or contribute to the recognition of an operation as a PE) under the revised thresholds, it is a very different profit attribution scenario from that applicable to the type of online retailer often referred to in relation to the 'preparatory and auxiliary' versus core activity dispute. As in Example 1 were there to be a warehouse in Country B, the value attributable to warehousing for businesses other than online retailers would tend to be considerably lower (the position is further considered in Example 5).
- Further, Example 1 illustrates the recognition of a balancing figure for costs where sales revenue is allocated to the DAPE. This is the only way to arrive at the appropriate



**EBIT comments on OECD Public Discussion Draft on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments**

attribution of profit for the DAPE, but is a problem that we have experienced with some tax authorities which don't have a concept of using such a balancing figure (preferring an allocation of local source income minus deductible expenses).

- Example 2 illustrates the situation in which an associated person acts on behalf of the non-resident enterprise and performs control functions related to risks contractually assumed by the non-resident enterprise. We would not generally expect an associated sales agent to control many functions without oversight on a regional or global basis.
- In Example 3, the non-resident enterprise acting as a principal sends an employee to the host country to perform activities that give rise to a DAPE. We find it a reasonable illustration of the situation in which the functional and factual analysis might attribute to the DAPE: inventory risk and receivables risk (significant people functions or SPFs performed by the employee), economic ownership of the company vehicle used (place of use and paragraph 75 of the 2010 Attribution of Profits Report) and capital to fund the risks and assets attributed to the DAPE.
- In Example 4, both the dependent agent and the head office have capacity to decide credit terms with customers and both actually perform the decision-making functions. The agent actively manages the recovery of customer receivables resulting from the decisions to extend credit, but significant decisions on account management are taken by head office (which contractually bears the bad debt risk, exercises control over the risk and has the financial capacity to assume the risk). On a functional analysis the attribution of risks and economic ownership of assets to the DAPE based on the SPFs undertaken by the agent on behalf of the head office (but also the head office itself) includes a proportion of the decisions that lead to the assumption of credit risk together with economic ownership of receivables. That is, in the context of the Article 7 analysis, there are considered to be split SPFs and so there is then a split of return on the receivables and then also on the fees paid. We believe that splitting SPFs can lead to significant complexity.
- Example 5 distinguishes the functioning of a warehouse in which scenarios B and C are most relevant to EBIT (Scenario A relating to ownership of inventory by customers). In Scenario B, in which the agent's employees operate the warehouse, a small return on inventory may be appropriate as noted above but additional clarity would be welcome to confirm that it is not assumed that there would be any allocation of customer revenues to the DAPE (a service fee would be more likely). In Scenario C, where the operation of the warehouse is carried out by a third party, if there is a DAPE it has no people and the profit attributable is likely to be zero on the basis of a risk free return and payment for funding costs and investment management services.

EBIT trusts that the above comments are helpful and will be taken into account by the OECD in finalising its work in this important area. EBIT is committed to constructive dialogue with the OECD and is always happy to discuss.

Yours sincerely,

**European Business Initiative on Taxation – September 2016**

For further information on EBIT, please contact its Secretariat via Bob van der Made, Telephone: + 31 6 130 96 296; Email: [bob.van.der.made@nl.pwc.com](mailto:bob.van.der.made@nl.pwc.com)).

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Tax Treaties, Transfer Pricing and Financial Transactions Division  
Centre for Tax Policy and Administration  
Organisation for Economic Cooperation and Development  
By email

## **PROPOSED ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS**

4 September 2016

Dear Sir / Madam,

By means of this letter, EY would like to share its comments on the public discussion draft on “BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments” (the Discussion Draft) as released by the OECD on 4 July 2016. We appreciate the opportunity to provide comments and to contribute to the public consultation and discussions regarding the guidance on the attribution of profits to permanent establishments (PEs). This letter presents the collective view of EY’s global international tax network.

Our comments with respect to the Discussion Draft are structured two-fold. First, we provide our overarching comments to the Discussion Draft which we consider to be relevant in addressing issues that are not covered by the specific questions raised to the public commentators, as well as to frame an accurate response to those questions regarding the profit attribution to PEs under the fact patterns and examples provided in the Discussion Draft. The second section contains our responses to the specific questions raised by the Discussion Draft in connection with the examples provided.

We emphasize our concerns detailed below about a proliferation of PEs with limited to no profit attributed to them. This will create a major compliance burden for both multinational taxpayers and tax administrations, while increasing the risk of double taxation. This effect (whether intended or not) clearly goes beyond the potential base erosion and profit shifting (BEPS) activities that are the focus of the OECD’s BEPS project and creates additional burdens on both the taxpayer and tax administration with no corresponding benefit for either party.

If you have comments or questions, please feel free to contact any of the following:

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Yours Sincerely,  
*On behalf of EY*

John Hobster / Ronald van den Brekel

## 1. General comments to the Discussion Draft

### Zero-profit PEs

It is expected that the lowered PE threshold of Article 5 of the Model Tax Convention (MTC) will result in an increase in situations where a taxpayer may have created a PE. The Discussion Draft recognizes that in some cases a taxpayer may have a so called “zero-profit” PE i.e. a PE where no profits are attributed to because there are no significant people functions performed by the PE. Further, the Discussion Draft acknowledges the additional compliance burden on the taxpayer that will result from the increased number of PEs, as well as the fact that other tax liabilities could also arise in connection with the creation of a zero-profit PE. This increased compliance burden is not only limited to the taxpayer, but also creates additional resource constraints on tax administrations that have to deal with the increased administrative burden in return for little or no additional taxable profits.

Clearly, such an outcome benefits neither the taxpayer nor tax administrations. As such, we urge the OECD to consider a pragmatic approach for dealing with zero-profit PEs. One possibility would be to provide an exemption to the creation of a PE if it is clear that no profit would be attributable to such PE under Article 7 of the MTC. In other words, a zero-profit PE should not be considered a PE, and therefore not trigger any filing or other administrative requirements. If this matter will not be solved by a further modification to Article 5 of the MTC, we urge the OECD to encourage tax administrations to address this by allowing an exemption for zero-profit PEs unilaterally through their domestic tax legislation. Such an action does not contradict the focus of the OECD’s overall BEPS project and would reduce the barrier on cross-border trade and investment created by the lowered threshold for the recognition of PEs under Article 5 of the MTC.

We support the guiding principle that the allocation of profits to PEs should be based on people functions only. From a policy perspective, no profit should be attributed to a PE without people functions and therefore these situations should be exempted from PE status to prevent the proliferation of zero-profit PEs that do not benefit the taxpayer or the tax administration.

### Coordinated application of Article 7 and Article 9 of the MTC

We are concerned about the possible negative side effects in the form of double taxation that may arise if a tax administration may disagree, or arrive at a different conclusion, when applying a singular analysis under either Article 7 or Article 9 of the MTC without considering the overall outcome that would result if an analysis under Article 7 and Article 9 of the MTC is performed in parallel, e.g. when a tax administration adjusts the profit of an dependent agent entity (DAE) without adjusting the profit of the dependent agent PE (DAPE).

Therefore we recommend further guidance be provided to tax administrations to ensure that a coordinated application of the analyses under both Article 7 and Article 9 of the MTC must be performed when examining a DAPE or DAE. Furthermore, taxpayers should be guaranteed access to dispute resolution mechanisms available and that access should not be restricted for reasons such as a reversal of burden of proof, or incorrect corporate income tax filing claims that may arise from a disagreement as to how Article 7 or Article 9 of the MTC have been applied.

### Pre-2010 Article 7 of the MTC

The Discussion Draft asked what would be the conclusion if a profit attribution approach other than the 2010 Authorized OECD Approach (AOA) is applied. We have understood this to mean the OECD approach used pre-2010. As the OECD itself acknowledges that few countries have adopted the 2010 version and are unlikely to adopt the 2010 version in the future, we believe it is very important for the OECD to provide concrete guidance on situations where countries apply pre-2010 versions of Article 7, including but not limited to clarifying the application of the 2008 version of the AOA to pre-2010 versions of Article 7.

### Clarification on the goal of the Discussion Draft

It is not entirely clear whether the guidance in the Discussion Draft will be included in further commentary to Article 7 of the 2010 MTC, or whether the guidance in the Discussion Draft will be incorporated in a future update to the OECD's 2010 Attribution of Profits Report. As such, clarification on this point would be helpful.

### Use of examples

Although the use of various examples throughout the Discussion Draft is very useful in illustrating how profits should be attributed to DAPes and fixed place of business PEs, additional guidance ought to be provided as well for other PEs not covered by the Discussion Draft. In particular examples illustrating how profits should be attributed to:

- ▶ PEs created by the application of the new “anti-fragmentation rule”;
- ▶ DAPes that provide services under ongoing contracts. In particular, should profits be attributed for periods following the period that the initial DAPE was created? The OECD should clarify the approach over the period of the service provision and whether the DAPE may be deemed to have ceased to exist after the initial recognition criteria for the DAPE have been met; and
- ▶ DAPes created by an entity that centrally performs activities on behalf of multiple local entities. The current Discussion Draft focuses on a local sales entity (SellCo) acting on behalf of a central entity (Prima) and thereby creating a DAPE of the central entity. However, multinationals today are also characterized by global organizational structures whereby certain activities are performed centrally on behalf of a number of local entities. Procurement and key account management are classical examples. Since under the new Article 5 those activities may potentially create DAPes of the local entities in the country where the central activity happens, it would be helpful to have an example in the Discussion Draft.

Clarification on how the internal dealings were characterized is required, specifically for those examples relating to DAPes. In Example 1, the construction of the profit and loss statements seems to presume that the dealing between the DAPE and the head-office is that of a buy-sell transaction as the sales in Country B were attributed to the DAPE. However, the facts of Example 1 are such that the dealing between the DAPE and head-office could also be seen as the provision of sales agent services. Example 1 contains no explanation as to why the dealing should not be seen as the provision of sales agent service. For completeness, the OECD should provide more guidance on the criteria used to characterize the internal dealing between the DAPE and the head-office since this

ultimately affects the construction of the hypothetical profit and loss statement of the DAPE and the determination of the most appropriate transfer pricing method.

*Application of profit attribution guidance to the financial sector*

Paragraphs 19-20 of the final version of the Report on Action 7 indicated “...that there is a need for additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in this Report, in particular for PEs outside the financial sector.” Does this mean that the profit attribution guidance in the Discussion Draft would also apply to PEs created in a financial sector context, or does the OECD take the view that the attribution of profits in a financial sector context is sufficiently covered by the 2010 Attribution of Profits Report?

## 2. Response to specific questions

Question 1. Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.

We believe an analysis under Article 9 should first be conducted, as the analysis under Article 7 can only be concluded after an arm's length business transaction attributable to the DAPE has been determined under Article 9. A key starting point for an Article 9 analysis involves analyzing the contractual relation between the DAE and its counterparty. This is a critical component if the dealing between the DAPE and the head-office is to be hypothesized properly so that a proper analysis under Article 7 can be carried out. We recommend that the OECD provide guidance on this.

Question 2. Do you agree with the functional and factual analysis performed in Example 1 under the AOA?

We agree with the functional and factual analysis performed in Example 1 under the AOA subject to our general comments above on the need for further clarification on how the dealing has been characterized and the basis for allocating sales to the DAPE.

Question 3. Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?

We have two questions/observations here:

- (a) Should the external sale be attributed to the DAPE (as a hypothesized entity) as a buy-sell dealing between the head-office and the DAPE, or should the external sale be attributed to the head-office, such that the DAPE is hypothesized as a sales agent (i.e., just as SellCo)?
- (b) Attributing external sales to the P&L of the DAPE in case of SellCo not performing any functions that go beyond a sales agent might tempt tax administrations to attribute more than a sales agent remuneration to the DAPE.

*Ad (a):*

Paragraph 36 of the Discussion Draft states that the external sale is attributable to the DAPE, but no criteria supporting the attribution are presented. Although it appears plausible to attribute the external sale to the DAPE (given that it is the sales activity of SellCo that gives rise to the DAPE under Article 5) it is also equally possible under the right facts and circumstances to hypothesize the DAPE as a sales agent (given that the AOA requires hypothesizing the DAPE as a separate entity) especially with the lowering of the DAPE bar to include entities simply taking the lead role in negotiations. Attributing the external sale to the DAPE may be correct in Examples 2 and 3 (where SellCo acts like a buy-sell distributor), but in Example 1, SellCo does not perform any functions that go beyond what a sales agent would do in transactions between unrelated parties. In other words, SellCo in Example 1 “walks, talks and acts” like a sales agent. In this case, hypothesizing the DAPE as a sales agent would be in line with the AOA. If unrelated parties can have sales agent arrangements, why should a DAPE not be able to have this arrangement under the AOA? Moreover, the 2010 Attribution of Profits Report (paragraph 230 – 245, in particular paragraph 244) does not include any reference to a mandatory attribution of the external sale to the DAPE.

The OECD should provide more guidance on the attribution of the external sale to the DAPE, as this step is critical for three reasons:

- ▶ The attribution of the external sale determines the profit and loss construction of the DAPE, and hence the construction of profits. It is technically doubtful whether the profit of the DAPE can still be zero if the DAPE is hypothesized as a buy-sell entity, while the local agent entity is a sales agent.
- ▶ Some countries require a full accounting set-up even for a DAPE. Costs for implementing and running a full transactional accounting set-up for a (hypothesized) buy-sell entity are significantly higher than for a (hypothesized) sales agent.
- ▶ Characterization of the dealing between the head office and the DAPE is a prerequisite for applying the second step in the AOA, i.e., determining which transfer pricing method is the most appropriate method for setting the arm's length price for the dealing.

*Ad (b):*

The DAPE is hypothesized as a buy-sell entity reporting sales and cost of goods in its (hypothesized) profit and loss statement. At the same time, the example states that no assets, risks, and capital are attributable to the DAPE. If receivables, payables, or inventory were allocated to the hypothetical P&L of the DAPE, tax administrations might be tempted to argue that an additional funding return (similar to Example 2) would also need to be allocated to the DAPE which is not absorbed by the commission payment (i.e. the payment made to SellCo whereby the expense is then allocated to the DAPE), since that commission payment clearly does not include a funding return due to the fact that SellCo does not own any assets.

While the end result of the construction of the P&L is correct (i.e. zero-profit), we question whether the external sales amount should be allocated to the DAPE. The OECD should provide further guidance on the two conceptual issues discussed above.

*Question 4. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?*

It is assumed that the wording of Article 7 referred to here is the pre-2010 version of Article 7 of the MTC.

The differences between the pre-2010 version and 2010 version of Article 7 of the MTC are in what might constitute a dealing. With the 2010 version of Article 7, and the full application of the AOA, this will include any occasion where a real and identifiable event has occurred (paragraph 134 of the 2010 Attribution of Profits Report). The only limitation to what might constitute a dealing is whether the dealing is of economic significance. In other words a threshold is applied.

The pre-2010 version of Article 7 of the MTC places greater restrictions as to what might constitute a dealing. This is partly due to an interaction of paragraphs 2 and 3 of the pre-2010 Article 7 which inter-alia limit the recognition of a dealing for general management functions and licenses for intangibles within an enterprise.

The question is how this difference between the pre-2010 and 2010 version of Article 7 of the MTC will affect the facts sets out in Example 1. In our view, much of the analysis for a hypothesized entity will remain the same. For the analysis it would be important to understand which dealings are to be recognized, but since there are no general management nor intangible dealings, the outcome would not be different under the pre-2010 Article 7. Given the number of treaties based on the pre-2010 Article 7, we recommend the OECD provide explicit guidance on this.

Question 5. In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?

If an arm's length price has been paid to the DAE under Article 9, then we agree that no further profits should be attributed to the DAPE in cases illustrated by Example 1.

Question 6. Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?

In Example 2, applying the guidance of BEPS Action 8-10 will first result in the commission payment due to SellCo already including a reward for the risks deemed to be assumed by SellCo but are contractually borne by Prima. This basically extinguishes the profits otherwise attributable to the DAPE, except for the funding return.

Example 2 raises three questions:

- (a) Has the DAPE been correctly hypothesized as a buy-sell entity? (see our comments to Question 3)
- (b) Has the guidance of BEPS Action 8-10 been applied correctly?
- (c) Has an adequate funding return been calculated?

*Ad (a):*

Given that SellCo in Example 2 performs additional functions, e.g., it manages inventory levels and customer receivables risk, it is correct to hypothesize the DAPE as a buy-sell entity.

*Ad (b):*

Under the guidance on BEPS Action 8-10, SellCo has to be remunerated for assuming the inventory and accounts receivable risks. It is also allocated the financial consequences of these risks materializing (i.e. bad debt losses and inventory losses).

*Ad (c):*

It seems as if the funding return in Example 2 is only calculated based on the inventory allocated to the DAPE. As a hypothesized buy-sell entity owning inventory, we would expect that in addition to inventory, customer receivables and inter-company payables would be allocated to the DAPE. Therefore, the funding return as calculated in Example 2 would also need to take into account the total working capital balance (i.e. receivables plus inventory less payables).

Question 7. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

Our response to Question 4 is also applicable to the fact pattern in Example 2. In summary, the differences between the pre-2010 and 2010 version of Article 7 of the MTC should not have an effect on the fact pattern presented.



Question 8. In your opinion, what would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?

If SellCo does not have the financial capacity to assume these risks, then the party that has the capacity to bear and manage those risks under the functional analysis should be allocated those risks. Based on an Article 9 analysis, the risk would be allocated to SellCo, assuming SellCo has the financial capacity to bear the risk, because Prima does not manage those risks. If SellCo does not have the financial capacity to bear these risks, they cannot be allocated to SellCo. As a result, we have a situation where neither of the parties can be allocated the risk because one did not have control of the risk (Prima), while the other did not have the financial capacity to bear the risk (SellCo). However, this is not an Article 7 issue, but an Article 9 issue, addressed in paragraph 1.99 of the OECD Guidelines. The mere fact that for Article 7 purposes the functions performed by SellCo are relevant for the attribution of profit to the DAPE does not mean that the control performed by SellCo can be allocated to Prima for Article 9 purposes.

Question 9. What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?

Paragraphs 230-245 of the 2010 Attribution of Profits Report are related to the possibility of the DAE performing significant people functions related to risks and assets which are contractually borne by the non-resident enterprise. In those examples, the profit associated with the risks managed/controlled by the DAE would have to be allocated to the DAPE, while the DAE would not be remunerated for those risks as it does not legally bear the risks. In giving these examples, the OECD was assuming that the commission paid to the DAE did not include a remuneration for the risk control functions performed by the DAE. In other words, paragraphs 230-245 of the 2010 Attribution of Profits Report did not yet take into account the guidance for risk allocation under Action 8-10.

Any further update to the 2010 Attribution of Profits Report will need to include substantial revisions to paragraphs 230-245 to reflect the guidance of BEPS Action 8-10.

Furthermore, although the conclusion that the economic ownership has to be attributed to the DAPE might be correct based on the current guidance of the 2010 Attribution of Profits Report, we question whether the outcome is desirable from a tax policy perspective. The effect of it is that profit - the investment return - is attributed to the source country, without any significant people functions performed by the entity itself. As a result, international business - and tax administrations - would be confronted with a myriad of PEs, with limited extra benefits for source countries. It would be more practical to clarify that no profit can be attributed to a (DA)PE, unless people functions are performed by the entity itself. If there are zero profits to be allocated to the DAPE, then taxpayers should be exempted from having a PE and the compliance burden associated with it.

Question 10. Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?

In Example 3, the DAPE is created by virtue of the sales activities performed by an employee, and not by a DAE. Similar to Examples 1 and 2, the DAPE is hypothesized as a buy-sell distributor due to the functions of the employee being similar to functions performed by SellCo in Example 2.

The main difference between Example 3 and Examples 1 and 2 is that there is no related entity in the country which has to be remunerated in line with the Article 9. Hence, there is no interplay between Article 7 and Article 9 in Example 3. While in Example 2 the commission payment made by Prima to the DAE basically extinguishes the profits attributable to the DAPE (except for the funding return), this is not the case in Example 3 where the commission payment to the DAE is replaced by a salary payment to the employee creating the DAPE. As the salary payment to the employee is not subject to an analysis under Article 9 of the MTC, there will typically be positive or negative profits attributable to the DAPE in case of situations similar to Example 3.

Question 11. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

Our response to Questions 4 and 7 is also applicable to the fact pattern in Example 3. In summary, the differences between the pre-2010 and 2010 version of Article 7 should not have an effect on the fact pattern presented.

Question 12. Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?

We believe that the outcome of the analysis in Example 4 is not correct and would also create unnecessary practical difficulties. Once it has been established that under article 9 the risk allocation to Prima should be accepted, and the related control functions of Prima are performed by employees of Prima at the head office only, no profits should be allocated under article 7 to the DAPE. The DAPE is not performing any significant people functions. The functions performed by SellCo as the DAE have been adequately remunerated under Article 9.

Question 13. Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?

We agree that the profits in example 4 result from a partial attribution of risk to Prima's DAPE while the contractual risk allocation between Prima and SellCo was respected in the first place. However, as indicated in the answer to Question 12, we do not agree that this is the correct answer.

Question 14. Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?

We agree that the end result of the construction of the P&L in Scenario A of Example 5 is correct as it essentially reflects the reward for the economic ownership of the asset and the routine functions performed at the warehouse. However we question if under the AOA, the dealings constructed to

compensate WRU for the granting of rights to the intangibles used by the PE, the services in analyzing inventory provided to the PE, and the compensation for investment advice, are necessary in this fact pattern.

Step 1 of the AOA is to identify the internal dealing between WRU and its PE, and where the significant people functions are performed relating to the assets used and risks assumed.

In this case, WRU performs all the significant people functions relating to the business and risk in Country A. It is also the legal and economic owner of all intangibles relating to the warehousing activity. There are no significant people functions performed in Country W. There is only a warehouse that is used by WRU to hold the spare parts of its third party customers through which WRU partly carries on its business in Country W. Based on this fact pattern, the internal dealing between WRU and its PE should be constructed as the supply of the warehouse (as an economic asset of the PE) for WRU to provide inventory holding services to its third party customers, as well as the provision of related warehousing services provided by the PE to WRU's head-office. It would then be necessary to price this dealing and attribute to the PE a reward for its (i) economic ownership of the warehouse and (ii) for the routine warehousing services performed. The end result of the profits in WRU's PE will be the same, however the construction of the profit and loss statements of WRU's PE to arrive at this outcome, will differ.

Additionally, we question whether the third party service transaction should be attributed to WRU's PE in this scenario, given that the outsourcing of these services has not been performed by WRU's PE in Country W, but have been performed by WRU's employees in Country A and therefore properly attributed to the head office and not the PE.

Question 15. Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?

We agree that WRU's PE should be attributed profits that reflect a return for the warehouse (asset) attributed to it and the routine functions it performs for WRU and that in this case, it would be correct not to attribute any of the third party fee income to WRU's PE since all significant people functions relating to this have been performed by WRU in Country A. Notwithstanding this, the dealing between the WRU and its PE should be clearly identified in step 1 of the AOA analysis. With respect to the return for the asset we refer to our answer to question 16 and 17.

Question 16. In particular, do you agree that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?

Question 17. Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?

We agree that in certain situations, based on the 2010 Attribution of Profits Report, economic ownership can be attributed to a PE, e.g. based on the use of tangible assets or the attribution of people functions performed by a DAE, without any people functions being performed by the PE. As indicated in our response to Question 9, we question whether the outcome is desirable from a tax policy perspective. It would be more practical to clarify that no profit can be attributed to a (DA)PE, unless people functions are performed by the entity itself. If there are zero profits to be allocated to

the DAPE, then taxpayers should be exempted from having a PE and the compliance burden associated with it.

Furthermore, paragraph 19 of the 2010 Attribution of Profits Report states that the consequences of attributing the economic ownership of assets under Step 1 for determining profits to be attributed under Step 2 may depend upon the type of asset and the type of business for which the asset is used. For example, economically owning a tangible asset used in a manufacturing process does not necessarily mean that the income from selling the goods produced using the asset are automatically attributed to the economic owner of the asset. This raises the question as to what level of return should be allocated under Article 7 to a PE that only has a mere economic ownership of an asset but does not perform any people functions.

Question 18. Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.

If there are no personnel operating at the fixed place of business PE, and significant people functions are performed by other parties in the jurisdiction of the PE for their own account, then these functions should not lead to the attribution of risks or assets nor profits to the PE.

Question 19. Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits to the PE of WRU?

This should not make any difference to the profit attribution outcome for the PE.

Question 20. What would the conclusion be, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

This concerns Example 5. Much of our answer to Question 4 is applicable here, although in scenario A, dealings to compensate the head-office for intangibles and for investment advice, may not be recognized under the pre-2010 Article 7. If the dealing would be determined as a warehousing service by the PE for the head-office, the dealing could be recognized. This stresses the importance of correctly determining what the dealings are, and whether the PE as a hypothesized entity would be allocated the sales income (with intangible and investment advice dealings from the head-office) or whether the head-office would be allocated the sales income (with the PE providing a service dealing).

Paragraph 35 of the commentary confirms that where the services of the PE are the same as supplied in the ordinary course of the enterprise's business or part of it that it will usually be appropriate to include a charge at the same rate applied to third party customers. Paragraph 36 then confirms that arm's length charges may be made in the attribution calculation where the services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise. These tests are different to that of the 2010 Article 7 threshold and may be seen it is suggested as less requiring of an arm's length price.

Question 21. Do commentators have suggestions for mechanisms to provide additional co-ordination for the application of Article 7 and Article 9 of the MTC to determine the profits of a PE, taking into account the considerations expressed above?

#### *Coordination of the application of Article 7 and Article 9*

The OECD should expressly state that tax administrations should not singularly apply either an Article 7 or Article 9 analysis upon their examination of the profits to be attributed to a taxpayer, but instead a coordinated and parallel examination should be performed. We are concerned about the possible negative side effects in the form of double taxation that may arise if a tax administration may disagree, or arrive at a different conclusion, when applying a singular analysis under either Article 7 or Article 9 and does not consider the overall outcome which would result if an analysis under Article 7 and Article 9 is performed in parallel. We envisage such situations arising where a tax administration performs an audit on only a dependent agent PE of an enterprise, and as a result of that audit, an upwards adjustment to that dependent agent PE's profits is assessed. Meanwhile, the dependent agent entity may have reported an arm's length reward under Article 9 of the MTC, however since the focus of the audit was only on the dependent agent PE the enterprise will suffer from the effects of double taxation

Moreover, the OECD must expressly require tax administrations to ensure that taxpayers must not suffer double taxation as a result of a tax administration performing a singular analysis either under Article 7 or Article 9 without considering the corresponding effect on the other analysis.

In this regard, further guidance must be provided to tax administrations to ensure that upon examination of either a dependent agent PE, or the dependent agent enterprise, that a coordinated application of both Article 7 and Article 9 analyses must be performed. Furthermore, taxpayers should be guaranteed access to all available dispute resolution mechanisms and not be barred from dispute resolution for reasons such as a reversal of burden of proof, or incorrect corporate income tax filing claims that may arise from a disagreement in the application of either Article 7 or Article 9.

#### *Zero-profit PEs*

As mentioned earlier, the OECD should consider a practical approach to dealing with zero-profit PEs to reduce the additional filing requirements and compliance obligations that will be created. We see several possibilities to address this:

- ▶ Create a specific exemption to the recognition criteria of PEs in cases where a zero-profit PE exists. In other words, a zero-profit PE should not be recognized as a PE, and any associated filing or compliance obligations are waived. As the changes made through the work under Action 7 has already been completed, and therefore this matter cannot be solved by further modification to Article 5, we urge the OECD to encourage tax administrations to address the exemption to zero-profit PEs unilaterally through their domestic tax legislation.
- ▶ Introduce a mechanism for local tax administrations to allow an existing resident taxpayer to specify or "elect" in its tax return that a PE of a related entity has been created in its jurisdiction and that the related entity has assessed that no profit is attributable to the PE. This election could override a local income tax return obligation for the PE and ensure that penalties (non-filing or compliance) would not be applicable if the election is made.

- ▶ Bilateral efforts between tax administrations should be encouraged to introduce an exemption to recognition criteria of DAPE's which would be created as a result of the activities performed by a DAE subject to the DAE being rewarded at arm's length. Such a clause can already be found in the protocol to the current Austria - Germany Income and Capital Tax Treaty.

Paris, le 1<sup>er</sup> septembre 2016

Madame, Monsieur,

La Fédération Bancaire Française (FBF), organisme professionnel regroupant l'ensemble des établissements de crédit en France, est heureuse de l'opportunité qui lui est offerte de présenter ses observations dans le cadre de la consultation organisée par l'Organisation de Coopération et de Développement Economiques (OCDE) sur l'action 7 du plan « BEPS », « additional guidance on the attribution profits to permanent establishments ».

Nous avons fait un certain nombre d'observations que vous trouverez dans la note ci-jointe, établie en anglais afin d'en faciliter la diffusion auprès des différents membres de l'OCDE et parties intéressées.

Nous restons à votre entière disposition pour tout renseignement complémentaire dont vous auriez besoin. Vous pouvez me joindre au 33 1 48 00 50 73.

Je vous prie d'agréer, Madame, Monsieur, l'expression de mes salutations distinguées.



Blandine LEPORCQ

Directrice du département fiscal

## **COMMENTS FROM THE FRENCH BANKING FEDERATION RELATING TO THE ACTION 7 OF THE BEPS PUBLIC DISCUSSION DRAFT ON “ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS”**

The FBF, as the voice of the French banking sector representing the interests of over 400 banks operating in France, encompassing large and small, wholesale and retail, local and cross-border financial institutions, is pleased to provide comments on the OECD Discussion draft entitled “BEPS action 7 : Additional Guidance on the Attribution of Profits to Permanent Establishments”. It is crucial for us to have the opportunity to provide our comments as well as our input, particularly given the complexity of certain issues under this discussion. We thank the OECD for the consultative process underway and call for a continued interaction with the private sector so that the voice of business is duly taken into account.

### **Preliminary remarks**

It is essential that the rules to determine the profits attributable to the branches especially transfer prices rules be applied to branches as applied to a separate entity especially in order to fully recognize the transactions between the head office and its branches.

### **Other remarks**

Indeed, for regulatory reasons, banks rely on permanent establishments or branches in very different ways to most companies. In particular for regulatory capital reasons, banks often use permanent establishments of a single legal entity in many countries. For example within the EU, regulatory permissions mean that a permanent establishment of a bank can rely on the permissions granted to it by the home country regulator to operate across the EU through permanent establishments.

Non-banking groups would be more likely to establish subsidiaries for these purposes as the same regulatory requirements do not exist. Therefore, the rules described in the draft are irrelevant for banks given their activities and their structural and operational organizations.

We are surprised at the methodology adopted which takes examples to identify principles when it would be have been more effective and safe to proceed in reverse order. The major principles should be proposed to cover all situations. Indeed the use by the tax authorities of the examples is a real concern. These examples should in no case be considered as economic model as they are somewhat basic and cover limited scenarios.

Especially, the guidance should made it clear that they far more complexed cases which would require a different approach than the ones described in the draft.



5 September 2016

Mr. Jefferson VanderWolk  
Head of the Tax Treaty, Transfer Pricing & Financial Transactions Division  
Centre for Tax Policy and Administration  
OECD

Dear Mr. VanderWolk,

We have pleasure in detailing below our comments on the BEPS Document: *Additional Guidance on the Attribution of Profits to Permanent Establishments*.

The following comments and responses are made with reference to the questions and paragraphs in the document in order to suggest further clarifications that the OECD might consider including in the final version of the guidance.

1. **Order of calculation of attributable profits** – We do not consider that the order in which this occurs should have any effect. However if it does the OECD may like to provide for flexibility to ensure that the taxpayer is not disadvantaged. Additionally we suggest that the OECD might like to acknowledge that the profits attributable to the DAFE less the profits declared by the DAE might result in no additional profits to be declared. This will be the case where the DAE's profits fully reward the activities being carried on in the country, as is often the case, and as is the conclusion on Example 1.
2. **Example 1** - We are in agreement with the conclusion of this example; that there are no profits attributable to the DAFE. However it is not our experience that tax authorities in practice agree with this based on similar fact patterns. We will be interested to see how tax administrations' thinking evolves on this point. OECD may like to note that even with this conclusion, it does not preclude a regular transfer pricing challenge on the DAE.
3. The profits seem to us to be fairly calculated.
4. We have no particular comments on this question.

5. The question asks whether the absence of significant people functions results in there being no profits to attribute to the DAPE. This is unclear in our view and seems to be a change to the definitions and basis of the conclusion from this example. The draft indicates that it is the lack of risk taking and assets that results in this conclusion in Para 37. The OECD may like to add some points of clarification here.

6. **Example 2** – We have some reservations about the profit attribution in this example because the assumptions in the fact pattern seem to us to be a little unrealistic. Few multinational groups wholly delegate the authority for all risk based decision making on credit extension, assessment of credit worthiness and inventory management to a subsidiary entity. Most have matrices of authorization under which subsidiaries are granted some authority for certain risks, but others have to be escalated to head office for approval, typically over certain predetermined monetary amounts. The OECD might like to make provision for such practical matters and acknowledge that in reality such arrangements are more complicated than the example provides. We note that these considerations partly come into play in Example 4.

That said, and within its own terms in the example, the profits attributable to the DAE do not seem consistent with the facts in the sense that inventory is not owned by Sellco, so it cannot assume the risks for it (Para 43), neither can bear the consequences of credit risks arising as it does not make the sales. These costs for inventory losses and bad debts fall to Prima, even though they may be managed to some extent by the DAE in terms of some delegated functions as noted in Para 48.

Setting these objections to one side and acknowledging the role of the SPFs in the 2010 draft guidance, the net result of the example is a loss to the DAPE as a result of the funding costs. We wonder how in practice relief for such a loss will be achieved as if the fact pattern remains the same, the DAPE will never have any profits against which it will be offset, whereas Prima will have additional profits taxed in its country. Thus an MAP claim for relief of the double taxation seems not only likely, but appropriate. Is this the result OECD intends?

7. We have no particular comments to make on this question.
8. In this case, the risks should be allocated back to Prima and the fee payable to the Sellco reduced accordingly. The DAPE would have the same net result
9. The attribution to both seems appropriate in this example. Yes, our reading of the 2010 draft paras supports the example's conclusions.
10. **Example 3** - Again we point out the unrealistic nature of the example regarding the authority over extending credit given to the employee. We also doubt one person's ability to run a sales function along with handling inventory and warehousing.

That said, we are in agreement with the conclusions of the example, although benchmarking the deemed distribution functions will be crucial to setting the DAPE operating margin. The OECD may like to emphasize the need to find supporting third party data for this, say from commercially available data bases or internal CUPs where they exist.



11. We have no particular comments to make on this question.
12. **Example 4** We are in agreement with the profit/loss construction in this example, but repeat our question in 6. above as to the DAPE's ability to relieve the losses arising in the second part of the example.
13. We are in agreement with the statements here.
14. **Example 5** The example depends on the service income being billed by the PE. This may, or more likely, may not be the case, as in practice it is hard to see why WRU would transfer its customer contracts to the PE (creating a potential exit charge for it), or otherwise allow the PE to earn profits from its sales activities, without a charge of some kind, such as a sales commission. Thus we consider that the 8% return on sales to the PE is probably too high as it omits such a cost/charge. This net profit can be benchmarked against similar service providers and the OECD should make reference to this possibility in order to sense check the result.  
  
In our view the services provided by the warehouse in country W should be tested/evaluated on a cost plus basis, by reference to the costs incurred in providing the services to WRU, assuming it retains the customer contracts, which we consider to be more realistic. Thus a net profit of not more than 2.85 should arise to it, using a cost plus say 5% base on its costs, including intercompany costs, if appropriate (see 15. below). The other transactions do not arise in this scenario. We note that this is approximately equivalent to the example in Scenario B.
15. **Scenarios B and C** We are in broad agreement with the profit allocation in the examples, but wonder as to the inclusion in the cost base of costs to which the PE adds no value and which it effectively has to buy in from WRU to provide its service. The OECD may like to expand the example to show which costs should be included and which marked up. Again the utilization of a cost plus approach here could be made plainer, and again, can be benchmarked against similar service providers' results.
16. As mentioned in 15. above we question the inclusion of such investment asset returns for the reasons stated by the OCED.
17. We have no particular input on this question.
18. We agree with this proposition.
19. No, we do not consider that there should be a difference, but we mention again our comments in 15.above on the applicable cost base for the mark up.
20. We have no particular comments to make on this question.
21. The OECD may like to give consideration to encouraging tax administrations to grant immediate double tax relief, along a more efficient and streamlined MAP procedure in these cases to ensure that the non-resident enterprise is not in the end subjected to double taxation, nor cash penalized in the process.

\*\*\*\*\*

We trust these comments are helpful to you and, as always, we would be happy to elucidate on them and to participate in future business consultations, in particular that scheduled in October 2016.

Yours sincerely,



Kate Noakes  
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5 September 2016  
Our reference:  
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## **Comments on the Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments**

Dear Sir or Madame,

Thank you for the opportunity to comment on the Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments as of 4 July 2016. We are firmly committed to the success of the Authorised OECD Approach (“AOA”) on the Attribution of Profits to Permanent Establishments and are pleased to assist in its development. We would like to share a few thoughts that are based on our practical experience of advising multinational enterprises (MNEs) in matters of the attribution of profits to permanent establishments under the AOA and approaches other than the AOA, both with respect to the pre-BEPS and post-BEPS versions of Article 5 of the Model Tax Convention (“MTC”).

### **Comments**

#### **1. Order of the application of the Articles 7 and 9 MTC analyses**

Question 1: In our view, the outcome cannot be affected by the order in which the analyses are conducted. The reasoning behind this is that the functions performed by the dependent agent enterprise (“DAE”) are decisive for the functions attributed to the dependent agent permanent establishment (“DAPE”) pursuant to para. 232 Part I Attribution of Profits 2010. However, it seems recommendable to start with the accurate delineation of the actual transaction between the non-resident enterprise and the DAE and the determination of the resulting arm’s length

reward to the DAE for the services it provides to the non-resident enterprise, which is tax deductible by the DAPE in an arm's length situation.

## **2. Comments on example 1 (question 2 to question 5)**

Question 2: We agree with the functional and factual analysis performed in example 1 of the discussion draft. Under the AOA, the functions performed by Sellco (i.e. DAE) on behalf of Prima (i.e. the non-resident enterprise as the principal) are decisive for the functions attributed to the DAPE. If Sellco does not perform significant people functions on behalf of Prima, no risks, functions or assets could be attributed to the DAPE.

Question 3: In principle, we agree with the construction of the profits or losses attributed to the DAPE in Example 1 of the discussion draft. Assets and risks of Prima should be attributed to the DAPE pursuant to para. 232 Part I Attribution of Profits 2010 only if Sellco performs significant people functions on behalf of Prima. Based on the facts and assumption in example 1 of the discussion draft, Sellco does neither perform significant people functions on behalf of Prima related to inventory, marketing intangibles and receivables nor controls the risks associated with these assets. Thus, the economic ownership of the inventory, marketing intangibles and receivables should not be attributed to the DAPE. However, the profits of the DAPE are determined by "sales income" less "COGS" and "sales commission to Sellco" according to para. 38 of the discussion draft. We do not agree with this construction of the P&L of the DAPE, because it implies that the economic ownership of the inventors is transferred to the DAPE, what is in contrast to the description in para. 34 of the discussion draft. As a result, only the "sales commission" for Sellco should be stated in the P&L of the DAPE (instead of "sales income" less "COGS").

Question 4: In principle, there should be no difference in the profits or losses of the DAPE under the wording of Art. 7(2) of the MTC 2008 as compared to the AOA. This stems from our view that the profits and related expenses (i.e. the sales commission to Sellco) should also be allocated to the DAPE under the wording of Art. 7(2) of the MTC 2008. As a result, the profit of the DAPE should be zero, as well.

Question 5: The functions performed by Sellco on behalf of Prima are decisive for the determination of the arm's length remuneration of Sellco under Art. 9 of the MTC as well as for the

attribution of the profits to the DAPE under Art. 7(2) of the MTC under the AOA. If those functions being performed by Sellco have been remunerated at arm's length, there are no profits attributed to the DAPE, i.e. they are zero. We support the clear statement that the profit allocation of the AOA follows the "single taxpayer" or "zero sum" approach in this respect.

### **3. Comments on example 2 (question 6 to question 9)**

Question 6: We agree with the construction of the profits or losses of the DAPE in example 2 of the discussion draft, because Sellco (dependent agent) performs significant people functions on behalf of Prima (principal), which results in an attribution of the economic ownership of the inventory and the inventory risk as well as the economic ownership of the receivables and the credit risk to the DAPE. Hence, the sales income obtained is attributed to the DAPE. The DAPE has to pay an arm's length sales commission from this sales income to Sellco considering its functions performed, assets used and risk assumed. The profit or loss of the DAPE is the "sales income" less "COGS" and "sales commission to Sellco". As a result, the income of DAPE after paying the commission fee to Sellco should be zero. However, example 2 does not describe who actually takes the decision about the funding and sourcing of the inventory. Therefore, we recommend to amend the given facts of example 2 in this respect.

Question 7: In principle, there are no differences in the conclusions under the wording of Art. 7(2) of the MTC 2008 compared to the conclusions under the AOA.

Question 8: If Sellco does not have the financial capacity to assume the inventory risk and the credit risk, those risks should be attributed to Prima under Art. 9 of the MTC, according to which the commission fee payable to Sellco should be lower. However, Sellco actually performs the significant people functions regarding the inventory and the credit risk. Therefore, Art. 7 MTC attributes the inventory risk and the credit risk to the DAPE and not to Prima's Head Office. Thus, profits from "sales income" less "COGS" attributed to the DAPE in example 2 of the discussion draft are not directly affected by the financial capacity of Sellco to assume those risks. In consequence the DAPE earns an own profit apart of Sellco's reduced sales commission fee.

Question 9: We support that the same functions are taken into account under Art. 9 and Art. 7 of the MTC for the analyses of the allocation of risks to Sellco (applying Art. 9 of the MTC)

and the DAPE (applying Art. 7 of the MTC). This treatment results in a consistent application of the arm's length principal and the treatment of the DAPE as a separate and independent enterprise. It is our opinion that the attribution of economic ownership of assets under Art. 9 of the MTC should follow the allocation of the inventory risk and the credit risk. Therefore, in this example the economic ownership of inventory and receivables should be attributed to Sellco. Further, our reading of para. 230 to para. 245 of the current guidance of the 2010 Attribution of Profits Report supports the conclusion of example 2 of the discussion draft.

#### **4. Comments to example 3 (question 10 and question 11)**

Question 10: In principle, we agree with the construction of the profits or losses of the DAPE in example 3 of the discussion draft under the AOA. However, para. 66 of the discussion draft reveals that the DAPE earns an operating margin of 4.5%. According to this it seems that the profits of the DAPE have been determined by using the transactional net margin method ("TNMM"). This transfer pricing methodology will release the DAPE from the impact of any materialized economic risks. This is because Prima guarantees the DAPE a certain arm's length operating margin from the sale of the respective products.

Question 11: In principle, regarding the wording of Art. 7(2) of the MTC 2008 there should be no difference in the profits or losses of the as DAPE compared to the AOA. This is because regarding the wording of Art. 7(2) of the MTC 2008 the "sales income" as well as the related expenses (COGS, salary of employee, bad debt losses, inventory losses, warehousing costs) should be attributed to the DAPE in the same way as under the AOA.

#### **5. Comments to example 4 (question 12 and question 13)**

Question 12: We agree with the construction of profits and losses in example 4 of the discussion draft, because the DAPE bears the credit risk and as a result the DAPE is the economic owner of receivables under Art. 7 of the MTC.

Question 13: We agree with the conclusion that the difference in the profit allocation under Art. 9 and Art. 7 of the MTC is a result of the different risk allocation which itself is a result of the split of significant people functions under Art. 7 of the MTC. Besides, example 4 shows the complexity of applying the split of significant people functions to the balance sheet.



## **6. Comments to example 5 (question 14 and question 20)**

Question 14: We agree with the construction of the profits or losses of the PE in example 5, because the significant people function is the warehousing for which the third party customers of WRU would pay a certain fee. As a result, WRU's PE obtains third-party revenues for the warehousing activity. Further, WRU should be compensated for granting rights to use the intangibles used by its PE and the services provided.

Question 15: We agree with the conclusion that the PE does not obtain third-party revenues for the warehousing activity in scenario B or in scenario C. WRU's PE should only be compensated for its services performed (i.e. operating the warehouse) on a cost-plus basis. The reasoning behind this is that, the significant people function is the sale of goods to third-party customers, which is performed only by WRU.

Question 16: We do not agree with the opinion that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating the PE, because if no WRU personnel is operating in the PE, all assets should be attributed to WRU. Only WRU (or Wareco, which is an unrelated enterprise) performs significant people functions which are relevant for the attribution of assets (economic ownership) under the AOA.

Question 17: If WRU's PE does not perform any functions, its profit should be zero. The economic ownership could belong to the PE only if it performs significant people functions relating to the warehousing. Thus, profits should be allocated to WRU and does not need to be identified for the profit allocation to the PE.

Question 18: We agree with the conclusion that, in the end, no profits would be attributable to the PE, since with because risks and assets can be attributed to the PE under the AOA only if the personnel of the non-resident enterprise is operating at the fixed place of business PE.

Question 19: There should be no differences in the outcome of the allocation of the profits between the outcome of the attribution of profits to the PE and WRU. The reasoning behind this is that additional profits can attributed to WRU's PE only if it performs additional functions.

Question 20: In principle, there should be no difference in the conclusions under the wording of Art. 7(2) of the MTC 2008 as compared to the conclusions under the AOA.

**7. Additional co-ordination for the application of Art. 7 and Art. 9 of the MTC**

Question 21: We suggest a harmonization of the risk allocation mechanism for Art. 9 and Art. 7 of the MTC in order to provide additional co-ordination in for the determination of the profits of a PE and between associated enterprises.

We are looking forward to the further process and hope that these brief remarks will contribute to the further discussion of the topic.

Yours sincerely,

Dr. Xavier Ditz

Dr. Sven-Eric Bärsch

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**Tax Treaties, Transfer Pricing and Financial  
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5 September 2016

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Dear Sirs

**Response from FTI Consulting to the OECD public discussion draft on BEPS Action 7 “Additional Guidance on the Attribution of Profits to Permanent Establishments”**

We welcome this opportunity to present our comments on the OECD public discussion draft on “Additional Guidance on the Attribution of Profits to Permanent Establishments”.

Thank you for this opportunity and we hope that our comments are helpful.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Marvin Rust'.

Marvin Rust

**Additional Contributors:**

- Ruth Steedman
- Sara Selvarajah
- Martin Brooks
- Julia Rigby

## **Commentary and response on the OECD discussion draft on BEPS Action 7 - “Additional Guidance on the Attribution of Profits to Permanent Establishments” [PE’s]**

### **Introduction**

Thank you for this opportunity to respond to the guidance paper on the Attribution of Profits to Permanent Establishments. With the exception of one particular question, for which we make specific comments, our thoughts set out below are with regard to the topic of the Attribution of Profits as a whole. Hence the main body of our comments are made without reference to the specific questions and refer to either potential additional material or suggestions as to additional practical measures which we would recommend for your consideration in relation to this subject matter. It is therefore worth noting at the outset that we do not have any particular disagreement with the content of the guidance.

As requested, our comments do not revisit the changes to the PE definitions that have been agreed under Action 7 and published in the 2015 Final Report nor do they seek to address the 2010 Report on the Attribution of Profits to Permanent Establishments [Report].

### **Complexity vs Simplicity**

In FTI’s experience the question of the attribution of profits to a PE is one of the most challenging areas of international tax, and, as agreed by many commentators, difficult to apply in practice. Difficulties arise because the profit attribution analysis involves the application of difficult economic and legal concepts, such as the identification of significant people functions, the assumption of risk, economic ownership and apportionment of capital. Arguably, the most difficult to apply is the mechanism of hypothesising a PE as a separate enterprise, as although being based in a different country, from a commercial, business, legal and economic perspectives, that PE forms part of the enterprise as a whole and, in most cases, functions as one. Furthermore, the practical consequences that arise from the need to split an enterprise’s business into its separate component parts, and then attribute an arm’s length return for each element, is both time consuming and difficult, such that the results are almost “de facto” subjective and therefore likely to be disputed by one or more fiscal authorities.

FTI’s concern with the guidance as it stands is that whilst the examples are welcome and helpful they belie the reality of the difficulties discussed above. We suggest that a statement which highlights the dichotomy be included in the text; a suggestion is set out below.

*‘The examples above are necessarily simplified in order to fulfil their purpose of illustrating the mechanisms of the AOA in the prescribed circumstances. It is recognised that the determination of significant people functions and the subsequent allocation of assets and risks and then where necessary the determination of an economic return to these elements is both complex and subjective. In all but the simplest scenarios there will be more than one right answer that meets the arm’s length standard.’*

## **Cost vs Benefit**

Due to the complex analysis involved, the practical application of the economic and legal principles of the AOA could be very costly and, in certain cases, would be wholly disproportionate from a cost perspective in the context of the overall business of the enterprise and the resulting profit and tax.

FTI urges the OECD to consider recommending some form of proportionality test designed to reduce the compliance burden on smaller and growing businesses where the tax at stake is not material, where materiality is considered in terms of tax risk rather than as a proportion of an enterprise's revenue or profits.

## **Compliance simplification**

One example in the discussion draft illustrates a case where there is no additional profit to be taxed in a newly-created permanent establishment. FTI welcomes the acknowledgement that such an outcome is feasible. In these circumstances, FTI think that it is important that participating countries consider simplification measures to minimise the compliance burden that will arise from separate filing of a nil permanent establishment tax return.

## **Double Taxation Risk**

As discussed above, given the complexity and subjective nature of the calculations involved, our concern is that tax authorities in different countries may not share the same view of the profits attributable to a permanent establishment. This is likely to lead to a significant increase in cases of double taxation and additional compliance costs for business.

Whilst we appreciate the availability of the Mutual Agreement Procedure in cases of double taxation, FTI believes that there is too much risk and consequent cost on the taxpayer and insufficient risk for the tax authority. To address this, FTI urges the OECD to consider recommending some form of entry into an elimination of double taxation agreement procedure with certainty of outcome, such as the EU Arbitration Agreement, alongside the filing of a PE return or the issuing of a PE tax assessment; providing this greater level of certainty may encourage additional inward investment in those countries willing to operate such a measure.

## **Question 1**

*Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome and what guidance should be provided on the order of application*

FTI agrees that, as noted in the discussion draft, the issue of the order of application of Article 9 and Article 7 is likely to arise in limited circumstances, e.g. where an enterprise has in a foreign jurisdiction both, a dependent agent PE [DAPE] and a dependent agent enterprise [DAE]. However, FTI expects that, following changes to the definition of the DAPE, there will be an increase in situations where a DAPE will be deemed to exist and, therefore, guidance on this matter will be most welcomed.

FTI notes that, in theory, upon the application of the principles in a plain vanilla situation, the order in which Article 9 and Article 7 analyses are performed should not affect the final outcome, mainly because it is considered that the functions performed by a PE and an enterprise could be deemed to be performed either on its own behalf or on behalf of the enterprise. FTI believes, however, that in practice, performance of the functional and factual analyses will not be straightforward. The main difficulties stem from the fact that while in relation to a company, the risks are assumed (and contractually evidenced), with regards to a PE, it is a matter of attribution. This difficulty is reflected in both the Report and the Discussion Draft. FTI further notes that the examples themselves indicate that where analyses under both articles are performed independently from each other, there is the possibility that some of the risks could be included more than once. Hence, the independent application of analyses under Articles 7 and 9, could lead to overlaps and/or double-counting.

FTI notes that the Report at paragraph 234 states that in calculating the profits attributable to the PE, the arm's length remuneration to the agent should be deducted. This suggests, therefore, that analysis under Article 9 should be performed before that in Article 7. FTI concurs and believes that it would be more practical and efficient to perform Article 9 analysis first<sup>1</sup>; performing Article 7 analysis first would necessarily require approximation of the arm's length remuneration to the DAPE, and so would require re-calculating of the actual result.

It is recommended that clear guidance should be provided on the order of application of analyses in Articles 7 and 9 in cases of DAPE. Due to the fact that the profits of the DAE should be deducted in arriving at the profits of the DAPE, it is considered most efficient and logical to apply Article 9 analysis first. FTI feels that the final guidance should be clear on this point so as to have the effect of limiting the scope of potential challenges by tax authorities and thus minimise instances of double taxation and MAP. Furthermore, such guidance will provide certainty and allow enterprises to perform the analysis more efficiently.

It may also be helpful if the guidance were to discuss how much of Article 9 analysis should be considered/relied on in performing the Article 7 analysis.

End of response.

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<sup>1</sup> and this is noted also in paragraph 19 of the Discussion Draft

## **GFIA's response to the OECD Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments**

GFIA is pleased to respond to the OECD's discussion draft on "Additional Guidance on the Attribution of Profits to Permanent Establishments" (the "discussion draft"). In general, GFIA supports the objectives of the OECD BEPS Action Plan to address weaknesses in the international tax environment. Accordingly, we support the OECD's broad objectives in combating aggressive tax planning aimed at preventing the artificial avoidance of Permanent Establishment ("PE") status. However, it is critical that any measures adopted by the OECD are workable, well targeted, and do not result in unintended consequences that negatively impact the efficiency of commercial insurance operations and the availability and cost of insurance coverage for consumers.

The preamble to the discussion draft refers to paragraphs 19-20 of the final Report on Action 7 of the BEPS Action Plan (Preventing the Artificial Avoidance of Permanent Establishment Status) which concludes that the changes discussed in the final Report do not require substantive modifications to the existing rules and guidance concerning the attribution of profits to a PE under Article 7 but that there is a need for additional guidance on how the rules of Article 7 would apply to PEs, in particular for PEs outside the financial sector (emphasis added). While the focus of the Additional Guidance is on PEs outside the financial sector, GFIA is concerned about the potential impact of certain proposals in the discussion draft on the insurance sector.

As outlined in GFIA's previous submission to the OECD (see Appendix), GFIA's main concern with the proposed PE rules is that, for some insurance business models, PEs would be recognised for tax but not for regulatory purposes with no or minimal additional profit being attributed to them. This would result in an excessive compliance burden for both insurers and tax authorities.

The discussion draft recognizes (see paragraph 104) that there could be situations where the profits attributed to a PE are nil but does not propose a solution to avoid the resulting disproportionate compliance burden for insurers. GFIA is disappointed with this situation and disagrees with the suggestion that these PEs may nevertheless be justified by the potential existence of "other tax liabilities". At least in an insurance context, this would not be the case.

GFIA reiterates its strong view that only the presence of Key Entrepreneurial Risk-Taking (KERT) functions in a jurisdiction should create a PE and the attribution of profits for tax purposes. The 2010 OECD Report on the

Attribution of Profits to Permanent Establishments Part IV (Insurance) ("Part IV") recognizes that the main KERT function of insurers is the assumption and management of insurance risk/business (i.e. underwriting).

The broader definition of PE in the discussion draft could potentially create PEs for insurers with no or minimal profit attributed to them in the following situations:

- The insurer sells and markets insurance products. Part IV recognises that such activities are unlikely to be KERT.
- A related service company performs non-KERT functions (such as back-office processing of applications, administrative support, claims handling and investment management).
- An unrelated third party agent performs non-KERT functions and acts exclusively for an insurer.
- An agent acts exclusively (or almost exclusively) for the insurer under a Delegated Underwriting Authority (DUA) and does not perform any KERT functions (which would be the case if the authority under the DUA is strictly limited).
- A connected agent performs regulated non-KERT activities (eg. sales and distribution) in the same jurisdiction as the customer and is rewarded directly by the customer on an arm's length basis (for example, a broker distributes insurance and is compensated through a fee charged to the customer, in addition to any fees from the insurer).

GFIA's view is that insurance distribution networks should not generally give rise to PEs for tax purposes since:

- distribution activities are compensated by commissions and
- the commissions are subject to tax in the distribution location.

There is no reason why further income should be attributed to a dependent agent PE if the agent's enterprise is remunerated on an arm's length basis, considering the risks assumed by the dependent agent enterprise.

Similarly, when a bank distributes insurance, the insurer should be viewed as independent from the bank since the bank:

- distributes products without the authority to negotiate insurance contracts and
- may also distribute similar products from other competing insurers.

GFIA believes the approach in example 1 of the discussion draft would be very difficult to apply in an insurance context, since there is nothing analogous to cost of goods sold (which in example 1 is equal to sales income to the head office in Country A to ensure there is no profit attributable to the PE in Country B). If the methodology of example 1 was for some reason applied to an agent undertaking non-KERT functions in Country B for an insurer, all the premium from writing the business in Country B would be inappropriately attributed to the PE in Country B, even though only non-KERT functions were performed in Country B. That would clearly conflict with Part IV.

GFIA strongly recommends that the OECD avoid the creation of PEs in the circumstances discussed above, particularly since the OECD recognizes that no profit will be attributed to these PEs. This would avoid an unnecessary compliance burden on insurers. One way to address this problem would be to add some words to the commentary on Article 5 under paragraph 39 to note that the facts and circumstances of the business value chain should be considered as part of the determination of whether or not a PE is created. We strongly



recommend adding a reference to Part IV since it provides comprehensive guidance defining and discussing the risks, risk management and allocation of risk in the context of the insurance business.

**GFIA contact**

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**About GFIA**

Through its 41 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 60 countries. These companies account for around 87% of total insurance premiums worldwide. The GFIA is incorporated in Switzerland and its secretariat is based in Brussels.

## APPENDIX

*The comments in this appendix were submitted to the OECD on 12 June 2015*

### **GFIA Comments on OECD Revised Discussion Draft on BEPS Action 7 (Prevent the Artificial Avoidance of PE Status)**

#### **Introduction**

The Global Federation of Insurance Associations (GFIA) through its 39 member associations represents insurers that account for around 87% or more than \$4 trillion in total insurance premiums worldwide. GFIA is pleased to provide comments on the OECD revised discussion draft on "BEPS Action 7: Preventing the Artificial Avoidance of PE Status" (the "discussion draft"). In general, the GFIA supports the objectives of the OECD BEPS Action Plan to address weaknesses in the international tax environment. Accordingly, we support the broad objectives of the discussion draft in combating aggressive tax planning aimed at preventing the artificial avoidance of Permanent Establishment ("PE") status. However, it is critical that any measures adopted by the OECD are workable, well targeted, and do not result in unintended consequences that negatively impact the efficiency of commercial insurance operations and the availability and cost of insurance coverage for consumers.

#### **General comments**

We welcome and fully support the conclusion of Working Party 1 that no specific rule for insurance operations should be introduced.

We welcome the decision to provide additional guidance on the issue of attribution of profits to PEs. The discussion draft notes that follow-up work on attribution of profits issues related to Action 7 will be carried on after September 2015 with a view to providing the necessary guidance before the end of 2016, which is the deadline for the negotiation of the multilateral instrument that will implement the results of the work on Action 7. ***We recommend that such guidance be released in draft form for public comment, with sufficient time (at least 45 days) for public review and consultation. The need for adequate consultation time is critical given the complexity of this subject.***

The revised commentary on interpreting Articles 5(5) and 5(6) to deal with commissionaire arrangements appears to be written in the context of businesses that sell goods. In addition, the commentary does not take into account the relative importance of the functions performed by the business in question – in particular, no recognition is given to where the KERT function (i.e. what drives the profit) is performed. If neither the nature of the business nor the importance of the function are taken into account, the outcome will be numerous PEs being created with nil or little additional profit being attributed. This would result in a disproportionate burden being placed on business. The particular concerns in the insurance context are with respect to:

- sales and marketing of insurance

- non-KERT functions performed by an in-house service company, such as back office processing of applications, claims handling, investment management, and administrative support.

With respect to the sales and marketing of insurance, the collection of premiums alone does not necessarily create value for the insurer. The 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) ("Part IV") notes that sales and marketing is only one of the functions in the insurance value chain. Paragraph 117 of Part IV recognizes that if the person (i.e. agent) collecting the premiums does not make the decision to accept the risks/business associated with the insurance policy, then the collection of premiums does not mean that insured risks/business have been accepted by that person. This is an important point since, as recognised under Part IV, the KERT for insurers is the assumption of insurance risk/business (see for example paragraphs 93<sup>1</sup> and 94). Accordingly, the KERT function rests with the entity which accepts and manages the risk/business (ie. the insurer and not the agent).

Part IV provides comprehensive guidance defining and discussing risks, risk management and the allocation of risk in the context of insurance businesses. Accordingly, given the extensive work that has gone into developing Part IV and the limited time remaining to complete the BEPS action plan, ***we recommend referencing the relevant existing guidance in Part IV for insurers in the commentary on Article 5(5) and 5(6) (for example in paragraph 39). We also suggest that the commentary be extended to ensure that, when consideration is given to whether a PE exists, the relative importance of the functions performed by the business in question should be taken into account.***

#### **GFIA contact**

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<sup>1</sup> Paragraph 93 of Part IV states in unequivocal terms:

All facts and circumstances need to be considered to determine which function assumes insurance risk for the enterprise, because the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise. Other functions performed by an insurance enterprise may be important and valuable functions and should be compensated accordingly, but these other functions are not functions that form part of the key entrepreneurial risk-taking function.



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5 September 2016

Dear Mr. VanderWolk,

**OECD Public Discussion Draft – BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments**

Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft entitled *BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments*, issued on 4 July 2016.

We appreciate the work that the OECD has undertaken in the area of permanent establishments. We have provided general comments in Appendix A to this letter and specific comments in Appendix B.

If you would like to discuss any of these points in more detail then please contact either myself or Darek Domeracki, Manager – Public Policy, Grant Thornton International Ltd (Darek.Domeracki@gti.gt.com; M: +44(0)7900706470).

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## APPENDIX A

### Order of application

Example 1 illustrates the overlap between Article 9 and Article 7 and sets out a process to establish profits attributable to the Dependent Agent Permanent Establishment ("DAPE"). The analysis initially focuses on the importance of functions to control Economically Significant Risks in Article 9, followed by the analysis of relevant Significant People Functions ("SPFs") in Article 7.

We note that Example 1 appears to be very simplistic and hence not necessarily reflective of practical issues surrounding multinational enterprises' business and pricing arrangements. For example, it is common in practice for a commissionaire agreement to provide for performance-related remuneration. If Sellco performed strongly in the relevant territory, the commission in Example 1 might be 15 instead of 10. This would turn the profit attributable to the DAPE of Prima in Country B into a loss of 5.

Some territories may permit the DAPE and the commissionaire to form a tax group or consolidation so that the loss in the DAPE could be offset against the profits of the commissionaire. However, in territories where domestic laws do not allow this, double taxation could arise within that territory if relief for the losses of the DAPE is not available. In addition, some territories may restrict the carry-forward or carry-back of losses of the DAPE.

This problem would be exacerbated by the fact that the profits attributed to Country A would remain the same and the tax rules in Country A may not permit the offset of the Country B DAPE loss against other Country A profits.

A further example of a potential practical problem would be a situation where the sales commission paid Prima to Sellco is subject to a transfer pricing adjustment (increase) in Sellco's jurisdiction. If the amount of the transfer pricing adjustment was 5, the sales commission would now again be 15, resulting in a loss of 5 for the DAPE of Prima. Again, double taxation and/or timing permanent differences could arise as already identified above. In both of the examples above, it can be seen that the OECD's suggested approach leads to additional complexities, particularly in Country B, without altering the overall profit attributable to that territory. There may therefore be instances in which it would be appropriate for the OECD to permit Contracting States to take a practical approach and not require an attribution of profits or losses to a DAPE of Prima where this results in the practical problems identified above.

### Splitting of contracts as a way to avoid PE status

Broadly the report proposes that the principal purpose test ("PPT") is applied when it is reasonable to conclude that one of the principal purposes of splitting up the contract is to obtain the benefit of the 12 months rule in terms of article 5(3). However the OECD does not provide clear guidance for the application of the PPT and in our opinion this may lead to uncertainty and an increase in conflict of interpretation between treaty parties.

Furthermore, the wording of the report raises our concern since a transaction motivated by commercial purposes may still not pass the PPT if gaining a tax advantage from the transaction was also a secondary principal purpose. This is clearly contrary to the freedom of establishment as defined by ECJ. Indeed ECJ case law on freedom of establishment allows residents to establish in other EU states and to benefit from tax provisions provided that the company has a genuine economic activity. Hence, a subsidiary set up and having a genuine economic activity and economic substance in a jurisdiction which has a more efficient or competitive tax regime may fall foul of the said PPT inhibiting the freedom of establishment sanctioned by EU law.

## APPENDIX B

### Example 1

#### **Do you agree with the functional and factual analysis performed in Example 1 under the AOA?**

Under the Authorised OECD Approach (the “AOA”), risks of a non-resident enterprise relating to inventory, marketing, intangibles or receivables should only be attributed to the DAPE in circumstances where relevant SPFs are performed by the DAPE on behalf of the non-resident enterprise. In this example there are no risks or assets attributable to Sellco as there are no relevant SPFs performed by Sellco on behalf of Prima.

Based on the facts in Example 1, we agree with the analysis. However, we would welcome further guidance on the identification of SPFs, as we consider the existing draft guidance to be very limited.

We also note that depending on how each case is interpreted, there potentially could be a range of outcomes based on the functional and factual analysis. This may lead to inconsistency across multinational enterprises. Clear guidance and detailed, comprehensive examples are therefore required.

#### **Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?**

Broadly we agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA.

We note, however, that Example 1 is simplified as compared to most business arrangements, and may not reflect the complexities most businesses may face when determining how much profit is attributable to the DAPE, as explained by our comments in 1 above.

#### **What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

With respect to Example 1, we are of the view that if an approach other than the AOA was to apply, the conclusion would unlikely be different. This is due to the simplistic nature of the facts as outlined in Example 1. However, for multinational enterprises whose commercial arrangements are more complex, the conclusion may be significantly different, as our comments on Example 1 illustrate.

For example, the wording of Article 7(6) of the UK/India Double Tax Treaty in conjunction with Indian domestic laws means that the attribution of head office company costs is very limited in calculating the profits attributable to an Indian PE of a UK enterprise.

Therefore, in Example 1, the amount of the cost of goods sold (“COGS”) of 190 that could be deducted against Country B sales income could be heavily restricted. This would result in the potential for significant double taxation where the head office territory operates an exemption system of taxation for foreign permanent establishments or where credit relief for foreign tax is limited to the head office country tax on the same profits that are subject to foreign tax.

In addition, Article 7(3) of the UK/India treaty contains a distinct and separate rule which states that where a PE takes an active part in negotiating, concluding or fulfilling contracts entered into by the enterprise, then, notwithstanding that other parts of the enterprise have also participated in those transactions, that proportion of profits of the enterprise arising out of those contracts which the

contribution of the PE to those transactions bears to that of the enterprise as a whole shall be treated as being the profits indirectly attributable to that PE.

While we note that India is not a full OECD member country, it has a strong working relationship with the OECD. In addition, India is part of the ad hoc group addressing the double tax treaty related measures to be implemented by BEPS Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties.

We would therefore encourage one approach to the attribution of profits across all relevant double tax treaties. This will mitigate uncertainty and risk of double taxation where, for example, one tax authority argues for an attribution of profit based on the AOA whilst another tax authority may not wish to adopt the AOA. This is the current situation in countries which have chosen not to adopt the AOA in practice, leading to a lack of consistency between countries and the actual/model treaties.

Many double tax treaties contain a provision in Article 7 that the same method of attributing profits to a PE should be used year-on-year unless there is good and sufficient reason to the contrary (e.g. UK/France treaty). The new proposals could affect existing PEs as well as clarify the position for new PEs. On this basis, we could seek the OECD's confirmation that the new proposals are sufficient for this purpose.

**In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?**

In principle, we agree with the conclusion of Example 1. Particularly, if the transfer pricing is correct for a non-resident entity and there are no relevant SPFs performed by the DAPE on behalf of the non-resident entity, no further profits should be attributed to the DAPE. As noted above, however, in practice multinational enterprises' business arrangements are often more complex than the facts of Example 1. Therefore, we do not believe that Example 1 will completely alleviate taxpayers' concerns that the process of attributing profits to new PEs which come into existence as result of BEPS Action 7 will be a complex and potentially subjective process.

We consider that multinational enterprises will generally welcome the clarification that some DAPes arising due to BEPS Action 7 should not give rise to additional tax. However, it would still appear that the revised definition of a PE will give rise to all of the associated reporting and compliance obligations (and potential penalties) even in a situation where there are no attributable profits or further tax.

Therefore, we consider that the relevant OECD commentary should be amended to provide that contracting states should have the option to pursue the existence of a PE and exempt the enterprise of the other contracting state from tax filings and other compliance requirements associated with having a PE in circumstances where no additional overall attribution of profits arises to the contracting state. This would also cover the situations which we have identified in 1 above.

## **Example 2**

**Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?**

In principle, we agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA.

**What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

With respect to Example 2, we are of the view that if an approach other than the AOA was to apply, the conclusion would unlikely be different. This is due to the simplistic nature of the facts as outlined in this Example. However, for multinational enterprises whose commercial arrangements are more complex, the conclusion may be significantly different. We refer to the comments we expressed for Example.

**In your opinion, what would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?**

If SellCo would not have the capacity to take over the risks in the first stage, the remuneration for the legal contract between SellCo and Prima needs to be adopted. Therefore, there would be a shift in the profit calculation towards Prima. In the second stage, Prima would then need to allocate the calculated profits between Prima in Country A and the permanent establishment in Country B. The criteria therefore would be the AOA.

**What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?**

We do not feel that the current guidance sufficiently supports the conclusions drawn in this Example. The example highlights the increased compliance burden that is likely to be faced for many of our clients with complex operating models. This simplistic example indicates a minimal tax increase of 2 in Country B.

### **Example 3**

**Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?**

With respect to Example 3, DAPE is created by the employee and no associated entity is created. Therefore, we consider that Article 9 of OECD Model does not apply. The example should be analyzed only by the application of AOA. The inventories, the credit risk, the ownership of company vehicle and capital are attributed to the DAPE.

The first step should be to perform a functional analysis to identify and compare significant activities and responsibilities undertaken; assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc. The nature of the assets used, such as the age, market value, location, property right protections available, etc.

#### *Functions*

According to the OECD Guidelines, “remuneration in independent transactions typically reflects the functions performed by each entity. The functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties, and therefore the remuneration each party would expect to receive in arm’s length transactions. In relation to contractual



terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction.

#### *Risks*

Risks usually refers to possible events that may arise while performing the activities, or inherent to them, which can be on detriment or benefit of the business. In general, it is to be expected that the entity bearing the greatest risk should be entitled to a relatively larger share of the profit earned on the business transaction. Therefore, the focus is to analyse which risks affect the different entities and whether those risks are significant. The main types of risks to consider include market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth.

Finally, we note that there are many risks, such as general business cycle risks, over which typically neither entity has significant control and, which at arm's length, could therefore be allocated to one or the other entity to a transaction. Analysis is required to determine to what extent each party bears such risks in practice.

Therefore, for a correct attribution of profits (or losses) in Example 3, it is essential that a proper analysis of the SPF is carried out, which can be rather simple if applied to certain assets on the one hand, but complicated if related to other assets (i.e. intangible assets) on the other hand.

Furthermore, an employee can be appointed by the company not only to manage a sale activity but also other administrative activities that are not connected to the country where they perform the main activity (i.e. sale of goods). That situation can influence the SPF analysis and result in a change of profit attribution over the principal company.

Therefore, we agree with the construction of the profits (and losses) under AOA, but we note that such an approach can be largely impacted by a more complex situation where an employee develops different activities and manages more complex assets. Under such circumstances, a deeper functional and risks analysis is required (as well as interaction with other Action plans as Actions 8-10).

#### **What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

On the basis of our above response, the attribution of profits may be influenced by other components that are not considered in Example 3, such as royalty flows or administrative functions developed by the employees, which may reduce the profits over the employee and shift the profits over the principal company. In addition, the determination of Capital to be attributed to the DAPE can be affected by this analysis, because DAPE has been attributed a lower level of risk.

Moreover, the OECD Commentary to paragraph 2 of Article 7 of the OECD Model highlights that the AOA determines the profits that are attributable to a permanent establishment. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2, it is necessary to determine whether and how such profits should be taxed, considering the domestic law of each Country. Therefore, the profits individuated in Example 3 would be subject to the taxation provided by the Country where the employee develops his activity, leaving less room for the application of international approaches.

Reference needs to be made to paragraph 15 and 16 of the document. The new text of Article 7 (and the 2010) report is contained in a limited number of treaties and, while some Countries have declared to use the AOA in "full" regardless of which version of Article 7 is present in their treaties, others have expressly

declared their reluctance to adopt the new text of article 7. This raises the question of whether the conclusions reached can be considered accurate with respect to Article 7 of the previous year (compared to 2010) and that of the 2010 report. In our view, all the documents referred to in the Discussion Paper would need to be re-analysed. Although it is most likely that the conclusions reached would be the same, there is an inherent risk of double taxation in a situation where a Country (eg. head office) follows one interpretation, while the other Country (PE) follows another. In this situation, there should be a mandatory MAP in place but given the conclusions of Action 14 it is unlikely that the OECD intend to implement this.

#### **Example 4**

#### **Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?**

The intent of Example 4 is to highlight scenarios where SPF's are performed in two jurisdictions and to illustrate a comparison of profit and loss scenarios. Despite the intent, the facts demonstrate the complexity and assumptions required to conduct this analysis, partly because the contractual arrangement allocates risks to SellCo.

The allocation of the profits/losses in the DAPE is being apportioned via the basis of the respective contributions to credit management costs (i.e. SPF) for Country B customers, which equates to 25% for the DAPE, which represents the costs incurred by Sellco.

However, Sellco is compensated for such costs already under Art 9 as reflected in the workings on paragraph 74, by way of a cost plus Service Fee and Incentive Fee. Consequently, under this example, Country B is being compensated twice for the credit management activities carried out in Sellco – partly in Sellco under Art 9 and partly in DAPE under Art 7.

In total, Country A shows profit of 967 and Country B shows profit of 1,632 (1,210 + 422.5) on the transaction, which does not reflect either the contractual risk basis or the SPF activity in either country.

We would suggest that the appropriate result should be that Sellco is remunerated as per Para 74 based on TP principles, and no additional income is attributed to the DAPE on the basis that adequate income has been reflected in Country B in Sellco.

Alternatively, if it is still necessary to reflect income in the DAPE under Art 7, then this income should be proportionally taken from the Income of Primco and Sellco, in order to avoid Country B being over compensated on the entirety of the transaction, in conflict with the contractual risk arrangements and SPF.

Consequently, we do not agree that the profits are being allocated on a reasonable basis in the examples given.

#### **Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of the risk within the same enterprise?**

Yes, as noted above, we agree that the profits or losses arise from differences between the allocation of risk between two separate enterprises and attribution of risk within the same enterprise, and this leads to the inevitable over attribution of profits to Country B in the examples provided.

It should be noted however, that it is difficult to analyse the real world commercial effects of such a scenario. Other factors may have to be considered in the construction of the profits to the DAPE.

### **Example 5**

#### **Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?**

Whilst we agree with the proposed P&L elements to calculate the service remuneration of WRU's PE in Scenario A, the calculation of the said elements, particularly the "Cost of workforce" should not be limited to a direct recharge of 'costs' but should also include the value created by the workforce as an asset, taking into consideration training and other qualities which WRU could have benefitted from had the workforce not been assigned to the PE.

Broadly, the notion is that employees are merely costs, and add no overall value to the PE as they are not "assets" and as such, no taxable profit is attributed. However, our view is that in an increasingly service dominated economy, employees could also be considered an "asset" for which an appropriate reward needs to be reflected.

In the case of scenario A, where third party revenue is received, this is reflective of both the location of the warehouse, and its service element to deliver appropriate parts/inventory in a timely manner. Hence, the arm's length pricing of the reward by the PE to WRU "for the economic ownership of the asset and the routine function performed at the warehouse" should include the overall value to the PE or correlated 'loss' to the non-resident enterprise. Furthermore, in line with paragraph 68 of the 2010 Report on the Attribution of Profits to Permanent Establishments, the reward for the "Cost of workforce" should also include a discounting factor by way of remuneration for the risk taken over by the PE from negligence of employees engaged in the function performed by the PE

#### **Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?**

We broadly agree with the conclusions reached, however, in applying the AOA the conclusions drawn are not clear on what constitutes the "asset" base. As noted in our comments above, the reward for the employees should go beyond the mere cost since people are intrinsically an asset to the operation. Hence, as the main distinction between Scenarios B and C is the outsourcing of the employees to a third party, arguably if the employees are maintained in-house, the reward for maintaining such employees should be equivalent to the third party scenario.

In addition, comparing scenario A to scenarios B & C, although the PE is respectively being compensated for operating the warehouse in the former whilst being rewarded as a cost centre in the latter scenarios, in our opinion, the risk borne by the PE goes beyond the warehouse asset and should include business continuity risk emanating from the maintaining of inventory, employee service and other business functions the failure or rewards from which should be adequately compensated to the PE.

The other area of potential discussion is the difference between third party inventories versus owned inventory. Should there be any taxable profit attributed to the jurisdiction holding the owned inventory? Perhaps there should on the basis that higher revenues are earned by virtue of having these inventory available at short notice. Currently the examples suggest that an investment return is only attributable based on the capital cost of the warehouse, not necessarily the stock on the basis of its working capital.

Under all scenarios, interest costs and free capital in connection with the warehousing facility (including depreciation of asset) should be equal to those allocated to WRU in Scenario A.

**In particular, do you agree that there can be investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?**

We agree that there can be, and should be, an investment return on the asset or assets when there are no personnel. However, in line with our comment to question 15 the elements constituting the asset base should be clarified (i.e. building only, inclusive of parts/inventory or not?, how to price employees as assets?)

**Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?**

Subject to our remarks in the foregoing comments, we agree with the approach. The investment return should take into consideration the WACC of the tax payer and comparable yield for identical investments.

**Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.**

Subject to our remarks in the foregoing comments, we agree that the proposed scenario should not lead to the attribution to the PE of risks or assets, nor profits, emanating from the significant people functions performed by third parties on account of the non-resident enterprise.

**Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits of the WRU?**

In our view, the proper application of the AOA should lead to the same outcome.

**What would the conclusion be, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

In theory, whatever the methodology applied, the same conclusion should be achieved for the purposes of allocating the taxable base between the respective jurisdictions. Hence, the AOA and any other methodology, should include an equivalent approach or formula which takes into consideration functions performed, risks incurred and assets employed, applying the right weighting for each element as is commensurate and akin to the market and economic dynamics of the sphere of operation of the enterprise.



### **Comments to the OECD Discussion Draft on “Additional Guidance on the Attribution of Profits to Permanent Establishments”**

ICC welcomes the opportunity to comment on the Discussion Draft. The revisions to the definition of permanent establishment which follow the publication of the Report on Action 7 will potentially result in the recognition of huge numbers of new permanent establishments. In some cases the profit to be attributed will be very small or even de minimis while in others novel questions of the application of the AOA and other relevant principles will arise. While ICC welcomes the additional guidance in cases involving dependent agent permanent establishments and warehouses there is concern that these represent only a small proportion of the circumstances in which uncertainty will arise. Given that this uncertainty will be an impediment to cross-border trade and investment, ICC hopes that this Discussion Draft will be only the beginning of the process and that more comprehensive guidance will be produced as a matter of urgency. This further process should certainly include additional guidance in terms of profit allocation regarding the new fragmentation clause, notably its limitation to those activities which constitute complementary functions and are part of a cohesive business operation. Clear statements should be included to confirm that profit attribution to complementary activities shall only be determined from an activity point of view.

We agree, as noted in paragraph 6, that the basic definition of what is deemed to constitute a permanent establishment has not changed, but what is fundamentally new is that a relatively high threshold has been removed such that disagreement can now arise in connection with very small attributions of profit. In order to avoid administrative burden for both taxpayers and administrations it would be helpful to address small and de minimis cases in the guidance. With this in mind and in response to question 21 raised after paragraph 105, ICC suggests that in cases where any attribution of profit would be small (in either relative or absolute terms) the guidance might provide for an administrative process whereby the permanent establishment would be disregarded for practical purposes.

It is of particular concern, as noted in paragraph 15 et Seq., that the AOA is implemented in very few treaties, that a number of OECD and non-OECD countries have expressly rejected the new Article 7 and that the implementation of the full AOA has been expressly rejected by the UN Committee of Experts on International Cooperation in Tax Matters. From the perspective of the ICC this is an unsatisfactory state of affairs and brings into question whether broader guidance, or at least discussion, would be helpful as the existing and proposed guidance is based solely on the application of the AOA. We need to deal with the full range of approaches actually applied in practice.

It is very likely that the attribution of profits to permanent establishments will develop rapidly in the near future as (i) multinational enterprises adapt their business models to the post-BEPS environment, (ii) business models continue to evolve with the digital economy and (iii) tax administrations reflect on and implement the new practice, not necessarily in consistent ways. It seems appropriate for the development of guidance in this area to be ongoing, at least until the law and practice becomes more settled. The work of the OECD should



therefore be taken forward on a continuing basis rather than terminated on publication of the final report. It should certainly include further alignment of the analyses under Art 9 and Art 7 of the OECD Model Tax Treaty.

We agree with BIAC that some of the key terms and expressions are not sufficiently defined and would benefit from further guidance. This applies, in particular, to the question as to when a party “plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification”; as well as to the precise meaning of “preparatory and auxiliary activities”.

The examples in the Discussion Draft are very helpful and it is particularly useful that computations are included. However, the examples are at the very simplest end of actual business models and it would be very common for there to be many more parties involved in the transactions. The guidance should make it clear that in more complex cases it may be necessary to take a pragmatic approach and a taxpayer’s reasonable practical solution should be acceptable notwithstanding that other approaches might be possible in theory. The questions posed in the Discussion Draft address a somewhat narrow range of circumstances and issues and it will be important, as noted above, to maintain a dialogue with business as practical problems emerge. The examples as well as the terms and expressions seem to include a number of assumptions which are not always clear. Further clarification should include being explicit about what assumptions have been made and that the assumptions in the examples are solely for explanatory purposes, and are not intended to be general rules.

Finally, it would be helpful to reiterate that the lowering of the threshold in relation to the definition of permanent establishment is not intended to have any spillover effect on other taxes. VAT, for example, should be addressed by application of the VAT Guidelines and the fact that an enterprise might have a new permanent establishment as a result of the revised guidance should not, in itself, affect the treatment of any other taxes.





## **The International Chamber of Commerce (ICC) Commission on Taxation**

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy.

Founded in 1919, and with interests spanning every sector of private enterprise, ICC's global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.

Mexico City, September 5, 2016

*Via e-mail*

[TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

**Tax Treaties, Transfer Pricing  
and Financial Transactions Division OECD/CTPA**

Dear all,

On behalf of IFA Grupo Mexicano, A.C. (Mexican Branch of the International Fiscal Association), kindly find below the comments on the Public Discussion Draft –“*BEPS ACTION 7 – Additional Guidance on the Attribution of Profits to Permanent Establishments*” (the “Draft”).

**I. GUIDANCE ON PARTICULAR FACT PATTERNS RELATED TO  
DEPENDENT AGENT PERMANENT ESTABLISHMENTS (“DAPE”)**

- 1. *Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.***

Conceptually speaking and assuming that the factual and functional analysis of the Dependent Agent Enterprise (“DAE”) (per Article 9 of the MTC) and of the DAPE (per Article 7 of the MTC) were aligned, the outcome would be the same; in this case, guidance could be provided in the sense that Step 2 of the Authorized OECD Approach (“AOA”) is unnecessary if such alignment is revealed in Step 1. If there is no alignment between the factual and functional analysis of the DAE and of the DAPE, then the outcome would be affected. In the latter case, the analysis of Article 9 should be applied first in order to determine the arm’s length profit of the DAE which in turn is the fee deductible in the DAPE, and guidance should be provided in that sense.

**a. EXAMPLE 1**

- 2. *Do you agree with the functional and factual analysis performed in Example 1 under the AOA?***



Yes. We agree with the functional and factual analysis under the AOA, since DAE does not undertake significant people functions (“SPF”) relevant to the assumption and/or management of risk on behalf of DAPE, nor it determines an economic ownership of assets by DAPE (See *Paragraph 232 of the 2010 Attribution of Profits Report*).

**3. *Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?***

Yes, because as mentioned in our answer to question 2 there are no SPF involved in this example and therefore no risks and/or assets should be attributed to DAPE. Under this scenario, it is correct to assess a Cost of Goods Sold (“COGS”) in an amount sufficient not to attribute any profits to the DAPE after an arm’s length reward is paid to the DAE.

**4. *What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

Under an approach other than the AOA (namely the single taxpayer approach), there would be no difference in the conclusion since DAPE is not being attributed any assets or risks under the AOA in this example.

**5. *In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?***

Yes, it is appropriate provided that DAPE is not attributed with the economic ownership of assets which would result in a profit under the AOA (see *Paragraph 235 of the 2010 Attribution of Profits Report*).

**b. EXAMPLE 2**

**6. *Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?***

Generally we do agree with the construction of profits or losses; however, we consider that additional guidelines should be provided in order to avoid a

double counting of deductible items or costs upon applying the analysis of the fee payable to Sellco under Article 9 of the MTC.

**7. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

Under an approach other than the AOA (namely the single taxpayer approach), there would not be any attribution of assets or risks to DAPE, since those would correspond to Prima. Therefore, DAPE would not be attributed with the \$2 funding return from Sellco since no economic ownership of assets is recognized.

**8. In your opinion, what would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?**

Per Article 9 of the MTC, risk will be assumed by Prima and therefore fees payable to DAE are reduced in proportion to the assumption of risks. The fee payable to Sellco would be reduced in order to reflect the new operating margin considering the new allocation of risks; on the other hand, the profits to be attributed to DAPE would increase in proportion to the risks assumed. Nevertheless the source state will still tax the \$9 of total profit but allocated in different proportions between DAPE and Sellco. The following chart reflects the reasoning that supports our conclusion:

	Sellco	Sellco Adjustment	DAPE Adjustment
Sales income	\$30.00	\$20.00	\$200.00
COGS	\$0.00	\$0.00	\$170.00
Gross P&L	\$30.00	\$20.00	\$30.00
Opex	\$8.00	\$8.00	\$0.00
Sales commission	\$0.00	\$0.00	\$20.00
Bad debts	\$4.00	\$0.00	\$4.00
Inventory loss	\$3.00	\$0.00	\$3.00

Warehouse cost	\$6.00	\$6.00	\$0.00
Operating Profit	\$9.00	\$6.00	\$3.00

9. ***(1) What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? (2) Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?***

(1) We agree on the fact that the same functions are taken into account for purposes of Articles 9 and 7 of the MTC since the analysis in the example properly analyzes “the actual conduct of the parties” (Article 9) and the SPF involved (Article 7).

In our opinion because there is an overlap of risk attribution to Sellco under Article 9 and thereafter to DAPE under Article 7, clear guidelines should be provided to prevent double counting of resulting costs and write offs in both the P&L of DAPE and in the fee payable to DAE.

(2) Yes. Paragraph 244 of the 2010 Attribution of Profits Report establishes that no presumption of assets and risks should be attributed to the DAPE merely by the fact that the same assets and risks were assumed by the DAE on the analysis of Article 9 of the MTC. In the case at hand, the SPF were properly attributed to the DAPE under the AOA functional and factual analysis.

### **c. EXAMPLE 3**

10. ***Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?***

Yes, provided that DAPE acts as a distributor and that, considering the fact pattern of the global group operation, the applied transfer methodology is appropriate (see *Paragraph 185 of the 2010 Attribution of Profits Report*) to calculate the DAPE’s profitability in an arm’s length basis in accordance with the

OECD's Transfer Pricing Guidelines ("Guidelines") and considering DAPE as a separate and independent enterprise.

- 11. *What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

The conclusion would be the same because, in this specific Example, there are no internal dealings between DAPE and Prima that could affect the allocation of profits in DAPE. Additionally, the profitability of DAPE, even with the different wording of Article 7, should be calculated in an arm's length basis as if DAPE were a separate and independent enterprise.

**d. EXAMPLE 4**

- 12. *Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?***

We agree with the construction of the P&L determined under the AOA; however, issues arise as to whether the collection of customer receivables by DAE translates into SPF of relevance for the DAPE (see *Paragraph 1.105 of the Guidelines*).

- 13. *Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?***

The differences arise since the analysis under Article 9 leads to risk being assumed entirely by Prima regardless that DAE is also exercising control over the risk, situation that does not occur under the AOA analysis because SPF in relation to the risk are appropriately shared between Prima and DAPE by the respective contributions to the total credit management cost.

We suggest that clear guidance is offered in terms of sharing SPF mirroring the guidance provided under Paragraph 1.94 of the Guidelines.

**II. GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS ARISING FROM ACTIVITIES NOT COVERED BY SPECIFIC EXCEPTIONS IN ARTICLE 5(4)**

**a. EXAMPLE 5**

**14. *Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?***

We agree with the conclusion of Scenario A of Example 5 under the AOA, considering that the nature of the internal dealings between the PE in Country W and WRU Head Office in Country A have been clearly identified.

As to the specific construction of profits or losses of the PE in Scenario A, since the functional and factual analysis of the assets, risks and functions have been appropriately attributed between the PE and the Head Office, there is a need to determine how much of WRU's free capital is needed to cover the assets and functions attributed to the PE in Country W (*see Part I, Paragraph 107 of the 2010 Attribution of Profits Report*). In this respect, considering that Scenario A lays the hypothesis that under Step 1 of the AOA the PE should be remunerated for operating the warehouse and that it has the economic ownership of such warehouse, we agree with the construction of profits.

**15. *Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?***

We agree with the conclusion reached in Scenarios B and C under the AOA since the profits are being attributed first, by identifying the assets economically owned by the PE in Country W, as well as considering the risks and functions performed therein. Then, as it occurred under Scenario A, the dealings between the PE and the Head Office should be recognized in determining the attributable income and losses of the PE, regardless of the absence of third-party income.

With respect to the conclusion reached in Paragraph 102 in Scenario C of Example 5, we agree that additional functions and assumptions of risks to Wareco would only affect the profits of WRU's Head Office and not those of the PE, since under the AOA's first step the attribution of profits depends on the distribution of functions and risks and none are being assigned to the PE under this last hypothesis. However, if additional SPF were to be carried out by WRU in Country W the PE would be involved in that distribution of risks and therefore its profits

would be affected (see *Part I, Paragraph 26 of the 2010 Attribution of Profits Report*).

- 16. *In particular, do you agree that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating the PE?***

Yes, we agree that there can be an investment return on the assets attributed to the PE regardless of whether there is personnel or not of the non-resident enterprise operating the PE. This is because the economic ownership of tangible assets is based on their place of use (see *Paragraph 75 of the 2010 Attribution of Profits Report*).

- 17. *Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?***

We agree that the streamlined approach could be a valid alternative for determining profits of the PE in absence of SPF in the latter. However, the streamlined approach is not recognized in the 2010 Attribution of Profits Report, and no additional guidance for its application is provided in this draft. Therefore, precise guidelines on the methodology applicable to the streamlined approach in cases such as Scenario B and C should be provided.

- 18. *Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.***

We agree. Parties performing SPF in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, provided that such SPF are performed on their own account. The foregoing since the key element for determining if SPF are relevant to the attribution of profits of a PE is whether the relevant parties are performing said functions on behalf of the non-resident enterprise (see *Paragraph 47 of the 2010 Attribution of Profits Report*).

**19. Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits to the PE of WRU?**

No. There would be no difference to the outcome of the attribution of profits to the PE of WRU since the functional and factual analysis of the PE would not be affected in any way, as it would otherwise be the case if dealing with a DAPE triggered out of the activities performed by Wareco if the latter was a DAE of WRU. The only change in the outcome of the operation would pertain to the compensation between WRU and Wareco, since it would need to be adjusted if such compensation is determined under the analysis of Article 9.

**20. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

In this particular case, there should be no difference in the conclusion since the PE is not being attributed with any risks arising from the performance of SPF, and the latter is only attributed profits considering an investment return which is recognized under the single taxpayers approach.

\* \* \*

The participation of IFA Grupo Mexicano, A.C. is made on its own behalf exclusively as an IFA Branch, and in no case in the name or on behalf of Central IFA or IFA as a whole.

We hope you find these comments interesting and useful. We remain yours for any questions or comments you may have.

Sincerely,

IFA Grupo Mexicano, A.C.

## Insurance Europe response to the OECD consultation on the Attribution of Profits to Permanent Establishments

Our reference:	ECO-TAX-16-103	Date:	30 August 2016
Referring to:	OECD Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments		
Contact person:	Alexandru Ciungu, Policy advisor, macroeconomics & taxation	E-mail:	Ciungu@insurancееurope.eu
Pages:	2	EU Transparency Register ID no.:	33213703459-54

### Comments

Insurance Europe welcomes the chance to respond to this consultation by the Organisation for Economic Co-operation and Development (OECD). Although the OECD's discussion draft mentions the fact that paragraphs 19-20 of the final report on Action 7 of the base erosion and profit shifting (BEPS) Action Plan indicate that Action 7 requires additional guidance on how the rules would apply **in particular for permanent establishments (PEs) outside of the financial sector**, Insurance Europe is concerned by the potential impact of certain proposals in the present discussion draft on the insurance sector.

As expressed in previous submissions to the OECD, Insurance Europe's main concern with the proposed PE rules is that, for some insurance business models, PEs would be recognised for tax but not for regulatory purposes with nil or minimal additional profit being attributed to them. This would represent a disproportionate compliance burden for insurers, as well as for tax authorities.

The discussion draft recognises in paragraph 104 that there will be situations in which the profits attributed to the PE will be nil, but fails to propose a solution which would avoid the disproportionate compliance burden that will be created for insurers in these cases. Insurance Europe considers that this is a disappointing outcome and disagrees with the suggestion that these PEs may nevertheless be justified by the potential existence of "other tax liabilities". At least in an insurance context, this would not be the case.

Insurance Europe maintains its view that **only the presence of Key Entrepreneurial Risk-Taking (KERT) functions in a jurisdiction should create a PE for tax purposes** and be relevant for the attribution of profits. The main KERT function of insurers is the assumption and management of insurance risk/business (i.e. underwriting). This is recognised by the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) ("Part IV").

The widened definition of PE (i.e. the new approach in respect to the attribution of profits) as presented in the discussion draft could however potentially generate new tax PEs for insurers with nil or minimal profit attributed to them in the following situations:



- The insurer sells and markets insurance products. Part IV recognises that such activities are unlikely to be KERT.
- An in-house service company performs non-KERT functions, such as back-office processing of applications, administrative support, claims handling and investment management.
- A third party unconnected agent acts exclusively for an insurer who is performing non-KERT functions.
- An agent acts (almost) exclusively for the insurer under a Delegated Underwriting Authority (DUA). If the authority granted under a DUA is strictly limited, the agent would not undertake KERT functions under this authority.
- A connected agent performs regulated non-KERT activities in the same territory as the customer and is rewarded directly, on arm's length terms, by the customer (e.g. a broker distributes insurance products and is rewarded through a fee charged to the customer in addition to any fees charged by the provider of the insurance products.)

In general, Insurance Europe's view is that **insurance distribution networks should not give rise to PEs for tax purposes** because distribution activities are remunerated by commissions and because the profits on these commissions are taxed in the distribution location. There is no reason why there should be further income attributable to a dependent agent PE if the agent's enterprise is remunerated at arm's length, taking into account the risks assumed by the dependent agent enterprise.

Similarly, when a banking network distributes insurance products, the insurer should be considered independent from the banking network, given that a) the banking network distributes products without authority to negotiate insurance contracts and b) the banking network may also distribute similar products from other insurance providers, therefore introducing effective competition.

Insurance Europe believes that the approach in example 1 of the discussion draft would be difficult to apply in an insurance context where there is nothing analogous to "cost of goods sold" (which appears in Example 1 to be payable to Country A to ensure there is no profit in the PE in Country B). If the methodology of Example 1 is applied to an agent undertaking non-KERT functions, for an insurer in Country B it would mean that all the premium from writing the business in Country B would be attributed to the PE in Country B even though the functions in that country would be non-KERT. This would clearly conflict with Part IV.

**Insurance Europe strongly believes that a solution should be found to avoid the useless generation of PEs in the circumstances outlined above, particularly because the OECD recognises that no profit will be attributed to these PEs.** Such a solution would avoid placing a highly disproportionate compliance burden on insurers. A possible way to ensure this would be adding wording to the commentary on Article 5 (e.g. under paragraph 39) to suggest that the facts and circumstances of the business value chain should be taken into account as part of the determination of whether or not a PE is created. Given that Part IV already provides a comprehensive guidance which defines and discusses risks, risk management and allocation of risk in the context of the insurance businesses, referencing Part IV would seem like a sensible solution.

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 200bn, directly employ over 975 000 people and invest nearly €9 800bn in the economy.

## INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

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September 5, 2016

### VIA E-MAIL

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**Re: Comment on Discussion Draft on BEPS Action 7 (Additional Guidance on the Attribution of Profits to Permanent Establishments)**

Dear Sir or Madam,

This letter is submitted on behalf of the International Alliance for Principled Taxation (IAPT or Alliance) to provide you with the IAPT's comments on the July 4, 2016 Discussion Draft on BEPS Action 7 (Additional Guidance on the Attribution of Profits to Permanent Establishments). We appreciate the opportunity to comment on the Discussion Draft.

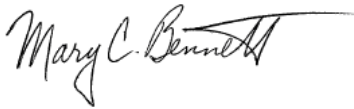
The IAPT is a group of major multinational corporations based both within and outside the EU, and representing business sectors as diverse as consumer products, media, telecommunications, oilfield services, computer technology, energy, health care, beverages, software, IT systems, publishing, management consulting, and electronics.<sup>1</sup> The group's purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally. The group participated actively as a stakeholder in the discussions leading to the October 2015 final reports from the OECD/G20 BEPS Project.

<sup>1</sup> The current membership of the IAPT is made up of the following companies: Accenture plc; Adobe Systems, Inc.; Anheuser-Busch InBev NV/SA; Cisco Systems, Inc.; The Coca-Cola Company; Exxon Mobil Corporation; Hewlett Packard Enterprise Company; Johnson & Johnson; Microsoft Corporation; Procter & Gamble Co.; REXL Group plc; TE Connectivity Ltd.; Thomson Reuters Corporation; Transocean Ltd.; Tupperware Brands Corporation; Vodafone Group plc; and Yum! Brands, Inc.

As we indicated in comments we submitted to the OECD in October 2013, January 2015, and June 2015, the IAPT fully supports the OECD initiative to develop clear and consensus guidance on the application of existing principles for attributing profits to permanent establishments (i.e., the “Authorised OECD Approach” or “AOA”) to the new forms of permanent establishment created under Action 7. We believe such guidance is crucial to the goal of minimizing costly and contentious disputes, and that it should be important to governments’ decisions about whether to adopt the changes recommended by Action 7.

The group’s comments are set forth in the Annex to this letter. We very much appreciate the willingness of the BEPS Project delegates to consider them as they continue their deliberations on the attribution of profits to the Action 7 permanent establishments. I look forward to discussing these comments with the delegates at the consultation to be held on October 11<sup>th</sup>-12<sup>th</sup>.

Sincerely yours on behalf of the Alliance,

A handwritten signature in black ink, reading "Mary C. Bennett". The signature is fluid and cursive, with a long horizontal stroke extending from the end of the name.

Mary C. Bennett  
Baker & McKenzie LLP  
Counsel to the Alliance

## **ANNEX**

### **IAPT Comments on the July 4, 2016 Discussion Draft on BEPS Action 7 (Additional Guidance on the Attribution of Profits to Permanent Establishments)**

#### **I. Executive Summary**

1. As a general introductory comment, we recommend that rather than using the 2010 “full AOA” as its exclusive reference point, the final guidance be expanded to include a discussion of the outcomes using the more generally applicable 2008 “partial AOA” as the primary reference point, while also retaining the discussion of the outcomes under the 2010 “full AOA”.

2. The IAPT recommends, at least for purposes of providing certainty as to the commitment of OECD member countries to a particular interpretation, that the final guidance to be provided on the attribution of profits to Action 7 PEs effectively be treated as a supplement to the AOA Reports, and that it be the subject of an updated version of Council Recommendation C(2008)106. We also suggest that a mechanism be provided through which non-OECD countries can express publicly their level of commitment to applying the AOA (whether the full or partial AOA, as appropriate) in interpreting their treaties that contain an Article 7 based on the 2010 or pre-2010 MTC. As indicated in our June 30th letter, we also recommend that countries be allowed under the MLI to adopt the new PE definitions of Action 7 only with respect to those treaty partners that commit to apply the AOA to PE profit attribution.

3. We recommend that the final guidance on the application of the AOA to Action 7 PEs address PEs arising from purchasing activities, from the application of the anti-fragmentation and contract-splitting rules, and from a warehouse owned and operated by an associated enterprise resident in the warehouse jurisdiction.

4. We recommend that the final guidance be expanded to include a more systematic discussion of the elements of the AOA. This should include a discussion under step 1 of the AOA of the dealings recognized between the head office and the PEs in the examples provided, including a description of the characterization of that dealing and the rationale supporting the selection of that characterization as correct, as well as a discussion under step 2 of the AOA of the transfer pricing method selected and the identification of comparables. The final guidance should likewise include a characterization of the hypothesized separate entity to facilitate the identification of comparables.

5. The IAPT has doubts that it should make a difference to the ultimate outcome whether one applies first the Article 9 analysis or the Article 7 analysis, but we believe it makes much more sense, and is more faithful to the principles of the AOA and of general application of treaties, to do the Article 9 analysis first. We further suggest that risks allocated from the foreign enterprise to the local enterprise under Article 9 (e.g., from Prima to Sellco in the DAPE examples) should not then be attributed to the foreign enterprise’s PE under Article 7, nor can the related assets be treated as economically owned by the PE.

6. The Examples should articulate their rationale for attributing the economic ownership of tangible property.
7. The Examples should articulate the basis on which transactions with separate enterprises are attributed to the PE.
8. The DAPE examples should articulate what form of new Article 5(5) PE they cover and should discuss, one way or the other, whether the new Action 7 DAPes involve any different considerations in relation to applying the AOA than traditional Article 5(5) DAPes.
9. The Examples should explain what is meant by “generic” and “not specialized” sales channels and should explain the effect on the attribution of marketing intangibles if sales channels do not meet that definition. Moreover, even if the sales channels used by the DAPE (or the dependent agent enterprise (DAE) on its behalf) are “specialized” or “non-generic”, the final guidance should clarify that their use does not give rise to a marketing intangible attributable to the DAPE if neither the DAPE nor the DAE has itself performed the significant people functions relating to the design or selection of those channels but if they are simply following instructions provided by the head office / principal.
10. Consideration should be given to whether Example 2 can properly be viewed as an example of a DAPE, or whether instead its facts point to the conclusion that Selco is acting not as an agent for Prima but in a principal to principal relationship with Prima, with the result that there is no DAPE.
11. In order to provide an administratively convenient way to reduce the compliance burdens arising from the new PEs while fully preserving countries’ taxing rights, we recommend consideration of a mechanism that would allow foreign enterprises that would otherwise have a PE in a Contracting State because of the fact that a related party in that State causes them to have a dependent agent PE or fixed place of business PE to elect out of PE status if the related person elects to be taxable in that State on the sum of: (i) the profits that would otherwise be taxable to that related person and (ii) the profits that would otherwise be taxable to the PE.

## **II. Introductory Comments**

12. The IAPT appreciates the opportunity to provide comments on the discussion draft (DD) on additional guidance on the attribution of profits to permanent establishments (PEs). The development of clear and consensus guidance on this issue will be crucial to minimizing the risk of costly disputes and will also be important to help governments decide about the desirability of following the Action 7 recommendations.
13. Before commenting on the DD’s proposed guidance on the two fact patterns selected for discussion, we would like to comment on three general issues: (i) the version of the “Authorised OECD Approach” (AOA) to the attribution of profits to PEs which should be used as the reference point; (ii) the format and status of the final guidance to be issued; and (iii) whether the guidance should cover other fact patterns as well.

#### **A. Version of the AOA to be used as the reference**

14. The IAPT strongly agrees with the conclusion in the Action 7 Final Report that the changes proposed there to Article 5 do not require substantive modification to the existing rules and guidance concerning the attribution of profits to a PE under Article 7. The existing guidance represents the conclusion of long and serious work on the topic by the OECD, and substitution of a different reference point at this stage would create significant uncertainty and potential for conflict.

15. The DD states that the analysis of the fact patterns it covers is performed by reference to Article 7 in the 2010 version of the OECD Model Tax Convention (MTC), and under the principles set out in the 2010 Commentary to the MTC, and the 2010 Report on the Attribution of Profit to Permanent Establishments (“the 2010 Attribution of Profits Report”). The DD goes on to note, however, that “(i) relatively few treaties currently include the new version of Article 7 which was included in the OECD Model in 2010 [footnote omitted]; (ii) through reservations and positions included in the OECD Model, a number of OECD and non-OECD countries have expressly stated their intention not to include the new version of Article 7 in their treaties [footnote omitted]; and, (iii) the inclusion of the new version of the Article in the UN Model (and, therefore, the implementation of the full AOA with respect to Article 7 of the UN Model) has been expressly rejected by the UN Committee of Experts on International Cooperation in Tax Matters.”

16. The DD correctly notes that the version of the AOA it has chosen to use as its exclusive reference point (i.e., the so-called “full AOA”) is not applicable to the vast majority of existing tax treaties, and the factors the DD cites point to the likelihood that this situation is liable to continue for a long time to come. The fact that the multilateral instrument being developed under Action 15 will likely not include a provision that would allow participating countries to introduce the 2010 version of Article 7 into their treaties simply confirms this point. As a result, the guidance provided in the DD risks having little applicability as a practical matter to most of the new PEs created by the changes introduced under Action 7, at least for many years into the future.

17. This does not mean, however, that the AOA is wholly irrelevant to the treatment of new PEs under most bilateral treaties. A review of the development of the AOA and related MTC changes illustrates that the AOA as implemented by the OECD under the pre-2010 version of Article 7 (i.e., the version that continues to be found in most treaties in force today) and in accordance with the 2008 Attribution of Profits Report and the 2008 Commentary on Article 7 is likely to have much broader practical applicability, now and for a long time to come. This version of the AOA as implemented under the 2008 MTC is referred to as the “partial AOA”.

18. When the work on the original 2008 Attribution of Profits Report was completed, the OECD said that its guidance “represents a better approach to attributing profits to permanent establishments than has previously been available”, but acknowledged that “there are differences between some of the conclusions

of the Report and the interpretation of the Article previously given” in the Commentary.<sup>2</sup> The OECD therefore stated as follows in the 2008 Commentary on Article 7:

For that reason, this Commentary has been amended to incorporate a number of conclusions of the Report that did not conflict with the previous version of this Commentary, which prescribed specific approaches in some areas and left considerable leeway in others. The Report therefore represents internationally agreed principles and, to the extent that it does not conflict with this Commentary, provides guidelines for the application of the arm’s length principle incorporated in the Article.

19. The 2008 Commentary on Article 7 includes most of the fundamental features of the full AOA. For example, it: (i) rejects the force of attraction principle (paragraph 10); (ii) expressly incorporates the AOA’s 2-step approach, including hypothesizing the PE as a separate and independent enterprise (based upon a functional and factual analysis, taking into account the economically significant activities and responsibilities undertaken by the PE), identifying “dealings” between the PE and the rest of the enterprise, and pricing those dealings by applying by analogy the arm’s length principle set out in the OECD’s *Transfer Pricing Guidelines* (paragraphs 17-18); (iii) confirms that PE accounts are a starting place, but that they must be reviewed to ensure they align with substance and reflect arm’s length pricing (paragraphs 16 and 19); (iv) expressly incorporates the Report’s guidance on the attribution of profits to dependent agent PEs (DAPEs) (paragraph 26); and (v) incorporates the Report’s guidance on the need for a PE to have an adequate amount of “free” capital (paragraphs 44 et seq.).

20. On the other hand, the 2008 Commentary retains some pre-existing language with which the 2008 Report was thought to be in conflict. Examples include the 2008 Commentary’s treatment of intangibles (paragraph 34) and to some extent its treatment of services (paragraphs 35-40) and interest (paragraphs 41-42).

21. At the same time that the 2008 Commentary was published, which laid out the “partial AOA” to be applied under treaties containing the pre-2010 version of Article 7, the OECD also published OECD Council Recommendation C(2008)106, which recommended that OECD member countries follow, when applying the provisions of such bilateral treaties, the guidance in the 2008 Report to the extent that its conclusions do not conflict with the 2008 Commentary on Article 7 (in other words, the “partial AOA”). While not legally binding, an OECD Council Recommendation represents a strong political commitment on the part of OECD member countries to adhere to the recommendation.<sup>3</sup> The Recommendation also invited non-OECD member countries whose treaties were drafted on the basis of the pre-2010 MTC to take account of the Recommendation’s terms.

22. In considering how many countries have expressed an intention to follow the partial AOA in interpreting their treaties based on the pre-2010 Article 7, it is worth noting that all OECD member

<sup>2</sup> 2008 MTC, paragraph 7 of Commentary on Article 7.

<sup>3</sup> The OECD website says with respect to Council Recommendations that ““practice accords them great moral force as representing the political will of Member countries and there is an expectation that Member countries will do their utmost to fully implement a Recommendation.”

countries took that position, with the exception of New Zealand.<sup>4</sup> Moreover, 30 non-OECD countries provided “positions” on the 2008 MTC. While many of those indicated they preferred to use a version of Article 7 that differed from the 2008 MTC text, only two of the 30 countries (Chile and India) said they did not agree with the conclusion that the version of the AOA implemented under the 2008 Commentary should be used in interpreting tax treaties that did contain an Article 7 based on the 2008 MTC.

23. In other words, there are strong grounds for concluding that, at least for the foreseeable future, the largest number of treaties under which the AOA might apply are going to be treaties based on the pre-2010 version of Article 7,<sup>5</sup> and that a very significant number of countries (including virtually all OECD member countries) have expressed some level of intention to apply the partial AOA in attributing profits to PEs under those treaties.

24. ***Suggestion:*** *Under these circumstances, the IAPT believes it would make sense for the guidance being developed under Action 7 to use the partial AOA as its primary reference point, while also retaining the discussion of the outcomes under the full AOA.* In doing so, the guidance would explicitly acknowledge the reality that the interpretations of Article 7 are not divided into “the AOA” and an interpretation “prior to the adoption of the AOA”, but instead include interpretations based on the full AOA, the partial AOA, and interpretations prior to any form of adoption of the AOA.

#### **B. Form and status of the guidance**

25. The DD does not address the question of the form the final guidance will take, nor what status it will have. We note that the 2008 and 2010 Reports were developed, like the *Transfer Pricing Guidelines*, as consensus documents and were both the subject of Council Recommendation C(2008)106, reflecting the strong political commitment OECD member countries expressed in favor of applying the Reports’ guidance in interpreting their treaties based on either the 2008 or 2010 version of MTC Article 7.

26. ***Suggestion:*** **The IAPT recommends, at least for purposes of providing certainty as to the commitment of OECD member countries to a particular interpretation, that the final guidance to be provided on the attribution of profits to Action 7 PEs should effectively be treated as a supplement to the AOA Reports, and should be the subject of an updated version of Council Recommendation C(2008)106.** It would also make sense for an appropriate reference to the final guidance to be included in updated Commentary to Article 7, including both the current version of Article 7 and the pre-2010 version preserved in current editions of the MTC.

27. The IAPT recognizes that with the participation of so many non-OECD countries in the development of the Action 7 guidance through the BEPS Project’s inclusion of non-OECD G20 and other countries, particularly under the Inclusive Framework, an OECD Report, Council Recommendation, and

<sup>4</sup> Only New Zealand entered an Observation disagreeing with the 2008 Commentary’s conclusion that the 2008 Report represents internationally agreed principles and, to the extent that it does not conflict with the 2008 Commentary, provides guidelines for the application of the arm’s length principle incorporated in the pre-2010 version of Article 7.

<sup>5</sup> The OECD made the extraordinary decision to retain the 2008 version of Article 7 and its Commentary in an Annex to the new Article 7 in the 2010 and later editions of the MTC, precisely because it recognized how important that guidance was likely to be the application of many existing bilateral treaties well into the future.



MTC Commentary update may not provide an appropriate mechanism for allowing non-OECD countries to express their level of commitment to the final guidance's conclusions. Nevertheless, it will obviously be important to know the positions of those countries, not only to give certainty to taxpayers but also to allow those countries' treaty partners to know what the implications might be of agreeing to include the new Action 7 definitions of PE in their treaties with those countries. In our comment letter on the MLI discussion draft submitted on June 30, 2016, the IAPT noted that "it may be worthwhile to allow States to introduce the new language only with respect to those treaty partners that commit to apply the Authorized OECD Approach (AOA) to PE profit attribution."

28. ***Suggestion:*** The IAPT suggests that a mechanism be provided in connection with the final guidance through which non-OECD countries can express publicly their level of commitment to applying the AOA (whether the full or partial AOA, as appropriate) in interpreting their treaties that contain an Article 7 based on the 2010 or pre-2010 MTC. The expression should relate not only to the new AOA guidance being developed under Action 7, but also to the entirety of the full or partial AOA.<sup>6</sup> It would be useful if the mechanism could take the form of an agreement made in connection with the conclusion of the MLI, so that it would be recognized as part of the context in which the treaty is to be interpreted under the principles of the Vienna Convention. As indicated in our June 30<sup>th</sup> letter, we also recommend that countries be allowed under the MLI to adopt the new PE definitions of Action 7 only with respect to those treaty partners that commit to apply the AOA (whether full or partial AOA, as appropriate to the relevant Article 7) to PE profit attribution.

### C. Coverage of other fact patterns

29. The DD suggests that new PE scenarios other than the two discussed in the DD are not in need of further guidance on how profits would be attributed to them under the AOA. The IAPT believes, however, that there could be value in elucidating the application of the AOA to some other new PE scenarios.

30. For example, among the changes made to Article 5(4) is restricting the scope of the Article 5(4)(d) exception (regarding "the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise") to cases where that activity is merely preparatory or auxiliary. Where, however, a treaty contains the pre-2010 version of MTC Article 7, paragraph 5 of that Article specifies that "No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise." Guidance could usefully clarify the continuing relevance of pre-2010 Article 7(5), where applicable, notwithstanding the change to Article 5(4).

31. Even under the 2010 version of Article 7, which allows the attribution of profits to purchasing activities, there is reason to consider clarifying the application of the AOA and the arm's length principle to a purchasing office. In particular, it would be useful to have such guidance dispel any misconception

<sup>6</sup> If countries are not clear about their position vis-à-vis the application of the basic AOA principles, it is likely that significant (and otherwise unnecessary) disputes could arise as to whether a PE which exists post-Action 7 would also have existed under the pre-Action 7 version of Article 5.

that a purchasing office that obtains volume discounts by virtue of activities that relate to a number of affiliates (or other parts of the same enterprise) will be attributed all the profit arising from those discounts.<sup>7</sup> That view conflicts with the guidance issued under Actions 8-10, which indicates that volume discounts achieved by a centralized purchasing function are typically shared among those members of the affiliated group that contribute to the group synergy producing the discounts.<sup>8</sup> The final guidance under Action 7 could usefully clarify that point in relation to purchasing offices.

32. The new anti-fragmentation rule of Article 5(4.1) can cause an enterprise (Company A) to have a PE by virtue of carrying on an activity at a location, even if that activity would otherwise be considered preparatory or auxiliary, if a closely related enterprise (Company B) carries on an activity at the same or a different location which constitutes a PE for that closely related enterprise, the activities in combination are not of a preparatory or auxiliary character, and they constitute complementary functions that are part of a cohesive business operation. This is the first time that one enterprise can be treated as having a PE due to activities carried on by a separate enterprise.<sup>9</sup> In such a situation, guidance could usefully clarify that the aggregation of the activities of Company A and Company B that is allowed for purposes of determining under Article 5 whether Company A has a PE in the host State will not apply in any way for purposes of determining the profits attributable to Company A's PE under Article 7. In other words, the profits attributable to Company A's PE must be determined by exclusive reference to a functional and factual analysis of Company A by itself, separately from the analysis that might apply to determine the profits attributable to Company B's PE.

33. Similarly, with respect to the Action 7 change relating to the splitting up of contracts, explanatory material contained in the initial October 2014 discussion draft had made it clear that the activities by related enterprises under separate contracts were to be aggregated under that rule *solely* for purposes of determining whether the PE time threshold had been met, and not for purposes of attributing profits.<sup>10</sup> This clarification was not repeated in the Action 7 Final Report, but it would be useful to repeat it as part of the final guidance on the application of the AOA to Action 7 PEs.

34. Finally, we recommend that Example 5 be expanded to cover what is a fairly common warehousing scenario, namely one where the warehouse in question is owned and operated by an associated enterprise resident in the warehouse jurisdiction.

35. ***Suggestion:* Accordingly, the IAPT recommends that the final guidance on the application of the AOA to Action 7 PEs address PEs arising from purchasing activities, from the application of**

<sup>7</sup> See, e.g., Example 1 in paragraph 26 of the October 31, 2014 Discussion Draft on BEPS Action 7: Preventing the Artificial Avoidance of PE Status.

<sup>8</sup> See *Transfer Pricing Guidelines*, paragraph 1.162.

<sup>9</sup> Prior to Action 7, paragraph 41.1 of the Commentary to Article 5 clearly stated: "The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State."

<sup>10</sup> See Discussion Draft on BEPS Action 7: Preventing the Artificial Abuse of PE Status, October 31, 2014, p. 22 ("The time periods spent by associated enterprises are merely aggregated for the purpose of deciding whether the 12 month period has been exceeded, not for the purpose of attributing the activities of one enterprise to the other.")

**the anti-fragmentation and contract-splitting rules, and from a warehouse owned and operated by an associated enterprise resident in the warehouse jurisdiction.**

### **III. Comments on the DAPE Examples**

36. The IAPT appreciates the effort reflected in the Discussion Draft to address the AOA implications of the two types of fact patterns selected, the DAPE cases and the warehousing cases. Before commenting on the specific examples, we would like to address a couple of points the delegates may wish to consider before they finalize these and any other examples in the final guidance.

37. One point is that the examples provided, while helpful, do not seem to address systematically each element of the AOA analysis. In particular, they do not describe the analysis underlying the identification and characterization of the “dealings” recognized between the head office and the DAPE, which is a critical element of step 1 of the AOA analysis.<sup>11</sup> Thus, Examples 1 through 4 appear to implicitly assume that a dealing has taken place in the form of a sale of inventory from the head office to the DAPE, without discussing whether or why that is considered the correct characterization of the dealing. There is a similar lack of discussion of the characterization of the dealing in the Example 5 scenarios. The IAPT believes it is particularly important under the new Action 7 PEs for taxpayers and tax authorities alike to understand the considerations involved in identifying and determining the nature of any intra-enterprise dealings relevant to the PE.

38. ***Suggestion:*** The IAPT recommends that the final guidance should be expanded to include a discussion of the dealings recognized between the head office and the PEs in the examples provided, including a description of the characterization of that dealing and the rationale supporting the selection of that characterization as correct. The final guidance should likewise include a characterization of the hypothesized separate entity to facilitate the identification of comparables.

39. The second point relates to Question 1 in the DD, which reads:

***Question 1.*** Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.

40. ***Response:*** The IAPT has doubts that it should make a difference to the ultimate outcome whether one applies first the Article 9 analysis or the Article 7 analysis, but we believe it makes much more sense, and is more faithful to the principles of the AOA and of general application of treaties, to do the Article 9 analysis first.

41. Where the foreign enterprise in question engages in a transaction with a related party that is of potential relevance to the attribution of profits to a PE of the enterprise, it is necessary under step 1 of the AOA to determine whether to attribute to the PE the rights and obligations arising out of the transaction

<sup>11</sup> See paragraph 172 of 2010 Attribution of Profits Report (“[I]n fully hypothesising the PE, it is necessary to identify and determine the nature of its internal ‘dealings’ with the rest of the enterprise of which it is a part.”).

between the enterprise of which the PE is a part and the related party.<sup>12</sup> It stands to reason that in order to be able to do this properly, one must first “accurately delineate” that transaction as is required as part of the Article 9 analysis. One also needs to price that transaction under Article 9 in order to be able to complete the portion of the Article 7 analysis that attributes profit to the PE. Moreover, as a practical matter, any issues that may arise as to the proper pricing of that transaction will most likely be resolved by the competent authorities of the jurisdictions of residence of the two enterprises (i.e., as an Article 9 issue), since the enterprise that has the PE may not be able to invoke the assistance of the competent authority of the PE jurisdiction, where it is not resident.<sup>13</sup>

#### **A. Example 1**

42. Example 1 provides a useful illustration of the principle set out in the AOA, that where a DAPE does not perform significant people functions relevant to the assumption and/or management of risk or relevant to the determination of economic ownership of assets, the attribution of profits to that DAPE may be “eliminated”.<sup>14</sup> Of course, this illustrates the point made by many commentators during the Action 7 consultations, namely that the new PEs might not result in much additional revenue in the host jurisdictions; it also reinforces the desirability of finding an administratively convenient way to address the compliance burdens created by the new PEs, a point to which we will return below. Before responding to the specific questions posed in the DD with respect to Example 1, we would like to address a few points.

##### *1. Nature of the dealing*

43. First, as noted in our introductory comments, this example does not include a discussion of the nature of the dealing between the head office of Prima and its DAPE. Somewhat confusingly, it concludes that the DAPE both cannot be allocated the economic ownership of inventory and must be allocated sales income from the sale of the inventory and a cost of goods sold (COGS) amount with respect to the inventory. This may reflect an assumption that the DAPE should be viewed as acting, vis-à-vis the head office, as a limited risk buy-sell distributor that takes flash title to the goods, but it would allow for a more complete understanding of how the AOA is to be applied if there was a clearer “delineation” of that dealing and an explanation of how to determine that delineation. An alternative characterization, which seems to have been rejected, is that the DAPE is simply providing a service to the head office, on whose behalf the sales are completed, and is entitled to a service fee (which would, in turn, be offset by the service fee paid to the dependent agent enterprise (DAE)). One question that arises with respect to the new Action 7 PEs is whether there is any greater likelihood that their dealings may be characterized as service dealings rather than buyer-reseller dealings, given that their PE status will no

<sup>12</sup> See paragraph 44 of the 2010 Attribution of Profits Report.

<sup>13</sup> While the foreign enterprise that has the PE will typically not be entitled to invoke the assistance of the competent authority of the PE jurisdiction to resolve a transfer pricing issue involving an affiliate in a third jurisdiction under paragraph 1 of a MAP article in a treaty between the PE jurisdiction and the third jurisdiction based on the OECD MTC (i.e., because the foreign enterprise is not a resident of either of those two jurisdictions), those two competent authorities may be willing to take up the case under their treaty’s Article 25(3); see paragraph 55 of the Commentary on Article 25 of the MTC.

<sup>14</sup> See paragraph 233 of the 2010 Attribution of Profits Report.

longer necessarily depend on their having “concluded” the sales contracts with third parties. Accordingly, some more guidance into the dealing characterization would be welcome. That guidance should also provide a characterization of the hypothesized separate entity (e.g., as full-fledged distributor, limited risk distributor, contract service provider) to facilitate the identification of comparables.

## *2. Application of step 2 of the AOA*

44. Second, the example does not really provide a discussion of the application of step 2 of the AOA, which involves application of the *Transfer Pricing Guidelines* by analogy to the pricing of the dealing between the head office and the DAPE. It assumes a profit allocation of zero (i.e., no profit, no loss) based on the non-existence of significant people functions at the DAPE and then reverse engineers the calculation to arrive at that result by using a plug number for the DAPE’s COGS. In practice, we would expect that a rigorous application of the AOA could involve an analysis of what is the most appropriate transfer pricing method to apply to the dealing (e.g., CUP, resale price margin, TNMM) and what comparables can be used to apply that method, taking into account the characterization of the hypothesized separate entity. To provide clearer guidance to taxpayers and tax administrations that will be trying to apply the AOA systematically, it would be helpful if the example could articulate its profit attribution conclusions taking into account those aspects of step 2.

## *3. Attribution of economic ownership of inventory as a tangible asset*

45. Third, the example states that economic ownership of the inventory is not attributed to the DAPE, seemingly on the grounds that no significant people functions are exercised through the DAPE that are relevant to determining the economic ownership of that asset. It is not clear from the example whether the AOA guidance on determining the economic ownership of tangible assets was considered. That guidance states that there was a broad consensus in favor of “applying [place of] use as the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view”.<sup>15</sup> The example does not indicate where the inventory is located. It may be that the example is signaling a conclusion that “place of use” is not the best criterion for attributing economic ownership of a tangible asset such as inventory (as opposed to, for example, machinery), and that a more general inquiry into significant people functions is appropriate for attributing the economic ownership of inventory (e.g., looking to the significant people functions relevant to deciding how much inventory to hold or where to store it or how to protect it or what price to sell it).<sup>16</sup> If so, it would be useful for the example to articulate that rationale, since attribution of the economic ownership of inventory will often be an important aspect of applying the AOA to Action 7 DAPes.

## *4. Type of new Article 5(5) DAPE*

46. Fourth, the example, like the other DAPE examples, does not discuss what type of new Action 7 PE is at issue. The revisions to Article 5(5) under Action 7 essentially address two new kinds of PEs.

<sup>15</sup> See paragraph 75 of the 2010 Attribution of Profits Report.

<sup>16</sup> We note that the existing DAPE guidance at paragraph 243 of Part I of the 2010 Attribution of Profits Report also implies that economic ownership of inventory can be attributed by reference to the location of significant people functions relevant to determining the economic ownership of the inventory.

One is what we'll call a "marketing services firm" DAPE, relating to a dependent agent that does not necessarily "conclude" contracts but "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise". The second is what we'll call a "commissionaire" DAPE, relating to a dependent agent that concludes contracts not "in the name of the enterprise" but "for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise". The "marketing services firm" type of DAPE could conceivably be viewed as involving less significant people functions than might have been involved in pre-Action 7 DAPes (e.g., because it is the head office, rather than the DAPE, that makes the ultimate decision whether or not to conclude the sale, with whatever risks may flow from that decision). The "commissionaire" type of DAPE could also conceivably be viewed as involving somewhat different risks from pre-Action 7 PEs (e.g., risks vis-à-vis incurring contractual obligations to commissionaire and vis-à-vis assuming credit risk relating to commissionaire's obligation, versus risks vis-à-vis incurring contractual obligations to third party customers and vis-à-vis assuming credit risk relating to third party customers' obligations). Since the purpose of the new guidance is to provide insight into how the AOA will be applied to the new Action 7 PEs, it would be useful if the final guidance would discuss, one way or the other, whether the new Action 7 DAPes involve any different considerations in relation to applying the AOA than traditional Article 5(5) DAPes.

#### *5. Attribution of marketing intangibles*

47. Fifth, Example 1 says there are no marketing intangibles attributable to the DAPE because there are no significant people functions performed by Sellco on behalf of Prima in Country B relevant to the attribution of economic ownership of such intangibles. The facts indicate that Sellco carries out the marketing strategy set by Prima, is reimbursed by Prima for all its local advertising expenses, and that the sales channels used are "generic and not specialised". Two issues are left unclear through these conclusions.

48. One relates to the unclear meaning of the reference to sales channels that are "generic and not specialised". Besides the basic ambiguity about the meaning of these terms, their use raises the question of whether a marketing intangible might be deemed attributable to the DAPE if Sellco carried out a marketing strategy set by Prima that involved the use of a "specialized" sales channel. It would be helpful if the final guidance clarified the meaning of the terms "generic" and "not specialized" in relation to sales channels and clarified the effect of using sales channels that do not meet that description. Moreover, even if the sales channels used are "specialized" or "non-generic", the final guidance should clarify that their use does not give rise to a marketing intangible attributable to the DAPE if Sellco has not itself performed the significant people functions relating to the design or selection of those channels but is simply following instructions provided by Prima.

49. The other issue relates to the question of whether the analysis would differ at all if under the relevant treaty the reference point for application of the AOA was the 2008 partial AOA rather than the 2010 full AOA. Under the partial AOA, paragraph 34 of the 2008 Commentary on MTC Article 7 carries forward the pre-AOA concept that "it may be extremely difficult to allocate "ownership" of the intangible

right solely to one part of the enterprise.” That paragraph further states that it may “be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly”. Because of the many countries that are likely to be applying the partial AOA, rather than the full AOA, it would be helpful if the final guidance could clarify what impact, if any, application of the partial AOA would have on the attribution of economic ownership of the marketing intangible in this example. This aligns with our recommendation above that the final guidance use the 2008 partial AOA as its primary reference point.

6. *Responses to DD questions on Example 1*

***Question 2. Do you agree with the functional and factual analysis performed in Example 1 under the AOA?***

50. ***Response:*** While the functional and factual analysis performed in Example 1 generally seems reasonable, we have questions, as outlined above, concerning: (i) whether the Example properly characterizes the dealing between Prima’s head office and the DAPE; (ii) the basis on which the Example attributes economic ownership of the inventory to Prima’s head office; (iii) whether the Example adequately considers the type of new Article 5(5) DAPE at issue; (iv) the basis on which the Example attributes economic ownership of marketing intangibles to Prima’s head office; and (v) how the hypothesized separate entity under the AOA is characterized for purposes of facilitating the identification of comparables.

***Question 3: Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?***

51. ***Response:*** While we agree with the Example’s conclusion that the DAPE has zero profits, we have questions, as outlined above, concerning the lack of any discussion of the elements of step 2 of the AOA relating to the selection of the most appropriate transfer pricing method and the selection of comparables, and instead the use of a “reverse engineering” approach to arrive at the profit attribution conclusion.

***Question 4: What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

52. ***Response:*** As outlined above, we believe it would be helpful if the Example clarified the difference, if any, in the conclusion that would be reached under the 2008 partial AOA versus the 2010 full AOA. We do not believe it is possible to give a definitive answer on whether or how the conclusion might differ under a treaty where a non-AOA approach applied.

***Question 5: In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?***

53. **Response:** Yes, it is appropriate. As noted above, it is fully in line with the DAPE guidance in the AOA.<sup>17</sup> The objective of the AOA is to determine the profits that would be attributable to a PE if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions,<sup>18</sup> applying by analogy the principles of the *Transfer Pricing Guidelines*. The *Transfer Pricing Guidelines* state the basic principle that in arm's length transactions between independent enterprises, compensation will usually reflect the functions that each enterprise performs (taking into account assets used and risks assumed). Where a foreign enterprise has no presence of its own in a host jurisdiction but is operating exclusively through a separate enterprise there, the arm's length requirements of Article 9 will require the separate enterprise to be fully compensated for the functions it performs (taking into account its assets used and its risks assumed). Once the functions performed in the jurisdiction have been fully compensated, the only possibility for there to be remaining profit in the DAPE arises if the foreign enterprise can be viewed as using assets of its own or assuming risks of its own through the activities performed on its behalf through the DAE. If the DAE is not performing in the host jurisdiction significant people functions that are relevant to determining the economic ownership of the foreign enterprise's assets or to assuming and/or managing risks of the foreign enterprise, the fundamental premise of the arm's length principle is that there is nothing more to compensate there, so the profits attributable to the DAPE are appropriately calculated at zero.

#### 7. Suggestions regarding Example 1

54. **Based on the foregoing, the IAPT has the following suggestions regarding Example 1:**

- **As a basic part of step 1 of the AOA, the Example should provide a description of the dealing between Prima's head office and the DAPE, as well as the manner in which the nature of that dealing is determined, as well as a characterization of the hypothesized separate entity.**
- **As a basic part of step 2 of the AOA, the Example should articulate the selection of the most appropriate transfer pricing method for pricing the dealing between the DAPE and the head office and the need to identify comparables for the application of that method.**
- **The Example should articulate its rationale for attributing economic ownership of the inventory, including if applicable its basis for concluding that the attribution should not follow the AOA's general presumption in favor of attributing tangible assets to the place where they are being used.**
- **The Example should identify the particular type of Action 7 DAPE at issue (i.e., "marketing services firm" or "commissionaire") and should discuss, one way or the other, whether the new Action 7 DAPes involve any different considerations in relation to applying the AOA than traditional Article 5(5) DAPes.**

<sup>17</sup> See paragraph 233 of the 2010 Attribution of Profits Report.

<sup>18</sup> In other words, it is necessary to identify the nature of the hypothesized separate enterprise.



- The Example should clarify what is meant by the terms “generic” and “not specialized” sales channels and what would be the effect on the attribution of economic ownership of marketing intangibles if the sales channels used did not meet those definitions. Moreover, even if the sales channels used are “specialized” or “non-generic”, the final guidance should clarify that their use does not give rise to a marketing intangible attributable to the DAE if Selco has not itself performed the significant people functions relating to the design or selection of those channels but is simply following instructions provided by Prima.
- The Example should, in line with our general recommendation for the final guidance to describe the application of the partial AOA as well as the full AOA, indicate the impact, if any, application of the partial AOA would have on the attribution of economic ownership of the marketing intangible.

## B. Example 2

55. Example 2 provides a useful basis for exploring the interaction between the analyses required by Articles 9 and 7 in cases where the DAE is an associated enterprise to the foreign enterprise. Before responding to the specific questions posed in the DD with respect to Example 2, we would like to address a few points. Most of these points relate to the fact that the Article 9 analysis in the Example results in the allocation of inventory and credit risk (and associated costs) from Prima to Selco, notwithstanding the contractual allocation of those risks to Prima and Prima’s legal ownership of the inventory and customer receivables.

### 1. Existence of a PE

56. The Article 9 analysis which results in the allocation of inventory and credit risk to Selco in Example 2 is an illustration of the requirement under the *Transfer Pricing Guidelines* to accurately delineate the “actual transaction” between Prima and Selco and to determine its “factual substance”.<sup>19</sup> The example stipulates that Selco will bear the economic downside of having assumed the inventory and credit risk, including the realization of bad debt losses and inventory losses. The Example also stipulates that Prima is entitled to a funding return with respect to the inventory.

57. It is difficult to understand this analysis other than one which is concluding that the *actual* transaction, *in substance*, between Prima and Selco is not one in which Prima is engaging the services of Selco to aid in the sale of Prima’s inventory to third parties, but instead one in which Prima has sold its inventory on credit to Selco and Selco is in turn attempting to sell that inventory to customers on credit and is holding customer receivables on its own account. That characterization is the most obvious one to explain how Selco could actually realize and bear losses from inventory obsolescence or non-recovery of customer debt (i.e., because Selco would actually have to have money at stake, in the form of its inventory purchase obligation to Prima, in order to realize and bear losses from those events). In other words, in conducting selling activities in Country B, Selco is not acting as an agent on behalf of Prima

<sup>19</sup> See *Transfer Pricing Guidelines*, paragraph 1.46.

but is acting as a buy-sell distributor on its own behalf. If this characterization holds true for purposes beyond the application of Article 9 (and we believe it should and will, at least in any jurisdiction that recognizes the concept of substance over form as a feature of its tax law), this would mean that a necessary condition for the finding of a PE under Article 5(5), namely that Sellco be acting “on behalf of” Prima, is not present. The fact that the nature of Sellco’s activities may be such that they would create a DAPE for Prima if Sellco were acting for Prima is irrelevant if those activities are being conducted on behalf of Sellco itself.

58. Accordingly, we recommend that consideration be given to whether Example 2 can properly be viewed as an example of a DAPE, or whether instead its facts point to the conclusion that Sellco is acting not as an agent for Prima but in a principal-to-principal relationship with Prima.

59. We note that acceptance of the reality of the actual transaction as outlined above would have a number of other consequences throughout the Example. For example, in the profit and loss statement shown at paragraph 44 of the DD to illustrate the results of the Article 9 analysis, Prima’s sales income should not necessarily be the 200 of revenue obtained from sales to third party customers, but instead a (presumably lower) amount at which it would have sold the inventory to Sellco for the latter’s resale to customers. Similarly, Sellco’s income should not be reflected as “sales commission” but should instead be based on the 200 of revenue obtained from sales to third party customers, and it should have a COGS charge.<sup>20</sup> In effect, we are suggesting that the Article 9 analysis should lead to a general conclusion for tax purposes that Sellco is the beneficial owner of the inventory and of the customer receivables, and that Prima’s asset is in the form of a receivable from Sellco. In other words, the accurate “delineation” of the transaction between Prima and Sellco amounts to a true recharacterization of the transaction, which implies a shifting of tax ownership of the inventory from Prima to Sellco with all the consequences that flow from that.

60. Notwithstanding that we believe, based on this analysis, that there is a good basis for concluding that no DAPE exists in Example 2, our further comments below will proceed on the assumption set forth in the DD that there is a DAPE.

## *2. Nature of the dealing*

61. Example 2 does not discuss the nature of the dealing between Prima’s head office and the DAPE. Like Example 1, it appears to implicitly assume that the DAPE has purchased the inventory from the head office and is then the recipient of the sales revenue from the inventory’s onward sale to the third party customers. As noted above, we believe the third party sales revenue belongs to Sellco, not Prima, and that Prima’s revenue is in the form of sales revenue from the sale of the inventory (on credit) to Sellco, and in the form of interest income from that extension of credit. The question that arises is whether that

<sup>20</sup> We note that the alternative approach adopted by the Example, which shows Sellco as receiving commission income offset by “inventory losses” and “bad debt losses” (both presumably in the form of payments back to Prima, since the Example presumes that Sellco has no investment of its own in the inventory or customer receivables) could result, depending on the facts, in a negative commission. To say the least, that would be a highly unusual form of sales agency arrangement, and any effort to find comparables in order to complete the pricing part of the Article 9 analysis would most likely end up having to rely upon more common transactions in an economically equivalent form, namely sales of inventory upon credit between a manufacturer and a distributor.

income is attributable to the head office or to the DAPE, and if to the DAPE, what the nature of the dealing, if any, is between the DAPE and the head office. For example, it is conceivable that one could conclude that there has been no dealing between the head office and the DAPE, and that the head office has directly sold its inventory on credit to Sellco; this could be consistent with an observation of where within Prima functions are carried out relating to the determination of the terms of the deal with Sellco. In any event, we believe it would be helpful for Example 2 to discuss the nature of the dealing, if any, taking place between the head office and the DAPE and the manner in which that dealing has been identified and its nature determined. The guidance should also characterize the hypothesized separate enterprise in order to facilitate the identification of comparables.

### *3. Attribution of economic ownership of assets*

62. As indicated by our discussion immediately above, we believe that the Article 9 analysis, which attributed inventory risk away from Prima to Sellco, necessarily implied a conclusion that Sellco should be treated as the owner of the inventory for tax purposes (i.e., as having purchased the inventory from Prima on credit), including for purposes of any Article 7 analysis. This would mean that Sellco is acting as a distributor rather than an agent, and that the asset of Prima for which the location of the economic ownership must be determined under Article 7 is a receivable from Sellco, not the inventory. In determining the location of the economic ownership of that asset, the relevant significant people functions would seem to be those relating to the decision-making about the nature of the relationship entered into in substance between Prima and Sellco (e.g., the decision to give Sellco the responsibility to warehouse the inventory and to determine the appropriate inventory levels, and to have Sellco make payments to Prima only once the inventory was either sold or “lost”, such as through obsolescence). The facts suggest that those significant people functions took place at Prima’s head office, which clearly points toward attributing economic ownership of that Sellco obligation to the head office, not to the DAPE.

63. If one continued to assume that it was necessary under Article 7 to treat Prima as still owning the inventory and to determine the location of that asset as between the head office and the DAPE, we would have the same questions as under Example 1 regarding the criteria to be used to attribute the economic ownership of that tangible asset (i.e., does one look to significant people functions, or to “place of use”).

### *4. Interaction of analyses under Articles 9 and 7 and impact on attribution of risk*

64. As indicated above in our response to Question 1, we believe it makes much more sense, and is more faithful to the principles of the AOA and of general application of treaties, to do the Article 9 analysis before doing the Article 7 analysis. Where, as here, the Article 9 analysis results in the allocation of certain risks away from Prima to Sellco, those risks should not be treated as risks of Prima to be potentially allocated to the DAPE under the Article 7 analysis. We understand the second sentence of footnote 10 of the DD to be consistent with that conclusion.

65. Even if, for argument’s sake, the Article 7 analysis was conducted first, and the inventory and credit risks in Example 2 were attributed to the DAPE under that analysis, those risks would then have to be allocated away from the DAPE to Sellco if a subsequent Article 9 analysis was conducted between the DAPE and Sellco. Either way, the DAPE cannot be attributed profit attributable to the bearing of those

risks where the Article 9 analysis concludes that they must be treated as belonging to Sellco. Any initial Article 7 analysis that might have been conducted on the assumption that the risks were allocable to the DAPE would have to be amended to reflect the Article 9 reallocation of those risks to Sellco; this illustrates how conducting the Article 9 analysis first is the more efficient approach.

*5. Determining whether Prima's transaction(s) with separate enterprises are allocable to the head office or the DAPE*

66. An essential part of step 1 of the AOA is “the attribution to the PE as appropriate of the rights and obligations arising out of transactions between the enterprise of which the PE is a part and separate enterprises”.<sup>21</sup> This means, for example, that one must determine whether Prima's transaction with Sellco is attributable to Prima's head office or the DAPE. For this purpose, we believe it is necessary to take into account the characterization of that transaction as determined by the Article 9 analysis (i.e., the extension of funding to Sellco for its acquisition of the inventory, as part of a sale of that inventory to Sellco) and to determine, through a functional and factual analysis, whether the head office or the DAPE should be hypothesized to have undertaken Prima's rights and obligations arising from that transaction.<sup>22</sup> When properly viewed from that perspective, the transaction with Sellco is one that the head office entered into, given that the head office manufactured and then transferred the inventory and determined the conditions under which Sellco could fund its acquisition of the inventory. Accordingly, the transaction with Sellco should be attributed to the head office, not to the DAPE.

67. Example 2 does not discuss the step 1 process by which it attributes transactions with separate enterprises to either the head office or the DAPE, but it deems the economic ownership of the inventory and receivables as attributable to the DAPE and likewise attributes to the DAPE the sales revenue from third parties and the funding return from Sellco. It attributes to the head office revenue from a notional internal sale of the inventory to the DAPE. As indicated by our discussion above, we believe this is incorrect, that the actual transaction with Sellco was in fact a sale upon credit directly from the head office, and that the third party sales revenue belongs to Sellco, not to Prima. In other words, a correct interpretation of the facts of Example 2 would show that the DAPE did not engage in any transactions with separate enterprises, nor in any dealings with the head office.

*6. Responses to DD questions on Example 2*

***Question 6: Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?***

68. **Response:** No, for the reasons outlined above, we believe that the Example is incorrect in allocating to the DAPE the inventory and inventory risk, the customer receivables and credit risk, the sales revenue from third parties, and the funding return. Assuming that the Article 9 analysis is correct, the funding return is appropriately allocable to the head office, and all the other items are appropriately allocable to Sellco. Under our interpretation, the head office P&L should show sales revenue from a sale of the inventory to Sellco (at a price which will take into account the fact that Sellco will bear inventory

<sup>21</sup> See paragraph 44 of the 2010 Attribution of Profits Report.

<sup>22</sup> See paragraphs 45 and 98 of the 2010 Attribution of Profits Report.

risk and warehousing costs and will carry out certain advertising), interest income from an extension of credit to Sellco, and a COGS amount. Sellco's P&L should show third party sales revenue of 200, as well as a COGS amount and expenses in the nature of advertising expenses, inventory losses, bad debt losses, any other operating expenses, and interest expense to Prima. The DAPE's P&L should not show any entries.

***Question 7: What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

69. **Response:** As outlined above, we believe it would be helpful if the Example clarified the difference, if any, in the conclusion that would be reached under the 2008 partial AOA versus the 2010 full AOA. We do not believe it is possible to give a definitive answer on whether or how the conclusion might differ under a treaty where a non-AOA approach applied.

***Question 8: In your opinion, what would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?***

70. **Response:** If Sellco did not have the financial capacity to assume the inventory and credit risks, we assume the risks could not be reallocated to Sellco under Article 9. The Final Report on Actions 8-10 does not provide clear guidance on how to allocate the risk if neither party to a transaction both exercises control over the risk and has the financial capacity to assume the risk, other than to say that: "As such a situation is not likely to occur in transactions between third parties, a rigorous analysis of the facts and circumstances of the case will need to be performed, in order to identify the underlying reasons and actions that led to this situation. Based on that assessment, the tax administrations will determine what adjustments to the transaction are needed for the transaction to result in an arm's length outcome. An assessment of the commercial rationality of the transaction based on Section D.2 may be necessary."<sup>23</sup> If the result of that analysis showed that the original transaction should be respected, and that the risks should remain with Prima, we assume that the results of the Action 7 analysis would be similar to those shown for Example 3 (i.e., that Sellco should be compensated for its service functions, and that the PE's profit should reflect the attribution of risk and economic ownership of assets to it based on the significant people functions performed on its behalf).

***Question 9: What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? Does your reading of the current***

<sup>23</sup> Transfer Pricing Guidelines, paragraph 1.99 (2016).

*guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?*

71. **Response:** As explained above, we disagree with the conclusions in the Example that attribute inventory and inventory risks, receivables and credit risk, to the DAPE when the Article 9 analysis shows that the inventory and credit risks belong with Sellco. In our view, those risks, as well as tax ownership of the inventory and customer receivables, should be allocable exclusively to Sellco if the Article 9 analysis is correct. We do not see anything in paragraphs 230 to 245 of the 2010 Attribution of Profits Report that would support those conclusions of the Example that attribute the same risks to both Sellco (under Article 9) and the DAPE (under Article 7) and that separately allocate the risks stemming from investment in assets and the economic ownership of those assets. Indeed, we read the guidance in those paragraphs as specifically requiring an inquiry into whether significant people functions relevant to the assumption and/or subsequent management of risk are carried out by the dependent agent enterprise (Sellco) “on behalf of” of the non-resident enterprise (Prima).<sup>24</sup> Where the Article 9 analysis confirms that Sellco’s functions relating to the assumption of inventory and credit risk are carried out on its own behalf (i.e., where those risks are properly allocable to Sellco, rather than Prima), the existing AOA guidance does not support treating those risks or the associated assets as attributable to a DAPE of Prima.

*7. Suggestions regarding Example 2*

72. **Based on the foregoing, the IAPT has the following suggestions regarding Example 2:**

- **Consideration should be given to whether Example 2 can properly be viewed as an example of a DAPE, or whether instead its facts point to the conclusion that Sellco is acting not as an agent for Prima but in a principal to principal relationship with Prima, with the result that no DAPE exists.**
- **Example 2 should discuss the nature of the dealing, if any, taking place between the head office and the DAPE and the manner in which that dealing has been identified and its nature determined. It should also characterize the hypothesized separate enterprise, if one is found to exist.**
- **The Example should recognize that, consistent with the Article 9 analysis, the asset of Prima for which the location of the economic ownership must be determined under Article 7 is a receivable from Sellco, not the inventory, and that the economic ownership of that Sellco obligation should be attributed to the head office, not to the DAPE, based on the performance of relevant significant people functions there.**
- **The Example should not allocate to the DAPE the risks attributable under Article 9 to Sellco.**
- **The Example should include a discussion of Prima’s transactions with separate enterprises and where and how those transactions are attributed as between the head**

<sup>24</sup> See paragraph 242 of Part I of the 2010 Attribution of Profits Report.

**office and the DAPE; such transactions attributable to the head office should not be attributed to the DAPE.**

**C. Example 3**

73. Before responding to the specific questions posed in the DD with respect to Example 3, we would like to address a few points.

*1. Nature of the dealing*

74. As in the case of the other examples, it would be helpful if Example 3 discussed more explicitly the nature of the dealing(s) it posits between the head office and the DAPE. The Example clearly implies that there has been a notional sale of the inventory from the head office to DAPE (through its reference to DAPE COGS of 158 and head office sales income of 158), suggesting that the DAPE should be characterized as a distributor. The Example does not address the question of whether there is a dealing between the head office and the DAPE in relation to the head office's development of a marketing strategy and advertising content for the goods to be sold by the DAPE, or for the protection of the Group's marketing intangibles.

*2. Allocation of advertising expenses*

75. The Example appears to assume, without explaining why, that the head office, rather than the DAPE, should bear the cost of reimbursing the Employee for the advertising expenses he incurs in placing local advertising for the products being sold by the DAPE. It would be useful to understand why that cost should be allocable to the head office rather than to the DAPE in its capacity as a deemed distributor, as determined under step 1 (i.e., why a manufacturer would agree to bear advertising expense for the onward sale by a distributor of inventory the distributor had purchased from the manufacturer).

*3. Application of step 2 of the AOA*

76. As in the case of other examples, Example 3 does not really provide a discussion of the application of step 2 of the AOA, which involves application of the *Transfer Pricing Guidelines* by analogy to the pricing of the dealing between the head office and the DAPE. It assumes a profit allocation of 9 (based on giving the DAPE an operating margin of 4.5% on sales of 200) and then reverse engineers the calculation to arrive at that result by using a plug number for the DAPE's COGS. While this may appropriately imply a proper application of a TNMM analysis, in practice, we would expect that a rigorous application of the AOA could involve an analysis of what is the most appropriate transfer pricing method to apply to the dealing (e.g., CUP, resale price margin, TNMM) and what comparables can be used to apply that method, taking into account the DAPE's characterization as a deemed distributor. To provide clearer guidance to taxpayers and tax administrations that will be trying to apply the AOA systematically, it would be helpful if the example could articulate its profit attribution conclusions taking into account those aspects of step 2.

4. *Responses to DD questions on Example 3*

***Question 10: Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?***

77. ***Response:*** Subject to the comments above concerning the desirability of better articulating both the dealing(s) between the head office and DAPE and the application of step 2 of the AOA, we believe the construction of the profits of the DAPE in Example 3 under the AOA is a reasonable one.

***Question 11: What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

78. ***Response:*** As outlined above, we believe it would be helpful if the Example clarified the difference, if any, in the conclusion that would be reached under the 2008 partial AOA versus the 2010 full AOA. We do not believe it is possible to give a definitive answer on whether or how the conclusion might differ under a treaty where a non-AOA approach applied.

5. *Suggestions regarding Example 3*

79. **Based on the foregoing, the IAPT has the following suggestions regarding Example 3:**

- **The Example should discuss more explicitly the nature of the dealing(s) it posits between the head office and the DAPE and should characterize the DAPE once hypothesized as a separate enterprise.**
- **The Example should explain why the advertising cost has been allocated to the head office rather than the DAPE.**
- **The Example should articulate the manner in which it applies step 2 of the AOA, including its selection of the most appropriate transfer pricing method and the identification of comparables.**

**D. Example 4**

80. Before responding to the specific questions posed in the DD with respect to Example 4, we would like to address a few points.

1. *Issues regarding Article 9 analysis*

81. While we appreciate that the importance of the DD relates to its Article 7 analyses, Example 4 raises an issue relating to the Article 9 analysis we would like to note. According to the Example, Prima both exercises control over the credit risk and has the financial capacity to bear that risk. As a result, the contractual allocation of the risk to Prima is respected under paragraph 1.94 of the *Transfer Pricing Guidelines*. The Example states that the service fee (cost plus 10%) paid by Prima to Sellco is arm's length compensation for Sellco's credit risk management services for Prima. The Example goes on, however, to describe a highly unusual "incentive" fee of 40% of the upside and downside realization of



the credit risk relative to expected losses<sup>25</sup> and states that this, too, is assumed to be an arm's length amount.<sup>26</sup>

82. It is not entirely clear how both the cost plus service fee and the contingent incentive fee can be arm's length compensation for the same credit management services. In effect, the incentive fee contractual arrangement appears to be a partial allocation of the credit risk itself to Sellco. Scenario B, which shows a negative incentive fee to Sellco (i.e., a net payment from Sellco to Prima) as a result of high bad debt losses, particularly clearly illustrates the effect of Sellco bearing a significant portion of the credit risk. Based on the facts in the Example, we believe a better interpretation would be that Prima and Sellco have contractually agreed to share the credit risk, and the Example suggests that the Article 9 analysis respects that sharing of the risk.

83. The Example states that this sharing of the potential upside and downside by Sellco is in accordance with the contractual arrangements "and the principles of paragraph 1.105 of the Guidelines". The latter paragraph provides that where a party contributes to the control of risk but does not assume the risk, "compensation which takes the form of a sharing in the potential upside and downside, commensurate with that contribution to control, may be appropriate." There are two points to note about this statement. First, because Sellco through the contractual incentive fee arrangement has in effect partially assumed the credit risk, the incentive fee represents its contractual compensation for the partial assumption of that risk. As in the case of Example 2, it will be important to ensure that risk that is properly allocated to Sellco under the Article 9 analysis is not again allocated to the DAPE in performing the Article 7 analysis. Second, if the contractual arrangement between Prima and Sellco had not included this contingent incentive fee, we do not believe it would be proper for the Example to imply that the principles of paragraph 1.105 of the Guidelines would necessarily require that form of compensation in order to satisfy the arm's length requirement. While paragraph 1.105 indicates that sharing of the upside and downside potential on risk "may" be an appropriate form of compensation to a party that contributes to the control but does not contractually assume the risk, that paragraph does not mandate such a form of compensation. The Example should be worded carefully so as not to imply that a profit split with respect to the credit risk is effectively required in such cases.

## *2. Nature of the dealing*

84. Once again, the Example does not describe the nature of the dealing(s) between the head office and the DAPE, although it posits that the DAPE should be attributed 25% of the credit risk and appropriate receivables asset, based on the fact that the credit management costs for the Country B receivables were incurred 75% by Prima's head office and 25% by Sellco. Is the assumption that the DAPE has acquired 100% of the receivables upon its sale of the inventory to customers and has factored

<sup>25</sup> We question the appropriateness of including such an unusual contractual provision in guidance which is supposed to be of general applicability.

<sup>26</sup> While we appreciate that the numbers in the examples are merely for illustrative purposes, it is interesting to note that the incentive fee gives Sellco 40% of the upside potential on the receivables, whereas Sellco has incurred only 25% of the credit management costs on those receivables and the Article 7 analysis attributes to the DAPE only 25% of the credit return on them.

75% of them to Prima's head office? It would be useful if the Example would more clearly articulate the nature of the dealing(s) between the two Prima locations and the rationale for that characterization.

*3. Relationship between sharing of costs and sharing of return on risk*

85. The Article 7 analysis in the Example attributes to the DAPE 25% of the risk return on the receivables and 25% of the fee to Sellco and the bad debts, but for unexplained reasons it attributes to the DAPE zero percent of the credit risk management costs incurred by Prima's head office. It would seem that the DAPE should be attributed 25% of all the credit risk management costs incurred with respect to the Country B receivables, including those incurred by Prima's head office. It would be useful if the Example could explain the reasoning for the lack of allocation of those costs to the DAPE.

*4. Application of step 2 of the AOA*

86. The Example isolates attribution of profit from credit risk and receivables, rather than also showing how the entirety of the DAPE's profit would be calculated. While this may be understandable for purposes of making an isolated point about the differences between the analyses under Articles 9 and 7, it would generally be preferable for the Examples to apply step 2 systematically and thoroughly.

*5. Responses to DD questions regarding Example 4*

***Question 12: Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?***

87. **Response:** As outlined above, we have questions about the appropriateness of using credit management functions performed by Sellco to both allocate some of the credit risk to Sellco under Article 9 and also attribute additional credit risk return to the DAPE under Article 7. We also have questions about the lack of allocation of head office credit management costs to the DAPE and about how the determination of DAPE profit on a particular slice of its activities interacts with the determination of DAPE profit on the balance of its activities.

***Question 13: Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?***

88. **Response:** As indicated above, our interpretation of the facts is that the incentive fee arrangement does constitute a partial contractual allocation of the risk to Sellco. If the Article 9 analysis had not in fact resulted in any allocation of the risk to Sellco, we do agree that Article 7 could result in a partial attribution of the risk to the DAPE based on the significant people functions in relation to credit risk management carried out by Sellco in Country B.

6. *Suggestions regarding Example 4*

89. **Based on the foregoing, we have the following suggestions regarding Example 4:**

- **The Article 9 analysis should be revised to recognize that the credit risk has been partially contractually allocated to Selco (and that Selco is effectively acting as a factoring entity with respect to that portion of the receivables) and to ensure that the Example does not imply such a profit split approach to the compensation of Selco's control functions is mandated in order to satisfy the arm's length principle.**
- **The credit risk contractually allocated to Selco (and respected under the Article 9 analysis) should not also be treated as attributable to the DAPE under the Article 7 analysis.**
- **The nature of the dealing between the DAPE and the head office (e.g., a factoring of the DAPE's receivables) should be articulated.**
- **The DAPE should be allocated a share of the head office credit management costs attributable to the receivables deemed economically owned by the DAPE.**
- **The Example should illustrate how the determination of profit attributable to the DAPE's assumption of credit risk interacts with the determination of profit attributable to the remainder of the DAPE's activities.**

**IV. Comments on the Article 5(4) Examples**

90. Before responding to the specific questions posed in the DD with respect to Example 5, we would like to address a few points.

1. *Attribution of economic ownership of the warehouse*

91. The DD indicates that economic ownership of the warehouse is attributed to the PE in Country B, using the "place of use" criterion from paragraph 75 of the 2010 Attribution of Profits Report. This is true notwithstanding the fact that all significant people functions relating to the warehouse, including the analysis of the commercial need for the warehouse, its location, and its configuration, the determination of how the warehouse should be operated, the recommendation of levels of inventory to be maintained by customers and replenishment policies, etc., are performed by WRU at its head office in Country A. Given the strength of the significant people functions relating to the warehouse carried on in Country A, it could be useful for the Example to explain why this is not a case where a criterion other than "place of use" is appropriate for attributing economic ownership of the warehouse (particularly given the attribution of economic ownership of inventory according to significant people functions under Example 1).

2. *Nature of the dealing*

92. The DD hints at a number of dealings between the PE and the head office in the Example 5 scenarios (e.g., head office's provision of investment advice to the PE upon the PE's acquisition of the

warehouse, head office's provision of advisory services in analyzing inventory usage and recommending replenishment policies, head office's provision of rights to use intangible assets in the warehouse facilities). It would be useful if the Example would explicitly identify each of these as "dealings". The head office also provides a workforce to the PE in Scenarios A and B, but the Example sidesteps the question of whether this is a compensable dealing; it appears to simply allocate the cost of the workforce to the PE. Here, too, greater clarity on the characterization of the dealing, if any, and on the characterization of the hypothesized separate enterprise would be useful.

3. *Need for an example where warehouse is owned and operated by an affiliate*

93. As indicated above, we believe it would be very useful for the final guidance to include an example of the fairly common situation whether a foreign enterprise stores its goods at a warehouse owned and operated by a related local enterprise. If a PE could exist in such a case (i.e., if the local enterprise's warehouse premises could be considered a fixed place of business of the foreign enterprise), questions similar to those addressed under Example 1 could arise (e.g., can there be any profit attributable to the PE when the foreign enterprise has no presence of its own in the host jurisdiction (other than inventory) and the local enterprise is not performing any significant people functions that would attract the economic ownership of foreign enterprise assets or the assumption of foreign enterprise risk to the PE location?). Such an example could address, for example, how to attribute the economic ownership of the inventory and the assumption of inventory risk.

**A. Example 5, Scenario A: Warehousing as the core business**

1. *Treatment of service fee*

94. Scenario A indicates (appropriately, we believe) that the PE should be deemed to pay a service fee to the head office for services related to inventory usage and replenishment, and for investment advice. It does not discuss how the service fees were calculated nor whether there would be any difference in the calculation as between treaties under which the 2010 full AOA applies and those under which the 2008 partial AOA applies (i.e., whether the result would be different between applying the principles of Chapter VII of the *Transfer Pricing Guidelines* or the guidance found in paragraphs 35-38 of the 2008 Commentary on Article 7).

2. *Treatment of know-how / software remuneration*

95. Scenario A also indicates (again, appropriately, we believe) that the PE should be deemed to pay an amount to the head office as compensation for the use of the know-how and software related to the efficient operation of the warehouse.<sup>27</sup> Here again, it would be useful if the final guidance addressed the question of whether there would be any difference between applying the 2008 partial AOA and the 2010 full AOA (i.e., between applying the principles of Chapter VI of the *Transfer Pricing Guidelines* and the guidance found at paragraph 34 of the 2008 Commentary on Article 7).

<sup>27</sup> Paragraph 93 of the DD refers to the provision of know-how and software as a service, but a more appropriate characterization might be a license.

3. *Interest expense*

96. The Example indicates (again, appropriately, we believe) that the PE should be entitled to a deduction for interest expense. It does not discuss how the PE's interest expense would be determined. It would be helpful if the final guidance gave some explanation of how to determine the PE's interest expense.

4. *Responses to DD questions regarding Example 5, Scenario A*

***Question 14: Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?***

97. ***Response:*** The construction of the PE's profit in Scenario A appears to be a reasonable application of the 2010 full AOA. As indicated above, it would be useful to expand the Example to include a discussion of the potential impact of the 2008 partial AOA.

**B. Example 5, Scenarios B (Warehousing as an internal function of the business) and C (Warehousing as an internal function of the business carried out by a separate enterprise)**

1. *Responses to DD questions regarding Example 5, Scenarios B and C*

***Question 15: Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?***

98. ***Response:*** The (very brief) conclusions regarding the profits attributable to the PE in Scenarios B and C seem reasonable, assuming it to be correct that economic ownership of the warehouse is attributable to the PE and not to the head office.

***Question 16: In particular, do you agree that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?***

99. ***Response:*** We do agree with that conclusion, provided it has been appropriately determined that economic ownership of the asset is attributable to the PE.

***Question 17: Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?***

100. ***Response:*** That seems to be an appropriate approach. The return could conceivably be determined by reference to rental income for comparable property.

***Question 18: Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE***

*do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.*

101. **Response:** We do agree, for the same reasons as articulated in response to Question 5, above.

*Question 19: Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits to the PE of WRU?*

102. **Response:** No.

*Question 20: What would the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?*

103. **Response:** As indicated above, we believe it would be useful if the Example could indicate whether there would be any difference, particularly to the calculation of the PE's deemed payments to the head office for services and intangibles, between the application of the 2010 full AOA and the 2008 partial AOA. We do not believe it is possible to give a definitive answer on whether or how the conclusion might differ under a treaty where a non-AOA approach applied.

## 2. Suggestions regarding Example 5

104. **Based on the foregoing, we have the following suggestions regarding Example 5:**

- The Example should address the reasoning for the attribution of economic ownership of the warehouse to the PE.
- The Example should provide greater clarity concerning the identification and characterization of dealings between the PE and head office.
- The Example should be expanded to include a scenario where a related local enterprise owns and operates the warehouse for the foreign enterprise.
- The Example should be expanded to discuss whether there would be any difference in the calculation of the PE's deductions in relation to services and intangibles provided by the head office between treaties under which the 2010 full AOA applies and treaties under which the 2008 partial AOA applies.
- The Example should give some explanation of how to compute the PE's interest deduction.

## V. Exploring Additional Approaches to Coordinate the Application of Article 7 and Article 9 of the MTC

*Question 21: Do commentators have suggestions for mechanisms to provide additional co-ordination for the application of Article 7 and Article 9 of the*

***MTC to determine the profits of a PE, taking into account the considerations expressed above?***

105. **Response:** The IAPT very much welcomes the DD's invitation to suggest mechanisms to provide additional coordination for the application of Articles 7 and 9. It is our belief that widespread adoption of the Action 7 recommendations will lead to a great many additional PEs for MNE groups operating around the world, and that many of these PEs will have little or no profit attributable to them, as is illustrated by several of the examples in the DD. Finding an administratively convenient way to deal with such cases would be to the benefit of both tax administrations and taxpayers in reducing the compliance burdens of both.

106. Paragraph 246 of the 2010 Attribution of Profits Report cited as one such mechanism an approach whereby the host jurisdiction could "actually collect tax only from the dependent agent enterprise even though the amount of tax is calculated by reference to the activities of both the dependent agent enterprise and the dependent agent PE. In practice what this means is taxing the dependent agent enterprise not only on the profits attributable to the people functions it performs on behalf of the non-resident enterprise (and its own assets and risks assumed), but also on the reward for the free capital which is properly attributable to the PE of the non-resident enterprise." This type of approach has been successfully implemented in practice by some countries.<sup>28</sup>

107. We would recommend consideration of a mechanism that would allow foreign enterprises that would otherwise have a PE in a Contracting State because of the fact that a related party in that State causes them to have a dependent agent PE or fixed place of business PE to elect out of PE status if the related person elects to be taxable in that State on the sum of: (i) the profits that would otherwise be taxable to that related person and (ii) the profits that would otherwise be taxable to the PE. We believe such a mechanism could be introduced through an appropriate treaty provision or competent authority agreement between the parties to a bilateral tax treaty, which could include a concept along the following lines:

***Notwithstanding the provisions of Article 5, activities conducted in a Contracting State by a person that is closely related to an enterprise or through a fixed place of business of any such person shall be deemed not to cause such enterprise to have a permanent establishment in that State if the enterprise and the person jointly make a binding election pursuant to which the profits of such person which may be taxed in that State shall be equal to the sum of the profits such person would have and the profits that would be attributable to any such permanent establishment of the enterprise in the absence of such election. It is understood that the enterprise and person that make the binding election provided under this paragraph shall ensure that the conditions established between them produce a result that is consistent with the effect of the election, and it is further understood that such conditions shall be considered to be consistent with conditions that are made or imposed between independent enterprises***

<sup>28</sup> See, e.g., IRS press release IR-INT-1999-13, regarding the competent authority agreement between the United States and Mexico to ignore the existence of a Mexican PE in certain cases in the maquila industry, where the taxpayers agreed that the Mexican maquila enterprise would pay tax to Mexico not only on its own arm's length profit but also on an amount determined by reference to what the profits of the U.S. enterprise's Mexican PE would have been.

*for purposes of the provisions of the domestic law of each Contracting State and Article 9 of this Convention.*

108. A mechanism of this sort would allow a nonresident enterprise that would otherwise be treated as having a PE in a host State to avoid being treated as having such a PE (and thus avoid the need to comply with host State tax and reporting obligations) in certain circumstances and provided that certain conditions are met. It would similarly allow the local tax administration to deal exclusively with its resident enterprise in obtaining all the tax to which it is entitled based on the combined features of the local enterprise and PE in its jurisdiction.

109. For this result to apply, the provision would require the resident enterprise and the nonresident enterprise to enter into:

- A binding election that provides the resident enterprise agrees to recognize profits, if any, equal to the sum of the profits that would be attributable to the PE of the nonresident enterprise that would exist in the absence of the binding election, based upon the functions undertaken on that nonresident enterprise's account (taking into account assets and risks attributed to the PE, and the necessary "free" capital to support them), plus the arm's length profits, if any, the resident enterprise would have in the absence of the binding election, based upon the functions undertaken by that resident enterprise on its own account (taking into account its own assets and risks).
- Intercompany arrangements that provide that where the binding election is made, the resident enterprise shall charge the nonresident enterprise, and the nonresident enterprise shall pay, an amount such that the total profits recognized by the resident enterprise are equal to the arm's length profits, if any, the resident enterprise would recognize in the absence of the election plus the profits, if any, that would be attributable to the PE the nonresident enterprise would have in the absence of the election. While the latter amount depends under the AOA on assets, risks, and capital deemed owned, assumed, or contributed respectively to the PE, such intercompany arrangement would not need to delineate such deemed assets, risk, or capital.

110. This mechanism would result in the nonresident enterprise having no PE, no filing obligation, and no corporate income tax liability in the host State arising from the activities conducted on the nonresident enterprise's account by the resident enterprise or at its premises. The nonresident would be entitled to deduct the amounts accrued under the intercompany arrangement with the resident discussed above. The mechanism would *not* eliminate a PE, filing obligation, or corporate income tax liability in a host State arising from a nonresident enterprise's *own* activities or operations in that State unrelated to a PE arising from a resident enterprise's activities or premises.

111. This is just one suggestion of a possible mechanism that could be used to achieve administrative simplification, while at the same time guaranteeing the host State its ability to collect the full amount of corporate tax due to it on the profits of its resident enterprise and the PE. We would be glad to work with delegates to consider modified or alternative versions to address their concerns.

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8th August 2016

Dear Sir or Madam,

**BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments**

IHG welcomes the opportunity to submit comments on the further OECD Discussion Draft on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments ('The Discussion Draft').

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### **Our Summary Comments on The Discussion Draft**

IHG has been supportive generally of the BEPS Review process and, in particular, supported the Action 7 measure to make the Article 5(4) exceptions subject to a general requirement that the activities concerned be preparatory or auxiliary when considered in the context of the particular business model and fact pattern concerned. We do however see a role for a preparatory or auxiliary exception, because that assists in maintaining compliance requirements at proportionate levels- which is in the interest of both Taxpayers and Tax Authorities. We therefore also welcomed the retention, within Article 5(5), of the corresponding exception where the activities of a local agent should similarly be viewed as preparatory or auxiliary.

We have three key generic comments concerning the Discussion Draft, which are as follows:

- (A) Whereas The Discussion Draft is focussed on the Attribution of Profits to PE's –and in particular how to compute incremental attributions which flow from the Action 7 amendments- it is in our view important to link this attribution issue to considerations of whether, or what, activities should be considered to be preparatory or auxiliary.

As is noted in para 104 of The Discussion Draft, circumstances can arise where there would *prima facie* be a Dependent Agent Permanent Establishment ('DAPE') by virtue of the Action 7 extensions, but where no profits are attributable to that PE- thus merely resulting in incremental compliance burdens rather than incremental tax.

We would suggest that, if the predictable/forecast outcome of such an attribution would be of nil or negligible DAPE profits, then that should be taken as *prima facie* evidence that the activities conducted by the Dependent Agent Enterprise ('DAE') on behalf of the DAPE should be viewed as preparatory or auxiliary functions so that PE recognition and filing is not required. This could, for example, be framed as indicative guidance that if the forecast Net Present Value of DAPE taxable profits are less than, say, 5% of the NPV of combined DAE and DAPE profits then the DAE activities should be viewed as Preparatory or Auxiliary under the general Article 5(4)(e) exclusion (as extended into Article 5(5)).

- (B) It seems to us that there may be a misinterpretation or confusion which leads to profits attributed to the DAPE being interpreted in The Discussion Draft as arising from services provided to the DAE, whereas our understanding is that –to be consistent with the conceptual underpinning of what the Action 7 changes were designed to achieve- those profits are part of the third party profits. This point arises, for example, in relation to the '2' amount described in Example 2 as 'Funding return from Sellco'. It seems to us that that is not an expense of Sellco- under Article 9 or otherwise- and should instead be dealt with as an Article 7 COGS item so as to leave an operating profit of 2 in the DAPE.

As we understand it the purpose of Action 7 was to ensure that there was a full allocation of aggregate attributable profits to the local jurisdiction (i.e. Country B in the examples) by reducing the exceptions from PE status. In the absence of PE status the profits protected by those exceptions are attributable to the Head Office jurisdiction (Country A in the examples). Removing or reducing such protection must therefore surely result in an Article 7 allocation difference and not an Article 9 difference.

And.

- (C) As is implicitly touched on in para 105 and question 21 there is rightly a concern that the extended PE provisions introduced under Action 7 may introduce unwelcome additional compliance burdens by multiplying the number of returns which are required within a single jurisdiction to charge and collect the right amount of tax. The clarification of the 'Preparatory or Auxiliary' provisions suggested under (A) above would perhaps ensure that this was not disproportionate. It may also be useful to support –as a best practise option- the domestic availability of options for a single, Country B, consolidated return for dealing with presences, which are linked or aggregated under the Action 7 provisions so as to enable Taxpayers to comply locally in the simplest possible fashion. The objective of most Taxpayers is to comply locally, and do so in the simplest fashion –by, for example, incorporating a local subsidiary to recognise and account for local obligations. The Action 7 extensions do create a concern that –even where this is done- unintended additional DAPE type filing requirements may arise.

### **Our detailed comments concerning The Discussion Draft Questions**

With respect to the detailed questions raised in The Discussion Draft:

- (1) *Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.***

As a conceptual matter it does not seem to us that the order in which the Article 9 and Article 7 analyses are performed should affect the outcome. It does however seem necessary as a practical matter to start with a functional understanding of what is done in Country B in relation to the Country A business. That functional understanding must then, in turn, be applied to determine whether and where, within the context of the extended Action 7 PE concepts, that relationship should be viewed as involving a domestic Article 9 supply to a DAPE which is thereby created, or alternatively as a cross-border Article 9 supply to Country A (ie. one which creates income in country B and expense solely in Country A, rather than expense in a Country B DAPE of the Country A host).

It is not clear to us as a conceptual matter that it is possible for mirror image domestic to domestic Country B supplies from the DAPE to the DAE to arise in this type of example (because local functions are carried on by the DAE). If that is a possibility however, then those mirror image domestic supplies should also identified.

We would suggest that a logical sequence to subsequently follow is:

- (i) First, make all Article 9 charges other than these domestic Country B to Country B charges;
- (ii) Then make an Article 7 determination as to what taxable profits are, in aggregate, properly attributable to Country B before considering domestic Article 9 charges within Country B. For this interim calculation purpose all functions performed in Country B with respect to domestic supplies are treated as if they are performed by the Company for whom the Article 7 analysis is being performed; and
- (iii) Then make Article 9 charges within Country B so as to separate local taxable profits/losses between local entities or presences.

We believe that this sequencing not only provides the most clarity, on a basis consistent with the Action 7 objectives and principles, but may also be either necessary or of assistance if

local consolidated filing options are to be pursued as recommended in item (C) of our summary comments.

- (2) ***Do you agree with the functional and factual analysis performed in Example 1 under the AOA?***

Yes we do agree with this analysis.

- (3) ***Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?***

Yes we do agree with the construction of profits in Example 1. It does seem to us to be a significant point (which we refer to later) that the gross external Sales income is attributed to the DAPE.

- (4) ***What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

It seems possible to us that, in the Example 1 type circumstance, the same conclusion would be arrived at under a non AOA approach following UN treaty principles- although this will depend on the specific treaty principles and domestic rules applied. As touched on below it is less clear to us that the same answer would arise in areas where either the UN treaty type non AOA approach does not fully prescribe a basis for allocating between head-office and PE (eg. capital/debt) or prescribes a non arms length charging basis between head-office and branch (eg. for the use of head-office intangibles by a branch).

- (5) ***In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?***

We believe that that is the correct conclusion.

- (6) ***Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?***

It is not clear to us that the construction of the profits or losses of the DAPE in Example 2 under the AOA is correct. It is possible however that any differences we have are to do with presentation and explanation (as elaborated upon below) rather than outcome.

We approach this from a consolidated group perspective and take as our starting point that, as in Example 1, the full 200 of external sales income should be attributed to the DAPE of Prima. We understand that all billings and collections are being made in Prima's name (even if, perhaps, being conducted by Sellco). Absent some form of internal factoring agreement between Prima and Sellco, whereby Sellco buys the receivables from Prima for 200 (which is not suggested), any bad debt losses are therefore, in the first instant, borne by Prima and would be expected to appear as Prima expenses. The only way that they can be passed to Sellco is via some form of onward recharge, or perhaps by adjustment of the sales



commission. These initial expense and subsequent recharge entries are however not shown in the example. The same comments apply with respect to the inventory losses.

In short, if the intent of the approach in the example is that Sellco gets a fixed commission, from which it must bear bad debt and inventory losses, as well as warehousing costs, then with respect to the former two items, this will not happen unless some form of intra-group mechanic is included, between Prima and Sellco, in order to achieve it. We suggest that the example requires adjustment in this respect.

It does not appear to us to be correct that the Prima amount of 2 shown for 'funding return from Sellco' is presented as such, and treated as a corresponding expense of Sellco. So far as we understand, no funding is provided by Prima to Sellco. In contrast, what is happening is that Prima is viewed as employing capital in Country B in a way which generates a funding return for its Country B DAPE from external sales, after deducting other expenses. It seems to us that this funding return is an Article 7 allocation item between the Country A head-office and Country B DAPE, and should be dealt with through COGS.

- (7) *What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the difference?***

This will of course depend on the details of the non AOA approach adopted. We are unclear as to whether the same conclusion would be arrived at if a UN treaty based approach applied. This is because –so far as we understand- such an approach does not give a prescriptive basis for determining what levels of capital and debt should be allocated to the DAPE. Furthermore, as we presume the DAPE will be an informal PE arising for tax purposes rather than a registered branch, there is no reference point in terms of recognised capital or debt from branch accounts. Thus, unless an attribution equivalent to an AOA attribution is considered to arise solely by virtue of the conjunction of the Action 7 extension and the notional separate entity approach-which typically still prevails in these non AOA circumstances-it seems to us that a different allocation of profits between Prima's head-office and DAPE may arise.

- (8) *In your opinion, what would be the conclusion if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?***

Our understanding of the intention of the updated Chapter 1 approach to risk is that it poses the question in a context which implicitly assumes that risk should be allocated to some party which sits within the relevant supply chain, with allocation following control provided that that party has the financial capacity to assume such risk.

This suggests that, if Sellco did not have the financial capacity to assume the relevant risk, then the primary risk should be allocated to the Prima DAPE (assuming that Prima did have such financial capacity- which the Prima DAPE presumably would [via the AOA allocation if necessary] by virtue of being entitled to receive the gross sales income and being capable of funding the inventory). It would however then be expected that Sellco's fee from Prima would have a variable component which reflected its success or failure in managing the risks-effectively sharing the risk in some fashion between Prima and Sellco.

- (9) *What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?***

This appears to us to be correct in principle taking into account the intention of Action 7 to attribute value to Country B by reference to functions carried on by DAE's in the specified circumstances. This conclusion is subject to the comments made in response to question 6 above concerning possible needs for amendment in the detailed allocations made in the Example (and/or their presentation and explanation).

- (10) *Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?***

Because, in this example, there is no separate entity DAE, the comments we make in response to question 6 do not apply and we broadly agree with the construction of profits or losses in Example 3 under the AOA. We do have a slight hesitation however about the way that the 4.5% operating margin (and 9 of consequential DAPE profit) is assumed to flow through into Example 3 based on the Example 2 precedent (see paras 66 and 67 –which we understand refers back to the 9 of operating profit on 200 of consolidated sales income from paragraph 44). Our hesitation arises because the 9 of operating profit in para 44 is a figure after deducting the actual bad debt and inventory losses for that single year. As those are identified risk items which will vary from year to year we would assume that a best practise approach for a comparable would be to either consider a comparable operating margin before those risk items, or to use an operating margin which reflects average bad debt and inventory loss figures rather than single year figures.

- (11) *What would be the conclusion if, because of the wording in Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?***

Our comments in response to question 7 apply.

- (12) *Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?***

Yes we agree with the construction of the profits or losses in this example.

- (13) *Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?***

Yes, we agree with this analysis.

**(14) Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?**

Yes we agree with the construction of profits or losses set out

**(15) Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?**

Yes we agree with the conclusions reached.

**(16) In particular, do you agree that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?**

It does seem to us that, on the same basis as in the dependent agent examples (and subject to the same limitations), there can be an investment return attributed to the PE in these circumstances. We note that the phrase 'investment return' is used here, rather than 'funding return' and understand this (and the para 101, and prior para 93, wording of 'reward for economic ownership') suggests some form of variable, risk based return, rather than a pure funding return. Given that assets are considered to be actively employed in the Country by WRU rather than merely funded this seems logical. The basis for considering the appropriate PE profit or loss would appear to be either consideration of a third party comparable such as Scenario A- or whatever is functionally the most appropriate method for splitting the consolidated WRU profits from the combined activities between the head-office and PE via either a charging or profit share methodology. For this purpose we assume that risk would primarily follow the required capital into the PE but with some partial sharing via variable fees paid for head-office control services (cf our answer to question 8 –for question 16 we understand that the relevant capital is attributed to the PE and that the control functions, but not associated capital, are in the, notionally separate, head-office).

**(17) Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?**

Yes, we agree –see our comments in relation to question 16.

**(18) Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.**

We do not understand how this conclusion is to be reconciled with the commentary in The Discussion Document and the conclusions commented on in questions 15 to 17 above- unless the phrase 'on their own account' is intended to imply activities relating to distinct businesses. Our understanding of the implication of the conclusion that a substantive

investment in a fixed place of business in the form of a warehouse is not, in context, performing a preparatory or auxiliary role, is that that implies that the investment in the warehousing activity is making a significant contribution to value creation over and above any returns which are already recognised and taxed in respect of local SPFs (relating to the same general business activity). As indicated above we would therefore assume that an investment return would be attributed to that activity –and a risk based return. This is of course, subject to our general comments concerning the interpretation of ‘preparatory or auxiliary’ –ie. it does need to be tested whether or not the warehousing function is preparatory or auxiliary.

**(19) Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arms-length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits to the PE of WRU?**

We do not, in principle, believe that this should affect the outcome –for the reasons and subject to the limitations given above.

**(20) What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

For the reasons indicated in our response to question 7 it is not clear to us that there would be the same outcome in the absence of the AOA because, for example, of the lack of determinative principles for allocating capital/investment to a branch in that circumstance. We understand that the fees to WRU head-office for know-how and software may also be affected.

**(21) Do commentators have suggestions for mechanisms to provide additional co-ordination for the application of Article 7 and Article 9 of the MTC to determine the profits of a PE, taking into account the considerations expressed above?**

We refer to our comments and suggestions above –particularly our general comments under (A) and (C) above. The most significant issue for minimising risks of double taxation (other than commitments to arbitration) is however to ensure that there is consistency of approach and interpretation. The potential differences of application in AOA and non AOA circumstances is of concern in that respect. We also note however that the proposed provisions and their application do seem likely to prove exceptionally complex as a practical matter, and that in itself seems likely to lead to risks of double taxation.

We hope that these comments are of constructive assistance to the OECD’s considerations.

Yours faithfully,



**C.P. Garwood**  
Head of Tax