

# 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 II

8 September 2016



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5 September 2016

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***Comments on the 4 July 2016 Discussion Draft on additional guidance on the attribution of profits to permanent establishments***

The International Tax Center Leiden welcomes the opportunity to provide comments on the 4 July 2016 Discussion Draft on Additional guidance on the attribution of profits to permanent establishments (hereinafter '**July 2016 Discussion Draft**'). Our comments will address some conceptual difficulties in the attribution of profits to permanent establishments as reflected in the numerical calculations, with a focus on those concerning the attribution of profits to permanent establishments under Art. 5 (5) OECD Model Convention (agency permanent establishment).

**1. Brief outline on the interpretation and application of Art. 7 (1) and (2) OECD Model.**

According to Art. 7 (1) OECD Model, business profits of a person of a Contracting State ('**Residence State**') shall be taxable only in that State unless the person carries on business in the other Contracting State ('**PE State**') through a permanent establishment ('**PE**') situated therein. The taxing rights granted to the PE State are however limited to those profits attributable to the PE in accordance with Art. 7 (2) OECD Model.

The determination of the profits attributable to the PE follows the rules set out in Art. 7 (2) OECD Model, which requires to treat PEs for tax purposes as if they were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the PE (functionally separate enterprise approach).

The attribution of functions, assets and risks is based on the significant people functions performed by the personnel of the PE<sup>1</sup> relevant for the assumption and/or management of risk<sup>2</sup> and for the attribution of economic ownership of assets.<sup>3</sup> The assumption when determining which assets and risks should be attributed to the PE is that risks and assets follow functions, *i.e.*, risks and assets cannot be segregated from related functions.<sup>4</sup> Once functions, assets and risks are attributed to the PE, the capital needed to fund those assets and risks should also be quantified and attributed.<sup>5</sup>

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<sup>1</sup> Sec. 68 of Part I of the OECD's 2010 Report on the Attribution of Profits to PEs.

<sup>2</sup> Sec. 22 of Part I of the OECD's 2010 Report on the Attribution of Profits to PEs.

<sup>3</sup> Secs. 75, 85, 94 and 97 of Part I of the OECD's 2010 Report on the Attribution of Profits to PEs.

<sup>4</sup> Sec. 15 of Part I of the OECD's 2010 Report on the Attribution of Profits to PEs.

<sup>5</sup> Sec. 28 of Part I of the OECD's 2010 Report on the Attribution of Profits to PEs.



The purpose of Art. 7 OECD Model is thus to determine in which cases the PE State may tax business profits derived by non-resident entities, as well as how to determine the amount of business profits that the non-resident person derives through the PE (*i.e.*, the amount of profits that is attributable to the PE).

As the Residence State will usually tax the worldwide income of its resident entrepreneur, the resulting double taxation of the PE profits needs to be taken care of. This is done by Art. 23 OECD Model which requires the Residence State to take care of the juridical double taxation by providing an exemption or a credit.

## **2. General comments on the OECD's suggested method to attribute profits to permanent establishments**

### **2.1. July 2016 Discussion Draft not suitable as general guidance**

BEPS Action 7 deals with the artificial avoidance of the PE status through, *inter alia*, commissionaire arrangements and structures falling within the scope of specific activity exemptions. For this reason, the October 2015 Final Report proposes a new wording to Art. 5 (4) to (6) OECD Model.

The new wording suggested by the OECD appears to target to some extent the business structures of specific multinational enterprises which have been subject in the past to increasing attention from the media (e.g. e-commerce operating models, where warehousing and logistics functions often constitute the only presence in a territory).

Unfortunately, the same approach was also reflected in the July 2016 Discussion Draft, which is excessively focused on certain well known structures, rather than diversifying the nature and content of the examples analysed. For this reason, the usefulness of the additional guidance provided by the OECD will be limited, since its scope clearly targets particular business structures.

### **2.2. Inaccurate application of Art. 7 (2) OECD Model**

The numerical examples of the July 2016 Discussion Draft are based on an inaccurate interpretation and application of the criteria set out by Art. 7 (2) OECD Model. Below we will try to demonstrate the misconceptions in the interpretation of Art. 7 (2) OECD Model.

Throughout the examples of the July 2016 Discussion Draft dealing with Art. 5 (5) OECD Model PEs, the OECD attributes the full amount of the sales revenue to the agency PE (in an amount of 200), regardless of the functions performed, assets economically owned and risks assumed by the agency PE. Such attribution of the full sales revenue does not seem to be in line with Art. 7 (2) OECD Model.

In Example 1 of the July 2016 Discussion Draft, the OECD concludes that only routine functions are attributed to the agency PE and, as a result, no assets or risks should follow, *i.e.*, the agency PE will not economically own any assets or bear any risks.<sup>6</sup> Notwithstanding, the starting point of the numerical calculation is the attribution of the full amount of sales revenue (200) to the agency PE.<sup>7</sup> Against the

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<sup>6</sup> Sec. 37 of the July 2016 Discussion Draft.

<sup>7</sup> See table in sec. 38 of the July 2016 Discussion Draft.



background that no assets are economically owned and no risks borne by the agency PE, there seems to be no legal basis to support the attribution of the sales revenue.

Further, in order to accurately attribute profits to the agency PE in Example 1, the OECD deems an internal payment by the agency PE as compensation for the functions performed in the Residence State in relation to the sales of products.<sup>8</sup> However, no framework is provided for such internal payment, since no internal dealing was identified and the OECD does not refer to any fact or assumption that could lead to the conclusion that there was a '*real and verifiable event*'.<sup>9</sup> For this reason, the usefulness of such guidance on a real scenario would be limited.

Differently, the starting point for the Art. 7 OECD Model analysis in Example 2 of the July 2016 Discussion Draft is that the significant people functions performed by the agency PE lead to the attribution of economic ownership of receivables and inventory, as well as to the assumption of credit and inventory risk.

Despite no additional functions being identified as performed by the agency PE (or the dependent agent itself), the July 2016 Discussion Draft attributes to the agency PE the funding return paid by SellCo to Prima (amounting to 2).<sup>10</sup> The attribution of such a funding return goes beyond an attribution taking into consideration the functions 'performed' by the agency PE, as there are no functions related to control or management of financing granted to SellCo being performed in the PE State.

Similar to Example 1, in Example 2 of the July 2016 Discussion Draft the OECD again deems an internal payment by the agency PE as compensation for the functions performed in the Residence State in relation to the sales of products without accurately identifying an internal dealing.<sup>11</sup> The same issue arises again in the context of Example 3, where although the sales revenue (200) was accurately attributed to the agency PE in accordance with the functions performed, assets economically owned and risks borne, the internal compensation deemed 'paid' by the agency PE did not refer to any specific internal dealing (although in Example 3 one could possibly assume that a deemed sale of products occurred).

A different issue arises in the context of the numerical calculations of Example 4 of the July 2016 Discussion Draft. In this example, the analysis under Art. 9 OECD Model leads to the conclusion that Prima will bear the full credit risk but that a contractual arrangement would be in place between Prima and SellCo, which would allow the latter to share in the profits or losses of the business (as compensation for the risk controlling functions performed). Against this background, the OECD assumes that an arm's length return for the (full) credit risk borne by the whole enterprise (Prima) would correspond to 5% of the value of the receivables.

In the context of the analysis under Art. 7 OECD Model, the OECD concludes that the functions performed by SellCo on behalf of Prima lead to the assumption of 25% of the credit risk by the agency PE. Despite bearing only  $\frac{1}{4}$  of the risk assumed by the whole enterprise, the OECD applied the same rate of return (5% over the value of the receivables) without further analysing (or explicitly making an

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<sup>8</sup> Sec. 36 of the July 2016 Discussion Draft.

<sup>9</sup> Sec. 35 of Part I of the OECD's 2010 Report on the Attribution of Profits to PEs.

<sup>10</sup> See table in sec. 55 of the July 2016 Discussion Draft.

<sup>11</sup> Sec. 53 of the July 2016 Discussion Draft.



assumption) whether in an arm's length scenario the performance of risk controlling functions over a smaller amount of receivables would imply a lesser return.

Further to the issues discussed above, the numerical calculations of the OECD in Example 2 of the July 2016 Discussion Draft lead to a questionable conclusion due to the lack of coordination in the application of Arts. 7 and 9 OECD Model (to be discussed in further detail in 2.4 below). Under Art. 9 OECD Model, the OECD concludes that SellCo performs the controlling functions over credit and inventory risk and therefore should be entitled to a risk adjusted return. Simultaneously, the OECD concluded as well that under Art. 7 (2) OECD Model the same assets and risks (previously attributed to SellCo under Art. 9 OECD Model) should be attributed to the agency PE.

The consequence for this 'double attribution' of risks is that the related expenses (*i.e.*, bad debt losses, inventory losses and warehousing costs) should be attributed to both SellCo and the agency PE. However, due to the risk of double deduction, such expenses would not be considered deductible at the level of the agency PE. This conclusion is not in line with Art. 7 (2) OECD Model, which does not provide any legal basis to deny attribution of expenses solely based on the risk of double deduction.

The outcome in Example 2 of the July 2016 Discussion Draft is a direct consequence of the independent application of Arts. 7 and 9 OECD Model, which leads to an inconsistent attribution of risks (credit risk) to two different legal entities (SellCo under Art. 9 OECD Model and Prima under Art. 7 OECD Model) within the context of the same treaty. The OECD numerical calculation should therefore have reflected a simultaneous or integrated application of both articles.

### **2.3. Inaccurate application of Art. 7 (1) OECD Model**

The numerical calculations of the OECD in the July 2016 Discussion Draft also reflect a misunderstanding on the interpretation and application of Art. 7 (1) OECD Model.

In Examples 1 through 3 of the July 2016 Discussion Draft, the determination of the profits to be attributable to the agency PE was computed on the basis of an allocation (*i.e.*, split) of the profits between the general enterprise ('GE') and PE, rather than just focusing in assessing the amount of profits (*i.e.*, income and expenses) attributable to the agency PE under Art. 7 (2) OECD Model 2010.<sup>12</sup>

In other words, instead of just determining the profits attributable to the agency PE as if it were a separate and independent enterprise, the OECD splits the profits deriving from the sales to third parties between the GE and the PE from an Art. 9 OECD Model perspective. The result is that no double taxation would arise, since profits would only be taxable either in the Residence State or in the PE State.

Such conclusion is confirmed by the OECD's calculations, where the profits taxable in the Residence State (at the level of the GE) are determined having recourse to the internal compensation deemed 'paid' by the agency PE. For this reason, in Examples 1 to 3 of the July 2016 Discussion Draft, the profits taxable in the Residence State never reach the full amount of sales revenue (200) but are rather limited to the amount of the internal compensation deemed 'paid' by the agency PE (190 in Example 1, 170 in Example 2 and 158 in Example 3). The Residence State would thus only be entitled to tax the notional income arising from an internal 'payment' by the agency PE.

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<sup>12</sup> See tables in secs. 38, 55 and 67 of the July 2016 Discussion Draft.



The OECD applies the same approach in the context of attribution of profits to warehouse PEs, within the scope of the analysis to Example 5 – Scenario A of the July 2016 Discussion Draft. In this example, the OECD states that the GE would no longer have to recognize the costs of interest, depreciation and employees' salaries in those cases where the economic ownership of the warehouse is effectively connected to the physical PE.

The consequences of such profit allocation between the GE and the PE are a restriction of the Residence State's taxing rights without any support in the wording of Art. 7 OECD Model 2010, thus reflecting a misinterpretation of the mechanics of the said provision.

The outcome of the profit allocation in the numerical examples of the OECD's July 2016 Discussion Draft suggests that the Residence State has applied Art. 23-A OECD Model (exemption method), as the profits attributable to the PE would not give rise to the assessment of tax in the Residence State. However, that is not necessarily the case since the OECD Model also foresees the alternative application of the credit method to eliminate or mitigate double taxation under Art. 23-B.

Regardless of whether Art. 23-A or Art. 23-B OECD Model is being applied, an allocation (split) of profits between the GE and the PE would be inaccurate and in breach of Art. 7 (1) OECD Model. Even assuming that the exemption method was applicable, the income would still be liable to tax in the Residence State but not subject to effective taxation as a result of the application of the exemption method.

Based on the above, the conclusion is that the OECD's profit allocation is not in line with Arts. 7 and 23 OECD Model, regardless of the method to relieve double taxation concretely applicable. Should the assumption be that the exemption method is being applied in the numerical calculations included in the July 2016 Discussion Draft, then the OECD should include an explicit reference to avoid misinterpretations by taxpayers and tax authorities relying on this guidance.

#### **2.4. Guidance on the relationship between Arts. 7 and 9 OECD Model**

BEPS Action 7 proposed a new wording of Art. 5 (4) to (6) OECD Model in order to cover situations that currently avoid artificially the PE status, namely through commissionaire arrangements and specific activity exemptions.

The new PE concept thus has a clear anti-avoidance purpose, reflected in its rather broader scope compared to the current wording of Art. 5 (5) OECD Model. For this reason, activities that currently do not lead to the granting of taxing rights to PE State will now create such PE exposure. Notwithstanding, the attribution of these activities to a PE should be expected to attract only a limited additional amount of profit (if any profit at all). In fact, the new proposed wording of Art. 5 (5) OECD Model may give rise to PEs in the PE State despite the dependent agent performing only routine functions. Accordingly, if no additional functions are also attributed to the PE, the tax revenue collected from this (new) taxable presence will be marginal in the PE State (as there would be no significant people functions relevant for the attribution of assets and risks being performed by the PE).

Due to the (expected) marginal impact in the collection of additional tax revenue, it seems that the proposed broader concept of PE under BEPS Action 7 may have an additional purpose other than increasing the collection of tax revenue through the broader scope of Art. 5 (5) OECD Model.



In those situations where both Arts. 7 and 9 OECD Model apply, the current (narrower) concept of agency PE would not cover many business structures implemented by multinational enterprises, which would allow tax authorities to tackle underreporting of income only through adjustments made under Art. 9 OECD Model. Differently, under the new wording of Art. 5 (5) OECD Model (in joint application with Art. 7 OECD Model), if Art. 9 OECD Model applies and no more profits are attributable to the entity resident in the PE State, the collection of taxes in PE State should not increase at all (or at least not significantly) due to the existence of an agency PE therein. However, the broader new concept of agency PE will require an additional compliance burden for the taxpayer, which may allow tax authorities to impose penalties for non-compliance with reporting obligations.

Based on this reasoning, it seems that the OECD is now providing tax authorities with two simultaneous alternatives to address the issue of underreporting of income, *i.e.*, Art. 9 and Arts. 5 & 7 OECD Model, which can be applied simultaneously. Such conclusion is confirmed by the OECD's analysis in Example 2 of the July 2016 Discussion Draft<sup>13</sup>, which clearly demonstrates that an analysis under Art. 9 OECD Model would lead to an adjustment of the profits allocated to SellCo, thus implying that there would be no additional need for adjustments to be made under Arts 5 & 7 OECD Model (as the functions performed, assets economically owned and risks assumed by the agency PE would be the same as those of SellCo).

The relationship between Arts. 7 and 9 OECD Model thus gains increased relevance in the context of the taxation of business profits. In the July 2016 Discussion Draft, the OECD seems to suggest that Art. 7 OECD Model should apply following the allocation of profits between related entities under Art. 9 OECD Model.<sup>14</sup> However, the numerical calculation in Example 2 reflects the application of Art. 7 OECD Model independent from Art. 9 OECD Model. Due to the lack of simultaneity in the application of both articles, the numerical calculation by the OECD requires some reverse engineering to reach an outcome in line with the wording of both Arts. 7 and 9 OECD Model (see discussion above).

The conclusion is therefore that the analysis on the application of Art. 7 OECD Model in Example 2 is redundant under the assumption that Art. 9 is applied simultaneously, which would attribute the performance of functions, ownership of assets and assumption of risks to SellCo (rather than to Prima, in accordance with the legal arrangements). For this reason, a correct application of the AOA would lead to the attribution of zero profits to the agency PE.

### **3. Additional guidance needed through the inclusion of two additional scenarios**

#### **3.1. General remarks**

The Examples of the July 2016 Discussion Draft dealing with the attribution of profits to agency PEs involving the application of Arts. 7 and 9 OECD Model only address situations where the dependent agent does not manage or control risk (Example 1) or the dependent agent does manage and control risk (Examples 2 and 4). No examples were included where the dependent agent (SellCo) performs exclusively day-to-day risk monitoring functions and the principal (Prima) performs all other relevant functions, including control functions over the outsourced activities, and therefore it is not clear in which situations can those control functions be attributed to the agency PE. Furthermore, examples dealing with scenarios involving three or more entities were also not included.

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<sup>13</sup> Secs. 48 and following of the July 2016 Discussion Draft

<sup>14</sup> Sec. 38, 55 and 67 of the July 2016 Discussion Draft.



For these reasons, the July 2016 Discussion Draft does not provide sufficient guidance to both tax authorities and taxpayers to deal with day-to-day issues regarding attribution of profits to PEs. Below we will briefly frame the issues on the attribution of profits to agency PEs arising in the two scenarios mentioned above.

### 3.2. Risk management functions performed by the dependent agent which are crucial for the performance of risk controlling functions by the GE

The facts of this suggested additional example ('**Example 2A**') are the same as Example 1 of the July 2016 Discussion Draft, with the following differences regarding inventory and credit related functions:

Inventory related functions	
Prima	SellCo
<ul style="list-style-type: none"> <li>Retains title to the inventory until it is delivered to customers;</li> <li>Responsible for determining inventory levels of the products to fulfil customer orders expeditiously while minimising obsolescence risk and costs based on the weekly reports provided by SellCo.</li> </ul>	<ul style="list-style-type: none"> <li>Responsible for warehousing the inventory and monitoring the inventory levels of the products. For these purposes, SellCo provides Prima with weekly reports about inventory level, as well as the levels of inventory obsolescence.</li> </ul>
Credit related functions	
Prima	SellCo
<ul style="list-style-type: none"> <li>Invoices customers and contractually bears credit risk with respect to customer receivables;</li> <li>Sets parameters within which credit can be extended to customers;</li> <li>Approves every sale to customers made in Country B through the review of the customer's creditworthiness based on reports prepared by SellCo;</li> <li>Handles collection of customer receivables.</li> </ul>	<ul style="list-style-type: none"> <li>Reviews creditworthiness of customers and provides Prima with detailed reports. No suggestions or instructions are included in the report on whether credit should be granted to customers.</li> <li>Assists in the collection of customer receivables upon detailed instructions from Prima.</li> </ul>

From an Art. 9 OECD Model analysis, the numerical calculations of Example 2A should be similar to those calculations performed by the OECD in Example 1. The analysis of the arm's length nature of the contractual allocation of risk under the 'control over risk' criteria would confirm that credit and inventory risk should be allocated to Prima. Outsourcing risk monitoring functions to SellCo will not lead to a different conclusion, since Prima still exercises control functions over the outsourced activities. However, because SellCo would be performing additional functions (compared to the ones performed in Example 1), the commission paid by Prima would have to exceed the amount of the commission paid by Prima in the context of Example 1 – 10 (for the purposes of Example 2A, assume that an arm's length commission would amount to 15).

From an Art. 7 OECD Model perspective, Example 2A raises additional questions concerning the attribution of profits to the agency PE. According to the *Authorized OECD Approach*, the significant people functions relevant for the assumption of risk are those '*performed by the personnel of the PE at the PE's location*'.<sup>15</sup> Following this reasoning, since the significant people functions regarding 'control

<sup>15</sup> Sec. 68 of Part I of Part I of the OECD's 2010 Report on the Attribution of Profits to PEs.



over risk' are performed in the Residence State, credit and inventory risks should not be attributed to the agency PE.

Notwithstanding, it is important to point that there may be a clear material connection between the risk controlling functions performed in the Residence State and the risk management functions performed in the PE State, *i.e.*, that the GE's personnel would not be able to perform their control over risk functions in the Residence State without the activities of the dependent agent in the PE State. In these situations, an issue arises regarding whether Art. 7 (2) OECD Model would allow for the attribution of the control functions to the agency PE (despite such functions not having been attributed to the dependent agent under Art. 9 OECD).

Assuming that the strict wording of the *Authorized OECD Approach* quoted above would apply literally, the result would be that no risk controlling functions would be attributed to the agency PE and, as consequence, neither would be any assets and risks. The outcome would therefore be exactly the same as in Example 1 of the July 2016 Discussion Draft: zero profits.

Differently, one may take the position that the fact that the GE's personnel would not be able to perform their control over risk functions in the Residence State without the activities of the dependent agent in the PE State is sufficient to attribute risk controlling functions to the agency PE. Consequently, also the related assets and risks would be attributed to the agency PE and therefore the outcome would be different from that in Example 1 of the July 2016 Discussion Draft, *i.e.*, the agency PE would assess profits (as demonstrated in the table below).

Prima (Country A)		Agency PE (Country B)	
Sales income	200	Sales income	200
- COGS	(40)	- COGS	(156)
Gross profit	160	Gross profit	44
OPEX		OPEX	
- Sales commission to SellCo	(15)	- Sales commission to SellCo	(15)
- Reimbursement of advertising expenses incurred by SellCo	(7)	- Reimbursement of advertising expenses incurred by SellCo	(7)
- Bad debt losses	(4)	- Bad debt losses	(4)
- Inventory losses	(3)	- Inventory losses	(3)
- Warehousing	(6)	- Warehousing	(6)
Operating profit	125	Operating profit	9

As demonstrated above, guidance on the attribution of profits to agency PE in Example 2A is needed. We would therefore welcome the inclusion of an additional example in the final report.

### 3.2. Cases where the non-resident principal engages two or more entities to perform agency activities and risk management functions on its behalf

The factual background for this second suggested additional example ('**Example 2B**') involves a segregation of the outsourced activities through different entities. Accordingly, the principal (Prima) would engage SellCo to perform agency activities in the PE State (same activities as in Example 1 of the July 2016 Discussion Draft), which will give rise to an agency PE under the new wording of Art. 5 (5) OECD Model. Furthermore, Prima engages another entity resident in the PE State (ServCo) to perform risk management functions on its behalf (e.g., monitoring inventory levels, collection of receivables, etc.), including functions related to financing. Functions performed by ServCo do not give rise to a PE



in the PE State (although connected with the activities attributable to the agency PE). The question is therefore whether the functions performed by ServCo can also be attributed to the agency PE deemed to exist through SellCo's activities.

As mentioned in 3.2. above, the *Authorized OECD Approach* provides that the significant people functions relevant for the assumption of risk are those '*performed by the personnel of the PE at the PE's location*'.<sup>16</sup> Further, the same reasoning is applied in the context of the Example 2 of the July 2016 Discussion Draft.<sup>17</sup>

Although the OECD's proposals in BEPS Action 7 deal with the splitting up of activities to avoid PE status (see the new proposed wording of Art. 5 (4) OECD Model), there is no proposed change to the guidance on attribution of profits to PEs in those cases where the segregation of activities does not have an impact in the assessment of the existence of a PE (but rather only on profit attribution). Against this background, a strict interpretation of Sec. 68 of the *Authorized OECD Approach* would lead to a non-attribution of the risk management functions performed by ServCo to the agency PE.

Nonetheless, the strict link between SellCo's activities and the significant people functions relevant for the management of risk performed by ServCo's employees on behalf of Prima raises the question whether Art. 7 (2) OECD Model would require the attribution of the related assets and risks to the agency PE. The narrow scope of the expressions employed in Sec. 68 of the *Authorized OECD Approach* (such as 'PE's personnel' and 'physical location of the PE') seems to be the consequence of guidance which was drafted in the context of Art. 5 (1) OECD Model PEs, according to which a permanent physical presence in the PE State is required.

For this reason, additional guidance would be welcome to clarify whether the significant people functions performed by ServCo's employees in the PE State can be attributed to the agency PE created by SellCo activities and whether Art. 7 (2) OECD Model would accommodate an interpretation with such an anti-avoidance purpose.

Furthermore, Example 2B raises different problems concerning the assessment of the financial capacity to bear the risk. The new guidance for the Transfer Pricing Guidelines provided by BEPS Actions 8-10 suggests that, in order for a certain risk to be allocated to an entity, that entity must have 'control' over the said risk, *i.e.* requires an entity to perform the relevant control functions and have the financial capacity to bear the costs with the materialization of the risk. The application of such guidance by analogy in an agency PE scenario raises an additional question on whether the financial capacity to bear the risk needs to be associated with the significant people function performed at the level of the agency PE, *i.e.* whether the financial capacity to bear a risk may still be attributed to the agency PE despite not being associated with the corresponding significant people functions.

Additional guidance on this topic is also needed, since all the numerical results for the examples of the July 2016 Discussion Draft are calculated under the assumption that the principal has the financial capacity to bear the associated risks. No reference whatsoever is made to whether significant people functions need to be attributed to the agency PE in order to deem the PE as having the financial capacity to bear the corresponding risks. The issue is therefore whether the OECD's assumption that the principal has the financial capacity to bear the associated risks should somehow influence and lead

<sup>16</sup> Sec. 68 of Part I of Part I of the OECD's 2010 Report on the Attribution of Profits to PEs. See also Sec. 20 of the OECD Comm. to Art. 7.

<sup>17</sup> Sec. 20 of the July 2016 Discussion Draft.



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to an assumption that capital allocated to the PE should be sufficient for the PE to have the financial capacity to bear the risk.

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Should you like to discuss in further detail any of the issues addressed above, please do not hesitate to contact us.

Yours sincerely,

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**Irish Tax  
Institute**

*Leaders in Tax*

## **Irish Tax Institute**

**Response to OECD Discussion Draft:**

**BEPS Action 7**

**Additional Guidance on the Attribution  
of Profits to Permanent Establishments**

**5 September 2016**

## About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition, many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.

## Our response

The Irish Tax Institute is writing in response to the Discussion Draft on Action 157 which the OECD released on 4 July 2016. We prepared this submission with consideration and input from our members.

## Introduction

Action 7 of the OECD's Base Erosion and Profit Shifting ("**BEPS**") project mandated the development of changes to the definition of "permanent establishment" ("**PE**") to prevent the artificial avoidance of PE status under certain circumstances. In relatively short order, the Action 7 outcome will enable changes to Article 5 of the Model Tax Convention ("**MTC**") to be adopted directly into numerous tax treaties through the Multilateral Instrument initiative.

We have chosen to provide comments of both general nature and specific to examples in the Discussion Draft that together will address issues raised for the consultation. Our response has been to focus on the questions and issues of most significant relevance to our members based on their observations of how these rules may be applied in practice.

The Irish Tax Institute recognise the Discussion Draft is the first step in ultimately developing new guidance to supplement (or modify) the OECD Report on Attribution of Profits to Permanent Establishments (2010). It is important that this consultation, where possible, takes into account the differences across jurisdictions on matters such as PEs, the Authorised OECD Approach (AOA), sourced-based taxation, to name a few. The purpose of Action 7 is to provide governments with new rules allowing them to tax profit on transactions arising from their jurisdictions that were not taxable before under pre-existing laws. It becomes important to balance these rights with mechanisms to avoid greater instances of double taxation.

## A. General comments

### *Exemption of tax filing obligation for “zero profit” PEs*

Revisions to Article 5 are due to result in newly created PEs, when businesses are commercially unable to restructure their operations accordingly. As already noted, tax laws often require a foreign entity to file an annual corporate income tax return if the foreign entity operates abroad in such a way to give rise to a PE. The Irish Tax Institute is aware that under the MLI initiative, the OECD is leading a simplification initiative to reduce the burden to file such returns if no profit is attributable to the PE. We strongly support this initiative as a broad simplification measure and recommend the OECD publicises developments in this area along with general updates under Action 15. Pgh 104 briefly remarks on the possible filing obligation of a zero income PE. It would be appropriate for the OECD, in developing guidance on the profit attribution to PEs, to explicitly advocate that no filing obligation is to be required by a government under these circumstances.

### *Practical guidance required on mix of control functions / significant people functions (SPFs) in both jurisdictions*

Most examples cited in the Discussion Draft (Examples 1-3 and Example 5) are useful to illustrate in basic terms the different outcomes on profit attribution analyses. The facts generally state that only one of the two parties is responsible for the control over risk or significant people functions (*except Example 4*). All risks - both strategic and routine - are within scope for analysis under Article 7 whereas in Article 9, only strategic risks are frequently of concern. In practice, most multinational businesses allocate some element of risk management to more than one location while control is centrally allocated. It would be helpful to have examples and guidance on more common scenarios, e.g. when the extension of credit involves both parties while only one party contractually assumes the risk. Later, we provide comments specific to Example 4, which has attempted to cover a mix of control functions.

### *Requirement to make practical decisions*

The Discussion Draft identifies two risk-bearing functions involved in selling product (inventory and credit management). In order to apply the proposed analysis, two assessments are required that would normally be subjective if one were to assess conduct within most multinational organisations. First, one must identify the personnel responsible for **each** individual risk management function. Second, one must benchmark the return associated with risks that require funding by the Head Office. It would be nearly impossible for two experts to agree on the complete spectrum of risks of an enterprise, the relative importance of people performing some control functions and the discrete returns associated with discrete risks. Hence, a pragmatic approach is best suited to deal with this subjectivity, i.e. the arm's length range as applied in the OECD Guidelines.

Tax authorities may deem DAPes to exist relying on new Article 5(5) (“*habitually plays the principal role....without material modification...*”) while the taxpayer disagrees with this basis. In disputed cases of DAPes, taxpayers may choose to just argue the profit attribution issue rather than contest the existence of the DAPE under the treaty law. Can the analysis look toward a bundle of risks and their control functions? Can there be a de minimis threshold (either objective or relative to the group) that would deem one of the parties to not undertake sufficient control functions to be considered in the Article 7 analysis? Perhaps the

OECD can advocate for such a simplification measure without having to quantify it to any extent.

*Greater analysis specific to importance of 'financial capacity'*

We believe that the relevance of financial capacity was overlooked in the Discussion Draft, in favour of a focus on functional capacity to control risk. The facts of each example largely indicate that one of the two parties has the financial capacity to assume the risks of the commercial transaction. In particular, Example 2 intently notes SellCo has this capacity such to allocate to it the inventory and credit risks and rewards. In addition to the prior request, it would be most helpful to obtain guidance on the relative importance of financial capacity in the context of the Article 7 analysis, which follows the Article 9 analysis on the same issue. Under Chapter I of the Transfer Pricing Guidelines, risk can be fully allocated to an entity if it performs the appropriate control functions and has the financial capacity to assume the risk. Many multinational companies may have established separate entities in the same jurisdiction solely for legal and/or regulatory purposes. This can create circumstances whereby the control functions and financial capacity are in separate entities, yet in the same jurisdiction. The guidance illustrating the AOA should cover such situations, as well as those where the control over risk and financial capacity are not in the same jurisdiction.

*Prohibit use for indirect / Source-based taxation*

Paragraph 13 of the Discussion Draft suggests that the P&Ls included are for illustrative purposes only, and that no domestic legislation should interpret the P&L for any use other than under the Article 7 PE profit attribution. The final direction from the OECD needs to be more detailed on these principles and stronger on the message. The OECD must make it clear that the PE analysis **cannot** be used by tax authorities for other purposes. A cautionary statement is in our view not adequate to prevent the unintended consequences already foreseen by the OECD.

A number of countries have and are enacting domestic tax laws that effectively tax notional transactions as a withholding tax and/or deny the ability for a PE to deduct arm's length margins applied to head office costs. We believe the concern could be pre-empted to some extent by committing to a peer review of inappropriate use of pro-forma P&Ls by tax authorities.

Further, it is unclear why the Discussion Draft states in pgh 36 that Article 7 attributes sales income and cost of sales to the DAPE when the sole purpose of Article 7 is the attribution of profit or loss from the enterprise. The analysis should solely focus on profit or loss linked to the risks and/or assets which the functional analysis attributes to the PE and avoid, where possible the notional recognition of sales and/or cost of sales not related to the PE itself.

*Lack of coherence between Article 9 and Article 7 approaches*

The relative operation of the two treaty analyses is fundamental to ensuring they are applied correctly. In conducting the Article 7 analysis, the Discussion Draft clearly relies on the assumed Article 9 analysis that provides the arm's length reward to SellCo. This illustrates that the revised Guidelines vis-à-vis Chapter I must be applied correctly and consistently.

The Article 9 determination of the appropriate reward to a sales activity is easily the most contested transfer pricing issue globally. DAPes that result from Article 5(5) extend the

basis for tax disputes connected to sales activity. We do not believe new mechanisms to ensure appropriate application could result in BEPS risks. Rather, there is a much greater risk of double taxation in absence of stricter rules on the application.

The core distinction between the two analyses is the relevance of contractual allocation of risk that applies in Article 9 but not in Article 7. This element in Article 9 provides a much needed simplification for cases when *some* element of risk management (routine or otherwise) is performed in more than one country. Absent the reliance on contractual risk allocation, the Article 7 analysis loses objectivity and can become unmanageable for businesses with a fact pattern different from the simpler examples in the Draft (see Example 4).

## **B. Technical comments – Dependent Agent Permanent Establishment (Examples 1-4)**

### *Examples 1-2*

- Both examples rely on the correct application of Article 9 to the compensation to SellCo as starting points to the DAPE analysis. In either example, the only potential profit (or loss) attributable to the DAPE is the return for funding investments in assets supporting risk.
- The two examples are good evidence that the Article 7 analysis on the DAPE is outweighed in quantum by the Article 9 analysis. We expect this to be a common theme.
- Example 2 illustrates that Article 7 has negligible impact on the tax base in Country B as the reward is represented as a cost of SellCo. This raises the technical issue of whether tax authorities would allow SellCo a tax deduction for a notional funding return to the DAPE in the same jurisdiction, especially in the event that a DAPE is deemed to exist by Country B's tax authority.

### *Example 3 – DAPE without local SellCo*

- On the irregular assumption that the single employee is responsible for all inventory and credit management functions and control decisions, we agree it is appropriate under the AOA to allocate the full operating expenses to the DAPE.
- Following comments already raised, we suggest the income of the DAPE is shown solely as notional income from Head Office (e.g. commission of 42) rather than an attribution of Sales and COGS to the DAPE. This would more reasonably follow the AOA particularly since we expect DAPes of this nature are most likely to be asserted by tax authorities and contested by taxpayers based on the merits of the Article 5(5) conditions.
- Example 3 affords the DAPE the same effective reward as provided to SellCo in Example 2 (a 4.5% return on sales). While the Draft notes the figures are illustrative, the link might be incorrectly interpreted to equate the margins for quite different functional profiles.

### *Examples 2 vs. Example 3*

- When comparing the figures of these two examples, we expected there to be similarity between the Opex of SellCo (Example 2) and the Salary of the Employee (Example 3). All other figures were the same, except for these and one would expect that SellCo would in fact have more expenses than the single employee. If the expenses were equated in these two examples, then it would be easier to contrast the outcomes from the perspective of both Country A and Country B.

### *Example 4*

- We acknowledge the intent of Example 4 to highlight scenarios where SPFs 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. As similar risk sharing transactions do not occur in the market, it would be a challenge to arrive at a definitive Article 9 conclusion on the reward to SellCo.

- First, there is a notional assumption that the return for credit risk management is 5%. In practice, the quantification of empirical risks is challenging, and in this case, the 5% return represents the entire pool of profit under analysis.
- Second, the share of return is measured by relative SPF costs, an approach that appears reasonable on first read. However, for scenarios involving returns more than credit risk, it can be extremely complicated to accurately identify the costs belonging to the right SPFs in more than one country. A SPF is not represented by the entire department but rather those in an active decision-making capacity.
- The example would be best explained if only Prima had contractually assumed the risks yet the risks were jointly controlled and managed.

### **C. Warehousing – Example 5 (A, B and C)**

#### *No economic ownership without SPFs*

In our view, the remuneration to the PE should be the same in each of the three Scenarios. In any case, the PE does not undertake any significant functions as all SPFs are undertaken in Country A. The Discussion Draft cites the 2010 PE Report where ‘use’ defines economic ownership. Noting member states were in disagreement on this issue (see pgh 75 of 2010 PE Report), for the purpose of this guidance the OECD should consistently advocate that SPFs (or KERT functions) are the sole determinant of economic ownership of assets.

In this case, the PE would not be attributed third party income from the warehouse and would be rewarded a same notional intra-group profit from WRU as in 5B and 5C. The Discussion Draft requires more detailed guidance on the determination of this profit, expanding on pgh 97.

**The Tax Treaties, Transfer Pricing and Financial transactions Division**  
Organisation for Economic Cooperation and Development

Accounting & Tax Committee  
Japan Foreign Trade Council, Inc.

**Comments on Discussion Draft on Action 7 of the BEPS Action Plan (Additional  
Guidance on the Attribution of Profits to Permanent Establishments)**

The following are the comments of the Accounting & Tax Committee of the Japan Foreign Trade Council, Inc. (JFTC) in response to the invitation to public comments by the OECD regarding the “Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments” released on July 4<sup>th</sup>, 2016.

The JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of JFTC’s Accounting & Tax Committee is to submit specific policy proposals and requests concerning tax matters. Member companies of the JFTC Accounting & Tax Committee are listed at the end of this document.

**General Comments**

1. While the redefinition of PE concept is scheduled to be reflected in the Multilateral Instrument, if only changes to the PE definition in Article 5 is to be reflected without any additional guidance on the attribution of profits to PE specified in Article 7, we are concerned that various countries will apply inconsistently the provisions and interpretation of Article 7 in calculating income attributable to PE. Therefore, as a means of securing predictability for taxpayers, we welcome the initiative of OECD by releasing the “Discussion Draft on the Additional Guidance on the Attribution of Profits to Permanent Establishments”.
2. Redefining the PE concept will result in lowering the PE threshold and, consequently, may cause concerns towards increased disputes over which a further PE is recognized unjustly by tax authorities in some countries and increased risk of incurring double

taxation. We therefore request OECD to take initiative to provide further guidance under which a common interpretation rules on the PE status is appropriately implemented and operated by all the participating countries.

3. In addition, in the additional guidance on the attribution of profits to dependent agent PE (DAPE) in the Discussion Draft, considerable inconsistency can be seen between the two analyses (i.e., the functional and factual analysis under Article 7 based on significant people functions and the functional and factual analysis under Article 9 based on arm's length principle). However, we believe that, in either analysis, the contractual relationship and the economic ownership should be considered, and the outcome from the analysis should be consistent with each other. In other words, if the profits are allocated appropriately through the functional and factual analysis under Article 9, there should be no additional income attributable to PE under Article 7. Considering that it is highly unlikely that each analysis reaches a different conclusion, a massive increase of the administrative burden could be a serious concern for both taxpayers and tax authorities. Therefore, in calculating income attributable to DAPE, we would strongly request OECD to explicitly state in the guidance that the additional analysis under Article 7 is unnecessary as long as analysis under Article 9 has been performed appropriately.
4. In addition, even in a case where the calculation of attribution under Article 7 is necessary, we believe that the same results of the functional and factual analysis under Article 9 are to be accepted. This point cannot be clearly seen in the Discussion draft, therefore we request OECD to state this point explicitly.
5. Finally, we highly appreciate the initiative of OECD to facilitate the work in a timely manner and to reflect the consistent guidance appropriately in the Multilateral Instrument and/or its commentaries by their release for signing.

## Specific Comments

### 【Example1】

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 the Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.

- As long as profits have been allocated appropriately based on the functional and factual analysis (i.e., transfer pricing approach) under Article 9, we believe that there should be no additional income attributable to PE based on the analysis under Article 7, and

therefore we request that guidance is provided, in which additional analysis of Article 7 is not needed.

- Although we understand that only comments on the methods of calculating income attributable to PE are requested, we would like to mention the following point. In Example 1, the activities conducted by Sellco seem to be just supporting activities for transactions between the non-resident manufacturer and the customer, not activities making any negotiations. In cases like this, the overall activities of Sellco should be characterized as a preparatory or auxiliary character and, therefore, does not itself constitute a DAPE.

### 【Example2】

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

- We disagree with the analysis and conclusion shown in Example 2.
- In Example 2, only in the functional and factual analysis under Article 7, the economic ownerships of inventory and receivables are attributed to the DAPE due to significant people functions, and, as a result, there is inconsistency with the analysis under Article 9 where these are not attributed to Sellco.
- In this regard, both the outcomes resulted from the functional and factual analysis under Article 7 and the functional and factual analysis under Article 9 should be consistent with each other, and the inconsistency seen here should not occur. Namely, the profits of 2 which come from “Funding return from Sellco” should be attributed to Prima, and there should be no income attributable to the DAPE. Therefore, in the case of DAPE, there should be no need for further consideration due to significant people functions on the allocation of risks and economic ownership of assets.
- Yet, in this Example 2, analyses have been made due to the understanding that “the contractual assumption of risk is not aligned with control of risk”, just because of the slight changes from Example 1 in the choice of words referring to the management of inventory and credits. Even if a minor difference between the allocated risks and controlled risks could be seen in some cases, these cases should be secured so as not to be falsely recognized as being the same pattern to Example 2.
- For example, when i) the importance of inventory risks and credit risks are limited to a

certain level, or ii) Prima also holds integrated functions of managing risks and its approval is required from Sellco, before Sellco formally practices its approving function (meaning the control of risks and approval of transactions are actually made by Prima), the understanding that “the contractual assumption of risk is not aligned with control of risk” is not appropriate.

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?

- Please refer to comments on Question 6.

#### 【Example4】

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

- We disagree with the analysis and conclusion shown in Example 2.
- In the functional and factual analysis under Article 7 where significant people functions are focused on, the allocation of risks are undertaken in a completely different method of calculation from that in the functional and factual analysis under Article 9, which has resulted in credit risks and economic ownership of receivables being allocated additionally to the DAPE. As a result, the allocation of income between Prima and the DAPE under Article 7 turned out to be completely different from the allocation of income between Prima and Sellco under Article 9.
- In this regard, both the outcomes resulting from the functional and factual analysis under Article 7 and the functional and factual analysis under Article 9 should match, and the inconsistency seen here should not occur. Namely, the allocation of risks due to functional and factual analysis under Article 7 and the functional and factual analysis under Article 9 should be consistent with each other, and as a result, there should be no income attributable to the DAPE. Therefore, in the case of DAPE, there should be no need for further consideration due to significant people functions on the allocation of

risks and economic ownership of assets.

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?

- Please refer to comments on Question 12.

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## **Public comment received from Johann H. Müller**

Dear Madam, Sir,

I respectfully submit the following comments to the Paper<sup>1</sup>.

I believe that the Paper could be clarified if the order of the examples were turned around and if the use of COGS is displayed a bit more in line with what a resale minus calculation might look like. In addition, I believe that putting the compensation for the activities in country B within the context of a value chain analysis, might help to bring clarity to what could be the right answers.

I will start with a series of short examples to demonstrate the points I wish to make before commenting on the Paper.

## **Part I – Examples arguing for consistent approaches**

### **1. Example 1**

#### **1.1 Facts**

Prima a company in country A sells its products in country B. Prima has employee X resident in country B earning a salary of 20 (like Example 4 in the Paper). X performs all the functions performed by SellCo as described under Example 1 of the Paper. In country A Prima procures manufacturing material, manufactures the products and performs all the other functions described in Example 1 of the Paper.

#### **1.2 Analysis**

##### **1.2.1 Applying a value chain analysis**

Applying a residual profit split approach to Prima's total value chain, a best effort estimate of the value added through the marketing and sales activities of X in B, determines that these are only routine functions (regardless of where they are performed), which require a routine compensation. It is determined that the most appropriate method for compensating these functions is a sale commission of 5% on gross sales.

##### **1.2.2 Applying art 7**

Prima has a PE in B through X's presence and activities. In determining this PE's profits, the PE first has to be hypothesized as a separate and independent enterprise, performing all the functions performed by X; next the profits from those functions. As the above value chain analysis shows, those profits should be compensated on a sales commission basis.

Due to the low risk nature of the PE's attributed activities, its EBT should be around 2. Therefore the PE profit should include a hypothesized true up agreement between Prima HQ and the PE under which Prima

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<sup>1</sup> The Public Discussion Draft BEPS ACTION 7 Additional Guidance on the Attribution Guidance on the Attribution of Profits to Permanent Establishments 4 July – 5 September 2016

will true up the PE's operating profit to 2, and the PE will credit Prima HQ down to an operating profit of 2 where needed.

X generates sales of 200. Besides X's salary of 20, other OPEX are 8. The PE's allocated commission income is  $(200 \times 5\%) = 10$ , leaving the PE with a loss of  $(10 - 20 - 8) = -18$ . The PE is entitled to true up payment of 20, to bring it to its arm's length profit of 2.

Description	Prima in A	Prima PE in B	Prima consolidated
Gross Sales	190 (200-10 comm)	200	200
COGS	-40	-190	-40
Net Sales	150	10	160
OPEX	(advertising, warehousing, inventory, bad debts) -20	(salary, other) -28	-48
True up	-20	20	0
Operating profit	110	2	112 (X =20)

## 2. Example 2

### 2.1 Facts

Like 1.1 hereabove, except that X performs all the functions performed by SellCo as described under Example 3 of the Paper including inventory and credit risk management. In country A, Prima procures manufacturing material, manufactures the products and performs all the other functions described in Example 3 of the Paper.

### 2.2 Analysis

#### 2.2.1 Applying a value chain analysis

Same as 1.2.1 for marketing and sales activities. The outsourced inventory management and credit risk management activities of X in B are low value routine functions (regardless of where they are performed), requiring a routine compensation. (inventory levels are effectively determined at the procurement of production materials, the transportation of the right amount of inventory from A to B is of limited value). X devotes approximately 25% of his time to inventory and credit risk management.

#### 2.2.2 Applying art 7

Same as 1.2.2 for marketing and sales activities. Assume a value chain analysis shows a cost plus 10% compensation for the outsourced inventory and credit risk functions.

Due to the low risk nature of the PE's attributed activities, its operating profit should be around 9. Therefore the PE profit should include a hypothesized true up agreement between Prima HQ and the PE under which Prima will true up the PE's Operating profit to 9, and the PE will credit Prima HQ down to an operating profit of 9 where needed.

The PE's cost plus reward for inventory and credit risk management is  $(20 \times 25\% \times 10\% =) 0.5$ . Together with its sales commission of 10, salary costs of 20 and other OPEX of 8, this leaves the PE with a loss of -17.5. The PE is entitled to true up payment of  $(9 + 17.5 =) 26.5$ , to bring it to its arm's length profit.

Description	Prima in A	Prima PE in B	Prima consolidated
Gross Sales	190 (200-10 comm)	200	200
COGS	-40	-190	-40
Net Sales	150	10	160
OPEX (incl. cost plus)	(advertising, warehousing, inventory losses, bad debts, outsourcing) -20.5	(salary, other costs, compensation for inventory & ct risk management) -27.5	-48
True up	-26.5	26.5	0
Operating profit	103	9	112 (X =20)

### 3. Example 3

#### 3.1 Facts

Same as 1.1 above, except Prima hires a third party company, XCo which employs X to do exactly the same as he did under 1.1. Such activities are not XCo's core business and it is assumed that XCo is a dependent agent for Prima. XCo would seek to at least cover its costs and make a small profit. If the analysis under Example 1 was correct, then XCo will charge Prima (20 for X, 8 for other OPEX and 2 for profit =) 30 for its services.

#### 3.2 Analysis

##### 3.2.1 Applying a value chain analysis

In theory, it could still make sense to apply a value chain analysis, as has been done in 1.2.1. Any difference in outcome, compared to the price paid to XCo, could arguably be allocated to the DAPE created by XCo. However, if there are no Prima employees performing activities for Prima in B, there are no functions to be allocated to the DAPE and hence no income. (I don't think this is a wrong conclusion, it may just be a different one from that of some OECD members and maybe the Secretariat).

##### 3.2.2 Applying art 7

There are no Prima employees performing activities for Prima in B, hence there are no functions to be allocated to the DAPE and hence no cost (you cannot incur cost in B if you are not there) and no income.

Description	Prima in A	Prima PE in B	Prima consolidated
Gross Sales	200	(arguably 0) 200	200
COGS	-40	(arguably 0) -200	-40
Net Sales	160		160
OPEX	(advertising, warehousing, inventory, bad debts) -20	0	-20

OPEX – XCo (could also be COGS)	-30	0	0
Operating profit	110	0	110

## 4. Example 4

### 4.1 Facts

Same as 2.1 above, except Prima hires a third party company, XCo which employs X to do exactly the same as he did under 2.1. Such activities are not XCo's core business and hence it is assumed that XCo is a dependent agent for Prima. XCo would seek to at least cover its costs and make a small profit. If the analysis under 2.1 was correct, then XCo will charge Prima (20 for X, 6 for warehousing, 8 for other OPEX, 9 for profit =) 43 for its services.

### 4.2 Analysis

#### 4.2.1 Applying a value chain analysis

Same as 3.2.1 here above. There are no people and hence no allocable functions performed. XCo has already received a satisfactory reward for everything it has done. The same action cannot be rewarded twice as it cannot be performed on behalf of two legal entities at the same time.

In addition, it would be illogical to reward economic ownership of the inventory and trade receivables to XCo, as it would never accept the inventory losses, or bad debts to be for its account, unless XCo bought the inventory (in which case Prima does not retain title to the inventory until it is delivered to customers) or such has been explicitly agreed and it receives additional compensation for that.

#### 4.2.2 Applying art 7

Same as 3.2.2 here above, because of the arguments under 4.2.1 here above.

Description	Prima in A	Prima PE in B	Prima consolidated
Gross Sales	200	(arguably 0) 200	200
COGS	-40	(arguably 0) -200	-40
Net Sales	160	0	160
OPEX	(advertising, inventory losses, bad debts) -14	0	-14
XCo	-43	0	-43
Operating profit	103	0	103

## Example 5

### 5.1 Facts

Same as 3.1, except that Prima sends an employee Y to country B for 50% of her time, to ensure that XCo performs as agreed. Y earns 20 on a full time basis.

## 5.2 Analysis

### 5.2.1 Applying a value chain analysis

Same as 3.2.1, except that Prima does now have people in country B performing functions. Applying a residual profit split approach to Prima's total value chain, a best effort estimate of the value added through Y's overseeing XCo's activities, determines that this is only a routine function requiring a routine compensation, being a cost plus 10% with an arm's length target of 1.

### 5.2.2 Applying art 7

Y does not perform any of X or XCo's functions. Therefore it makes no sense to allocate these to her. She only oversees their activities (she has not negotiated the XCo contract or prices, she reports to Prima in A, she does not manage XCo or X, she simply reviews what they do, provides guidance and reports to Prima in A, when XCo deliberately ignores contractual terms or interprets them differently from what Prima in A does). Hence are the only costs and income to be allocated to the DAPE is the 50% time Y spends in country B to do her job. None of her actions justify divergence from 3.2.2 here above.

Y earns 20, of which 50% is allocated to the DAPE, which earns a cost plus 10% = 1 on that.

Description	Prima in A	Prima PE in B	Prima consolidated
Gross Sales	200	(arguably 0) 200	200
COGS	-40	(arguably 0) -200	-40
Net Sales	160		160
OPEX	(advertising, warehousing, inventory, bad debts) -20	0	-20
OPEX – XCo (could also be COGS)	-30	0	0
OPEX Y	(50% of time) -10	(50% of time) -10	-20
Oversight service Y	-11	11	0
Operating profit	89	1	90

## Example 6

### 6.1 Facts

Same as 4.1, except that Prima sends an employee Y to country B for 50% of her time, to ensure that XCo performs as agreed. Y earns 20 on a full time basis.

## 6.2 Analysis

### 6.2.1 Applying a value chain analysis

Same as 5.2.1.

### 6.2.2 Applying art 7

Same as 5.2.2. In particular, none of her actions justify divergence from 3.2.2 here above in terms of allocating inventory losses or bad debts losses or inventory assets or trade receivables to the DAPE.

Y earns 20, of which 50% is allocated to the DAPE, which earns a cost plus 10% = 1 on that.

Description	Prima in A	Prima PE in B	Prima consolidated
Gross Sales	200	(arguably 0) 200	200
COGS	-40	(arguably 0) -200	-40
Net Sales	160	0	160
OPEX	(advertising, inventory losses, bad debts) -14	0	-14
XCo	-43	0	-43
OPEX Y	(50% of time) -10	(50% of time) -10	-20
Oversight service Y	-11	11	0
Operating profit	82	1	83

## 7-10. Examples 7 - 10

### 7-10.1 Facts

As examples 3.1 – 6.1 respectively, except that XCo is an independent agent as it performs similar activities for other parties as part of its core business.

### 7-10.2 Analysis

1. There would no PE under 7.2 or 8.2 as Prima had no presence in country B outside of the activities of XCo. Country B would lose no revenue.
2. There arguably is PE under 9.2 and 10.2 due to Y's presence and activities in country B. It would make no sense to diverge from the analyses under 5.2 – 6.2 with regard to her activities. Thus the PE should be compensated on a cost plus 10% basis with a net income of 1. Country B would lose no revenue.

## 11-18. Examples 11 - 18

### 11-18.1 Facts

As examples 3.1 – 10.1 respectively, except that XCo is a 100% subsidiary of Prima.

### 11-18.2 Analysis

It would make no sense to diverge from the analyses under 3.2 – 10.2 just because XCo has a different shareholder.

#### 11-18.2.3 Article 9 analysis

Naturally one would have to do an article 9 analysis for the compensation between Prima and XCo. In a world where taxpayer certainty and relative pragmatism is valued, I see no reason to diverge from the conclusions reached under 1.2.1 and 2.2.1 here above, in combination with the true ups discussed in the second paragraphs of 1.2.2 and 2.2.2 respectively. The distinctions made between article 7 and 9 in the current guidelines are larger than they need to be for a fair allocation of profits to PE's. See my comments hereafter.

## Part II – Responses to the Paper

Paragraph 8, last sentence. I do think that there should be consistency in the arm's length remuneration between various scenarios. See Examples 11 – 18 hereabove.

Paragraph 16. The 2012 UN Practical Manual on Transfer Pricing for Developing Countries does not use the term free capital anywhere in the sense it is used in the AOA and I doubt that one could state that developing countries do not see the complexity of free capital calculations as problematic. Let alone the fact that due to free capital, subsidiaries are allowed to determine their own debt:equity ratios (within reason), but PE's are not.

Paragraph 19. I wonder how companies are going to represent these figures in their financial systems.

Question 1. No comment at this stage.

Paragraph 37. I find argumentation in this paragraph problematic and goal oriented. The TP Guidelines are best when they stick to reality. That is not what this paragraph does. The paragraph may be more readable if it follows a more resale minus line of argumentation as described in my Example 1 here above. However, even then, if there are no Prima people in B to buy for 190, or to negotiate a sales commission with Sellco for 10, or to sell for 200, the whole analysis becomes a tower of fictions built on to fictions with no resemblance of reality. TP should be more solid than that.

Question 2. I do agree with the conclusion but not the way in which it has been reached. It is overly complex and artificial.

Question 3. No, see response to question 2.

Question 4. The result will not be different, but the argumentation will be less artificial.

Question 5. Yes.

Paragraph 40. As Prima has no people in country B, Sellco should be compensated by Prima in A and not the DAPE. There is no one in the DAPE to negotiate with Sellco, review what Sellco is doing, or discussing Sellco's performance with Sellco. How can the DAPE then pay Sellco?

Paragraphs 42 and 43. This paragraph does not consider the possibility of outsourcing of functions at all. It requires various assumptions about financial capacity and zero activity in A in order to stay afloat. It is artificial and goal oriented. It will not work at all if Sellco were a third party doing the exact same thing: see 4.2.1, second paragraph under Part I hereabove. Paragraphs 42 and 43 creates a dichotomy between third party agents and subsidiary agents where none is needed.

Paragraph 44. Sellco's risks are limited to its own negligence as a service provider. There is no funding needed, because there is no transfer of inventory. Considering the simplicity of inventory as an asset vis a vis intangibles, this is either an inappropriate application of chapter VI or the use of a fictional transfer where none is needed.

Paragraph 47. The Paper does not say that commentators cannot comment on the AOA. The AOA is wrong in blindly allocating the ownership of all assets to a PE when those assets are involved in functions

performed by the PE. 1) This line of interpretation leaves no room for an HQ to outsource (part of) the management of risks to a PE. This constitutes a divergence for reality if one were to treat the PE as a separate enterprise, because as the new chapter I.D.I acknowledges, risk management can be outsourced. 2) It forces ownership of assets onto PE's where independent parties would never dream of buying when they can lease instead. Think for examples about USD 1 billion dollar drilling rigs which create PE's for their owners in the places where they drill for e.g. 13 months (I would be happy to explain this point further should the OECD wish).

Paragraph 49. I do not see how the DAPE can have economic ownership of the inventory and receivables when it is Sellco picking up the losses. As is the case in paragraph 44, this overusing Chapter VI solutions for complex assets in cases where the underlying assets are simple. In addition I regret the use of economic ownership: the previous CFA leadership for WP 6 very much resisted the use of the concept and opted for a complicated allocation of functions instead. Key concepts within the TP Guidelines should be included or excluded consistently and not vary from chapter to chapter.

Paragraph 53. Again I find the argumentation and conclusions artificial. One should also consider how all this argumentation is going to be applied from an HQ country perspectives. With so many fictions stuck on top of each other and conclusions so far removed from facts such as the presence of Prima people in country B, the room for disagreement between tax authorities and the opportunities of juxtapositioning of opposite fictions and assumption become vast. In fact, the second bullet even hints at principal behavior from a DAPE with 0 people.

Paragraph 54. See comments on the AOA allocation of assets here above.

Paragraph 56. I disagree with the conclusion that there are significant people functions in the DAPE. No people, no functions. The DAE already received its compensation for all the functions performed.

Question 6. No, for the reasons above.

Question 7. The conclusion would be more realistic, in large part because there will be no artificial allocation of assets.

Question 8. I disagree with too many assumptions and conclusions in this example to be able to answer this question.

Question 9. Please see my responses to the paragraphs above on the AOA and the application of chapter VI solutions and economic ownership.

September 5, 2016

Tax Treaties, Transfer Pricing and Financial Transactions Division  
Centre for Tax Policy and Administration  
Organisation for Economic Co-operation and Development

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

**1. General Comments**

In response to the recommendations of the BEPS final report, Article 5 of the OECD Model Tax Convention will be revised to expand the scope of agent permanent establishments (PEs) and determine on a case by case basis whether an entity's activities are of a preparatory or auxiliary character. However, the report did not address the issue of the attribution of profits to newly recognized PEs. In this sense, we welcome the Public Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments, which is based on the Authorised OECD Approach (AOA).

Under the AOA provided for in Article 7 of the OECD Model Tax Convention, profits attributable to a PE are defined as profits earned by the PE if it were a separate and independent enterprise and calculated based on the concept of the transfer pricing taxation. However, the AOA is a relatively new concept and not adopted by all jurisdictions. While OECD member countries are expected to introduce the AOA, non-OECD countries are unlikely to do the same, which has created a concern over the continuation of income calculation approaches that are not consistent with the AOA (e.g., taxation based on deemed profit rates and worldwide taxation).

Under these circumstances, the expansion of the scope of PEs will inevitably result in an increased double taxation. With the scope of PEs to be broadened as a result of the BEPS Project, it would be necessary for the purpose of striking a balance to build an appropriate consensus on the calculation of profits attributable to a PE. We agree with the direction of the Draft's discussions as they suggest that an appropriate application of the AOA will in most cases result in zero or insignificant profits attributable to a PE. Going forward, it is critical to further refine the Guidance and ensure that rules on the

scope of PE and profit attribution are interpreted and implemented in a consistent manner across OECD members and non-members.

If the multilateral instrument, which will be open for signature by the end of this year, is used to modify a bilateral tax treaty, such modification must be accompanied by the adoption of this AOA-based Guidance. We consider that it is unreasonable and unacceptable to make a modification to Article 5 only, prior to the adoption of this Guidance.

The Public Discussion Draft provides examples of both dependent agent PEs and warehouse PEs. All of them include specific numerical values, helping taxpayers and tax authorities share a better understanding of them. However, the Draft has also raised some questions, in relation to which we would like to make comments in the section below.

## **2. Comments on Specific Issues**

### **(1) Dependent Agent Permanent Establishments**

In its section providing for dependent agent permanent establishments (DAPEs), the Draft presents Examples 1, 2, and 4, in which Prima, a consumer product manufacturer in Country A, engaged Sellco, Prima's associated enterprise in Country B, to perform selling activities in Country B for Prima, and the activities performed by Sellco for Prima give rise to a PE of Prima in Country B. In these examples, a transfer pricing analysis is performed first under Article 9 of the OECD Model Tax Convention to allocate profits of Prima and Sellco, and then an AOA analysis is carried out under Article 7 to calculate profits attributable to Prima's head office and the PE. We consider that the order of the analysis, that is, beginning with the analysis under Article 9, is easy to understand and reasonable.

In order that there be certain profits attributable to the PE, there needs to be significant people functions performed by Sellco on behalf of Prima. In Example 1, on the grounds that Prima assumes inventory and credit risks and Sellco does not perform significant people functions, it is concluded that no profits are attributable to the PE. On the other hand, in the case of Example 2, Sellco assumes inventory and credit risks and Sellco performs significant people functions, but no profits are attributable to the PE until a funding return in relation to inventory is recognized. In Example 4, while Sellco assumes inventory risks, functions related to credit management are performed

jointly by Prima and Sellco, and there is a significant amount of profits attributable to the PE. Three questions arise in relation to this.

The first question is about the significance of assigning a PE status when no profits are attributable. In Example 1, while it is a convincing argument that the amount of profits attributable to the PE should be zero, it would be a waste of effort for both taxpayers and tax authorities if an enterprise needs to compute profits and file income tax returns despite not being required to pay corporate income taxes. In addition, once a PE status is assigned, it may create, depending on the jurisdiction, certain adverse effects, including the imposition of individual income tax. We thus believe that assigning a PE status is inappropriate in and of itself in such a case.

The second question is concerning the concept of Example 2. The OECD's 2010 Report on the Attribution of Profits to Permanent Establishments, which is frequently referred to in this Public Discussion Draft, suggests that in a case where a dependent agent (Sellco) performs significant people functions on behalf of a non-resident enterprise (Prima), a certain amount of profits should be attributed to the PE (para. 234), explicitly denying the "single taxpayer approach," which contends that a payment of an arm's length reward to a dependent agent enterprise fully extinguishes the profits attributable to the dependent agent PE (para. 235-239). However, in Example 2, while Sellco is assumed to be performing significant people function, the amount of profits attributable to the PE before recognizing a funding return is determined to be zero. Moreover, it seems that loss may be attributed to the PE depending on the amount of interest costs.

In addition, in Note 10, this Public Discussion Draft says, "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." This apparently suggests the adoption of the "single taxpayer approach." Although we are comfortable with the concept of the "single taxpayer approach," it would be helpful for us if the OECD clarifies its stance on this matter. Any guidance on the method of calculating funding returns would also be helpful. Anyway, it is again pointless to assign PE status in a case where profit attributed to the PE is extremely insignificant.

The third question is about the relationship between Examples 2 and 4. While Sellco bears overall credit risk in Example 2, it performs credit management functions jointly with Prima in Example 4. According to our understanding, this suggests the fact that in Example 4, Sellco performs less functions compared to Example 2, but the amount of

profits attributed to the PE in Example 4 is larger than that in Example 2. Although we are not sure that it is correct to assume that, under the AOA, the amount of profits attributable to the PE will increase in accordance with the extent to which Sellco performs significant people function on behalf of Prima, the result of Examples 2 and 4 is not consistent with the assumption, which is a little bit confusing.

The Public Discussion Draft explains that the risk allocation approach differs between Articles 9 and 7 of the Convention (para. 80). In addition, the 2010 Report on the Attribution of Profits to Permanent Establishments also describes that the AOA is not designed to achieve the equality of outcome between a PE and a subsidiary in terms of profits (para. 55). Even if certain differences are unavoidable, a clear explanation will be necessary about the significant difference in outcome between Examples 2 and 4. From our standpoint that the analysis under Article 9 should be respected, it seems to be a double count by the host country in which Sellco is situated (service and incentive fees received by Sellco under Article 9 of the Convention/Prima's profits attributed to the PE under Article 7 of the Convention). We consider that further review would be necessary during the finalization phase of the Guidance.

We withhold judgment on the appropriateness of the result of Example 3. Although the facts of Example 3 are the same as those in Example 2 except that the person who bears inventory and credit risk is Employee instead of Sellco, profit attributed to the PE in each example differs. We have general concern that a source country could casually assign PE status to activities performed by company employees and unfairly argue that more profits should be attributed to the PE.

## **(2) Warehouse PE**

The warehouse PE section in the Public Discussion Draft discusses Scenarios A, B, and C, in which a warehouse PE status in Country W is assigned to WRU, a company resident in Country A. In Scenario A, WRU provides warehousing services to third party customers. In Scenario B, WRU is engaged in the sale of products and runs the warehouse through its own employees. In Scenario C, WRU is engaged in the sale of products and the warehousing function is performed by a separate enterprise. In all scenarios, the amount of profits attributable to the PE is observed to be very small, but certain points need to be clarified.

In Scenario A, the PE needs to compensate WRU's head office for the granting of rights to the intangibles and the provision of advice regarding the inventory usage and

replenishment. In this regard, it would be helpful if some information on the compensation computation approach would be given.

In Scenarios B and C, it is explained that the attribution of profits to PEs can be “streamlined” by attributing to the PE profits commensurate with investment in that asset (para. 97 and 101). However, we have found vagueness in the meaning of the wording “streamlined” and therefore recommend that the profits attributable to the PE be explained in the same way as Scenario A, i.e., by using the income statement. We consider that no profits including the investment return on the assets should be attributed to the PE at least in the Scenario C, since WRU has no employees at the PE and uses the PE only to store its inventory in the scenario.

It should be noted that, similarly to an agent PE, it will be of little practical benefit to assign a PE status to a warehouse to which no profits are attributable. In such a case, the assignment of a PE status should be refrained from.

Sincerely,

Subcommittee on Taxation  
KEIDANREN

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

From KPMG International (“KPMG”) Ref

CC Manal Corwin, Stephen Blough, Tom Zollo  
KPMG in the U.S.

### **Comments on Attribution of Profits to Permanent Establishments Discussion Draft**

KPMG International (“KPMG”) appreciates the opportunity to present to the Organisation for Economic Co-operation and Development (“OECD”) our comments on the OECD’s Discussion Draft titled “BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments” (the “Discussion Draft”). We have provided below responses to some, but not all, of the questions on which public comments were specifically sought in the Discussion Draft, as well as general comments on Example 4. We thank the OECD in advance for consideration of our comments.

#### **Question 1**

*“Commentators are invited to express their views on whether the order in which the analysis 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.”*

See comments on Question 9 below.

#### **Example 1**

As a general comment on Example 1, although we recognize that the intent of the examples are not to illustrate the facts relevant for permanent establishment (PE) determination (i.e., the example states that it is “assumed” that a PE exists), the example could benefit from adding additional facts to avoid any implication that the activities of Sellco as described in the example always result in a dependent agent permanent establishment (“DAPE”). The facts state that Sellco solicits and places customer orders. However, there is no mention of which party actually negotiates the terms of the orders. Under Article 5(5) of the revised OECD Model Treaty, for example, Prima would not have a PE under the facts of Example 1 if Prima modified the orders presented to it by Sellco. To avoid any confusion and to accomplish the purposes of Example 1, we suggest adding facts relevant to the finding of a DAPE.

#### **Questions 2 and 3**

*“Do you agree with the functional and factual analysis performed and the construction of profits and losses of the DAPE in Example 1 under the AOA?”*

- KPMG agrees with the analysis in paragraph 34 concluding that no risks or assets or economic ownership are attributable to the DAPE because Sellco does not perform any significant people functions on behalf of Prima in Country B relevant to the assumption of risks.
- While the example assumes a PE exists, it does not explain what people functions Sellco performs on behalf of Prima that cause it to have a PE. Nevertheless, it is clear from the facts that legal, contractual and economic ownership of the inventory belongs to Prima. Why then is it appropriate to attribute all sales income to the DAPE? The constructed P&L appears to treat the DAPE as the seller of record for the inventory. How can the DAPE be credited with and treated as the seller of record of inventory of which it has no legal, contractual or economic ownership based on the factual and functional analysis of Step 1 of the Authorised OECD Approach (“AOA”)?
- Consistent with the analyses and conclusions in paragraph 34 and paragraph 39 (concluding that there are no profits to be attributed to the DAPE because there are no 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), none of the sales income should be attributed to DAPE under Article 7 or in the constructed profit and loss statement (“P&L”) in the example as a threshold matter.
- Para 36 of the Discussion Draft states that “[u]nder Article 7, the sales income obtained in Country B is attributable to the DAPE of Prima in Country B.” Article 7, however, is about the attribution of profits realized from sales, not about the imputation of sales. The OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments (the “2010 Report”) confirms that any deemed attribution of sales to the PE is solely for purpose of ‘profit attribution’, “*Assume for this purpose* that the PE should be deemed to have purchased the product from the head office for on-sale to third parties.” (Emphasis added).
- If, under Step 2 of the AOA, the OECD wishes to apply a hypothetical formula that as a matter of administrative convenience attributes third party sales to a DAPE solely for purposes of calculating the proper profits of the foreign enterprise attributable to the DAPE, it should clarify that the treatment of the DAPE as the seller under Step 2 is solely for purpose of applying the AOA to calculate a profit amount and that the DAPE should not be treated as the seller for any other purpose (VAT, customs duties, or other legal non-income tax purposes).

## Example 2

- As elaborated further below, a central issue in Example 2 is whether the entire activities of the dependent agent should be treated as within the scope of the

dependent agency relationship when, under the Discussion Draft's application of the principles of Chapter I of the OECD Transfer Pricing Guidelines ("Chapter I"), the dependent agent is considered to be performing certain functions for its own account and not on behalf of the principal. In Example 2, Sellco is characterized as exercising all the significant people functions with respect to inventory and credit decisions in Country B and as having the financial capacity to bear those risks. The example concludes that under Chapter I, Sellco is allocated those risks, notwithstanding the contractual arrangement between Prima and Sellco. As a result, Sellco may be characterized as managing those risks on its own behalf, and not on behalf of Prima. If this is the adopted approach, the profits from those activities should be separately allocated between Prima and Sellco (with Prima being limited to a funding return) before the remaining profits (which are within the scope of the dependent agency) are allocated under the principles of Articles 9 and 7. The analysis under Example 2, on the other hand, treats all the activities of Sellco as within the scope of the agency arrangement and thus implicitly as performed on behalf of Prima. It seems inconsistent to conclude that it is not possible for Sellco to perform these functions on behalf of Prima (solely as a service provider rather than on a full risk basis) for purposes of Chapter I, but that these functions should be treated as performed on behalf of Prima for purposes of applying the AOA analysis.

#### **Question 6**

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

See comments on Questions 8 and 9 below. KPMG commends the OECD on presenting an example with scenarios illustrating both profits and losses resulting from the assumption of risk, given the importance that both taxpayers and tax authorities understand that risk assumption cannot be a "heads I win, tails you lose" proposition.

#### **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?"*

Risk should not be allocated to entities who do not have the capacity to bear it. This is an essential element of risk attribution, and proper treatment of this issue is especially important to financial services businesses.

The financial capacity to bear risk should be taken into account in the Article 9 analysis under Chapter I of the Guidelines. If Sellco does not have the financial capacity to bear risk, it should be treated as managing those risks on behalf of Prima (and thus as Prima's agent). The Article 9 analysis should only allocate the profit to Sellco

commensurate with the limited risk value of its service. The balance of the profit of loss should be allocated to Prima.

### **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?”*

- It is critical for the OECD to provide further guidance on the order in which the Article 9 analysis and the Article 7 analysis should be performed in the context of a related enterprise DAPE and to reconcile the functional analysis to be conducted under Section D of Chapter I pursuant to allocating profits between related enterprises for purposes of Article 1 with the functional analysis to be undertaken to determine the allocation of profit to a PE for purposes of Article 7.
- This is particularly important given the new guidance in Section D of Chapter I. Under that guidance, as applied to Example 2 in the Discussion Draft, it appears possible for tax authorities to ignore the contractual allocation of risk between related parties where the contractual allocation of risk is not aligned with the control of risk. In the absence of a PE, the effect of this analysis is to allocate economic ownership of risk and assets to the related party controlling those risks and to preclude the possibility that the party performing the people functions associated with the control of risks is doing so solely as a service provider on behalf of the related party with legal and contractual ownership of the risks and assets.
- The analysis in Example 2 of the controlled transaction between Prima and Sellco under Article 9 illustrates this point by concluding that since Sellco, not Prima, exercises control over the inventory and credit risk, it is effectively given economic ownership of those risks (other than a funding return) for purposes of determining its profits.
- Paragraph 232 of the 2010 Report describes the AOA as follows:  
*“Under the first step of the AOA, a functional and factual analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. 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 AOA then attributes profits to the dependent agent PE on the basis of those assets, risks and capital.” (Emphasis added.)

- In applying the AOA to Example 2, paragraph 49 of the Discussion Draft states that “economic ownership of inventory and credit risk are attributed to the DAPE because Sellco performs on behalf of Prima in Country B the significant people functions relevant to the attribution of economic ownership of inventory and the credit risk.”
- The OECD should clarify why, if under an Article 9/Chapter I analysis it is determined that an affiliate is performing the people functions associated with control of risk on its own behalf (notwithstanding contractual allocation to the principal), is it appropriate in applying step 1 of the AOA to conclude that these same people functions are performed on behalf of the principal rather than on the agent’s own behalf? In other words, the OECD should reconcile the conclusion under Chapter I that Sellco performs the control functions on its own behalf (and thus entitled to a full risk return), with the application of the AOA in the example concluding that Sellco is performing the control functions on behalf of Prima.
- In this regard, the OECD should also elaborate on the interpretation of paragraphs 230 to 245 of the 2010 Report in light of the changes that have been made to Chapter I and Article 5. In particular, paragraph 236, in explaining the difference between the AOA and the single taxpayer approach to attribution of profits makes the following observation.

“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 taxpayer approach, those risks can never be attributed to the dependent agent PE of the non-resident enterprise, whilst the AOA 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. Indeed, such an approach would go against one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises (including their assets and risks) in respect of their activities in the source jurisdiction. The single taxpayer approach simply does not consider that if the risks (and reward) legally belong to the non-resident enterprise it is nonetheless possible to attribute those risks (and reward) to a PE of the non-resident enterprise created by the activity of its dependent agent in the host country.”

- The 2010 Report was obviously written before the recent modifications to Chapter I. Under the revised guidelines in Chapter I, it is no longer the case that inventory and credit risk can never be allocated to the source country if they are legally and contractually allocated to the principal. As shown in the Article 9 analysis of example 2, those risks are allocated to Sellco notwithstanding the contractual allocation to Prima. The conflict arises in that the 2010 Report would appear to allocate those risks to the DAPE, while under the new guidelines those risks are allocated to the affiliate.
- The OECD should clarify whether the revisions to the guidelines in Chapter I:
  - Supersede the approach to the AOA described in the 2010 Report (with the consequences described in the comments to Example 1 above).
  - Only apply in the absence of a PE
  - Will depend on the order in which Article 9 versus Article 7.

The analysis in Example 2 appears to try to apply both approaches simultaneously by first applying an Article 9 analysis to allocate inventory and credit risk to Sellco. It then applies step 1 of the AOA analysis and concludes that economic ownership of inventory and credit risk is attributable to the DAPE (presumably consistent with the 2010 Report). Finally, it uses step 2 of the AOA to revert back to the Chapter 9 analysis to shift the inventory and credit risk back to Sellco.

- The fundamental question that must be answered is whether the Article 9 analysis under the new guidelines, by attributing economic ownership of inventory and credit risk to Sellco, precludes the possibility of Sellco performing those functions on behalf of Prima rather than on its own behalf. If that is the case, then those functions should not be taken into account in applying the AOA to determine profits attributable to the PE, because they are not performed on behalf of the principal.

#### **Example 4**

Example 4 as presented is not helpful. It presents a hypothetical fact pattern that is neither simple, nor represents a realistic scenario. The Example should be replaced by one or more alternatives, as discussed below.

In Examples 1 and 2, the contractual relationship of the parties allocates substantially all risk to Prima.

- In Example 1, Prima has complete functional control over risk. Therefore, the contractual allocation is respected in the Article 9 analysis.
- In Example 2, SellCo has complete functional control over risk. Therefore, the contractual allocation is disregarded in the Article 9 analysis, leading to a reallocation of the greatest part of the system profits to SellCo under Article 9.

A natural and useful subsequent example would maintain the same contractual relationship of the parties, allocating substantially all risk to Prima, as is used in Examples 1 and 2, but where control over risk is split between the two parties. Such an example would be highly relevant to common structures found in many MNEs. In such an example, Prima would be hypothesized to have sufficient control over risk that the contractual allocation is respected in the Chapter I analysis (*cf.* paragraph 1.94). The example could then usefully illustrate how an analysis per paragraph 232 of the 2010 Report would determine the extent to which Sellco functions including management of risk were being performed on behalf of the non-resident enterprise Prima, and consequent allocation of income or loss associated with such risk assumption and management to the DAPE.

However, the Discussion Draft does not provide such an example. Instead, Example 4 changes both the contractual allocation of risk and the relative functional control over risk, from those found in Examples 1 and 2. While Example 4 shows shared functional control over risk, it presents a complex and unusual contractual structure that shares the outcome of credit risk by means of an incentive payment to SellCo.

KPMG is concerned that the failure to provide an example with one-sided contractual risk allocation but two-sided functional control over risk, may reflect a lack of clarity within the OECD about the appropriate analysis of such a fact pattern under Article 9. KPMG would view any such lack of clarity with a very high degree of concern. Chapter I paragraph 1.94 is explicit that a one-sided contractual risk allocation may be respected in cases where both parties perform risk management and control functions. KPMG recognizes that two-sided contractual allocations may also be appropriate (*cf.* paragraph 1.107) but that does not preclude the very important example of one-sided contractual allocation.

In addition to the relatively simple example suggested above, the OECD should provide an example in which more than one risk is present, and illustrate how an analysis would determine which functions, risks and assets of the agent pertain to the non-resident enterprise and thus attributed to the DAPE, vs. those which the agent is performing on its own behalf.

### ***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 OECD should prescribe a pathway for administrative relief for DAPE’s with no profit attribution**

- Paragraph 104 of the Discussion Draft observes that “there could be situations where the profits attributed to the PE are nil. Nevertheless, the existence of a DAPE for corporation tax purposes may arise even when there are no profits attributable to the DAPE, and notwithstanding this, may create filing requirements and may give rise to other tax liabilities.”

- It is critical to recognize that in such situations, where the proper application of Articles 9 and 7 to the facts results in no profits attributable to a DAPE, the additional filing requirements and potential other non-income tax consequences impose significant burdens on the taxpayer and inhibit cross-border investment without furthering the policy objective relating to BEPS.
- Paragraph 246 of the 2010 Report dealing with administrative matters and documentation notes that even where profits are found to be attributable to a DAPE, “nothing in the [AOA] would prevent countries from using administratively convenient ways of recognising the existence of a dependent agent PE and collecting the appropriate amount of tax resulting from the activity of a dependent agent. For example, ... a number of countries 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.”
- While the 2010 Report suggests that “such administrative matters related to the taxation of dependent agent PEs are for the domestic rules of the host country and not for the AOA to address,” it also emphasizes that “the potential burden on the non-resident enterprise of having to comply with host country tax and reporting obligations in the event it is determined to have a dependent agent PE cannot be dismissed as inconsequential, and nothing in the AOA should be interpreted as preventing host countries from continuing or adopting the kinds of administratively convenient procedures mentioned above.”
- KPMG believes that the changes made since the release of the 2010 Report to Chapter I and Article 5 (relating to DAPes) likely will significantly increase the circumstances in which a DAPE will have no attributable profit after the applications of Article 9 and 7. As a result, the concerns acknowledged in the 2010 Report will have even broader and more significant impact on taxpayers and administrators than originally contemplated.
- In light of the developments since the 2010 Report and the exacerbation of concerns acknowledged even prior to these developments, KPMG urges the OECD to prescribe a more deliberate pathway for administrative relief in circumstances where no profits are found to be attributable to a PE.
- There are a number of approaches to prescribing such administrative relief. In general, treaty partners should agree that in circumstances where either (1) no profits

are attributable to a DAPE under Article 7, or (2) a taxpayer elects to allow the source country “to tax 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” (see the 2010 Report), then the taxpayer would not be required to file as a PE.

- The changes to Article 5, if included in the multilateral instrument (the “MLI”), will lead to the proliferation of DAPes without profit attribution. Accordingly, we believe that administrative relief provisions should also be included as part of the MLI, ideally as a standard provision, but at the very least as an optional provision. This would provide countries a pathway to implement such relief reciprocally if and when they adopt the new PE standard.

**The OECD should clarify the application of the 2010 Report interpreting Article 7 in light of the changes made to Chapter I of the transfer pricing guidelines**

- To better coordinate the application of Article 7 and Article 9 in the determination of profits attributable to a PE, KPMG recommends that where Chapter I is interpreted to override the contractual arrangement between a foreign enterprise and a DAE to preclude an agency relationship and to allocate income (or loss) to one of the parties contrary to their contractual arrangement, the people functions associated with such re-allocated income (or loss) should not be considered within the scope of the dependent agency relationship in the application of Article 7. As discussed above, Example 2 of the Discussion Draft treats both the DAE and the DAPE as the “economic owners” of the inventory and receivables – once under Chapter I (in applying Article 9) and once under Article 7. The “economic ownership” of these assets should be attributed to only one taxpayer. Attributing economic ownership to both the DAE and the DAPE is both confusing and unnecessarily complicated. We recommend that the notion that Article 7 always requires attribution of economic ownership of assets of the foreign enterprise to the DAPE (where the DAE undertakes related significant people functions) be modified to reconcile the role that revised Chapter I now plays.

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**About KPMG**

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. We operate in 155 countries and have more than 162,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

By e-mail

Tax Treaties, Transfer Pricing and Financial Transaction Division

FROM Loyens & Loeff N.V. - Harmen van Dam / Jonneke Dijkstra / Arjan Oosterheert  
REFERENCE 22452863  
DATE 5 September 2016  
  
RE Comments Loyens & Loeff on the Public Discussion Draft regarding BEPS Action  
7 - Additional Guidance on the Attribution of Profits to PEs

Dear Sir / Madam,

In response to the invitation of the OECD to interested parties to provide comments on the public discussion draft on "Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments" (the **Discussion Draft**), please find in this letter the comments on the Discussion Draft on behalf of Loyens & Loeff N.V.<sup>1</sup> (**Loyens & Loeff**, we or derivative terms). The comments we provide in this letter are our own comments as tax professionals. They do not represent the comments of particular clients.

Loyens & Loeff appreciates the work of the OECD to develop guidance on the attribution of profits to permanent establishments (**PEs**) and more specific to dependent agent permanent establishments (**DAPEs**). We have read the Discussion Draft with great interest and we welcome the opportunity to submit comments. In summary we like to address two important remarks in reaction to the Discussion Draft:

1. **Confirmation profit allocation to PEs is more appropriate than arbitrary adjustments under Action 8-10.** We expect and hope the Discussion Draft to be a useful document for convincing local tax authorities to be reluctant to "easily" ignore contractual risk allocation between related parties. The Discussion Draft offers sufficient options to correctly allocate risk and equity related returns via a PE. This substantially reduces the current practical uncertainty concerning the scope of Action 8 – 10.
2. **Suggestion for reduction administrative burden.** The Discussion Draft could offer tax payers the option to report DAPE's result in the dependent agent enterprise' (**DAE**) tax

<sup>1</sup> As a leading firm, Loyens & Loeff is the natural choice for a legal and tax partner if you do business in or from the Netherlands, Belgium, Luxembourg, and Switzerland our home markets. You can count on personal advice from any of our 900 advisers based in one of our offices in the Benelux or in key financial centres around the world. Thanks to our full-service practice, specific sector experience and thorough understanding of the market, our advisers comprehend exactly what you need.

return. This would eliminate the need for individual tax returns of multiple “non-resident enterprises”. We notice that this approach works quite well in the Netherlands. It should be noticed that in the “non-resident country” we sometimes encounter some complexities related to the credit of taxes levied accordingly.

Please find below our remarks in more detail with links to your examples.

## **1 Profit allocation to PEs is more appropriate than arbitrary adjustments under Action 8-10**

### *Guidance provided in the Discussion Draft*

The factual and functional analysis performed as well as the construction of the profit or losses of the DAPE in Examples 1-4 is in our view in line with the current guidance in the 2010 Attribution on profits report (the **2010 Report**).

Following para. 232 of the 2010 Report, the Authorized OECD Approach (**AOA**) distinguishes between the significant people functions (**SPFs**) performed by the DAE (i.e. Sellco) on its own account and on behalf of the non-resident enterprise (i.e. Prima). If Sellco performs SPFs for its own account, it should be rewarded for this functionality. If Sellco performs SPFs on behalf of Prima, these SPFs should be attributed to the DAPE of Prima. As a next step, step 2 of the AOA, profit is attributed to the DAPE in line with its functionality.

### *Example 1*

Based on the above guidance, no income should be attributed to the DAPE in Example 1, as in this example the DAPE does not perform any SPFs, nor does Sellco perform SPFs or assume risks on behalf of Prima.

### *Example 2-4*

In the Examples 2-4, Sellco (or the Employee in the DAPE) performs key-decision making functions with respect to the inventory (risk) and the receivables/credit risk on behalf of Prima. Sellco / the Employee binds Prima, by approving sales made to customers. Furthermore, Sellco (or the Employee) sets parameters within which credit can be extended to customers and is responsible for warehousing the inventory and monitoring appropriate inventory levels. As such, it can be said that Sellco / the Employee performs activities for the risk and account of Prima.

Under step 1 of the AOA, the SPFs performed by Sellco on behalf of Prima, should be allocated to the DAPE. Under step 2 of the AOA, a profit is attributed to the DAPE, in line with the functionality determined under step 1.

Based on the above we agree with the construction of the profits of the DAPE in Example 2-4 under the AOA. We also agree with the conclusion in Example 4, that the profits are partly allocable to the

head office, as risk management functions and decision making functions, i.e. the SPF's, are partly performed in the head office.

We would like to note that the assumptions made in calculating the profits, should not be interpreted as guidance. It might be useful to mention that in the text regularly.

#### *Relation to BEPS Action 8-10*

In our view, it follows from the guidance set out in the Discussion Draft and the Examples 1-4 of the Discussion Draft that the contractual risk allocation between entities is in principle often respected under BEPS Action 7 and BEPS Action 8-10. Reallocation between entities under Action 8-10 only takes place in exceptional cases. In this approach Action 7 reinforces the taxing rights in the source country by providing sufficient options to correctly allocated risk and equity related returns via a PE. This substantially reduces the current uncertainty concerning the scope of Action 8 – 10.

If a different explanation of Action 8-10 was applied, this would lead to an overlap between Action 7 and Action 8-10. It could then be argued that under the principles of the new Chapter I OECD Guidelines, Sellco can be considered the economic owner of the inventory and the receivables, as it performs the key decision making functions with respect to the risks and has the capacity to assume the risks. Arguably according to the explanation of Action 8-10, Sellco, as economic owner, should be appropriately remunerated and bear the financial consequences of failure and enjoy the consequences of success with respect of the inventory and the receivables. The activities are then performed by DAE for its own risk and account and It can no longer be said that that DAE performs the activities on behalf of Prima. Following para. 232 of the 2010 Report, no assets and risks would be attributed to the DAPE in this situation. If the above explanation was applied, Action 8-10 would already provide for the reinforcement of taxing rights in country B, and the guidance in this Discussion Draft would be irrelevant for cases as illustrated by Example 2-4.

## **2 Reduction administrative burden**

The application of the guidance under the 2010 Report and this Discussion Draft, will lead to an substantially increased number of (DA)PEs. This increased number of PEs will lead to a huge administrative burden in the country of the newly recognized PEs for an entity or group, given the formalities and obligations that should be fulfilled when a PE is recognized. Specifically statute of limitations could be an important problem as the application of the rules by the individual countries is far from obvious.

This increased administrative burden is undesired and may not always be in proportion with the problem the OECD wants to solve (avoiding the artificial avoidance of PE status and allocate profits to such PEs). Therefore, solutions should be sought to reduce the impact of this undesired effect. In this respect it could be considered to offer tax payers the option to report DAPE's result in the DAE's tax return. This is in our view an administratively convenient way of collecting the appropriate amount of tax resulting from the activities of both the DAE and the non-resident enterprise in

country B. We notice that this approach works quite well in the Netherlands. It should be noticed that we sometimes encounter some complexities related to the credit of such taxes in the non-resident country.

Loyens & Loeff N.V.

Harmen van Dam / Jonneke Dijkstra / Arjan Oosterheert

**By E-Mail**

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

To whom it may concern,

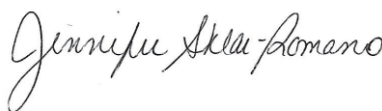
RBSM – RoeverBroennerSusatMazars and WeiserMazars welcome the opportunity to submit comments on the Discussion Draft “BEPS Action 7 Discussion Draft: Additional Guidance on the Attribution of Profits to Permanent Establishments”. We appreciate this opportunity to share our views and hope you find our comments useful in your work on BEPS.

We remain at your disposal for any further discussion of these issues.

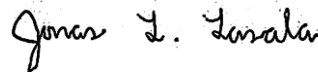
Yours sincerely,



*Gertrud R. Bergmann*  
Diplom-Kauffrau  
Auditor  
Tax Advisor  
Partner



*Jennifer Sklar-Romano*  
International Tax Director  
WeiserMazars, LLP



*Jonas Lasala*  
International Tax Manager  
WeiserMazars, LLP

## Questions for Consultation:

1. We agree with the order of analysis under Article 9 and Article 7 of the MTC under the limited assumptions provided in Example 1. However, additional guidance should be provided on the effect of the attribution of profits to the PE where members of the non-resident enterprise, other than Prima and Sellco, perform additional business functions and activities in connection with the sale of products in the host country.
2. We agree with the functional and factual analysis performed in Example 1 under the AOA because, under the fact pattern provided, Sellco does not perform significant people functions. The commercial business risks associated with the Country B sales are contractually undertaken by Prima and the risk control functions related to such risks are performed by Prima in Country A.
3. We agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA based upon the limited assumption of Example 1 that no significant people functions are performed by the DAPE in the host country.
4. No comment.
5. We agree that no profits should be attributed to the DAPE after the payment of an arm's length fee under Article 9 if the DAPE does not perform significant people functions.
6. We agree with the attribution of profits to the DAPE based upon the assumptions in Example 2 that the DAPE performs significant people functions that result in the attribution of risks and economic ownership of assets for inventory and receivables.
7. No comment.
8. We believe that Sellco's lack of financial capacity is irrelevant and should not affect the analysis because Prima has control over Sellco's financial capacity and can sufficiently capitalize Sellco's business operations if necessary.
9. We believe that the conclusion reached in Example 2 is supported by the AOA in the 2010 Attribution of Profits Report.
10. We agree with the construction of the profits or losses of the DAPE in Example 3 based upon the significant people functions performed by Prima's employee in the host country. Under the AOA, significant people functions are attributable to the PE if the significant people functions are performed "by the people in the PE," "by employees of the PE," or "by the personnel of the PE." See 2010 Report on the Attribution of Profits to Permanent Establishments, paragraphs 15, 23 and 68. However, absent a clear definition of such terms, additional guidance should be provided in determining when the functions performed by an employee of a non-resident enterprise may be attributed to the DAPE.

11. No comment.
12. We agree with the construction of the profits or losses of the DAPE in Example 4 because it considers the relative contributions by all parties regardless of where they are located. We further agree that the outlined methodology ensures a consistent remuneration irrespective of whether the transaction results in a profit or loss position.
13. We agree that the profits or losses in Prima's DAPE over and above the fee payable to Sellco arise because of the differences between allocation of risk between two separate enterprises and the attribution of risk within the same enterprise. In the analysis under Article 9, Prima contractually bears credit risk and Sellco's exercise of control over the risk does not affect Prima's contractual assumption of risk. However, in the analysis under Article 7, the attribution of risk is made within a single enterprise (Prima's Head Office and Prima's DAPE). Under paragraph 24 of the Attribution of Profits Report, credit risk is attributed to the part of the enterprise whose people make decisions that lead to the assumption of credit risk. In this case, both Prima's Head Office and Prima's DAPE perform active decision-making functions that lead to the assumption of credit risk. Therefore, credit risk should be partly attributed to Prima's Head Office and partly to Prima's DAPE.
14. We agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA. In particular, we agree that the economic ownership of the warehouse should be attributed to the PE as the warehouse is used in the host country consistent with Part I, paragraph 75 of the 2010 Attribution of Profits report. From a transfer pricing perspective, the construction of profits could be simplified by applying a cost plus remuneration for WRU's PE. In practice, the identification of a reliable arm's length remuneration for WRU's PE as a "tested party" (i.e., a mark-up on full-costs, with the cost base consisting of the workforce and the depreciation of assets) is more straightforward than determining an arm's length fee for the comparatively more complex and higher value-adding contributions of WRU.
15. We agree with the conclusion reached in Scenario B of Example 5 of the AOA. With respect to Scenario C of Example 5 of the AOA, the conclusion is based upon the assumption that there are no significant people functions performed in the host country. Additional guidance should be provided regarding the nature and degree of control functions that must be performed by PE employees to constitute significant people functions in the host country PE.
16. We agree that, generally, 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.
17. With respect to Scenario B, we agree to the extent that the streamlined approach attributes profits commensurate with investment in the asset and for the performance of routine functions. However, additional guidance should be provided on how the investment return should be calculated. For this purpose, the investment return may be determined by reference to the rate of return on all investment assets held by the non-resident enterprise with adjustments to

prevent distortion in investment returns on account of investments in underperforming or non-performing assets or in assets denominated in currencies subject to high rates of inflation.

To the extent Scenario B also attributes profits to the PE commensurate with the compensation payable for investment advice, we suggest that additional support for this position be provided. The facts of Example 5 and Scenario B should describe the nature of the investment advice and its relevance to the assumption of risk and economic ownership of assets by the PE.

18. Under the assumption there is no personnel operating at the fixed place of business PE, we agree that the 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. However, a variation of the example should be provided wherein the fixed place of business PE has personnel who exercise control over the functions performed by third parties and the circumstances under which significant people functions performed by these third parties may reasonably be attributed to the PE and lead to the attribution of risks or assets to the PE.
19. We agree under the limited assumption that Wareco does not perform significant people functions. However, if Wareco performs significant people functions, additional profits should be attributed to the PE of WRU.
20. No comment.
21. We believe that the examples are very limited and additional fact patterns should be provided that involve other activities such as toll manufacturing, the storage of goods by a non-resident enterprise in a host country warehouse owned by a related party, and scenarios wherein the head office and PE perform different significant people functions in different years.



September 2, 2016

Organisation for Economic Cooperation and Development  
Centre for Tax Policy and Administration  
Attn. Mr. Jefferson VanderWolk  
Head, Tax Treaties, Transfer Pricing, and Financial Transactions Division  
2, Rue André Pascal  
75775 Paris, France

Re: Comments on Discussion Draft of Additional Guidance on the Attribution of Profits to Permanent Establishments

Dear Mr. VanderWolk:

The National Foreign Trade Council (the "NFTC") is pleased to provide written comments on the Discussion Draft: Additional Guidance on the Attribution of Profits to Permanent Establishments, published July 4, 2016 (the "Discussion Draft").

The NFTC, organized in 1914, is an association of some 250 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD in establishing international tax and transfer pricing norms that provide certainty to enterprises conducting cross-border operations, and we appreciate the opportunity to comment on this important project. A list of the companies comprising the NFTC's Board of Directors is attached as an Appendix.

This letter addresses each of the questions posed in the Discussion Draft. In general, our responses are intended to promote conceptual clarity and enhance administrability without hindering the objective of ensuring that profits reported in a country are consistent with the value created in that jurisdiction. Consistent with the 2010 AOA, the Discussion Draft should more clearly identify the dealings between the head office and the PE, and apply the transfer pricing rules by analogy to those dealings. The Discussion Draft should clarify that the only purpose of those dealings is to facilitate the appropriate attribution of profits to the PE, and that they should not otherwise be given effect. In general, we believe that the Article 9 and Article 7 rules should be administered together in a manner that promotes the objectives of the BEPS project, while minimizing PEs, dealings, and hypothetical offsetting flows between the head office and the PE. The NFTC strongly urges that simplifying mechanisms be promoted that would permit a DAE to file a return that reflects the profits attributable to it and to the DAPE (if any) in lieu of multiple reporting and filing requirements, and to permit disputes as to the

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existence of a DAPE to be resolved by adjusting the profits reported by the DAE to a mutually agreeable level. The NFTC urges the OECD to consider these and other comments from business groups as it moves forward with this project.

*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.*

The NFTC believes that Article 9, where applicable, should be applied before Article 7. We agree with the last two sentences of paragraph 19 of the Discussion Draft: it would be logical and efficient to first delineate the transaction(s) between the non-resident enterprise and the DAE, which will then provide the fee deductible in the DAPE in respect of the functions performed by the DAE, consistent with the 2010 Attribution of Profits Report. This ordering is consistent with the objectives of Actions 8-10 and Action 7 taken together, which are to ensure that profits reported in a country are consistent with the value created in that country. Finally, this ordering would be consistent with simplifying mechanisms that would permit a related party DAE to file a return that reflects the profits attributable to the DAE and to the DAPE (if any) in lieu of multiple reporting and filing requirements. In this regard, the AOA observed that “where a dependent agent PE is found to exist under Article 5(5), a number of countries 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.” 2010 AOA, ¶ 246.

#### Example 1

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

The NFTC agrees that no profits should be attributed to the DAPE in Example 1. The DAE does not perform any “significant people functions” on behalf of the non-resident enterprise in the source country which would be relevant to the attribution of risks related to inventory, marketing intangibles, or receivables, or relevant to the attribution of economic ownership of such assets. Accordingly, there are no risks or assets attributable to the DAPE. In addition, the DAE does not utilize any tangible property in the source jurisdiction.

We note that the example (correctly, in our view) does not attribute the economic ownership of inventory (a tangible asset) to the DAPE because there are no relevant significant people functions in the source country performed for the non-resident enterprise. The AOA generally attributes the economic ownership of tangible assets to the place of use unless circumstances dictate a different result. It would be helpful to clarify the Discussion Draft to provide that, in general, the economic ownership of inventory should be attributed to the location in which



significant functions with respect to that inventory take place, such as decisions related to warehousing and inventory levels.

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

The NFTC agrees that no profits should be attributed to the DAPE in Example 1. The construction of profits or losses of the DAPE appears to be driven by the conclusion that there are no profits attributable to the DAPE, coupled with the attribution to the DAPE of the 200 of third-party sales. Once the fee to the DAE is determined, then COGS are set to eliminate any profit from the DAPE.

An alternative approach would be to more clearly articulate the dealings between the head office and the DAPE. It is possible under this example that there are no dealings between the head office and the DAPE at all given the lack of significant people functions (and attributable assets) in the source country (and perhaps no PE). It is also possible that the dealings are the provision of sales agency services by the DAPE to the head office, and the on-payment of any fee received by the DAPE to the DAE. Each of these constructs lead to the same conclusion under the facts of Example 1: no profit attribution to the DAPE. That said, it is important to clarify the conceptual framework for the analysis in simple cases so that the framework can be applied more consistently in complex cases. We note that the conclusion that there are no dealings, or that the dealings consist of the provision of back-to-back services, may be more consistent with simplifying mechanisms that would permit a related party DAE to file a return that reflects the profits attributable to the DAE and to the DAPE (if any) in lieu of multiple reporting and filing requirements.

*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 difficult to answer this question given the different pre-AOA formulations of Article 7 in existing tax treaties. We note that few existing tax treaties include the 2010 version of Article 7, and that some countries have stated an intention not to follow the AOA in new treaties. One of the foundational elements of the BEPS project has been to return coherence to the international tax rules. In our view, moving forward with a new PE standard without consensus on how profit would be attributed to newly created PEs lacks coherence and will lead to disputes and double taxation.

*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?*

The NFTC agrees that there should be no profits attributable to the DAPE because there are no significant people functions performed by the DAPE applicable to the assumption of risk or relevant to the economic ownership of assets. This result is consistent with the objectives of Actions 8-10 and Action 7 taken together, which are to ensure that the profits reported in a country are consistent with the value created in that country. The value created in the source country is reflected in the arm's length return to the DAE.

While we are aware that the definition of a PE is beyond the scope of this Discussion Draft, we question whether any objective is served by applying the expansive PE definition in cases like Example 1. Deeming a PE to exist in such circumstances does not provide a revenue benefit to the source country, but potentially imposes significant administrative burdens on the tax authority in the source country. Additionally, the creation of a PE results in a major burden on taxpayers. Non-resident enterprises will be burdened by reporting obligations for the PE. In many jurisdictions, filing will be required to avoid penalties and/or to secure certain protections. *See* 2010 AOA, at 63, n.12 ("the potential burden on the non-resident enterprise of having to comply with host country tax and reporting obligations in the event it is determined to have a dependent agent PE cannot be dismissed as inconsequential[.]"). As noted above, the NFTC strongly supports simplifying mechanisms that would permit a related party DAE to file a return that reflects the profits attributable to the DAE and to the DAPE (if any) in lieu of multiple reporting and filing requirements.

## Example 2

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

The NFTC believes that Example 2 provides a useful example of the benefits of applying Article 9 before Article 7 where both are applicable. Under the facts of the example and Article 9, Sellco is assumed to control inventory and credit risk and therefore to bear such risks notwithstanding contractual provisions to the contrary, in particular, contractual provisions providing that Prima is the owner of the inventory and the owner of the receivables. The transaction between Sellco and Prima may therefore be accurately delineated as the performance by Sellco of risk management and control functions with respect to the risks associated with its own assets for its own account, and not the performance of such functions as a service for Prima. This allows Sellco to derive the appropriate compensation as a buy-sell distributor bearing risk with respect to inventory and receivables, and receiving financing from Prima.



Assuming this is the proper characterization, it is unclear why Prima should be considered to have a DAPE even under the expanded PE standard. The finding of a DAPE appears to be premised on respecting the contractual arrangement between Prima and Sellco, which provides that Sellco is a sales agent for Prima. But key terms of that contract are disregarded as inconsistent with an accurate delineation of the transaction under Article 9. The Article 7 analysis should proceed based on the transactions between Prima and Sellco as accurately delineated. In such a case, it is not clear that Sellco is a DAE and therefore that Prima has a DAPE. Stated differently, the inventory risk and credit risk attributed to the DAPE in paragraphs 49 and 50 have already been attributed to Sellco; these risks do not reside in Prima and therefore are not subject to attribution as between the head office and a DAPE. This analysis is consistent with the text of footnotes 10 and 11.

Even if Sellco is treated as a DAE and Prima therefore has a DAPE, it is not clear that any profits should be attributable to the DAPE. The Discussion Draft appropriately treats Prima as earning a funding return for its financing of inventory. It is not clear why this return is attributable to the DAPE rather than the head office. The funding risk appears to be managed and controlled by Prima; accordingly, it should not be treated as borne by Sellco under Article 9. There is no suggestion in the example that the activities related to the funding risk take place in the source country. Note in this regard that Sellco is assumed to have the financial capacity to bear the risk under the Article 9 analysis, and therefore the capital supporting Sellco's inventory risk is already being taxed by the source country.

It is important for the Discussion Draft to provide additional analysis in the context of Example 2 to better clarify the nature of the accurately delineated transaction between Prima and Sellco, and to explicitly conduct the Article 7 analysis on the basis of that transaction. We believe that the objectives of the BEPS project are best served by applying the Article 9 analysis to conclude that Sellco is performing functions for its own account and not for Prima, and to ensure that Sellco earns an appropriate return for such functions (including risks and assets attributed to Sellco as a result of its risk management and control functions). These issues could be addressed by providing a simplifying mechanism that would permit a related party DAE to file a return that reflects the profits attributable to the DAE and to the DAPE (if any) in lieu of multiple reporting and filing requirements.

*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?*

See our answer 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?*

The new guidance under Article 9 is not definitive with respect to the allocation of risk where the party responsible for the management and control of that risk does not have the financial capacity to bear the risk. Assuming that Prima is regarded as bearing that risk, then under Article 7, the DAPE would be allocated the capital to support such risks. In all events, the return on that capital (whether actually or constructively held by Sellco, or allocated to the DAPE) will be subject to tax in the source country.

*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?*

Consistent with our response to question 6, the Article 9 analysis should be conducted first to ensure that the profits of each enterprise are appropriately determined. The Article 7 analysis should then proceed in accord with whatever conclusions were reached under the Article 9 analysis. This framework will best ensure consistent results and avoid superfluous dealings and offsetting transactions within entities.

### Example 3

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

The NFTC generally agrees with the results of Example 3. Consistent with our response to question 3, we note that the formulation of profits or losses of the DAPE appears to be driven by a conclusion as to the net profits attributable to the DAPE, coupled with the attribution to the DAPE of the 200 of third-party sales. Once the appropriate profits are determined, COGS are set to reach that level of profits. An alternative approach would be to more clearly articulate the dealings between the head office and the DAPE and to proceed with the analysis under such dealings.

*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?*



See our answer to question 4.

#### Example 4

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

Consistent with our response to question 3, we note that this example would be more helpful if it included a clear articulation of the dealings between the head office and the DAPE.

The results of Example 4 depend on two critical assumptions. First, Prima and Sellco have entered into a contract under which Sellco performs some (but not all) of the credit management functions related to credit risk on sales in the source country in exchange for an incentive fee. In our experience, this is an unusual arrangement given the relatively routine nature of the functions being performed by Sellco. Second, the incentive fee amounts to 40% of the difference between the value of the credit risk and the bad debt write-off. This is assumed for purposes of the example to be an arm's length amount (even though Sellco incurs only 25% of the credit management costs related to the source country, and even though those costs are remunerated on a cost-plus basis).

Under these assumptions, in Scenario A, the DAE and DAPE are deemed to earn approximately 62% of the operating profits (again, notwithstanding the fact that together the DAE and DAPE incurred 25% of the total credit management costs). In Scenario B, the DAE and DAPE are deemed to have approximately 40% of the losses. The imbalance arises from two facts. First, the credit management costs incurred by the DAE in the source country are fully reimbursed on a cost-plus basis by the non-resident enterprise. Second, those same credit management costs attract a proportionate share of the non-resident enterprise's actual profits to the DAPE.

The NFTC is concerned that the assumed facts of Example 4 could be read to suggest an over-allocation to a DAE and DAPE than is warranted in more typical factual contexts. In a more typical factual context, the contract between Prima and Sellco would not provide for an incentive fee; rather, Sellco would be compensated for its functions with a plus that accounted for the additional risk management and control functions it has undertaken. Because Prima also undertakes risk management and control functions and has the financial capacity to bear risk, the contractual allocation of risk to Prima would be respected under an Article 9 analysis. The analysis under Example 4 would proceed in the same manner, with 25% of the risk return and Sellco fee expense attributed to the DAPE. An alternative arrangement could provide for a contract with a much lower percentage incentive fee and/or some unreimbursed credit management costs borne by Sellco.



The Discussion Draft should be clarified to avoid any implication that persons exercising some (but not all) risk management and control functions must share in upside from the associated risk, as that conclusion would be inconsistent with the Transfer Pricing Guidelines. To that end, we recommend the introduction of a further example in which an associated enterprise operating in a third country undertakes some (but not all) risk management and control functions related to credit risk and receives a fee that is not contingent on the outcome of such risks.

*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 this explanation. As noted in our response to question 12, we believe that the unrealistic factual assumptions in Example 4 could be used to justify over-allocations of profit to source countries in more typical factual situations. Relatedly, the analysis in Example 4 depends on a finding that some (but not all or even most) risk management and control functions are taking place in the source country. Given the disproportionate amount of profits in Example 4 that turn on the finding of such functions, we are concerned that the analysis in the Example would lead to unnecessary factual disputes over the nature of activities taking place in the source country.

#### 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 NFTC generally agrees with the results in Scenario A of Example 5. It is appropriate for the PE's profit to be limited to a routine return for owning the warehouse facility and for the functions performed at the warehouse, because all significant people functions in relation to the business and related risk are performed in Country A. Consistent with our earlier responses, we note that this example would be more helpful if it included a clearer explanation of the dealings between the head office and the PE. The Example assumes that the PE is the recipient of the third-party fee income, and that the PE reimburses the head office for intangibles and services. An alternative construction would be for the head office to receive the third-party fee income and pay a fee to the PE for services and for use of the facility.

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



In general, we agree with the conclusions reached in Scenarios B and C of Example 5. In Scenario B, it is appropriate for the PE's profit to be limited to a routine return for owning the warehouse facility and for the functions performed at the warehouse, because all significant people functions and related risk are performed in Country A. In Scenario C, the PE does not employ any personnel, but it is still appropriate for the PE to receive a routine return for owning the facility, because economic ownership of tangible assets is generally attributed to the place of use. 2010 AOA, ¶ 75.

*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?*

See our answer to question 15. Note that although the investment return on a tangible asset is generally attributed to its place of use (without regard to the presence or absence of personnel from the non-resident enterprise), the return from an intangible asset is attributed to the location of the significant people functions relevant to the economic ownership of the intangible.

*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?*

In general, the NFTC agrees with the "streamlined approach," in these circumstances. The streamlined approach may reflect a dealing between the head office and the PE whereby the head office is considered to make a service payment to the PE to provide it an appropriate return on its investment, consistent with the alternative construction described in our response to question 14.

*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.*

The NFTC agrees with this statement.

*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?*



The NFTC does not believe there would be any difference in the outcome.

*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?*

See our answer to question 4.

#### Coordination 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, in a number of jurisdictions, if the activity of a dependent agent gives rise to a permanent establishment, the tax on the profits of the DAPE (if any) are collected from the DAE. 2010 AOA, ¶ 246. The AOA declined to require the uniform adoption of this “administratively convenient” practice, because “[s]uch administrative matters related to the taxation of dependent agent PEs are for the domestic rules of the host country and not for the [AOA] to address.” *Id.* Since the publication of the AOA, the BEPS project has generated two significant and relevant outcomes: Action 7 has produced an expanded PE definition, which creates DAPes in a broader and less predictable set of circumstances, and Actions 8-10 have provided new standards for the allocation of risk in the transfer pricing area, which generally allocate risk to the enterprise exercising risk management and control functions. Taken together, these developments make DAPes (and disputes regarding whether a DAPE exists) much more likely, and also make it more likely that such DAPE will have little or no profits attributable to it because returns to risk may have already been allocated to the DAE under Article 9. In light of these developments, the NFTC believes the administrative practice identified in the AOA should now be available on a uniform basis across jurisdictions to promote the orderly transition to the new PE standard.

The availability of a simplifying mechanism is particularly important in cases where there is a dispute as to whether a DAPE exists. Action 7 has created significant uncertainty with respect to the threshold at which a DAPE is created. In particular, ambiguity surrounds the precise determination of when a dependent agent “habitually play[s] the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise[.]” Failure to file a return for a PE poses the risk of penalties, the risk of disallowed deductions, and myriad additional negative consequences. Such collateral consequences are not appropriate in circumstances involving genuine uncertainty of the existence of a DAPE, particularly in cases for which “the profits attributed to the PE are nil” – a scenario specifically identified in the Discussion Draft. *See* ¶ 104. The NFTC therefore recommends the adoption



of attribution rules that permit a related party DAE to file a return that reflects the profits attributable to the DAE and to the DAPE (if any) in lieu of multiple reporting and filing requirements. Among other benefits, this would facilitate the resolution of disputes as to the existence of a DAPE by adjusting the profits reported by the DAE to a mutually agreeable level.

Sincerely,

A handwritten signature in black ink, reading "Catherine G. Schultz", is displayed within a rectangular box.

 Catherine G. Schultz  
Vice President for Tax Policy  
National Foreign Trade Council  
[cschultz@nftc.org](mailto:cschultz@nftc.org)  
202-887-0278 ext. 2023



## **Appendix**

### **NFTC Board Member Companies as of August 30, 2016**

ABB Incorporated	Hanesbrands Inc.
AbbVie Inc.	HP Inc.
Applied Materials	Johnson & Johnson
British American Tobacco Company	KPMG LLP
Baxter International, Incorporated	Mars Incorporated
Caterpillar Incorporated	Mayer Brown
Chevron Corporation	McCormick & Company, Inc.
Cisco Systems, Inc.	Microsoft Corporation
The Coca Cola Company	National Foreign Trade Council
ConocoPhillips, Inc.	Occidental Petroleum Corporation
Deloitte & Touche	Oracle Corporation
Dentons US LLP	Pernod Ricard USA
DHL North America	Pfizer International Incorporated
eBay Inc.	PricewaterhouseCoopers LLP
E.I. du Pont de Nemours & Company	Procter & Gamble Company
Ernst & Young LLP	Qualcomm Incorporated
ExxonMobil Corporation	Siemens Corporation
FCA US LLC	TE Connectivity
FedEx Express	Toyota Motor Sales, USA, Incorporated
Fluor Corporation	Tyco International
Ford Motor Company	United Parcel Service, Inc.
General Electric Company	United Technologies Corporation
Google Inc.	Visa Inc.
Halliburton Company	Wal-Mart Stores, Incorporated

## **Appendix to NFTC Comments on BEPS Discussion Draft on the Attribution of Profits to Permanent Establishments**

### **NFTC Board Member Companies:**

ABB Incorporated	Qualcomm Incorporated
AbbVie Pharmaceuticals	Siemens Corporation
Applied Materials	TE Connectivity
Baxter International Inc.	Toyota Motor Sales, USA Incorporated
British American Tobacco	Tyco International
Caterpillar Incorporated	United Parcel Service, Inc.
Chevron Corporation	United Technologies
Cisco Systems	Visa, Inc.
Coca-Cola Company	Walmart Stores, Inc.
ConocoPhillips, Inc.	
Deloitte & Touche	
Dentons US LLP	
DHL North America	
eBay, Inc.	
E.I., du Pont de Nemours & Co.	
Ernst & Young	
ExxonMobil Corporation	
FCA US LLC	
Federal Express	
Fluor Corporation	
Ford Motor Company	
General Electric Company	
Google, Inc.	
Halliburton Company	
Hanesbrands Inc.	
Hewlett-Packard Company	
Johnson & Johnson	
KPMG LLP	
Mars Incorporated	
Mayer Brown LLP	
McCormick & Company, Inc.	
Microsoft Corporation	
Occidental Petroleum	
Oracle Corporation	
Pernod Ricard USA	
Pfizer International Inc.	
PricewaterhouseCoopers LLP	
Procter & Gamble	

## Additional Guidance on the Attribution of Profits to Permanent Establishments Comments by NERA Economic Consulting<sup>1</sup>

September 5, 2016

to TransferPricing@oecd.org

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

Dear Sir, Dear Madam,

In the context of BEPS Action 7, OECD has released on July 4, 2016, a document for public review (the “Discussion Draft”) titled “Additional Guidance on the Attribution of Profits to Permanent Establishments”.

We thank you for the opportunity to provide comments on this document.

With this Discussion Draft, the OECD has produced a document which explores aspects of one of the most subtle concepts in tax, the Permanent Establishment (“PE”) and in particular the Dependent Agent PE (“DAPE”), following from Article 5.5 of the OECD Model Tax Convention (“MTC”). It represents the work on attribution of profits related to Action 7 of the BEPS Action Plan, elaborating the 2015 Final Report.

In spite of the considerable work done, we remain uncertain that the Draft addresses the concerns attached to the question of profit attribution to PEs, in particular in the context of what in the BEPS process is called “the Digital Economy”. Reasons are the following.

- The examples given in the Draft are based on deliberately simplified fact sets. Most of the key assumptions are unexplained. They tend to represent fact sets from the past, and to ignore the challenges attached to dealing with the consequences of business models that companies apply in the Digital Economy. In these models parties, whether or not associated in the sense of Article 9.1 MTC, seamlessly work together in the form of integrated processes in order to jointly create value; the parties involved are often globally dispersed.

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<sup>1</sup> These comments represent views of the authors and do not necessarily reflect the views of NERA Economic Consulting.

- The essential mission of the BEPS initiative is to align taxation with value creation. Today's business models can only be captured on the basis of understanding these value creating processes, and identifying the contribution to that joint value creation by the individual parties involved. The current Draft seems to have overlooked the value dimension nearly completely. The examples are based on static description of activities and operational or financial risks (ignoring strategic and human and intellectual capital risks). Consequently, no relevant insight is offered into how parties involved contribute to joint value creation.
- We think that it is important to note that the current Discussion Draft on profit attribution to permanent establishments may benefit from the insights offered by the Discussion Draft, issued simultaneously, containing Guidance on Profits Splits, and which are applicable integrally to the PE profit attribution. We strongly recommend alignment of the current Discussion Draft with the Draft on profits splits. This is the case in particular where it concerns the importance of Value Chain Analysis, the economic significance of risk and the application of profit split as a method in situations of integrated operations. The comments invited were requested to stay away from the PE definition as such. But given the interaction between the determination in today's business models of the existence of a PE or not and the attribution of profits, it is doubtful whether this request is justified<sup>2</sup>.

This being said, we may add the following comments to the examples and the Questions asked in the Discussion Draft. Please note that our comments are restricted to the field of economics, and that pure tax concepts (such as the application of the AOA) as such are left untouched.

**Pim Fris**  
**NERA Economic Consulting**  
**Paris**

**Guillaume Madelpuech**  
**NERA Economic Consulting**  
**Paris**

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<sup>2</sup> We may also refer in this respect to our comments on the BEPS Action 7 Discussion Draft of January 9, 2015, and to the article in BNA TP International Journal of December 16, 2008 by Fris, Llinares and Gonnet titled "PEs and transfer pricing: the playing field in international taxation redefined".

## **Detailed responses to the Draft Questions**

### **Guidance on Particular Fact Patterns related to DAPes (Q1)**

**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.**

The 2015 Action 8-10 BEPS report stressed the importance of (i) a first phase of “delineation” of the transactions as well as (ii), possibly, the consideration of a situation distinct from the one reflected in the contractual arrangements, in the context of the DEMPE framework.

Article 9 therefore dictates that a careful analysis of the economic contribution of the legal entities be performed, which may deviate from the legal arrangements.

Consequently, we believe that the order of the analyses may, in certain circumstances, affect the allocation of profit between the DAE and the DAPE, insofar as the true scope of functionality<sup>3</sup> attributable to a legal entity such as the DAE or the NRE will be performed at the level of Article 9.

We think however that the order should not affect the attribution of profit amongst jurisdictions.

### **Example 1: DAPE – Agent (Q2 – Q5)**

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

Most of the functional and factual analysis relies on assumptions. Therefore, we understand that Question 2 primarily relates to the following sentence, in §34:

*“the DAPE has not been attributed the economic ownership of any assets (inventory, marketing intangibles, or receivables) of Prima because there are no significant people functions performed by Sellco on behalf of the non-resident enterprise (Prima) in Country B relevant to the attribution of economic ownership of such assets. Accordingly, there are no risks or assets attributable to the DAPE and there is no need to attribute capital to the DAPE”*

The conclusion that no risks or assets attributable to the DAPE and there is no need to attribute capital to the DAPE is possibly correct. In the absence of a value chain analysis however, the conclusion cannot be categorically confirmed.

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

We do agree that the outcome in terms of profit allocation between the head office and the DAPE is possibly correct. See the proviso at the end of Question 2.

We think that, from a transfer pricing perspective, certain questions arising from the construction of the intra-company P&Ls (for example, whether or not third party sales should be recognized at the level of the DAPE or at the Head Office) are irrelevant for profit attribution purposes.

**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?**

No comment.

**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?**

Yes, this is how we read §232. The question may be raised whether, in these circumstances, a PE can be deemed to exist. See also the provision at the end of Question 2.

### **Example 2: DAPE - Distributor (Q6 – Q9)**

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

Example 2 consists in attributing the return for inventory and receivable risks and assets to the DAPE because the DAE manages such assets.

In the way the example is drafted, it is difficult to know to which extent the “return of 9” attributable to the DAE

<sup>3</sup> Including assets and risks

accounts for the inventory and receivable management functions.<sup>4</sup> The only way to assess whether such a return is appropriate would be to have access to the economic analysis to determine how this return was determined, and, possibly, to review the external comparables that may have been used.

We assume that the return of 9 corresponds to the return that independent companies comparable to Sellco –acting as a distributor –, and with the same level of added value, but neither owning nor managing directly the inventory and receivables, would earn.

By the same token, it is not clear how the return of 2 has been determined. We assume it to be a risk-free return on the inventory and receivable, since we would expect the Functional Return to capture all of the return in excess of this risk-free return.

We may conclude that the total return of 7 already accounts for the whole of the functions and services provided by the DAE under Article 9 and reflects a situation where the DAE would manage the inventory and receivable on behalf of its principal, without actually owning those.

In this regard, we do appreciate that the profit of the DAE under Article 9 already accounts for the exploitation of the customer list, which is therefore not taken into account at the level of the analysis Article 7.

As such, we agree that the profit attributed to the DAPE is possibly reasonable.

**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?**

No comment.

**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 the inventory and credit risks, under Article 9, the return attributable to such risks should be attributed, in whole or in part, to Prima.

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<sup>4</sup> 44. Assume that the outcome of the analysis under Article 9 determines that the profits of Sellco should be 9, taking into account the functions of Sellco including the risks and the associated costs that Sellco assumes.

The analysis under Article 9 also determines an appropriate funding return for Sellco in relation to the funding advanced by Prima in relation to inventory.

Yet, if we assume that these risks are entirely managed by Sellco's SPFs, then, under the AOA, the return for these risks would be attributable to the DAPE.

**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?**

Based on our reading of the 2010 Report, we agree with the Draft that, under Article 7 and the AOA:

- The same functions are likely to be considered simultaneously for risk (or intangible) allocation under Article 9
- The inventory and credit risks are to be allocated to Sellco under Article 9 and the economic ownership of inventory and receivables is to be attributed to the DAPE

### **Example 3: DAPE – no DAE (Q10 – Q11)**

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

The main difference between Example 2 and Example 3 is the absence of DAE.

The numerical figures may (surprisingly!) differ between Example 2 and 3, but we understand the overall logic of the P&L to be exactly the same. The Example seems to imply that additional marketing and sales efforts lead only to increased costs, with no impact on sales revenue as such. We fear this may illustrate the unconvincing relevance of the examples.

In that case, Article 7 substitutes indeed to Article 9, as if the Employee had been a DAE.

As reflected in the Example, the legal form of an economic agent does not affect the arm's length outcome of dealings. In Example 3 the profit of the DAPE under Article 7 would be expected to be at least the same as if the Employee had been a DAE, under Article 9.

**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?

No comment.

#### **Example 4: Closely integrated functions (Q12 – Q13)**

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

Example 4 relates to a situation of integrated functions and where in substance, (i) functions performed by the DAE do not lead to the assumption of risk under Article 9, largely as a result of a close or literal reading of 1.95 of the BEPS Report 5 but (ii) these functions include SPFs which drive the allocation of assets and risks to the DAPE.

We do not reach the same conclusion as the Draft.

We believe such approach not to make any sense and the reason for this conclusion to be the too literal reading of §1.95. We believe this article to have been prepared so as to prevent abusive application of the AOA, in case of duplicative risk control. Nevertheless, we believe that it is not intended to be applied when high value adding risk control functions are effectively shared amongst several parties.

**Question 13.** Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Selco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Selco, 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?

See response to question 12

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<sup>5</sup> “Furthermore, in some cases, there may be more than one party to the transaction exercising control over a specific risk. Where the associated enterprise assuming risk (as analysed under step 4(i) controls that risk in accordance with the requirements set out in paragraphs 1.65-1.66, all that remains under step 4(ii) is to consider whether the enterprise has the financial capacity to assume the risk. If so, the fact that other associated enterprises also exercise control over the same risk does not affect the assumption of that risk by the first-mentioned enterprise, and step 5 need not be considered.”

#### **Example 5: Fixed Place PE - Scenario A (Q14)**

**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?

No we do not agree.

In the example, the Draft uses an unspecified method to determine the fee attributable to WRU's intangibles. We believe that the application of such a method to be highly complex.

We would rather recommend a TNMM or modified TNMM with a PLI based on the financial return of third parties. In that case, comparables relied upon would be independent companies providing low value-adding warehousing services.

#### **Example 5: Fixed Place PE – Scenario B & C (Q15 – Q20)**

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

In Scenario B:

- We agree that the profit should be identical to that of scenario A as the service provided is identical. By saying that, we assume that the fact that the Draft mentions that the warehouse is run as a profit centre in Scenario A and as a cost centre in Scenario B does not reflect a difference in functionality between the two scenarios. We understand that such difference would be actually reflected at the level of the Head Office.
- We also note that in the above, the terms cost centre and profit centre are used without proper definition; the most pertinent challenges in respect of PEs arise in situations where the (related) party's profile is that of an expense centre or a revenue centre<sup>6</sup>.

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<sup>6</sup> We suggest the following set of definitions:

**Investment Centre:** Profit centre the responsibility of which is linked to the continuity of the business

**Profit Centre:** Responsible for the bottom line on a given period of time (one to three years in general)

**Revenue Centre:** Its main objective is sales maximization taking into account costs discipline

**Cost Centre:** Characterized by a measurable and thus manageable relationship between inputs and outputs

- As previously stated, we do think that third party income should be a valid reference point for the economic analysis.

We do agree with conclusions in scenario 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?**

Yes, we do agree.

In a bottom-up analysis, such approach may also be relevant in certain circumstances (i.e. total compensation would be the sum of a return on assets plus a profit of the PE's operating costs, respectively determined by appropriate reference to the dealings of independent parties)

**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?**

No, we do not agree with this approach to the extent that the functional analysis in Scenario C in particular, does not show the existence of any investment advice.

In such circumstances, we believe that a risk-free return may be appropriate.

**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 do agree that the fact that SPF may be performed by other parties (such as Wareco in Scenario C) would not lead to an additional attribution of risk or assets to the PE.

The profit attributable to a Fixed Place of Business PE would be determined based on the tangible assets and functions (including SPF) attributable to such 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?**

No, we do not think there would, as long as the interest is not included in the basis for the mark up.

**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?**

No comment.

#### **Additional approaches (Q21)**

**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?**

See Preamble.

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Expense Centre: Resembles cost centre for which it is almost impossible to quantify precisely the relationship between inputs and outputs

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Milan, September 2016

## OECD – DISCUSSION DRAFT - ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

Following the publication of the *Public Discussion draft on Additional guidance on the attribution of profits to Permanent Establishments* on 4 July 2016, in this document we provide some comments on the issues under discussion, in the light of the indications contained in the Public Discussion Draft and the 2010 Attribution of Profits Report to permanent establishments and of operating guidance subsequently issued by the Italian Tax Authorities.

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As a general introduction, we note that the Public Discussion Draft appears to base most of its observations and conclusions on the AOA, the Authorised OECD Approach, which – albeit not universally accepted – constitutes the accredited method for the determination of the income of permanent establishments (PEs) under international tax rules.

Moving from the assumption that a PE must be considered as an enterprise separate from its foreign head office, this approach states that the profits to be attributed to such independent and autonomous entity must be determined through an analysis of the functions and risks assumed by the PE pursuant to the “*significant people function doctrine*” (in line with the location of significant functions).

We agree with this approach which we consider applicable to the determination of the profits to be attributed to i) an “existing and registered” PE of a foreign head office or ii) a “hidden” PE (based on the examples proposed in the Discussion Draft, in the case of transformation of SELLCO to a DAPE), when SELLCO carries out activities to the benefit of the foreign head office (PRIMA).

We are of the opinion that this approach should be validated and adopted consistently by Tax Administrations during audits in order to avoid interpretation doubts; a possible solution would be to include an express and exhaustive reference to the Authorised OECD Approach in article 7(2) of the OECD Model Tax Convention.

Guidance should be provided with respect to the cases of “hidden” PE to acknowledge that the recognition of dealings between the PE and the rest of the enterprise of which it is part or of transactions between the PE and other enterprises appears to be more complex than in the cases of an “existing and registered” PE. Indeed, in such a case accounting records and contemporaneous documentation that usually represent the starting point to show that a dealing that transfers economically significant risks,

responsibilities and benefits are not necessarily available even to the taxpayer. Therefore, it should be reminded that the Authorised OECD Approach should not be intended to impose on the taxpayer more burdensome documentation requirements in connection with deemed intra enterprise dealings than apply to transactions between associated enterprises and the taxpayer should not bear costs and burdens disproportionate to the circumstances.

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Specifically, in the proposed examples the Public Discussion Draft focuses on the case of a company resident in Country A (PRIMA or the Principal) with a subsidiary in Country B (SELLCO or DAE) carrying out activities which give rise in the latter state to a PE of Prima (DAPE): in the circumstances, based on the reasoning proposed in the discussion draft, Country B will exercise its taxing rights on two different entities, namely the subsidiary (SELLCO) and the PE (DAPE).

This statement – which is quite interesting in some respects – carries some practical difficulties, for instance with regard to the allocation of income among the two entities (SELLCO and DAPE) whenever significant functions/risks are carried out/assumed in Country B by the same people (based at SELLCO) also – rather than exclusively – to the benefit of PRIMA. In other words, under these circumstances, it does not seem to us that there is an automatic way to share the income generated in Country B between SELLCO and DAPE, or identify an allocation key ensuring the proper attribution of the income generated in Country B between the two entities.

There are however significant practical difficulties which make it hard to estimate the economic value of the two activities due to the close link between the business carried out by the DAE and that of the DAPE. A separate economic analysis for each of the two activities would be particularly challenging especially if the TNMM (transactional net margin method) is adopted for transfer pricing purposes. TNMM – which is the most widely used method in similar transfer price determination processes – is based on the level of operating profit realised by a selected sample of companies chosen on the basis of specific comparability factors (benchmark), which by definition takes into account the operating cost for the services which DAPE “obtained” from the agent in order to conduct its business.

In the circumstances, since the market value of the agency service may not be determined based on a reliable benchmark, the result of the analysis should be refined by specific adjustments aimed at reducing the profit attributed to the PE by an amount corresponding to the operating profit deriving from any activities preparatory to the main business activity.

Therefore in our opinion, the approach suggested by the consultation document – according to which the arm’s length amount of the remuneration paid to the DAE for services rendered to the foreign company must be determined in advance - is correct, provided that as PE such determination can be made separately from the attribution of the profits to the PE in accordance with article 7 of the OECD Model Tax Convention, when the market benchmarks

are representative of the functions performed by each of the tested businesses with no duplication of remuneration.

Furthermore, there may be cases where SELCO realizes a profit whereas DAPE is in a loss position: the fact that they are two different entities, would make it impossible – at least in principle – to offset profits against losses, resulting in double taxation.

It would probably make more sense to consider SELCO and DAPE as a single tax subject carrying on business in Country B, with the result that:

1. the sales commission paid by PRIMA to SELCO may be deducted (as proposed in the Discussion Draft examples) from the income of the single tax entity carrying on business in Country B;
2. any losses realized by da DAPE may be offset with SELCO's profits;
3. SELCO's and DAPE's respective profits and losses can be consolidated for tax purpose in Country B.

To sum up, although two separate entities exist in Country B, in our opinion they should be treated as a single and indivisible tax subject, with the possibility to consolidate any opposite financial results realized in Country B by SELCO and DAPE.

With particular regard to the 5 proposed examples, and bearing the above comments in mind, we agree with the basic approach adopted in the Discussion Draft, with regard in particular to the following issues of interest.

- (a) As a general rule, we agree with both the functional analysis made in the examples and the method of reconstruction of DAPE's profits and losses based on the AOA approach, as they take into account the functions performed and risks assumed in Country A and Country B by PRIMA and by SELCO; we are also confident in saying (with particular regard to Example 2) that – between PRIMA and SELCO – the risk is allocated to the entity with the risk control functions and the financial capacity to assume the risk. Where a PE is deemed to exist the functional analysis is the starting point in the process of determining its income, inter alia to avoid remunerating both SELCO and DAPE for the same functions performed in Country B (with the associated double taxation issues). Therefore, the approach suggested by the consultation document – according to which the arm's length amount of the remuneration paid to the DAE for services rendered to the foreign company must be determined in advance – is correct, provided that as PE such determination can be made separately from the attribution of the profits in accordance with article 7 of the OECD Model Tax Convention, when the market benchmarks are representative of the functions performed by each of the tested businesses with no duplication of remuneration. To this end, the Tax Administrations should coordinate the application of the rules under article 9 of the OECD Model Tax Convention (*Transfer Pricing*) – to be prioritized (see point 3 below) – with those under article 7 of the OECD Model Tax Convention.

- (b) With particular regard to the reconstruction of DAPE's profits and losses based on the AOA approach, we agree with the position stated in the Discussion Draft to deduct the sales commission paid by PRIMA to SELCO when determining DAPE's income in Country B: should no deduction be allowed, double taxation would arise. This is a key and crucial issue in those cases in which the tax authorities' position is that the sales commission paid by PRIMA to SELCO – as well as any losses incurred by SELCO – are not generally allowed for deduction from the DAPES' income. An alternative way of avoiding double taxation would be to determine that the taxes paid by SELCO in Country B are creditable against the total tax liability in Country B.
- (c) In our view, for the purposes of determining DAPE's income, it would be appropriate (as well as more efficient), to apply first the transfer pricing rules under article 9 of the Model Tax Convention (if applicable) to the transactions carried out between PRIMA and SELCO, before determining the profits to be attributed to DAPE under article 7, thus prioritizing Article 9 over article 7. The application of the arm's length principle to the transactions between DAPE and SELCO, and the arm's length remuneration of any functions carried out in Country B to the benefit of PRIMA, imply per se a "fair" attribution of income to SELCO in Country B, which should neutralize the tax claims of the latter State.

—With regard to example 1, we do not see any issues with either the functional analysis or the construction of the profit and loss account of the foreign company's PE. Furthermore, we are of the opinion that the level of profits attributable to the DAPE would not have significantly changed even if a method other than the AOA approach (i.e., the "single taxpayer approach", consisting in an economic analysis of the overall activities of the agent and the PE) had been adopted: an aggregate analysis of the transactions performed in the territory of Country B would have led to conclude for the attribution of nil remuneration to the DAPE, on the basis that the only functions in respect of which a remuneration should be paid (i.e. those deriving from the agency agreement) are typical of the dependent agent and are therefore rewarded by a commission taxable in the hands of the agent. Therefore, when a dependent agent carries out limited functions in the territory of Country B and provides preparatory and intermediation services to the foreign company (as described in Example 1), Country B will have taxing rights only on the income (i.e. commission fees) attributable to the enterprise carrying on agent business, even though, a PE of the non-resident enterprise pursuant to article 5 of the OECD Model Tax Convention has been ascertained to exist in Country B. On the other hand, the functional analysis conducted pursuant to article 9 of the Model Tax Convention did not lead to the identification – in Country B – of different economically significant functions from those carried out under the agency agreement. Thus, regardless of the legal form taken by the dependent agent in the State (i.e. controlled agency business or PE of the foreign company), only the amount of the commission – to be determined on an arm's length basis – will be relevant for the purposes of Country B's taxing rights

With respect to example 2, it may be noted that (unlike Example 1) the second proposed example attributes economically significant functions (linked to the ownership of trade receivables and stocks) to the DAPE which, due inter alia to the operational risks incurred, is entitled to separate remuneration. However, should it not be possible to attribute to the

DAPE, the economic risks in connection with the management of accounts receivable and stocks, the case would fall under example 1, as these risks would be attributable solely to the foreign controlling company. In this event, no remuneration other than the agency fees would be liable to taxation in Country B. As mentioned, we emphasize that in order to avoid a duplication of the remuneration attributed to the DAE and the DAPE in respect of the same risks, it would be necessary to determine the profit taxable in Country B as a whole and subsequently the value of the commission in accordance with article 9 of the OECD Model Tax Convention, making the necessary adjustments in order to account for the agent's routine functions.

**Pirola Pennuto Zei & Associati**

## **Public comment received from Porus F. Kaka**

Email : [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

9<sup>th</sup> July 2016

The Tax Treaties  
Transfer Pricing and Financial Transactions Division  
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Sub: **Action 7 Artificial Avoidance of PE Status and Attribution – Can an Arm's Length Test reduce subjectivity and disputes**

Over the last few months I have had the pleasure of analyzing in some details Action Plan 7 on BEPS, along with the new US Model Treaty, along with my experiences in India and in particular the Indo US DTAA of 1989 and the Indo French DTAA of 1994. This research and analysis has also greatly benefited from my interaction, on different panels with several LEADING Government Officials from India, US and also from the OECD at different conferences.

I am also aware that the OECD work on attribution is still underway as well as the concerns expressed by some countries, especially the United States around Action Plan 7.

I do not believe I have a solution, but I have some food for thought, gleaned from my experiences in and out of Court and research and interaction with many distinguished folks. These are my personal views.

### **Effect of Action Plan 7**

Justifiably Action Plan 7 seeks to prevent an "artificial avoidance" of the PE status by business entities/corporates in cross border situations.

It does so in my opinion in many stages;

Firstly, it emphasizes and expands on the concept of *"habitually exercising an authority to conclude contracts"*. This is already there so it is an extension.

Secondly, it adds a new concept *"playing the principle role" leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are -*

*(a) In the name of the enterprise, or*

*(b) 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*

*(c) For the provision of services by that enterprise*

This I believe is an addition and not merely an extension to the one supra, greatly increasing subjectivity in the analysis with words like "playing the principle role", "routinely concluded", etc.

Thirdly, it reduces the chances of associated enterprises (now called closely related) of being treated as independent agents, even if they are carrying on business in the ordinary course if they are found to be working wholly or almost wholly for closely related enterprises. Therefore it would make it now difficult for members of a Group to not become counted as PE's if the work is within the Group as would mostly be the case, amongst multinational Groups.

Under the current Model Treaty, Article 5.5 warrants an Agent-Principal relationship for the creation of a Permanent Establishment. Article 5.6, is negatively phrased, to

exclude Dependent Agents, if they are of an independent status acting in the ordinary course of business.

Whether an agent is independent of its principal depends on the nature and extent of the agent's legal and economic obligations to the principal. Firstly an agent is legally independent of the principal if the contractual relationship between the agent and the principal does not allow the principal to dictate in detail the activities of the agent or otherwise supervise closely those activities.

### **A few Elements of an Independent Relationship**

- Undertaking of entrepreneurial risk and the reward received
- Allocation of efforts more to other principals
- Extent of obligations which the person undertakes vis-à-vis the enterprise
- Legal and economic independence

In this context as you will see below, if an arm's length criteria is added it could be clarified that the arm's length provision, which specifies that even if the Agent devotes wholly or almost wholly, its activities, on behalf of that enterprise it may be considered independent. This could be an objective financial test of Attribution. This criteria of arm's length could take precedence over other tests which suggest dependency, in two ways set out as policy considerations herein below:

### **Dilution (Action 7) cum Attribution Solution**

When I look at Action Plan 7 and the significant increase in the subjectivity required for determination of a PE, coupled with the tightening of the dependent and independent agent concept, I do feel significant uncertainty and lack of clarity, possibly leading to disputes, litigation and ultimately double taxation.

I do believe that attribution and work on attribution can be used as a tool to create objectivity in contradistinction. I wish to place this upon an existing treaty namely the Indo US Treaty of 1989 and the Indo-French Treaty of 1994. Significantly in the Indo-US Treaty you will find that the US accepted a dilution of the PE concept (if that be the proper expression!) similar to Action 7 by adding a new dependent agent clause namely;

Article 5 (4)(c) which reads as -

*"He habitually secures orders in the first mentioned State, wholly or almost wholly for the enterprise."*

**This is so similar to Action Plan 7, perhaps India and US were psychic anticipating BEPS!!!**

In my opinion this clause is similar to the new "playing the principle role" clause in Article 7. Therefore the dilution in Action Plan 7 finds reflection in a tax treaty way back in 1989 and that to in the case of the United States. However transfer pricing and attribution, is used objectively in the same treaty to reduce the rigour of the dilution.

Article 5 (5) of the Indo-US Treaty reads as under:

*An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.*

Similarly the Indo-French Treaty 5(6) has a similar article which reads as under:

## Article 5(6) of Indo-French DTAA

*An enterprise of one of the Contracting States shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other Contracting State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph if it is shown that the transactions between the agent and the enterprise were not made under at arm's length conditions.*

Therefore there are two possible outcomes of an “arm’s length” or “attribution” solution to the expansion of the PE provisions –

### **A Extinguish the Dependent Agent PE itself**

You will note that it is possible to argue that a proper transfer pricing and arm’s length payment specifying the attribution of the activities carried out in the PE jurisdiction could lead to one being determined as an independent agent and hence actually “extinguish” the PE itself. Though this interpretation may be an issue for litigation, I do not wish to get involved in the same as it is not necessary for this article, but wish to proceed on the possible interpretation given supra.

Therefore what I am suggesting is that considering all the other transfer pricing work that has been carried out and completed in Action Plan 8 to 10 on Transfer Pricing, a bold solution from the past ought to be considered for the present.

Though I am fully conscious that this may be radical, especially as it goes against the AOA, I do believe that BEPS is to change the tax world radically and hence place the same for consideration.

There is support within Indian Jurisprudence for this interpretation. See Delmas, France vs ADIT Mumbai (2012) 17 Taxman.com 91 (Mum).

**B Reducing the rigour of a closely related Enterprise being treated as PE**

The second less radical interpretation is that the arm's length test does not extinguish the dependent agency PE but, merely, creates a possibility for closely related enterprises, to be treated as independent agents, even if they are working exclusively or almost exclusively for the group.

The above makes complete logic since the basis of transfer pricing is to ensure arm's length conditions as are found between third parties and/or uncontrolled transactions. Therefore if arm's length condition is met and after appropriate transfer pricing is carried out, it should continue to remain possible for closely related companies to also be treated as independent agents.

**CONCLUSION**

What I am suggesting above is an Attribution Solution could be worked into the dilution of the PE status. This will give some objective tests to reduce the subjectivity that Action Plan 7 may create.

Perhaps the wisdom of the past, namely in the two Treaties I mentioned above, could be a good glimmer for a solution in the present!

Kind regards,

Porus F. Kaka  
Senior Advocate



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5 September 2016

Dear Mr. VanderWolk,

***Discussion Draft: attribution of profits to permanent establishments***

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD's *Public Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments*.

As an overall comment, we view the paper as providing helpful guidance which can be used to evaluate inter-company arrangements in light of BEPS Action 8-10 and to understand what additional profit, if any, would be allocated to permanent establishments (PEs) arising following a lowering of the PE threshold. We also agree that the lowering of the PE threshold under BEPS Action 7 does not modify the nature of a deemed PE and that in many cases the additional profits which would be attributable to new PEs would be minimal.

However, we do see profit attribution as an incredibly complex area, and feel that the complexity of these issues is potentially hidden through the use of overly simple examples in this paper where a number of the difficulties we find in practice have been assumed away. We have made a number of comments on points on the detail and in response to the questions which we include later, but wanted to take the opportunity to elaborate on a few key points we feel still need to be addressed.

We see areas of significant subjectivity within the existing AOA where further guidance would ensure better uniformity of application between tax authorities and recommend that this paper should not be seen as the conclusion of the OECD's work on profit attribution. We suggest that there be an ongoing process of discussion and work to ensure greater guidance and clarity on a number of areas of the AOA within a timeline which allows careful consideration of the issues. Given the likely increase in instances of PEs, further clarification is necessary in order to reduce the subjectivity and likelihood of double taxation. Our earlier comments on Action 7 highlighted that we thought it essential that Article 5 and Article 7 were considered together. Instead, we have seen a significant lowering of the PE threshold without due consideration to whether this lowering of the threshold will result in a change of

profits attributable. We expect that this will lead to many more PEs with accompanying uncertainty as to how tax authorities will apply the multitude of profit attribution approaches that are taken (e.g. in local legislation, differing local interpretations of the AOA, etc.). Whilst the Discussion Draft is an important step in that direction, as noted, we urge the OECD to continue working with stakeholders after the BEPS papers are finalized to develop critically needed detailed guidance in a deliberative process.

Related to the above point, a crucial area of uncertainty for taxpayers which remains unresolved is the acceptability of a common set of standards for applying Article 7 (i.e. the AOA) given how few countries currently have adopted the AOA. The recent consultation on BEPS Action 15 (relating to the Multilateral instrument) was specific in requesting that there be no comments in relation to the scope of the provisions of the Multilateral instrument.

**However, we think it is important to make the point that if standardising the wording and interpretation of Article 7 is not included in the multilateral instrument then, given the significant lowering of the PE threshold resulting from Action 7, we expect that the frequency and significance of double taxation in relation to PE issues will exponentially increase.**

A particular concern we have with the guidance is that having performed exercises to apply the AOA to several non-financial services (FS) businesses, a clear identification of SPFs remains difficult, particularly where in most cases both parties (PE and head office) are involved in managing the risk or asset to some extent. In this regard, Example 4 has re-introduced the concept of split SPFs without adequately addressing the complexity of accounting for this from a balance sheet perspective and the associated systems constraints most groups would face. Whilst, in theory, contributions from numerous parties may be an accurate representation of the functions undertaken across a group and can sometimes be useful in splitting certain asset returns at a high level, our practical experience has made it clear that split SPFs can also lead to significant complexity through creating multiple asset owners. In particular, the application of split SPFs (i.e. KERTs) in the financial sector (with specific allocation of the SPFs to certain assets) has been shown to be onerous (given that there was not always a common standard for the relevant tax and accounting policies which would be applied to the attribution of balance sheet). This particular point was discussed extensively as part of the OECD public consultation process on the AOA at a Geneva conference. At this conference, the view was taken that, as a practical alternative to split SPFs, there should be a single asset “owner” for each class of asset (i.e. attribution of an asset class in accordance with the balance of SPFs) with the other jurisdiction with SPFs rewarded for their contribution but without attribution of assets and it would be helpful if the OECD could confirm that this is an acceptable approach. As the paper stands, it offers no guidance on how to avoid these practical difficulties which have previously been recognised by the OECD. We have made suggestions in relation to this point in response to Question 12.

As a general matter, the examples shown are simple when compared to most business arrangements we see in practice. Whilst we can see why this was carried out (i.e. to show the principles of guidance) the examples disguise the complexity of applying these principles in practice, the development of further examples in coordination with stakeholders as part of a continuing project independent of the BEPS actions should be a priority in the next year.

As we note in our response to question 3, we think it is very helpful that the guidance clarifies that under the AOA, where there is a sales agent and the functional analysis supports it, the Cost of Goods Sold may be a dealing which is treated as a 'balancing figure' to ensure an appropriate level of reward is earned by the DAPE which is treated as the tested party (effectively treating the relationship as that of principal for the manufacture and IP ownership selling to a routine distributor). This is a key difference between the AOA and local practice in many territories. In this view, there would be some concerns with acceptability of the "balancing figure" by tax authorities in countries where such balancing figures are not recognised or regulated by domestic tax rules in a PE or non-PE context.

As requested, we focus the remainder of our comments on answering the specific questions posed 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.**

It is necessary that Article 9 is applied on all transactions an entity has with related parties before Article 7 is applied. In many of the client cases we have seen, the head office entity will have several transactions with different related parties, not just with the dependent agent enterprise, and it is important to ensure that the starting point for the profit attribution is the correct amount of profit taking into account the contribution of other related parties entities. In addition to this, there are a number of related tax issues which need to be considered when thinking about the order of analysis, including:

- Withholding taxes, customs duty and indirect taxes could be applicable on certain payments from a dependent agent enterprise to a head office. The treatment of remittances from a PE to a head office for these taxes in many cases is not the same as would be the case in a separate entity situation - it is therefore important that the dependent agent enterprise is making arm's length payments to the head office to ensure these taxes are correctly accounted for.
- We are aware of some examples where territories levy different corporate tax rates on companies versus branches, so again ensuring the dependent agent enterprise is making arm's length payments is important.
- A number of territories have domestic transfer pricing legislation where it is necessary to ensure that any transactions between a local dependent agent enterprise and local PE are arm's length.
- Finally, loss utilisation rules in different territories may differ between companies and PEs which means it is important to analyse the arm's length level of profit in the dependent agent enterprises versus the PE.

To conclude, we consider that the Article 9 analysis is a prerequisite of the Article 7 analysis. This ordering does not influence the outcome of the Article 7 analysis, but rather enables the appropriate application of the arm's length principle under Article 7.

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

We have two comments where clarification in the example would be helpful.

There is currently no mention of the location of warehousing for inventory for sale to customers in Country B. If there were a warehouse in Country B we query whether inventory would be allocated to the PE based on the place of use concept in p. 75 of the AOA (even though SPFs for inventory are located in Country A).

Paragraph 34 explains that no assets or risks have been allocated to Sellco as there are no SPFs performed by Sellco. However, there is no specific narrative on allocation of rights and obligations and we note that sales income, which derives from the right/obligation of the customer contracts, has been allocated to Sellco which implies that Sellco has an SPF in relation to customer contracts. However, the facts state that while Sellco does liaise with customers, Prima is responsible for setting pricing, determining marketing strategy, and approving all orders. We suggest the reasons for the allocation of customer revenue to the PE are elaborated on further in the example as it is not completely clear to us why this conclusion was reached and perhaps the facts in the example could be adapted to support the allocation to Sellco.

As a more general point, the guidance on rights and obligations in the AOA is limited to one paragraph (p.98) and yet in our experience the outcome on the PE P&L can be very significant depending on whether certain transactions with external parties are allocated to the PE or not. In particular, this applies in relation to cases where there is a question as to whether external sales revenues or IP licences with external parties would be attributed to a PE. In our view, further guidance in this area is needed.

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

Yes, subject to our comments in relation to the allocation of inventory and sales revenue in relation to Question 2.

In particular, it is very helpful that this example makes it clear that, where there is a sales agent whose functions are sufficient to lead to the conclusion that sales revenue should be allocated to the DAPE, the Cost of Goods Sold may be a dealing which is treated as a 'balancing figure' to ensure an appropriate level of reward is earned by the DAPE which is treated as the tested party in this example.

**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 pre-AOA approaches where there is a restricted concept of independence and a direct / indirect approach for allocation of profits (revenues and expenses), it would be unlikely that it would be accepted that there would be profit on intra-enterprise transactions and in addition there would be

restrictions on deductibility of certain payments (interest, royalties and similar payments). While we do not suggest the following approach leads to a fair reward for the contributions of the parties and do not agree it as an alternative to the AOA, we have seen the following approaches taken in by various tax authorities:

- the sales income of the DAPE is likely to remain the same as shown in the example;
- that COGS might be cost of manufacture of goods solely allocable to the Prima enterprise in relation to goods sold in Country B;
- some allocation of Prima expenses might be allowed (e.g. head office staff, and in some cases cost of internal development of intangibles) if incurred for the purposes of DAPE;
- it is unlikely that a COGS dealing calculated as a 'balancing figure' to reach a target return in DAPE would be allowed, in any case it would be unlikely that any such balancing figure would be higher than the third party cost to Prima;
- it is unlikely that any charge for use of intangibles would be deductible for the DAPE;
- the level of profitability as a margin in the PE is likely to be much closer to the overall Prima margin;
- given the PE profits could be earned only from transactions with third parties (or with associated enterprises) and no profit would be earned from a transaction between the PE and the enterprise it would prevent the PE from being attributed a profit if the entity itself had made a loss;
- in a more extreme scenario, all profits derived from the territory of the DAPE, whether coming from the DAPE activities or other activities performed by Prima could be subject to DAPE attribution allowing minimum deduction in the DAPE territory. This relates mainly to tax jurisdictions that are not OECD members where in a number of cases their treaties follow the UN Model Tax Convention; and
- this and other non-AOA cases may lead to potentially unresolvable double taxation cases, particularly where in practice each of the tax authorities relies on and accepts a different set of rules concerning PE profit attribution.

**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, we agree with this statement. Although note that with a complete absence of SPFs we would not expect there to be a PE in the first place, i.e. for a dependent agent PE to exist personnel of the PE would generally be leading sales negotiations. Aligned with this in Example 1 the analysis indicates Sellco has SPFs in relation to customer contracts as a right and obligation, otherwise there would not be a basis for allocating sales income to Sellco in an Article 7 analysis.

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

Yes, subject to our comments in relation to the allocation of sales revenue in relation to Question 2. However, we note that in reality it would be very unusual in an MNC context that responsibility for these areas would be entirely devolved to a sales agent as for efficiency reasons they tend to be managed or there is oversight on a regional or global basis. In particular in the case of inventory where the Prima is the manufacturer, it is likely Prima would be involved in inventory decisions and this therefore makes it hard to see wider applicability of the conclusions for the Article 9 analysis presented. See answer 9 below for more discussion on this point.

**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?**

See answer 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?**

The first part of this question seems relevant only for the Article 9 analysis. According to BEPS Actions 8-10 (p1.98-1.99), an entity needs to have both control over risk and the financial capacity to bear the risk in order to earn the associated returns. If Sellco does not have the financial capacity to bear the risk then it is hard to see how that risk could be allocated to Sellco, and it would remain with Prima assuming Prima has some level of control over the risk. However, under an Article 9 analysis following Actions 8-10, Sellco's remuneration would still need to reflect its functions in relation to controlling credit risks and if Prima's only role was providing funding to support the risk (i.e. no control functions performed) then Prima would only be entitled to a risk free funding return relating to the capital required to support the credit risk. When considering other types of risks and assets the analysis of an appropriate functional return could become extremely complex.

If the risk were not allocated to SellCo under the Article 9 analysis, due to lack of financial capacity, then we do see that a difference could potentially emerge between the Article 9 and Article 7 analysis due to a need to give a funding return under an Article 9 analysis which would not be the case under an Article 7 analysis. Given this situation is likely to be far more common than the one presented (i.e. a sales agent would generally not have the financial capacity to bear such risks) we suggest the example is adapted to reflect this.

**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?**

In Example 2 all responsibility and decision making associated with the relevant risks are made by Sellco. In this case, and putting to one side the considerations discussed in question 8, we agree that the allocation of risk is the same in the Article 9 and Article 7 analysis in this simplified case.

We suggest the guidance in paragraphs 241 and 242 are reviewed as the conclusion of this analysis as it is currently worded, under what appears to be similar facts to Example 2, leads to the allocation of additional income to the DAPE rather than the dependent agent enterprise (i.e. the additional income is taxed in the PE of the non-resident rather than in the local sales agent subsidiary).

However, we think there are many cases where the concept of “control over risk” as set out in p1.65 of the final BEPS Action 8-10 report will not align with the concept of “SPF” in the AOA. This is illustrated well by the example in p.1.70 of the final BEPS Action 8-10 report. In this case, the investor is seen to be controlling the risk through what could potentially be a relatively infrequent level of intervention and supervision of the fund manager. As long as sufficient monitoring occurs, the day to day activities are performed, and risks within parameters are managed by the fund manager. In the case of the SPF concept, our interpretation is there seems to be a much greater focus on the decision-making being active if it is to count for SPF identification, including the suggestion that economic ownership of assets and risks will often be determined by functions performed below the strategic level of senior management given that this is the level at which the active management occurs and where the ability to actively manage the risk lies (AOA Part I, p. 86, 87, 94). Although made in the context of the discussion on intangible assets, the following statement reiterates in relation to identifying an SPF in the PE: "in short, the key factor is whether the PE undertakes the active decision making with regard to the taking on and active management of the risks" (Part I, p. 91).

The outcome of Example 2’s exercise to attribute profit through the AOA does not demonstrate any division between the SPFs required for economic ownership of an asset and the “risk adjusted” return due on that asset. In effect the SPFs for the inventory and credit risk are treated in a similar way to how Key Entrepreneurial Risk Taking (“KERT”) functions are treated in Parts II, III and IV of the AOA (i.e. it is the risk accepting and management functions that determine attribution of asset and risk) (Part II, para 8). Whilst it is not clearly stated in Part I, the drafting of Part I of the AOA suggests that there could be a difference between the SPFs relevant for control over risk and economic ownership for certain assets (Part I, para 70, 72). This suggests that SPFs for the inventory risk and economic ownership of inventory may differ – it would be helpful to have an example setting out how SPFs in the case of certain assets meeting this criteria may differ (i.e. in cases where the SPFs for economic ownership of assets and allocation of risk may differ). In the absence of this more general detailed guidance on the definition of an SPF for risk and asset purposes we would expect that, in the absence of clear guidance and for practical ease, one or both of two approaches may be adopted in applying the AOA. For example, it could be assumed that, for the purposes of practical application of Article 7 and Article 9, that the SPFs relevant to the economic ownership of assets and control of risk are the same in all circumstances (i.e. SPFs become equivalent to KERTs). Alternatively, it could be assumed that the risk control threshold required as part of the Article 9 analysis is equivalent to the SPF threshold required through the AOA.

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

Yes.

**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?**

See answer to question 4.

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

Example 4 presents facts which are, of the examples, closest to those which we would expect to arise for a typical MNE. The example helpfully highlights at paragraph 80 that the Article 9 analysis and Article 7 analysis do not necessarily result in the attribution of risks. In this case the SPF relating to credit risks and economic ownership of the associated receivables is considered to be undertaken by the DAPE of the Head Office created by Sellco. This is then clarified to state that Prima also undertakes some activity that should be considered to qualify as a SPF. This clarification appears to be on the basis that Sellco's decision making ability is limited by the guidance provided by Prima and therefore Sellco should not be considered to be assigned all the value for the decision making. 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 fees paid to Sellco between Prima and the DAPE created by Sellco. We have provided our comments on the importance of split SPFs in our covering letter.

**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 there may be a difference in profits which arise under the two analyses resulting from the difference in attribution of risk under the two approaches.

**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 explanation in p.92 of the discussion draft implies that 62 is the profit of WRU deriving from third parties (although not sure if this is meant to say revenue). We would question why the third party profit/revenue is allocated to the PE as from the earlier narrative the SPFs in relation to customer contracts would be based in WRU head office and therefore allocated as a right/obligation to WRU head office. We cannot see a basis for allocating this income to the PE and instead we would characterise the dealing between WRU head office and WRU PE as a service dealing where WRU PE profits might equate to a return on the warehouse asset and return for routine functions.

We note, that in many countries who do not follow the AOA, the fee for know-how and software might not be deductible in the PE and that no margin would be allowed on the fee for services.

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

In Scenarios B and C we assume the inventory held in the warehouse is owned by WRU (whereas in Scenario A it was owned by WRU's customers). As suggested in the discussion draft and aligned with our comments above in relation to Scenario A, we see no basis for allocating customer revenues to the PE and instead suggest a service fee dealing, although some additional return on inventory may be required for the PE for the same reason as discussed in our response to 2.

In relation to Scenario C we agree with the comments in p. 101-102 in the discussion draft, subject to our comments in Question 16 below.

**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?**

BEPS Actions 8-10 implies that where a party to a transactions performs no control functions over an asset and no control over associated risks it will generate no more than a risk free return. For example this would be the case with a 'cash box' performing no functions. As result, and to be consistent with this guidance, in a situation where there is a PE with no personnel it is hard to see how the profits attributable to that PE would exceed zero after it receives a risk free return and then any funding costs and investment management services are remunerated.

As a result, we would suggest the most streamlined approach in these situation is the default that in the absence of any people the return to the PE would be zero. Otherwise there is potential that the outcome would be inconsistent with Actions 8-10.

**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?**

Please see response to Question 16 for our alternative suggestion.

**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.**

Yes

**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, subject to our separate comments about calculation of a return on assets in Question 16.

**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?**

A key difference would be that some tax authorities would take the approach of the allocation of local source income minus deductible expenses, please see answers to Question 4 and Question 14 for further comments.

**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 explained in response to question 1, we see it is as essential that Article 9 is applied first for a number of reasons outlined.

Our key suggestion would be mechanisms to simplify the tax filing procedures for DAPes. In particular, the adoption of legislation to allow the Dependent Agent enterprise to file on behalf of a non-resident within its existing corporation tax filings. This might also include legislation where tax authorities could allow the Dependent Agent enterprise taxpayer to notify on behalf of the non-resident that there is a PE with no profit attributable, and be considered to have fulfilled their local tax filing requirements, unless specifically directed to file an additional separate tax schedule or return by the tax authorities. Where there are locally taxable PE profits, these could be incorporated within the corporation tax filings of the dependent agent enterprise in a similar way as is typical for overseas branches of the local enterprise.

In addition, a further suggestion related to the above would be that if a dependent agent PE issue were to arise, and the local dependent agent enterprise were to include in their transfer pricing documentation an analysis of why the profits attributable to any dependent agent PE were zero, this would provide penalty protection for taxpayers in relation to the non-resident having a failure to notify the relevant tax authority in relation to chargeability to corporation tax in that territory.

We look forward to discussing any questions you have on the points we raise above or on other specific matters raised by respondents to the Discussion Draft and would welcome the opportunity to contribute to the discussion as part of the public consultation meeting in October.

Yours faithfully,

A handwritten signature in black ink, appearing to be "Stef van Weeghel", written in a cursive style.

Stef van Weeghel, Global Tax Policy Leader

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Organization for Economic Co-operation and Development

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## Discussion draft on additional guidance on the attribution of profits to permanent establishments

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We would like to take advantage of the new invitation addressed to stakeholders by submitting our comments on the OECD Discussion Draft on additional guidance on attribution of profits to permanent establishments (hereinafter the "Discussion Draft").

Based on the above, we would like to thank you very much for your efforts and for the ongoing interest with which the OECD is working on this topic. We also truly appreciate if we could participate in the public consultation that will be held in October, 11-12<sup>th</sup>.

These comments are sent on behalf of the Rödl & Partner Transfer Pricing Group, in particular for these comments have participated the transfer pricing professionals mentioned below.

With best regards,

Germany	Spain
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### Introduction

Our comments will be structured as follows: The answers to the question made to public commentators will be provided in the same chronological order as the one set out in the body of Discussion Draft to which these comments make reference and without reproducing or paraphrasing it.

Our answers are focused on the questions related to the dependent agent PEs.

## Question 1

Generally, the order should have no impact on the outcome.

However, according to 2010 Attribution of Profits Report, Part I, para 51-54, Article 9 has been always the heart of Article 7 and to be able to apply Article 7 to attribute profits to the PE, it is necessary with the AOA to identify the arm's length remuneration of Article 9. Therefore, from our perspective, when related parties are under analysis, first the Article 9 shall be applied before the analysis of the Article 7 is performed.

Additionally, a non-performance of significant people functions by the DAE on behalf of the non-resident enterprise would lead to no profit attribution to the DAPE. To reduce administrative work it should be recommended to analyze the DAE under Article 9 of the MTC firstly. If no significant people functions are performed by the DAE, an allocation of the PE profit is not necessary or needed just on a formal level.

Finally, all the examples in the Discussion Draft are structured in such way that the order in which the Article 7 and 9 are applied seems natural and the best possible approach. However, the practice is less predictable, both temporally and factually.

## Question 2

We agree with the functional and factual analysis performed in Example 1 under the AOA, because of the following reasons based on the 2010 Attribution of Profits Report:

- Part I, para 8: according to the AOA the profits to be attributed to a PE: *"are the profits that the PE would have earned at arm's length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise."*
- Part I, D-5: which deals with the analysis of the dependent agent PEs, as well as with the application of the AOA for such cases. According to this Report, the first step on the application of the AOA is to perform a functional and factual analysis, which would determine the functions performed by the dependent agent company both on its own account and on behalf of the non-resident enterprise. In this regard the functional and factual analysis has the aim to identify the type of functions performed and especially if such functions are considered as significant people functions, and if they are performed by the dependent agent enterprise on behalf of the non-resident enterprise.

## Question 3

We do not agree.

There are no significant people functions performed on behalf of the DAPE. Thus, no assets could be allocated to the DAPE. As a consequence no risks can be allocated to the DAPE. Without any assets or risks as well as with no functions performed by the DAPE, the DAPE cannot be part of dealings or third

party transactions. Thus, the sales income has to be allocated to the principal in country A. This would be in line with general accounting standards. As from our understanding a turnover or sales income has always to be allocated to the owner of the customer order. As such an order is an intangible asset (also under BEPS Action 8; marginal number 6.6) and as the DAPE has no assets, the sales income cannot be allocated to the DAPE. Allocating the sales income to the DAPE would additionally create problems, as the credit risk is generally with the party having the sales income. Allocating the sales income to the DAPE and the credit risk to the principal in country A would have the need to conclude a dealing. According to the facts this is not the case.

Furthermore, as all activities in relation to controlling the DAE as well as concluding contracts with the DAE are performed by the principal in country A, the costs for remunerating the DAE for its services rendered cannot be allocated to the DAPE.

To conclude, as there are no significant people functions performed on behalf of the DAPE, no assets or risks can be allocated to the DAPE. As a consequence the DAPE cannot be involved in any business transaction or dealings. Without business transaction, no income or costs can be allocated to the DAPE. Additionally, attributing sales income to the DAPE in Example 1 could increase the risk of taxing profits that do not exist, since some tax administrations may require a profit when a sale is accounted in the PE's level.

#### Question 4

As the DAPE is not involved in any business transaction at all (no functions performed on behalf of the DAPE and no risks born by the DAPE) the result is the same as described under Question 3 above. Thus, no different treatment between AOA and alternative treaty approaches would incur.

#### Question 5

We totally agree with that, since it is in line with 2010 Attribution of Profits Report, Part I, para 233. *"In practice the dependent agent enterprise may not perform the significant people functions relevant to the assumption and/or management of risk or the significant people functions relevant to the determination of economic ownership of assets and if it does not then the attribution of the assets, risks and profits to the dependent agent PE is correspondingly reduced or eliminated. (...)".*

Furthermore, we would conclude that no assets, risks and thus no income and costs could be allocated to the DAPE.

#### Question 6

Yes, we do agree. However, we would like to highlight that in most of the cases and especially for the SMEs the funding costs in relation to the overall turnover generated is immaterial. Therefore, a higher burden is being created to the companies for the identification and administration of such kind of funding cost in comparison to the real risk of shifting such kind of profit.

#### Question 7

The result might be the same, however as there will be no dealings between Prima and the DAPE there are no COGS as 170 at the level of the DAPE but only a portion of the sales income attributable to the DAPE of an amount of 30 (=Gross Profit).

Moreover, the non-recognition of the funding returns (i.e. a dealing) between the DAE and the DAPE, would lead to the same results as the one of Example 1 (i.e. the profit of the DAPE would be 0).

#### Question 8

The remuneration granted in Example 2 to the DAE (Sellco) for inventory risk and credit risk will be allocated to the DAPE if it has the capacities to bear these risks. The capacities to control the risks are performed by the DAE on behalf of the DAPE. As the assets also have to be allocated to the DAPE, the free capital attribution should reflect that the DAPE has the assets and controls the risks so that the DAPE should be granted the capacities to bear the risks also (2010 Attribution of Profits Report, Part I, para 233).

The DAE will get no remuneration for assuming the risk over the inventory and credit to customers because such risks will be assumed by the DAPE, but it should be compensated for the functions performed on behalf of the DAPE.

#### Question 10

Yes, we do agree.

#### Question 11

The result might be the same.

#### Question 12

We do not agree, since according to the example the DAE shall nor bear the credit risk because of a lack of capacities. A negative incentive fee would shift part of the credit risk to the DAE.

#### Question 21

We appreciate the effort made by the OECD in order to clarify the application of the attribution of profits to the new classification of dependent agent.

However, we would like to mention that in most of the cases, especially for the SMEs, the burden created to identify the remuneration or the profit allocation for transactions as in Example 2 (funding costs), as well as in Example 4 (credit risk management) is much higher than the risk of profit shifting in this area. The significance of the remuneration mentioned in Example 2 and 4 is immaterial if it is compared with the overall activity and sale performed. Additionally, after performing a complete analysis of Article 9 and 7 the result of the profit attribution in one of the examples is zero. Regarding the DAE, an easier way to tax this entity without having the necessity to tax the DAPE is identifying the functions and risks performed and requiring a profit that is in line with the value creation. For example, the commission paid for an agent that performs more functions has to be higher than the one paid to other agent that performs less functions without the necessity to attribute sales income and costs to a DAPE. In other words, the recognition of such dealings is much more complicated for both taxpayers and tax

administration than of the arm's length remuneration when taking into account the functional profile with  
a broader perspective.

September 5<sup>th</sup>, 2016

\*\*\*\*\*

Directors

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September 5, 2016

**VIA ELECTRONIC TRANSMISSION**

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**Re: Comments on July 4, 2016 OECD Public Discussion Draft on BEPS Action 7**  
***Additional Guidance on the Attribution of Profits to Permanent Establishments***

Dear Sirs or Madams,

The Silicon Valley Tax Directors Group (“**SVTDG**”) hereby submits these comments on the above-referenced Public Discussion Draft (“**PDD**”). SVTDG members are listed in the Appendix of this letter.

Sincerely,

A handwritten signature in blue ink that reads "Robert F. Johnson".

Robert F. Johnson  
Co-Chair, Silicon Valley Tax Directors Group

## I. INTRODUCTION AND SUMMARY

### A. Background on the Silicon Valley Tax Directors Group

The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley, that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace.

### B. Summary of recommendations

Because the PDD has used the 2010 AOA as its reference point, we generally do the same. However, to ensure the final guidance will be considered relevant to the many treaties that do not yet incorporate the 2010 version of Article 7, we think it very important for the guidance to confirm that the analysis provided will also apply under treaties with the pre-2010 version of Article 7, or to explain any differences in outcome, as appropriate.

#### 1. Recommendations on guidance on fact patterns related to DAPes

We provide four general comments on the guidance.

First, we recommend the authorized OECD approach (“*AOA*”) should, in the context of associated enterprise PEs, be revised to better align with the *2016 TPG*, especially regarding risk attribution. The *2010 Report on the Attribution of Profits to Permanent Establishments* (the “**2010 Report**”) by its terms must comport with the 2016 post-BEPS version of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the “**2016 TPG**”). If the AOA under the *2010 Report* takes into account changes to the *2016 TPG*, a very strong argument can be made that the attribution of risks to an associated enterprise dependent agent PE (“*DAPE*”) under the AOA should, in cases in which the dependent agent enterprise (“*DAE*”) has the financial capacity to assume the risks, be materially the same as the allocation of risks between a nonresident enterprise (“*NRE*”) and the DAE under Article 9. As a consequence, in the context of attributing profits to an associated enterprise DAE as a result of risk attribution, we believe the host country’s taxing rights in many cases will be exhausted by ensuring an arm’s length compensation to the DAE.

The discussion of attribution of risks under the AOA has a counterpart in the attribution of intangibles. We recommend, second, the AOA also be revised to better align with the *2016 TPG* regarding intangibles attribution. The *2016 TPG* is relevant under the AOA to the attribution of intangibles and to the attribution of profits to a PE, which strongly suggests there should be consistency with the outcomes of an Article 9 determination of arm’s length profits of the DAE. In the context of attributing profits to an associated enterprise DAE as a result of intangibles attribution, we believe the host country’s taxing rights in many cases will again be

exhausted by ensuring an arm's length compensation to the DAE. In effect, allocation of the return on the intangibles to the DAE under Article 9 should eliminate any attribution of a return on the economic ownership of the intangibles to the DAE under Article 7.

Third, we believe the facts of Examples 1 & 2 are typical of those likely to arise in the context of MNEs, especially as a result of lowering the PE threshold under Article 5(5) and Article 5(4) under BEPS Action 7. In these Examples the host country's taxing rights are exhausted (or virtually exhausted) by ensuring an arm's length compensation to the DAE under Article 9. In these sorts of common situations the host country will collect tax under Article 9 but no more (or very little more) tax under Article 7, but the NRE would face a variety of compliance burdens. We accordingly recommend, third, the OECD consider revising the guidance on attribution of profits to PEs to recommend not proceeding with Article 7 enforcement actions in situations in which no or de minimis profits would be attributable to PEs.

Fourth, we recommend the OECD adopt a new paragraph in Article 5<sup>1</sup> allowing a NRE that would otherwise be treated as having a PE as a result of host country activities of a closely related person to avoid such treatment if the NRE and the resident enterprise (i) make a binding election pursuant to which the latter agrees to recognize profits equal to the sum of those profits otherwise attributable to the PE and any arm's length profits the resident enterprise would have based on functions performed on its own account; and (ii) execute intercompany arrangements pursuant to which the resident enterprise charges the NRE, and the NRE pays, an amount such that the total profits recognized by the resident enterprise are described in (i). This provision, if availed of, would ensure the host country collects from the resident enterprise the same total tax it would if the PE existed, yet result in the NRE having no PE, no filing obligation, and no corporate income tax liability in the host country arising from activities conducted on the NRE's account by the resident enterprise or at its premises.

We also provide responses to particular numbered questions, referencing where applicable our general comments.

## **2. Recommendations on guidance on attribution of profits to PEs arising from activities not covered by specific exceptions in Article 5(4)**

We provide general comments on the guidance. We discuss the issue under the AOA of attributing tangible property to the place of use rather than to the place where significant people functions (“*SPFs*”) relating to the property are performed. We ask for clarification that notional payments associated with “dealings” aren't taken into account for withholding purposes. We

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<sup>1</sup> An alternative route to achieve the same goal could be for the competent authorities of two Contracting States to enter into a mutual agreement under Article 25(3) to provide the same approach, and we recommend that the OECD endorse this alternative route as well.

also request clarification of the Examples relating to a return the NRE is entitled to for any control and/or oversight of the workforce made available to run the PE.

We also provide responses to particular numbered questions.

## II. SPECIFIC CONCERNS WITH THE *PDD*

### A. Comments on guidance on particular facts patterns related to DAPes

#### 1. General comments

##### a. The AOA should, in the context of associated enterprise DAPes, be revised to better align with the *TPG*, especially regarding risks

##### i. Summary and consequences

The *2010 Report* relies critically on the *TPG* in an ambulatory way<sup>2</sup>—i.e., in particular, changes made in § I.D (“Guidance for applying the arm’s length standard”) of the *2016 TPG* must be reflected in how the AOA is applied. When changes to § I.D of the *2016 TPG* are taken into consideration in applying the AOA, a very strong argument can be made that—in the context of associated enterprise DAPes,<sup>3</sup> as discussed in Examples 1, 2, and 4 of the *PDD*—the attribution of risks to a DAPE under the AOA should, in cases in which the DAE has the financial capacity to assume the risks, be materially the same as the allocation of risks between an NRE and the DAE under Article 9.

In the context of an associated enterprise DAPE, a general consequence of such material similarity is that, with respect to determining profits attributable to such a DAPE arising from risk attribution, contrary to ¶ 240 of the *2010 Report*, the host country’s taxing rights in many cases will be necessarily exhausted by ensuring an arm’s length compensation to the DAE under Article 9.<sup>4</sup> This will be the case either if Article 9 analysis proceeds first (in which case risks allocated from the NRE to the DAE couldn’t, strictly, also be attributed from the NRE to the

<sup>2</sup> *2010 Report*, Preface ¶ 10 (“[This *2010 Report*] has been based upon the principle of applying by analogy the guidance found in the [*TPG*] for purposes of determining the profits attributable to a PE. To the extent the [*TPG*] are modified in the future, this [*2010 Report*] should be applied by taking into account the guidance in the [*TPG*] as so modified from time to time.”)

<sup>3</sup> That is, a DAPE arising under Article 5(5) because of activities performed by an associated dependent agent enterprise (i.e., an associated DAE).

<sup>4</sup> The profit profiles under Article 9 (using the arm’s length standard in the *2016 TPG*) and under Article 7 (determining the profits attributable under the AOA, which again relies on the *2016 TPG*) depend on the most appropriate transfer pricing methods for evaluating pricing of the accurately delineated transaction (Article 9) and profit attribution (Article 7), which in theory might differ. If risks allocated under Article 9 are consistent with those attributed under Article 7, however, it’s difficult to envision a situation in which those methods differ to any significant extent.

DAPE, so Article 7 analysis is moot), or Article 7 analysis proceeds first (in which case risks attributed to the DAPE as a result of activities performed by the DAE give rise to an arm's length payment from the DAPE to the DAE under Article 9, leaving no related profit in the DAPE).

We note also the further complexity introduced by the form of compensation chosen for the arm's length pricing under Article 9 (regardless of which transfer pricing method is most appropriate). Contingent pricing forms can have the effect of shifting risks between associated enterprises.<sup>5</sup> Any such shifted risks should in principle also be taken into account under the AOA.

In the context of an associated enterprise DAPE, a specific consequence of such material similarity is that the “spread around” risk attribution of the AOA should be changed to more closely approximate the “all-or-nothing” risk allocation of the 2016 TPG. In Example 4 the risk allocation under Article 9 (using the 2016 TPG) should match the risk attribution under Article 7 (using the AOA).

**ii. Attribution of risks to an associated enterprise DAPE under the AOA will in many cases match the allocation of risks between an NRE and the DAE under Article 9**

The 2010 Report states that a requisite functional and factual analysis is the foundation of a two-stage attribution of risks to a PE under the AOA:

The functional and factual analysis will [1] initially attribute to the PE any risks inherent in, or created by, the PE's own [SPFs] relevant to the assumption of risks and [2] take into account any subsequent dealings or transactions related to the subsequent transfer of risks or to the transfer of the management of those risks to different parts of the enterprise or to other enterprises.<sup>6</sup>

That is, [1] there's an initial attribution to the PE of risks based on the PE's own SPFs; for an associated enterprise DAPE the relevant SPFs will be those performed by the DAE on behalf of the NRE.<sup>7</sup> This is followed possibly by [2] the subsequent shifting of risks, or of management of risks, either within the enterprise or to other enterprises.

<sup>5</sup> See, OECD Public Discussion Draft on BEPS Actions 8–10 *Revised Guidance on Profit Splits*, ¶ 6.

<sup>6</sup> 2010 Report, ¶ 21 (emphasis added).

<sup>7</sup> 2010 Report, ¶ 47.

SPFs relevant to [1] initial attribution to a PE of risks are those requiring “active decision-making with regard to the acceptance and/or management” of the risks.<sup>8</sup> Under the *2016 TPG*, delineation of the actual transaction involves determining which party or parties bear each economically significant risk, meaning determining which party controls the risk and has the financial capacity to assume the risk.<sup>9</sup>

Regarding [2] the subsequent shifting of risks, or the management of risks, within the enterprise, the *2010 Report* states—

Being attributed risks in the Article 7 context means the equivalent of bearing risks for income tax purposes by a separate enterprise, with the attendant benefits and burdens, in particular the potential exposure to gains or losses from the realisation or non-realisation of said risks. This raises the question of whether, and if so, in what circumstances, dealings resulting in the transfers of risks should be recognised within a single entity so that risks initially assumed by one part of the enterprise will be treated as subsequently borne by another part of the enterprise. The circumstances in which it is possible to recognise such a transfer are discussed in Section D-2(vi) [“Recognition of ‘dealings’”].<sup>10</sup>

The referenced § D-2(vi) of the *2010 Report* discusses how to adapt the *TPG* to the PE context, and concludes the functional and factual analysis “will require the determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the dealing.”<sup>11</sup> The discussion of intra-enterprise dealings is noteworthy—

A dealing takes place within a single legal entity and so there are no “contractual terms” to analyse. However, the [AOA] treats “dealings” as analogous to transactions between associated enterprises and so the guidance in [¶¶ 1.52–154 of the *2010 TPG*—entitled “Contractual terms”] can be applied in the PE context by analogy. . . . Further, [¶ 1.48 of the *2010 TPG*] notes that “in line with the discussion below in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties’ conduct should generally be taken as the best evidence concerning the true allocation of risk.” Paragraph 1.49 [of the *2010 TPG*] goes on to note that “an additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of

<sup>8</sup> *2010 Report*, ¶ 22. See also, ¶ 25, which, in the context of a sales PE example outlined in ¶ 23, reiterates the “the [SPFs] relevant to the assumption of risks are those which involve active decisionmaking.”

<sup>9</sup> See, e.g., *2016 TPG*, ¶ 1.60.

<sup>10</sup> *2010 Report*, ¶ 21 (emphasis added).

<sup>11</sup> *2010 Report*, ¶ 178.

such an allocation in arm's length transactions. In arm's length dealings it generally makes sense for parties to be allocated a greater share of risks over which they have relatively more control.<sup>12</sup>

In addressing intra-enterprise dealings that might shift risk, the *2010 Report* thus references segments of the *2010 TPG*, dealing with risks, that were extensively overhauled in the *2016 TPG*.<sup>13</sup> Significantly, risk shifting [2] should also align with control of risks.

The *2010 Report's* guidance on the AOA's [1] initial attribution of risks, and [2] possible subsequent shifting of risks, or risk management, overlaps with guidance in the *2016 TPG* on control of risk. Control of a risk under the *2016 TPG* means having—

the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decisionmaking function.<sup>14</sup>

These requirements for control of risk under the *2016 TPG* are arguably materially the same as the “active decision-making” required for initial attribution of risks, and the control required for subsequent shifting of risks (or risk management), under the AOA. At a minimum, we think it unlikely in practice a tax authority could suitably parse and apply the two standards to reach materially different outcomes.

For an associated enterprise to bear risk under the *2016 TPG*, the bearer must—in addition to controlling the risk—have the financial capacity to assume it. A consequence of risk attribution under the AOA is that the part of the enterprise performing SPFs relevant to risk assumption are attributed sufficient capital to support the risks—i.e., that part of the enterprise is deemed to have the financial capacity to assume the risk.<sup>15</sup> Accordingly, under Article 7 (AOA) initial attribution, and possible intra-enterprise shifting, of risks to a DAPE should be consistent with the Article 9 (*2016 TPG*) allocation of risks to the DAE if the DAE has the financial capacity to assume the risk. Risks allocated from the foreign enterprise to the local enterprise under Article 9 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.

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<sup>12</sup> *Id.*, ¶ 179 (emphasis added).

<sup>13</sup> *See also, Id.*, ¶ 182, (“Once the above threshold has been passed and a dealing recognised as existing, the [AOA] applies, by analogy, the guidance at [¶¶ 1.48–1.54 and 1.64–1.69 *2010 TPG*].”) )

<sup>14</sup> *2016 TPG*, ¶ 1.65.

<sup>15</sup> *2010 Report*, ¶ 47.

**b. Attribution of intangible property assets, and profits, under AOA as compared with arm's length profits under Article 9**

The above discussion relating to attribution of risks, and corresponding profits, under both the AOA and under Article 9 in the context of an associated enterprise DAPE has a counterpart for the attribution of intangible property.

Under Article 7, the AOA attributes economic ownership of intangible property to a DAPE by considering SPFs performed by the DAE, in particular considering SPFs relating to risks applicable to the intangible property (entailing application of the *2016 TPG*).<sup>16</sup> The AOA then allocates sufficient capital to the DAPE, and then determines profits attributable to the DAPE's ownership of attributed intangible property and capital using Article 9 principles (again applying the *2016 TPG*).<sup>17</sup>

By comparison, an Article 9 analysis using the *2016 TPG* respects legal ownership of intangible property, but hinges the legal owner's entitlement to profit from exploiting such intangible property on the legal owner's (i) performance and control of D-E-M-P-E<sup>18</sup> functions; (ii) provision of D-E-M-P-E assets, including funding; and (iii) assumption of risk relating to D-E-M-P-E of the intangible.<sup>19</sup> To the extent an associated enterprise engages in (i), (ii), or (iii), it must be compensated by the legal owner on an arm's length basis for its contributions.

The use of the *2016 TPG* for determining both attribution of intangible property, and attribution of profits, under the AOA to an associated enterprise DAPE suggests there should be consistency with the outcomes of an Article 7 determination of profits attributable to the DAPE and an Article 9 determination of the arm's length profits of the DAE (assuming the DAE has the financial capacity to absorb any risks associated with intangible ownership). As we stated above in connection with the attribution of risks under the AOA, at a minimum we think it unlikely in practice a tax authority could suitably parse and apply the two standards to reach materially different outcomes. Also as stated above, risks (including those relating to intangibles) allocated from the foreign enterprise to the local enterprise under Article 9 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.

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<sup>16</sup> *2010 Report*, ¶ 80.

<sup>17</sup> *2010 Report*, ¶¶ 183–223.

<sup>18</sup> Development, enhancement, maintenance, protection, and exploitation.

<sup>19</sup> Intangible property fares differently under an Article 9 analysis than does risk. The *2016 TPG* doesn't directly address (shifting) economic ownership of intangibles (focusing instead on determining entitlement to profits from exploiting the intangible), but it addresses determination of risk bearing.

Given the importance of the use of intangible property in multinational enterprises, we recommend the OECD revise the PDD—and issue it for comment and review—to include examples addressing attribution of intangibles, and related profits or losses, to an associated enterprise DAPE.

**c. The OECD should recommend no Article 7 enforcement action be undertaken in situations in which no or de minimis profits would be attributed to any PE**

In Example 1, no profits are attributed to the associated enterprise DAPE because no risks or assets are attributed to the DAPE under the AOA. In Example 2, ignoring a small funding return associated with attributed economic ownership of inventory, no profits are attributed to the associated enterprise DAPE because, although risks and economic ownership of assets (and sufficient capital) are attributed to the DAPE, the DAPE must pay an appropriate arm's length fee to the DAE to compensate it for risks it assumes under an Article 9 analysis. In Example 2, a de minimis profit attributable to the DAPE comes from a routine funding return related to economic ownership of inventory.

The facts of these examples are, we believe, typical of those likely to arise in the context of MNEs, especially as a result of the 2016 lowering of the PE threshold under Article 5(5) and Article 5(4) under BEPS Action 7. These examples aptly demonstrate the principle that in typical associated enterprise DAPE fact patterns—largely contrary to the assertion in the *2010 Report*<sup>20</sup>—the host country's taxing rights will be virtually exhausted by ensuring an arm's length compensation to the DAE under Article 9. It's possible to construct hypothetical associated enterprise DAPE examples in which residual non-de minimis profits attributed to the DAPE remain after it pays arm's length compensation to the DAE (e.g., Example 4, but see comments below). We think the fact patterns in such examples would, however, be extraordinary and certainly atypical of those found among our members.

This prompts the broader policy question of whether it's sensible to pursue Article 7 enforcement actions, deeming the existence of associated enterprise PEs, if the host country's taxing rights in the majority of situations will be virtually exhausted by ensuring an arm's length compensation to the relevant in-country associated enterprise. In these situations enforcement ensures theoretical concerns will have been met, but at the practical expense of no or de minimis additional tax revenue being collected by the host country, and of increased host country reporting obligations by the NRE and/or DAE. We accordingly recommend the OECD revise guidance on attribution of profits to PEs to recommend not proceeding with Article 7 enforcement actions in situations (commonplace, we believe) in which no or de minimis profits would be attributable to a PE.

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<sup>20</sup> *2010 Report*, ¶ 240.

**d. We recommend Article 5 be amended to provide that no PE be deemed to exist in certain situations involving closely related enterprises**

As noted, Examples 1 & 2 present (common) situations in which a host country's taxing rights will be exhausted (or virtually exhausted) by ensuring an arm's length compensation to the associated enterprise DAE under Article 9. This prompts the observation that there's no practical relevance—in terms of tax collected by the host country—to deeming the existence of a PE in a situation in which the host country can recover (just) from the DAE the same amount of tax it otherwise could from both the DAE and the PE. In this case the host country is made whole on tax collected, and the NRE avoids additional compliance burdens accompanying the existence of a PE. Lower burdens would also be put on tax administration resources in the host country.

The OECD previously acknowledged the possibility that host countries may wish to adopt an approach under which they collect from a DAE an amount of tax calculated by reference to the activities of both the DAE and the PE.<sup>21</sup> Such an approach has been successfully implemented in practice by some countries.<sup>22</sup>

To this end, we recommend the OECD adoption in Article 5<sup>23</sup> the following new paragraph:

8. Notwithstanding the preceding provisions of this Article, 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 not 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

<sup>21</sup> 2010 Report, ¶ 246 (“[N]othing in the [AOA] would prevent countries from using administratively convenient ways of recognising the existence of a [DAPE] and collecting the appropriate amount of tax resulting from the activity of a [DAE]. For example, where a [DAPE] is found to exist under Article 5(5), a number of countries actually collect tax only from the [DAE] even though the amount of tax is calculated by reference to the activities of both the [DAE] and the [DAPE].”).

<sup>22</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, if the taxpayers agreed 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 profits of the U.S. enterprise's Mexican PE would have been.

<sup>23</sup> An alternative route to achieve the same goal could be for the competent authorities of two Contracting States to enter into a mutual agreement under Article 25(3) to provide the same approach, and we recommend that the OECD endorse this alternative route as well.

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 for purposes of the provisions of the domestic law of each Contracting State and Article 9 of this Convention.

This provision would allow a NRE that would otherwise be treated as having a PE in a host country to avoid being treated as having such a PE (and thus avoid the need to comply with host country tax and reporting obligations) in certain circumstances and provided certain conditions are met. The provision would potentially apply only for Article 5(5) DAPes (i.e., PEs arising from activities of a person closely related to the NRE and resident in the host country) or from activities conducted at the premises of such a person (e.g., a so-called “fixed place of business PE” under Article 5(1)).

To achieve such “no PE” treatment, the provision requires the resident enterprise and the NRE to enter into:

- [i] a binding election that provides the resident enterprise agrees to recognize profits, if any, equal to the sum of the profits attributable to the PE of the NRE that would exist in the absence of the binding election, based on functions undertaken on that NRE’s account (taking into account assets and risks attributed to the PE, and necessary “free” capital to support them), plus arm’s length profits, if any, the resident enterprise would have in the absence of the binding election, based on functions undertaken by that resident enterprise on its own account (taking into account its own assets and risks) and
- [ii] intercompany arrangements providing that where the binding election is made, the resident enterprise shall charge the NRE, and the NRE 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, attributable to the PE the NRE 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.

If, for example, a resident enterprise performs services in a host country on behalf of a closely related NRE, those services could cause the NRE to have a PE in the host country under the normal operation of Article 5(5) if they fall within the activities covered by that provision. Suppose the profits attributable to that PE under the AOA would be 100, before any deduction for the arm’s length service charge payable to the resident enterprise. Suppose further the arm’s length charge for those services under Article 9 would be 88, and the arm’s length profit

recognized by the resident enterprise from receipt of that payment would be 8, after deduction for its own costs of 80. That would leave 12 of profit attributable to the NRE's PE, and a total profit of 20 taxable by the host country (i.e., 8 in the hands of the resident enterprise and 12 in the hands of the NRE). If, however, the enterprises were to make the binding election authorized by proposed Article 5(8), the NRE would agree to increase its payment to the resident enterprise from 88 to 100, and the resident enterprise would agree to be taxable in the host country on a total amount of 20. The host country would be entitled to collect tax on the profit of 20 from the resident enterprise, and the NRE's country of residence would agree to allow the NRE a deduction for the full payment of 100 to the host country's resident enterprise.

This provision would, if availed of, result in the NRE having no PE, no filing obligation, and no corporate income tax liability in the host country arising from activities conducted on the NRE's account by the resident enterprise or at its premises. The NRE would be entitled to deduct amounts accrued under the intercompany arrangement with the resident, discussed above. This provision wouldn't eliminate a PE, filing obligation, or corporate income tax liability in a host country arising from a NRE's own activities or operations in that country unrelated to a PE arising from a resident enterprise's activities or premises.

## 2. Responses to questions raised

*[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 Article 9 analysis (between a NRE and an associated enterprise DAE whose activities give rise to a DAPE) should be done before Article 7 analysis, but the final results should strictly be the same regardless of order. Article 9 analysis (under the 2016 TPG) is, of course, relevant in general to the second step of the AOA—determining profits attributable to the deemed separate and independent PE.<sup>24</sup> But in the context of an associated enterprise DAPE, it's “necessary to determine and deduct an arm's length reward to the [DAE] for the services it provides to the [NRE] (taking into account its assets and risk if any).”<sup>25</sup> The arm's length reward earned by the DAE from the NRE is determined under an Article 9 analysis. Accordingly, the Article 7 analysis involves determining arm's length payments under Article 9.

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

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<sup>24</sup> 2010 Report, § D-3, ¶¶ 183–226.

<sup>25</sup> 2010 Report, ¶ 234.

Generally, yes, but more explanation could be given regarding characterization of the dealings between the Head Office and DAPE and the underlying rationale for attributing economic ownership of assets (inventory and marketing intangibles) to the Head Office.

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

We agree the DAPE has no profits, but it's attributed neither risks nor economic ownership of assets. It's unclear in Example 1 why the DAPE is deemed to earn sales revenue (from which various costs are backed out to arrive at a pre-determined profit—either zero or a funding return on assets attributed). This comment is applicable more generally, but it's especially apt in a situation in which no SPFs are performed in the host country. The *PDD* should be revised to accommodate this.

*[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's not possible to answer this question meaningfully without some understanding of the relevant approach applied.

*[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, this is the appropriate conclusion, entirely consistent with the AOA in the *2010 Report*.

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

No. Doing Article 9 analysis first results in Sellco being allocated credit risks (and costs) and inventory risks (and costs), and Sellco earns a return for this risk (and cost) bearing. These risks (and costs) accordingly aren't borne by Prima and can't be attributed to the DAPE.

*[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?*

It's not possible to answer this question meaningfully without some understanding of the relevant approach applied.

[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 2016 TPG provide—

In exceptional circumstances, it may be the case that no associated enterprise can be identified that both exercises control over the risk and has the financial capacity to assume the risk. 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>26</sup>

If, in Example 2, Sellco hasn't the financial capacity to assume inventory and credit risks, it would under the 2016 TPG not be entitled to the full return it would otherwise get if it had such capacity. Instead, Sellco would be compensated for its service functions, the full risk would remain within Prima and would be attributable to the DAPE as appropriate in light of the functions performed by Sellco on Prima's behalf, and the DAPE's profit would be adjusted accordingly.

[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?*

In § II.A.1.b we explained that Article 9 analysis can allocate risks (based on control functions); Article 9 analysis strictly respects legal ownership of (intangible) property, but can allocate profits relating to the property to associated enterprises performing functions, bearing risks, or using assets related to D-E-M-P-E functions. By contrast, Article 7 analysis using the AOA can attribute economic ownership property and related profits, but in doing so the AOA relies on the 2016 TPG in both stages (i.e., determining both attribution of economic ownership of property, and attribution of profits). We believe the AOA should be revised so there's consistency with

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<sup>26</sup> 2016 TPG, ¶ 1.99.

the outcomes of an Article 9 determination of the arm's length profits of the DAE as a result of understanding D-E-M-P-E functions performed by the DAE (assuming the DAE has the financial capacity to absorb any risks associated with intangible ownership). The different formal treatment—respect of legal ownership but allocation of risks and profits (Article 9) versus attribution of risks and economic ownership, and profits—should produce the same results. In other words, risks allocated from the foreign enterprise to the local enterprise under Article 9 (e.g., from Prima to Sellco in Example 2) 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.

We recommend the PDD be revised to clarify the difference, if any, between the “funding return” in Example 2, and the “investment return” in Example 5.

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

We agree. It would help to give a better explanation of any dealings between the Head Office and the DAPE.

*[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?*

It's not possible to answer this question meaningfully without some understanding of the relevant approach applied.

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

No. Note first that the contingent fee arrangement between Prima and Sellco results in risks being shifted to Sellco.<sup>27</sup> Allocation of risk (and cost) under an Article 9 analysis (which should be done first) should be consistent with attribution of risk (and cost) under Article 7 (assuming this is done first). Risks (and costs) allocated from Prima to Sellco accordingly aren't borne by Prima and can't be attributed to the DAPE. No other risks should be attributed under the AOA from Prima to the DAPE that aren't allocated to Sellco under Article 9. The DAPE's P&L is thus wrong.

*[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*

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<sup>27</sup> See, OECD Public Discussion Draft on BEPS Actions 8–10 *Revised Guidance on Profit Splits*, ¶ 6.

*difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?*

We agree the difference in Example 4 arises because the outcome of how Article 9 analysis allocates risks between the NRE and the DAE differs from how Article 7 analysis attributes risk from the NRE to the DAE. Normatively, however, this result is wrong. As discussed in § II.A.1.a, above, the AOA should be revised take into account changes to § I.D of the 2016 TPG regarding risk allocation. If this is done we believe no material differences between risk allocation and risk attribution will arise.

## **B. Comments on the attribution of profits to PEs arising from activities not covered by specific exceptions in Article 5(4)**

### **1. General comments**

In Scenarios A–C the profits attributable to the PE “reflect the reward” for the warehouse asset, economic ownership of which is attributed to the PE. The 2010 Report noted “there is a broad consensus that assets generally are to be attributed to the part of the enterprise which performs the [SPFs] relevant to the determination of economic ownership of assets.”<sup>28</sup> The 2010 Report also stated, however, that “there was a broad consensus among the OECD member countries for applying use [as opposed to SPFs] 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>29</sup> This choice for tangible assets was justified on the grounds that over the useful life of the tangible asset the deductions allowable in the case of economic ownership (depreciation and interest payments (to the extent the asset is debt financed)) as compared with leasing (lease payments) “may not differ significantly in practice.”<sup>30</sup> While we understand the simplicity afforded by tangible asset place-of-use attribution under the AOA, we think undesirable consequences could flow from blanket application of such rule, particularly if there’s a mismatch between location of tangible-property SPFs and location of use. We accordingly recommend the AOA be revised to more clearly permit both approaches to tangible-property attribution.

In Scenario A the P&L for the PE reflects payments for three “dealings” between the PE and Head Office, including payments for “cost of workforce” and “fee to WRU for know-how and software.” We recommend the PDD be revised to clarify the recognition of such notional payments is relevant only to the attribution of profits to the PE, but not for withholding purposes.<sup>31</sup>

<sup>28</sup> 2010 Report, ¶ 18 (emphasis added).

<sup>29</sup> *Id.*, ¶ 75 (emphasis added).

<sup>30</sup> *Id.*

<sup>31</sup> See, e.g., 2010 Report, ¶ 203.

In Scenario A the profit attributable to the PE reflects a deduction for a payment (of 22) by the PE to the Head office for “cost of workforce.” This profit includes “the reward for . . . the routine functions performed at the warehouse,”<sup>32</sup> and these functions presumably include the operation of the workforce using know-how and software provided by WRU. In Scenarios A & B (and presumably C, too) the workforce used in Country W to run the warehouse “have no specialised knowledge.”<sup>33</sup> Under the *2010 TPG* an assembled workforce is treated as an asset but not an intangible,<sup>34</sup> and Scenarios A & B presume the PE has use of this asset (in Scenario A, as a result of the payment of 22 for “cost of workforce”). The facts of Scenarios A & B (and presumably C, too) suggest some SPFs relevant to the control and/or oversight of the warehouse workforce are performed in the WRU Head Office. We recommend the *PDD* be revised to clarify that to the extent SPFs relevant to the operation of the warehouse workforce (a routine asset) are performed by WRU Head Office employees, the Head Office—not the PE—would be entitled to a return appropriate for the SPFs.

While the analysis in the three Scenarios was informative, it would be helpful if the analysis in the *PDD* were revised to include a discussion of how the (full) AOA under the 2010 Article 7 applies and a discussion of how the (partial) 2008 AOA applies.<sup>35</sup>

## 2. Responses to questions raised

Our responses below reflect the assumption the (full) AOA under the 2010 Article 7 applies. Our responses should also be read in light of our general considerations, above, especially regarding economic ownership of assets.

*[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.

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

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<sup>32</sup> *PDD*, ¶ 93.

<sup>33</sup> *PDD*, ¶ 89.

<sup>34</sup> *2016 TPG*, ¶¶ 1.152–1.156.

<sup>35</sup> By the “(full) AOA” we mean the application of treaty provisions based on Article 7 of the 2010 OECD Model Tax Convention by reference to the associated Commentary and the *2010 Report*. By the “(partial) 2008 AOA” we mean the application of treaty provisions based on Article 7 of the 2008 OECD Model Tax Convention by reference to the associated Commentary and the *2008 Report on the Attribution of Profits to Permanent Establishments*. We note that the “full” and “partial” versions of the AOA may differ on a limited number of issues.

We agree.

*[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?*

Assuming economic ownership of such assets is appropriately attributable to the PE, we agree.

*[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. The investment return might be estimated using third-party rental data from a comparable asset.

*[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. This interpretation is, we believe, the most sensible reading of Article 7, the Commentary on Article 7, and the AOA.

*[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. See, however, our comment above regarding the extent to which SPFs relating to the control and/or oversight of the warehouse workforce are performed in the WRU Head Office.

*[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?*

It's not possible to answer this question meaningfully without some understanding of the relevant approach applied.

**C. Exploring additional approaches to co-ordinate the application of Articles 7 & 9 of the MTC**

*[20] 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?*

Yes. In this letter we recommend Article 7 analysis under the AOA be revised to make attribution of risks and property consistent with the guidance in the *2016 TPG*. The framework for determining profits attributable to a PE—based on the fiction the PE is a functionally separate and independent enterprise, and applying Article 9—is best maintained by ensuring consistency with the *2016 TPG*. We also recommend Article 5 of the MTC be changed<sup>36</sup> to include a new paragraph 8, allowing a NRE and a closely related person in a source country to make a binding election, and maintain their intercompany arrangements, so as to ensure the host country collects the same tax it would if the closely related person gave rise to a PE, yet resulting in no PE being deemed to exist. This simplification would reduce compliance burdens for the NRE, and also lower burdens on tax administration resources in the host country.

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<sup>36</sup> An alternative route to achieve the same goal could be for the competent authorities of two Contracting States to enter into a mutual agreement under Article 25(3) to provide the same approach, and we recommend that the OECD endorse this alternative route as well.

## Appendix—SVTDG Membership

Accenture	Integrated Device Technology, Inc.
Activision Blizzard	Intel Corporation
Acxiom Corporation	Intuit, Inc.
Adobe Systems, Inc.	Intuitive Surgical
Advanced Micro Devices, Inc.	KLA-Tencor Corporation
Agilent Technologies, Inc.	Lam Research Corporation
Amazon.com	LinkedIn Corporation
Apple Inc.	Marvell Semiconductor, Inc.
Applied Materials, Inc.	Maxim Integrated
Autodesk	Mentor Graphics
Bio-Rad Laboratories, Inc.	Microsemi Corporation
BMC Software	Microsoft Corporation
Broadcom Limited	NetApp, Inc.
Brocade Communications Systems, Inc.	Netflix, Inc.
Cadence Design Systems, Inc.	Oracle Corporation
Chegg, Inc.	Palo Alto Networks, Inc.
Cisco Systems, Inc.	Pandora Media, Inc.
Dolby Laboratories, Inc.	PayPal Holdings, Inc.
Dropbox Inc.	Pivotal Software, Inc.
eBay, Inc.	Plantronics, Inc.
Electronic Arts	Pure Storage, Inc.
EMC Corporation	Qualcomm, Inc.
Expedia, Inc.	Rovi Corporation
Facebook, Inc.	salesforce.com
FireEye, Inc.	SanDisk Corporation
Fitbit, Inc.	Sanmina-SCI Corporation
Flextronics	SAP
Fortinet	Seagate Technology
GE Digital	ServiceNow, Inc.
Genentech, Inc.	Snapchat, Inc.
Genesys	Symantec Corporation
Genomic Health, Inc.	Synopsys, Inc.
Gilead Sciences, Inc.	Tesla Motors, Inc.
GitHub	The Cooper Companies
GLOBALFOUNDRIES	The Walt Disney Company
GlobalLogic, Inc.	Trimble Navigation Ltd.
Google, Inc.	Twitter, Inc.
GoPro, Inc.	Uber Technologies
Groupon	VMware Corporation
Harmonic	Xilinx, Inc.
Hewlett-Packard Enterprise	Yahoo!
Hewlett-Packard Company	Yelp, Inc.
Ingram Micro, Inc.	

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Sydney  
Taipei  
Tokyo  
Yangon**Europe, Middle East  
& Africa**Abu Dhabi  
Almaty  
Amsterdam  
Antwerp  
Bahrain  
Baku  
Barcelona  
Berlin  
Brussels  
Budapest  
Cairo  
Casablanca  
Doha  
Dubai  
Dusseldorf  
Frankfurt/Main  
Geneva  
Istanbul  
Jeddah\*  
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Kyiv  
London  
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Madrid  
Milan  
Moscow  
Munich  
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St. Petersburg  
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Vienna  
Warsaw  
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Porto Alegre\*\*  
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Washington, DC

\* Associated Firm

\*\* In cooperation with  
Trench, Rossi e Watanabe  
Advogados

September 4, 2016

**Submitted by email**  
TransferPricing@oecd.orgTax Treaties, Transfer Pricing and Financial Transactions Division  
Organisation for Economic Co-operation and Development –  
Centre for Tax Policy and Administration**Comments on the Public Discussion Draft on BEPS Action 7: Additional Guidance  
on the Attribution of Profits to Permanent Establishments**

Dear Sir or Madam:

The Software Coalition thanks the OECD for the opportunity to provide comments on the Public Discussion Draft on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments, issued on July 4, 2016 (the “Discussion Draft”).

The Software Coalition is the leading software industry group dealing with U.S. domestic and international tax policy matters. The Software Coalition was formed in 1990 and now comprises 24 companies which operate in the software and e-commerce sectors. Software Coalition members account for approximately \$550 billion per year in total gross revenue. Member companies employ over 1.5 million individuals around the globe.<sup>1</sup> We respectfully submit the following comments with a view towards enhancing the goal of providing tax administrations and taxpayers with clear guidance on the application of Article 7 to the determination of the profits attributable to permanent establishments (PEs).

<sup>1</sup> The Software Coalition’s current membership comprises the following companies: Adobe Systems Inc.; Amazon.com, Inc.; Autodesk, Inc.; BMC Software, Inc.; Cisco Systems, Inc.; Electronic Arts, Inc.; EMC Corporation; Facebook, Inc.; General Electric Co; IBM Corporation; Imperva, Inc.; Mentor Graphics Corporation; Microsoft Corporation; Micro Focus International plc; Nuance Communications, Inc.; Oracle Corporation; PTC Inc.; Pivotal Software, Inc.; Salesforce.com Inc.; SAP America, Inc.; Symantec Corporation; Synopsys, Inc.; Veritas Technologies; and VMware, Inc.

Organisation for Economic Co-operation and Development

## Executive Summary

We believe that the Discussion Draft in general provides a thoughtful and well-rounded application of the AOA to the challenging topic of PE profit attribution. Our main general observations to the Discussion Draft are as follows:

1. AOA Adoption: Ideally, jurisdictions which agree to the MLI to implement the Action 7 recommendations should also conform their treaties to Article 7 of the MTC and expressly adopt the 2010 AOA Report as reflected in the Article 7 Commentary. To the extent that is not possible at this stage, we urge the OECD/G20 governments to encourage widespread adoption of the AOA as an expected implementation step of the BEPS Project.
2. 2008 vs. 2010 Version of Article 7: The examples in the Discussion Draft are appropriate illustrations of the principles of both the 2008 and 2010 AOA Reports. We suggest that the Final Guidance state that it applies to both the 2010 and pre-2010 versions of Article 7. This would ensure that this guidance will have the widest possible application in the international treaty network and would be consistent with the prior agreement that the 2008 AOA Report represented internationally agreed principles.
3. Form of Final Guidance: It would be useful to add the examples in the Discussion Draft to the Article 7 Commentary, to establish this guidance as precedential. Alternatively, the Final Guidance could be published as a stand-alone report, or perhaps as a supplement to the 2010 AOA Report.
4. Mechanics of the AOA and the Core Concept of “Dealings”: The Discussion Draft’s technical discussions in the examples do not include a clear statement of what the “dealing” would be between the PE and the rest of the enterprise. We suggest that the Final Guidance should more explicitly identify the relevant “dealings” between the head office and the PE (deemed or actual) and provide examples that show contrasting ways of determining the “dealing.” Further, if the Final Guidance retains the current examples from the Discussion Draft, we believe that the Final Guidance should clearly state that buy-sell dealings are not necessarily appropriate in all cases. It is certainly conceivable that many PE dealings are better described as services dealings, even where the nonresident enterprise is engaged in the sale of property to customers with some assistance from the PE.
5. Significant People Functions: The Discussion Draft does not provide any direct guidance on how to assess whether a function rises to the level of a significant people function relevant to the economic ownership of an asset or assumption of risks. Readers of the Final Guidance will likely infer that the stated asset and risk attributions used in the examples for illustration purposes are appropriate interpretations of the AOA under the facts as assumed. We suggest that the Final

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Guidance elaborate as to why the mentioned functions are regarded as significant people functions in its analysis of each of the examples.

6. Attribution of Gross Revenue to the PE: The Final Guidance should make clear that there is no requirement that the gross revenue derived from in-country sales necessarily is attributed to the PE. The fact that the preponderance of the examples in the Discussion Draft attribute all of the gross revenue to the PE could be mistakenly interpreted to suggest that this is the normal result. We believe it would be useful to identify the reasons why gross revenue would be attributable to the PE in some cases but not in others, and to provide guidance as to what items of income or loss should be attributed to the DAPE, based on how the hypothetical “dealing” is conceptualized. In particular, customer revenue should be attributable to the head office and not the PE, if the significant people functions that are the most directly related to sales solicitation and conclusion are performed by the head office instead of the PE (either directly or by attribution).
7. Article 7 vs. Article 9 Priority: We suggest that the logical order of application of the articles is that, after the accurate delineation of the transaction: 1st) Article 9 applies to determine whether the price charged is arm’s length; 2nd) the jurisdictional issue is addressed, whether the nonresident is also subject to tax in the host state by virtue of Article 5; and 3rd), if so, then Article 7 applies to attribute profits to that PE.
8. Zero and Negative PE Profit: The Final Guidance should retain examples which result in zero and negative (in addition to positive) profits attributable to the PE. Further, Coalition members hope that jurisdictions following the guidance will be mindful of compliance burdens that require additional resources for tax administrations as well as taxpayer without generating any additional tax revenue in the case of zero or negative profits and consider these results in their policy making and administrative practices.

In addition to these general observations, we have also provided detailed technical comments in response to your questions. We believe questions 2, 3, 6, 9, 10, 12 and 21 are of greater consequence and deserve particular attention.

## Introduction

The Software Coalition compliments the working group for the significant progress made in this Discussion Draft towards providing practical guidance which addresses the difficult issues of profit attribution to PEs. Coalition members particularly appreciate the efforts to provide guidance on the attribution of profits to deemed PEs arising under Article 5(5), as those issues have proven in the past to be the most contentious PE profit attribution issues. Guidance in this area will become even more important after the adoption of the Multilateral Instrument (“MLI”), as we expect that the proposed changes

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to Article 5(5) under the Action 7 Report<sup>2</sup> will result in a considerable increase in controversies over the scope of the deemed PE standard.

We believe that the Authorized OECD Approach (“AOA”)<sup>3</sup> expresses a conceptually solid foundation for PE profit attribution, including in the case of deemed PEs created through the application of Article 5(5). We are pleased to see that the Discussion Draft adheres closely to AOA principles.

Our comments are divided into two parts. The first part provides general observations on the Discussion Draft, as summarized in the Executive Summary. The second part specifically addresses the questions posed to commentators.

### **I. General Observations**

#### **1. AOA Adoption**

We are pleased to note that the analysis in the Discussion Draft is firmly grounded on AOA principles. Members of the Coalition strongly believe that OECD/G20 member governments should endeavor to achieve broad acceptance of the AOA as part of the implementation phase of the OECD/G20 BEPS Project. The determination of tax nexus (i.e. PE) and the consequences of that nexus (i.e. profit attribution) cannot be considered separately and in isolation as a matter of developing sound international tax policy.

Coalition members note the acknowledgement in the Discussion Draft that very few treaties have been amended or renegotiated to include the new version of Article 7 included in the 2010 OECD Model Tax Convention (“MTC”), that several OECD member and non-member countries have indicated that they do not intend to adopt the new Article 7, and that the new Article 7 has been expressly rejected for inclusion in the UN Model.<sup>4</sup> This is a regrettable situation, as the discrepancies in commitment to the AOA raise concerns about the effectiveness of the final guidance to be issued under this Discussion Draft (the “Final Guidance”).

In these circumstances, the best and most appropriate result of both the Action 7 work on nexus standards and this PE attribution project is that jurisdictions which agree to the MLI to implement the Action 7 recommendations also should be expected to conform their treaties to Article 7 of the MTC and expressly adopt the 2010 AOA Report as reflected in the Article 7 Commentary.

<sup>2</sup> Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report (the “Action 7 Report”), October 5, 2015, *available at* <http://www.oecd.org/ctp/beps-2015-final-reports.htm>.

<sup>3</sup> The AOA is set out in the 2010 Report on the Attribution of Profits to Permanent Establishments (the “2010 AOA Report”), July 22, 2010, *available at* <http://www.oecd.org/ctp/transfer-pricing/45689524.pdf>.

<sup>4</sup> Discussion Draft, para. 15.

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Coalition members appreciate that it may not be possible to add this element to the MLI at this stage. Nevertheless, we urge the OECD/G20 governments to encourage widespread adoption of the AOA as an expected implementation step of the BEPS Project.

## **2. 2008 vs. 2010 Versions of Article 7**

The absence of universal acceptance of the 2010 AOA Report and the 2010 versions of Article 7 and Commentary creates the unfortunate situation that jurisdictions which have not adopted the revised Article 7 may not regard the Final Guidance as applicable to their treaties if the Final Guidance is described as applying only to the 2010 version of Article 7. We note that the limited number of examples presented in the Discussion Draft describe relatively simple cases. We believe that the cases presented in the Discussion Draft and the analysis of those examples are applicable equally to the 2008 and 2010 Reports and Commentary. We suggest that the Final Guidance make this point clear, in order that the Final Guidance will have the widest possible application in the international treaty network.

Virtually all OECD countries agreed that the 2008 AOA Report represented internationally agreed principles and, to the extent that it did not conflict with the 2008 Commentary, provided guidance to the application of the pre-2010 version of Article 7. We believe that the OECD/G20 governments should at a very minimum restate their consensus on this point.

## **3. Form of Final Guidance**

The Discussion Draft does not state the form in which the Final Guidance will be issued. It would be useful to add at least some of the examples in the Discussion Draft to the Article 7 Commentary, in order to establish this guidance as precedential. Alternatively, the Final Guidance could be published as a stand-alone report, or perhaps as a supplement to the 2010 AOA Report. In any event, the OECD Council should encourage widespread adoption, even by jurisdictions which have not revised their treaties to include the 2010 version of Article 7.

## **4. Mechanics of the AOA and the Core Concept of “Dealings”**

One of the core principles of the AOA is that profit attribution is based on the recognition of “dealings” between the PE and the rest of the enterprise as if the PE were a separate and independent enterprise engaged in the same or similar activities under the same or similar circumstances.<sup>5</sup> In principle, under the AOA, hypothetical “dealings” should be recognized between parts of the enterprise, and the recognition and determination of the

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<sup>5</sup> See, e.g., 2010 AOA Report, para. 172.

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nature of those dealings define the hypothetical transaction (e.g. sale of inventory property, provision of marketing services, lease of equipment, etc.) to which transfer pricing principles are applied to determine the actual profit attribution. A functional and factual analysis will determine the nature of the internal events giving rise to a “dealing” based on the analysis of whether there has been any “economically significant transfer of risks, responsibilities and benefits” as a result of the dealing.<sup>6</sup> The 2010 AOA Report lists the physical transfer of stock, the provision of services, the use of intangibles, and the transfer of an asset as examples of dealings.<sup>7</sup>

We were surprised to note that the technical discussions in the examples do not include a clear statement of what the “dealing” would be between the PE being considered and the rest of the enterprise. The concept of “dealing” is essential as it creates the mechanism to divide the profits between the PE and the head office. Based on the numerical analysis described in Examples 1-3, we infer that the “dealings” in those examples are that of a buy-sell relationship where the PE is attributed the gross sales revenue derived from customers, and notionally purchases the item from the head office. Example 4 is not as clear, but it appears to assume that a service transaction is the “dealing” between the head office and the deemed PE.

Further, in the two warehouse examples that do not involve an enterprise which derives third party revenue for warehouse services, the Discussion Draft proposes a “streamlined” approach to attributing profits to the use of the warehouse asset. This “streamlined” approach appears to be a *sub silentio* decision on how to conceptualize the “dealing” in that case, without using the term. In both cases, the assumed dealing could be a lease of assets or a provision of services to the head office, but the analysis is not clear on that point.

The Final Guidance will apply to a wide range of business circumstances beyond the narrow case of credit and inventory risks addressed in the examples. Articulating the “dealing” will be a critical technical element of the analysis. Accordingly, we suggest that the revised Discussion Draft or Final Guidance should more explicitly identify the relevant “dealings” between the head office and the PE (deemed or actual) and provide examples that show contrasting ways of determining the “dealing.” We illustrate how the failure to articulate the “dealings” could impact the results in our responses to the questions posed by the Discussion Draft. Further, if the Final Guidance retains the current examples from the Discussion Draft, we believe that the Final Guidance should clearly state that buy-sell dealings are not appropriate in all cases. It is certainly conceivable that many cross-border dealings are better described as services dealings,

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<sup>6</sup> See 2010 AOA Report, para. 178.

<sup>7</sup> See 2010 AOA Report, para. 177. See also paras. 194-220 for commonly occurring dealings. We note the statement in paragraph 16 of the Discussion Draft that the concept of “dealings” in intangibles is an important difference between the 2010 AOA and the interpretation of Article 7 prior to the adoption of the 2010 AOA. We believe that in general, the concept of dealings in other property or services is consistent with pre-2010 interpretations of Article 7.

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even where the nonresident enterprise is engaged in the sale of property to customers with some assistance by the PE.

### 5. Significant People Functions

One of the most challenging interpretative issues in the application of Article 7 to a dependent agent PE (“DAPE”) is to articulate the circumstances under which a dependent agent will be regarded as performing “significant people functions relevant to the determination of economic ownership of assets” or to “the assumption and management of risks”.<sup>8</sup> This determination is a critical element of the PE profit attribution exercise for both fixed place of business PEs arising under Article 5(1) (“FPOB PE”) and DAPEs arising under Article 5(5), but it is particularly difficult in the DAPE context as the DAPE, by definition, does not have any people functions attributed to the PE.

The Discussion Draft does not provide any direct guidance on how to assess whether a function rises to the level of a significant people function relevant to the economic ownership of an asset or assumption of risk. Each of the examples assumes the conclusion of which assets and risks are attributed to the DAPE or FPOB PE, and then bases the profit attribution result on that assumed allocation. The Discussion Draft in paragraph 13 cautions that the facts in the examples do not have applicability beyond serving as a basis for illustrating the analysis.

Despite the words of caution, and assuming that the Final Guidance will contain examples, readers of the Final Guidance likely will infer that the stated asset and risk attributions are appropriate interpretations of the AOA under the facts as assumed. In general, Coalition members believe that the assumed asset and risk attributions are fair interpretations of the consequences of the credit and inventory management functions recited as assumed facts, although in responses to the specific questions below we make some suggested revisions to the examples in order to conform the examples more closely to commercial reality. In the absence of guidance as to why those functions were regarded as significant people functions with respect to the assets and risks in the examples, however, it will be difficult to apply this critical principle to other factual contexts, possibly yielding inconsistent results under similar facts in many cases.

If the working group chooses to elaborate this element of the analysis, we note that a “significant people function” in the context of a sales support organization cannot mean an activity that simply is useful or even important to the solicitation or consummation of a sale. Rather, it should signify an activity that involves active decision making with respect to a critical business judgment that results in the assumption of a significant business risk of the enterprise. This is true also for the application of the test to assets, as the significant people function must be relevant to the economic “ownership” of the asset,

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<sup>8</sup> 2010 AOA Report, paras. 18 and 21.

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not just the effective use or exploitation of that asset.<sup>9</sup> In this regard, some guidance might be drawn from the concept of Key Entrepreneurial Risk-Taking functions, as used in the sections of the AOA applicable to financial institutions.<sup>10</sup>

### 6. Attribution of Gross Revenue to the PE

In our experience, many tax auditors assume that once a PE is found, then all third-party revenue generated from the sales activities that form the basis of the PE determination are attributed to the PE. There is no requirement or implication in Article 7, the Commentary or the AOA that the gross revenue derived from in-country sales necessarily is attributed to the PE. Accordingly, the Final Guidance should make this point clear.

Automatically attributing all of the gross revenue to the PE skips an important step in the Article 7 analysis, i.e. the recognition of “dealings” between parts of the enterprise, treating a PE as a separate and independent enterprise. The AOA recognizes that a variety of “dealings” might be constructed between the PE and the remainder of the enterprise. It is certainly true that in the case of a DAPE created by sales activity, such as by the sales activity of a commissionaire, one possible “dealing” would be that the PE is treated as making the sale, recognizing the full customer revenue as contracted for by the commissionaire, and also recognizing a deemed COGS amount as deemed paid to the rest of the enterprise.

On the other hand, it is possible that other “dealings” could be constructed that do not assume that the full customer revenue would be recognized by the PE. For instance, where only the credit risk and inventory risks are allocated to the DAPE, a more plausible “dealing” might be the provision of a credit guarantee or other services, and not a buy-sell dealing. These alternative dealings will be more prevalent under the Action 7 changes to Article 5(5) creating PEs based on “principal role” activities, as PEs then can be created even if the dependent agent has no authority to assume risk by contract. This also will be particularly true in PE contexts outside of sales solicitation. For example, in a DAPE created by purchasing activity, that contract conclusion is not directly connected to third party revenue.

The first three examples in the Discussion Draft result in the full customer revenue being recognized by the PE. The amount of profit or loss ultimately attributed to the PE is

<sup>9</sup> See e.g., 2010 AOA Report, paras. 80, 85-87 (discussing significant people functions in the context of different types of intangibles).

<sup>10</sup> Similar to the concept of “significant people functions”, the “key entrepreneurial risk-taking functions” are those that require active decision-making with respect to the acceptance and/or management of risks and are closest to the transactions that give rise to risk for the enterprise. See e.g., 2010 AOA Report, paras. 8-11, Part II. The key entrepreneurial risk-taking functions are to be distinguished from support functions, for example. The level of corporate authority exercised by the relevant personnel and the financial significance of the active decision making required in Part I of the AOA Report as applied to the examples in the Discussion Draft should not be less than that required in the other parts (i.e. Parts II-IV dealing with financial, trading and insurance transactions) of the AOA Report.

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determined by the amount of the commission expense payable to the sales entity and a COGS amount deemed paid to the head office. The COGS amount is determined as a residual, presumably by applying the TNMM to the PE. In contrast, Example 4 appears to illustrate a services “dealing” whereby the DAPE is attributed a risk return based on an internal service fee/guarantee fee, instead of an external gross revenue amount.

The fact that the preponderance of examples attribute all of the gross revenue to the PE could be mistakenly interpreted to suggest that this is the normal result. We believe it would be useful to identify the reasons why gross revenue would be attributable to the PE in some cases but not in others, to provide guidance as to what items of income or loss should be attributed to the DAPE, based on how the hypothetical “dealing” is conceptualized. For example, it would seem that customer revenue would be attributable to the head office and not to the PE, if the significant people functions that are the most directly related to sales solicitation and conclusion are performed by the head office instead of the PE (either directly or by attribution).

We note that in cases where the DAPE is allocated few assets or risks, it is not likely that reliable comparables could be found to determine the deemed COGS amount. In these cases, reliability of the result likely will be improved in many, if not most, cases by using services provider comparables.

### 7. Article 7 vs. Article 9 Priority

The Discussion Draft requests comments as to whether there should any priority of application between Article 9 (transfer pricing) and Article 7 (PE profit attribution). There would seem to be a clearly correct answer to this question: namely, that the logical order of application is that, after the accurate delineation of the transaction, Article 9 first applies to determine whether the price charged is arm’s length; second, the jurisdictional issue is addressed, whether the nonresident is also subject to tax in the host state by virtue of Article 5; and third, if so, then Article 7 applies to attribute profits to that PE.

This conclusion on the appropriate priority is made more compelling by observing an important aspect of Example 2—the possibility of double counting of income where the factors relevant to the FAR analysis under Article 9 are the same as the facts relevant to the determination of the significant people functions under Article 7. In that example, credit and inventory risks are allocated to Sellco for purposes of Article 9, even though contractually those risks were allocated to Prima. This presumably was done as a result of the principle that the “accurate delineation of the contract” concluded that Sellco employees performed risk management activities that required those risks to be assigned to Sellco for transfer pricing purposes, even though commercially that risk was borne by Prima. Presumably the transfer pricing result as determined under Article 9 included in the return earned by Sellco a return to bearing those risks. Since the personnel activities constituting risk “control functions and risk mitigation functions” that resulted in that risk being allocated to Sellco for Article 9 purposes are probably similar to, if not identical to, the activities which would have caused the risk to be attributed to the PE, it would seem

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that some sort of priority rule would be required in order to avoid double counting the income arising from that risk.

This priority sequence also supports suggestions for simplified compliance options. In circumstances where the income or loss is first allocated to Sellco under Article 9, leaving little or no profit to be allocated to a PE of Prima, the nonresident taxpayer should not have to prepare and file returns of a hypothetical PE or register as a taxpayer in the local country. That is because the intended result (allocation of profits or losses to the source country) is reflected in Sellco's reported return following the Article 9 analysis. This ensures administrative efficiency for both taxpayers and tax administrations.

### 8. Zero and Negative PE Profit

Coalition members were pleased to see that the Discussion Draft includes examples which result in zero and negative, as well as positive, profits attributable to the PE. This is an important point, and the Final Guidance should include examples showing this range of results.

The AOA is clear that it is not necessarily the case that all PEs must be attributed some profit. It is probably the case that it is relatively less likely that a DAPE which is created due to the "plays the principal role" standard under the revised Article 5 as proposed by the final Action 7 Report will have positive profits attributable to the DAPE than would be the case under the existing "authority to conclude contracts" standard. This is because the new Action 7 standard can create a PE due solely to the performance of sales activity in the jurisdiction to convince a customer to buy, without the performance of any of the functions involved in agreeing to contracts which typically are the actions which cause an entity to assume commercial risk. Accordingly, guidance which makes it clear that absent relevant significant people functions, no profit or loss can be attributed to the DAPE will be even more important in the future than it has been in the past.

We note that once a PE is determined, many jurisdictions will impose certain filing obligations on the DAPE, such as return filing obligations, possible VAT registration consequences, and the like, even if the profits attributed to the PE are nil or a loss. Coalition members hope that jurisdictions will be mindful of these compliance burdens that require additional resources for tax administrations as well as taxpayers without generating any additional tax revenue and consider these results in their policy making and administrative practices.

## II. Answers to Questions

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.*

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See comments in text above.

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

We agree that under the facts as described, Sellco does not perform any significant people functions relevant to the ownership of assets or the assumption of risks.

We suggest that the sentence referring to sales channels as “generic and not specialized” be deleted. A “sales channel” is a description of a business concept, as opposed to something that can be described as “generic” or not. In any event, it is not clear what a “generic” sales channel would be. Finally, as there is no direct connection between the nature of the “sales channel” and whether Sellco might perform significant people functions related to the ownership of assets or the assumption of risks, there seems to be no need to include that sentence in the statement of facts.

To this point, we note that paragraph 233 of the 2010 AOA Report states that “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 DAPE would generally not be attributed profit as the economic owner of that intangible.” Accordingly, the reference to “generic” sales channels as a justification for concluding that a marketing intangible is not attributable to the DAPE is not supported by the AOA.

The facts also state that Sellco implements the marketing strategy in Country B which is decided by Prima, and is reimbursed by Prima for all local advertising expenses. The facts then state that Sellco’s activities do not create any local marketing intangibles in Country B. The second statement is more of a conclusion than a fact. Therefore, it would be useful to state that Sellco’s activities do not create local marketing intangibles because Sellco implements a marketing strategy decided by Prima, and because its local advertising expenses are reimbursed by Prima.

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

As noted above, we believe it is important for analytical clarity for each example to describe the separate and distinct steps of the AOA analysis, namely an identification of the assets and risks that are attributed to the PE, and a statement of the hypothetical dealings that are constructed between the PE and the head office with respect to those assets and risks. In this example, paragraph 34 of the Discussion Draft correctly concludes that no assets or risks are attributable to the DAPE. The next step should be a statement of the hypothetical dealing between the DAPE and the head office. Paragraph 37 states that all of the external revenue is attributed to the PE. That conclusion assumes that the dealing is a sale of inventory by the head office to the DAPE, for resale to customers. Given that there are no functions, assets or risks attributed to the DAPE, it

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would seem that the better conclusion on dealings is that there is no dealing at all. Given that it should not always be the case that any dealing with a DAPE should be a hypothetical purchase of goods for resale, it would be useful for the analysis here to state why the buy-resale dealing is chosen as the most appropriate dealing.

We also suggest that Example 1, by virtue of its role as the baseline example upon which further examples are based, clarify that the physical location of the inventory is not determinative of which party is attributed inventory risk. The example notes that “Prima is responsible for warehousing the inventory and determining and monitoring inventory levels of the products to fulfil customer orders. . .” It does not state where the inventory is physically located. The Example 1 analysis will be correct even if the inventory is located in Sellco’s territory, as long as Prima performs the significant people functions with respect to the inventory in Prima’s location.

**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 difficult to speculate as to the answer to this question without reference to the actual alternative treaty language. That said, Coalition members regard this question as a very serious issue in practice, in light of the absence of universal adoption of the 2010 version of the AOA (or even the 2008 version for that matter). The result shown in Example 1 is clearly the correct result under any interpretation of Article 7, in light of the absence of relevant significant people functions being performed in Country B. In practice, many tax auditors reflexively take the view that significant profits are necessarily attributed to any PE, in the event that a PE exists, regardless of the technical basis for the creation of the PE. It would be useful for the Final Guidance to note that the result of Example 1 is the appropriate result under pre-2010 versions of Article 7, so as to encourage tax administrations to apply these same economic principles to the interpretation of all treaties based on the MTC.

**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 agree with the result of this example. We also think that this strongly suggests that compliance simplification is appropriate, such that the DAPE has no registration or compliance obligations. Please refer to our response to question 21.

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

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We believe that the factual descriptions and technical analysis can be refined to more closely reflect normal commercial practice.

We note that it might be useful to state as one of the assumed facts in this example that Sellco is acting under a commissionaire contract. The assumed facts that Sellco approves every sale through review of the customer's creditworthiness and collects customer receivables are typical features of a commissionaire's commercial responsibilities, but not of a sales agent without contract concluding authority.

The example suggests that performing the collections function supports the conclusion that Sellco (or the DAPE) is allocated the credit risk. In most cases, a collections function by itself does not involve the assumption or management of any risk. The active decision making relating to the management of credit risk as it relates to the collections function is the decision to write-off a debt or pursue extraordinary collection activities. Accordingly, it would be appropriate for the example to refer to the functions of exercising the authority to decide the terms of credit to be extended to customers (as is done in Example 4) and the decision whether to write-off or pursue extraordinary collection activities as the significant people functions that relate to the assumption of credit risk.

We believe that the description of the nature of inventory risk can be improved. Inventory risk generally relates to the risk that an enterprise will not be able to sell products at a price that the enterprise expected when the goods were manufactured. Much of that risk is embedded in decisions made during the design, manufacturing and sales forecasts processes, and those decisions determine what goods will be manufactured for the market, and whether the goods are manufactured to acceptable quality standards. A smaller component of inventory risk relates to logistics planning and to risk of loss or damage during transit or storage.

The facts state that Sellco makes decisions about stocking levels, and that Prima produces to Sellco's orders. For Sellco to be making the decisions relevant to the greater part of inventory risk, Sellco would need to enter into an agreement with Prima to pay for any goods that it ordered. These arrangements are common in contract manufacturing arrangements (e.g. "take-or-pay" contracts), but are exceedingly uncommon in sales agent relationships. A more realistic description of the risks assumed by Sellco in this case would be the risk of damage or loss while the goods are stored in the local warehouse, as those are risks that conceivably can be affected by decisions of where and how to store goods in a location remote from the factory. The hypothetical financial analysis then would need to isolate those profits or losses related to the realization of those risks, to the extent not already compensated under Article 9 as part of Sellco's sales support services. It would not be an appropriate interpretation of the AOA to conclude that Sellco has assumed all inventory risks of all sorts simply because it is providing sales forecasts to its principal, which seems to be the conclusion expressed in this example.

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The amount of profits attributable to bearing such risks naturally will vary according to the types of goods involved. A useful addition to this example would be to note that the goods involved are heavy equipment, or some similar type of product where the risk of damage is material.

The Discussion Draft does not seek comment on the Article 9 analysis by which bad debt losses, inventory losses and warehousing expenses are attributed to Sellco under Article 9. We note, however, that allocating all inventory risk gain or loss to Sellco in particular would seem to be an extreme application of Article 9, given all of the design, production, quality control, and sales management activity that clearly takes place outside of Sellco's jurisdiction.

**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?***

See 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?***

As between Sellco and Prima, those risks necessarily would be allocated to Prima. It would be a different application of Article 9 if those risks were further reallocated from Prima to another enterprise in the group which did have the financial capacity to bear the risk.

**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?***

We believe that the case postulated in this example which considers that the same functions could allocate risks or assets both to Sellco and to the DAPE could exist only under very unusual circumstances. It is conceivable that a single set of functions could result in the attribution of different risks and assets to Sellco and the DAPE. Otherwise, a conclusion that the same assets and risks can be allocated to both Sellco and the DAPE would seem to not respect the essential distinction made in the AOA between the two taxpayers.

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The AOA is clear that the factual and functional analysis of the dependent agent enterprise must determine separately “the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise.” The reason for identifying the two separate activities is because the two taxpayers will report income attributable to those separate functions.

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.<sup>11</sup>

Activities conducted by the dependent agent enterprise (“DAE”) on its own account should result in assets or risks being attributed to that enterprise for purpose of Article 9. The only assets and risks that can be attributed to the DAE are those where the actions of the dependent agent enterprise are being undertaken “on behalf of the non-resident enterprise”. It is hard to see a circumstance where the same activities could be undertaken both for the DAE and the non-resident. At a minimum, it would seem that the same general set of functions could result in the attribution of assets and risks to the two different entities only if the assets and risks under consideration for attribution to one or the other entity were clearly different assets and risks. Once the specific asset or risk is attributed to the DAE for purposes of Article 9, it would logically follow that such asset or risk not also be attributed to the DAE.

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

This example illustrates the importance of specifying the dealing and the application of the appropriate transfer pricing method as integral parts of applying the AOA. It appears that the profit level indicator being applied is return on sales (“RoS”), as the DAE is stated to earn an operating margin of 4.5%, if it were regarded as a separate and independent enterprise. In practice, that RoS figure will be determined by the review of appropriate comparables. We recommend including in this example the point that in assessing comparability, the test must be applied to a deemed distributor with the FAR profile of the activities performed by the Employee, plus the assets and risks attributed to the DAE under the AOA as explained in the example. To improve reliability, adjustments to the comparables might be necessary as described in TPG Ch. III.

We agree that use of the vehicle should be attributed to the DAE. If the dealings were more completely described, it would be necessary to identify whether the auto would be treated as owned by the DAE, with depreciation expense being allowed in the DAE’s

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<sup>11</sup> 2010 AOA Report, para 232.

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accounts, or owned by the head office and leased to the DAPE, with lease expense being shown in the DAPE accounts.

The comments made above regarding “generic” sales channels and the nature of inventory risk are applicable to this example as well.

**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?***

See 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?***

This example is important as it demonstrates that a loss could be attributable to a DAPE. We agree that this result is possible under the assumed facts when both parts of the enterprise share the credit risk, and thus, the potential upside and downside of the realization of that risk.

That said, this example proposes very fine distinctions among activities for purposes of distinguishing between an Article 9 assessment and an Article 7 profit attribution. For example, in Example 4, both Prima and Sellco have credit management teams. It is not clear which facts in particular are the most relevant, but in general terms Sellco makes credit decisions on smaller accounts while Prima makes decisions on larger accounts, including MNC customers. Sellco provides account management services for all accounts, but Prima makes the decision whether to write-off or pursue a questionable receivable. Based on that allocation of functions, the example concludes that the Sellco functions are not sufficient to cause the credit risk to be allocated to Sellco under Article 9, yet the functions are significant people functions that cause a partial attribution of the risk to a DAPE. The example thus contemplates a highly nuanced approach that could require identifying, allocating and splitting returns to risks and assets in granular ways that undoubtedly will be difficult to perform in practice. Although both Sellco and Prima share in the review of customer creditworthiness, the review of large accounts (exceeding €1M) normally would require a relatively higher degree of business judgment and decision-making authority than the review of small, routine credit applications, especially since the facts imply that Prima sets the guidelines for that review. In light of that allocation of responsibilities, we question whether any profits should be attributed to the DAPE by virtue of those routine credit review activities.

It seems clear that Prima in fact exercises by far the most important functions relating to customer credit. Prima has sole responsibility for decisions on extending credit to large accounts and to MNC customers, Sellco is required to consult with Prima before it denies credit or deviates from credit policies (presumably established by Prima), and Prima has sole responsibility for the decision to write-off or pursue extraordinary collection

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remedies. Sellco's responsibilities that it can exercise without Prima's active review appear to be only granting credit terms to small customers if the terms conform to Prima's guidelines. In that case, it seems that Prima should be regarded as exercising the significant people functions relevant to the assumption and management of credit risk for all customers. If an example is desired that results in a profit / loss split between Prima and Sellco, it would be appropriate to find an example that assumes more significant active decision making by Sellco than is the case here.

**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 infer that the point of this question is to contrast this case, where the credit risk was not allocated to Sellco under Article 9, with the case in Example 2. If that is the purpose, we agree that this example demonstrates the difference between the allocation of risk between two separate enterprises and the attribution of risk within one enterprise. As noted in the response to the questions to Example 2, the conclusion that the credit risk should be reallocated to Sellco as part of the accurate delineation of the contract seems like an extreme result. We believe that the analysis in this Example 4 would be the more common result, where Prima would be allocated the ownership of the asset, but then the normal Article 7 analysis would be applied if the facts indicate that Prima had a PE (DAPE or FPOB PE) in Sellco's state.

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

This example provides the clearest information as to what "dealings" were determined between the head office and the PE (in this case, a FPOB PE). It would be useful to make those dealings more explicit to illustrate the complete operation of the AOA. It appears that the dealing consisted of a purchase of the warehouse premises and equipment by the FPOB PE without a dealing with the head office (although it is conceivable that the dealing could have been a long-term lease of the premises to the FPOB PE), with the head office providing advisory services and extending a license for the use of IP for operating the warehouse. The deemed service fees and the deemed royalty would be determined by the application of the appropriate TPM to those dealings. It would be useful if the example described why a "purchase" dealing was adopted.

For example, if all of the significant people functions relating to making sales and performing customer-facing functions are performed by Prima in Country A, then there is no obvious reason that the customer revenue should be attributed to the FPOB PE. Instead, the revenue would remain as revenue of the Prima head office, and the dealing would be a lease of assets or the provision of a service.

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We comment further on what those dealings should be in our answer to the question immediately below.

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

We agree that these conclusions are appropriate applications of the AOA.

The comparison of these examples with Scenario A brings out the need to explain further under what circumstances the profits of the PE should be calculated with reference to third-party revenue. Coalition members do not believe that just because the business model in Scenario A involved third party sales of warehouse services, that the accounts of the PE necessarily should be constructed with third-party revenue as the deemed revenue of the PE. In Scenario A, it appears from the facts that all significant people functions relating to sales, customer support, advertising, software development for the warehouse management programs, know-how development, and other business functions critical to the business were performed by employees in the head office. Under such circumstances, the more appropriate dealing in Scenario A would be substantially the same as in Scenario B, namely the provision of warehouse services to the head office, as opposed to treating the PE as the putative entrepreneur, but then needing to find comparables for a wide variety of value-added services and intangible property licenses as supplied by the head office. We expect that this latter approach will be much more reliable in terms of the choice of method, available comparables, and required adjustments.

**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?***

We agree that this is possible, although any comparable used to benchmark that return may require adjustments to isolate the return due solely to asset ownership.

**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 with the result of the “streamlined approach”, but we believe that it would be more appropriate to express the “streamlined approach” in terms of the “dealing” that is assumed in these examples. The dealing appears to be the provision of warehouse services to the head office in Scenario B, and the lease of warehouse premises in Scenario C. The investment return could be determined according to the return for finance leases, net of payments to the head office for services related to the acquisition and management of the asset.

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**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.**

This appears to be the correct result. Risks and assets can be attributed to a PE only if the personnel of the PE are engaged in active decision making relevant to the economic ownership of assets or the assumption or management of risks. Absent such personnel, it is hard to see how any risks or assets could be attributed to the PE.

**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 should be no difference, as all activity taking place in country W has been compensated at arm's length. In addition, if the Wareco contract was managed by personnel in the head office of WRU, then the expense of the Wareco contract should be recorded as an expense of the head office, and not an expense of the PE.

**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?**

See 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?**

Concerning the determining of profits of a PE, we believe that the most important clarifications are to establish the proper order of application, and to clarify that the proper dealings will not always allocate third party revenue or expenses to the PE, if the critical decision making with respect to those revenue or expense items are not performed by the PE.

Concerning administration, we note that paragraph 246 of the 2010 AOA Report, as referenced in the Discussion Draft states that "a number of countries 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." We understand that such practices are informal. In order to provide transparency and equitable treatment for all taxpayers, we suggest that such practices be formalized. For example, corporate income tax returns should allow for a resident taxpayer to report on that return any income attributable under the AOA to a same-country PE. To achieve transparency, that income could be reported on a separate line of the return. The liability

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to pay the tax, however, would be solely that of the resident taxpayer. Any audit adjustments would be made to that line of the resident's tax return. Such inclusion in the resident's tax return would replace any obligation of the PE to file a separate tax return, eliminating the risk of penalties, disallowed deductions or other negative consequences to the nonresident.

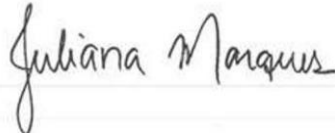
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We trust that you will find these comments useful. We look forward to further participation in this very important project.

Sincerely,



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Ref  
Submission File

6 September 2016

**Organization for Economic Co-operation and Development (OECD)**  
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BY E-MAIL: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

Dear Sir/Madam

**SUBMISSION: DRAFT DISCUSSIONS ON BEPS ACTION 7 AND BEPS ACTIONS 8 to 10**

1. We herewith present the South African Institute of Chartered Accountants (SAICA) written submissions on the Draft Discussions on BEPS ACTION 7 relating to Additional Guidance on the Attribution of Profits to Permanent Establishments and BEPS ACTIONS 8 to 10 relating to the Revised Guidance on Profit Splits on behalf of the SAICA Transfer Pricing Subcommittee (a subcommittee of the SAICA National Tax Committee).
2. Our submissions include comments on the questions specifically raised in the discussion papers, as well as further input to simplify and clarify examples. We have deliberately tried to keep the discussion of our submissions as concise as possible, which does mean that you might require further clarification. In this respect, you are more than welcome to contact us in this regard.

**BEPS ACTION 7**

Question 1:

3. We are of the view that the result will be the same irrespective of the order that article 7 and article 9 of the Model Tax Convention (MTC) are applied.
4. The guidance should suffice, provided that the entity operating in its own capacity and creating the Dependent Agent Permanent Establishment (DAPE) for the offshore entity is rewarded with an arm's length return for the undertaking of its activities.



Questions 2 and 3:

5. In principle yes. However, the functional analysis is simplistic. It may occur that the selling DAPE also takes some risk associated with logistics, depending on the nature of the product sold.

Question 4:

6. The key difference is that under the old interpretation of Article 7, cognisance of the overall profit situations is considered.
7. For example, a commission rate which provides for a reasonable allocation of a portion of the profit to SellCo may differ from an amount determined in pricing a notional transaction.

Question 5:

8. Not necessarily. The people function is not the only factor that needs to be considered when performing the functional and factual analyses.
9. Consideration should also be provided to the level of risk, and furthermore how and where such risk is managed.

Question 6:

10. It is submitted that if SellCo bears credit and stock risk, it may be more likely be classified as a buy/sell entity. In such instance a commission based approach may not always be the most appropriate.

Question 7:

11. Please refer to paragraph 6 and 7 above for an answer to the question raised.

Question 8:

12. The consequences in the example and the question to which party inventory and credit risk should be allocated depend on how the term “financial capacity” is determined.

Question 9:

13. We concur with the conclusion reached in example 2.

Question 10:

14. The construction of the profits or losses of the DAPE in Example 3 is dependent on whether the employee remains employed by Prima or is seconded to SellCo.
15. Furthermore, an analysis of the customer relationships should be undertaken to determine whether the employee has marketing intangibles as a result of these relationships.

Question 12 and 13:

16. We agree with the construction of the profits/losses of the DAPE in Example 4, as well as the conclusion reached regarding the difference that arises due to the allocation of risk between different enterprises and attribution of risk within the same enterprise.

Question 14 to 20:

17. While we agree with the conclusions, the various scenarios of the Example are simplistic. For example, the outcome can be impacted if the goods are stored in bond and the answer to the question regarding which entity is responsible for raising this may change the outcome.
18. The nature of the example suggests that some people need to be in the warehouse location, but these need not necessarily result in a significant people function (SPF).
19. For example, these people in the warehouse may be operating under the guidance of the offshore entity.
20. It should be considered if a cost plus method is not appropriate for this Example.

**BEPS ACTIONS 8 TO 10**

Question 1 to 3:

21. The distinction between transactional profits splits of anticipated profits and actual profits seems to be clear.
22. Practical examples and guidance on how entities would share risks would also be useful.
23. It is furthermore our understanding that often one entity typically takes certain risks associated with a transaction, while the other entity takes different risks. Where the parties to a transaction arguably share risks (for example the market risk) one may be able to separate these based on how the risks are managed. For example reputational risk and brand related risk versus customer relationship risk.

Question 4 and 5:

- 24. Yes, strengths and weaknesses appear to be captured clearly. One of the key strengths of the transactional profit-split-method (PSM) is that it aligns more to business practicalities than some of the other methods.
- 25. Accordingly, if a business operates in a way which makes the PSM a natural fit, then this would support the application of this method.
- 26. For instance in a retailing environment where there is a gradual shift from heavy support to a more autonomous operation over a period. A retailer may therefore have a number of markets in different stages of maturity.
- 27. As retailers operate internally in a similar manner to franchise arrangements, providing a combination of know-how, the brand, support services, centralised purchasing etc., a PSM often makes sense.

Question 6:

- 28. It is submitted that the sharing of economically significant risks does exist. It may be useful to clarify how the relevant risk is managed and by which entity it is managed.

Question 7:

- 29. No examples showing the application of a transactional profit split of anticipated profits have been observed.

Question 8 and 9:

- 30. The distinction between parallel and sequential integration of business operations is a useful refinement, but it should be noted that there may be instances where lines are close and difficult to differentiate. More detailed guidance would be appreciated.

Questions 10 and 11:

- 31. No responses.

Question 12:

- 32. The question to be put forward in this regard is how the group synergies came about. It may be argued that if one entity incurred costs in development, it should be rewarded over and above the marginal sharing.

Question 13:

- 33. The undertaking of a value chain analysis is effectively a more detailed functional analysis. However, a value chain analysis involves an in-depth assessment of value

drivers in an industry or organisation along the chain of primary and support activities of a multinational group that lead to the delivery of a product or service to end customers. Thus, the value chain analysis relies on more than just a functional analysis, it uses a value focused, end-to-end, functional analysis.

34. The more detailed analysis may however give rise to instances where the level of contribution is misunderstood as being more valuable than it really is, leading to a greater risk of default to a PSM. Thus, clear guidance is required.

Questions 14 and 15:

35. No responses.

Questions 16 to 18:

36. It is submitted that in reality profit splitting is mostly subjective, and a quantifiable basis for profit splitting can result in distorted outcomes.
37. Guidance regarding the application of the profit split method should therefore only point into a direction, but it should not be exhaustive, as there will need to be a degree of subjectivity.
38. The key area where additional guidance would be helpful is around the different measures for allocating and splitting profits between functions, risks and assets.

We would like to thank the OECD for the opportunity to participate in the development of the Base Erosion and Profit Shifting regime.

Yours sincerely

**Pieter Faber**  
**SENIOR EXECUTIVE: TAX LEGISLATION AND**  
**PRACTITIONERS**  
*The South African Institute of Chartered Accountants*



September 5, 2016

Sent via email to: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

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## **Re: Comments on “BEPS ACTION 7: ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS”**

Studio Biscozzi Nobili (SBN) is pleased to provide comments on the public discussion draft “*BEPS ACTION 7: ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS*”.

SBN commends the work that the OECD has undertaken to date in relation to the BEPS Project and offers its assistance in support of its further efforts.

### Preliminary remarks

The Public Discussion Draft (the “*Draft*”) addresses the issues deriving from the application of the Dependant Agent PEs under article 5(5) applies and Warehouses as fixed place of business to which exemptions under article 5(4) do not apply.

The first scenario is particularly of interest for commissionaire arrangements (and similar contracts) given the changes to the wording of article 5(5) by the post BEPS version, which now no more refers to the “*authority to conclude the contracts in the name of the enterprise*”, but rather it is now focused on the facts that the DAPE “*concludes contracts or plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise*”.

Given the foregoing, we think that the examples exposed, although adopted for the mere clarification of the principles discussed, are of great utility to the discussion about the AOA and the deductibility of internal dealings by the permanent establishments with the related head offices.

More in general, and in line with the 2010 Attribution of Profits Report), both the Authorities and the taxpayers are required to:

- provide a functional and factual analysis of the (not only people) functions (and thus risks and assets consequent) ascribed to the (DA)PE;
- analysis of how much profit is attributable to the (DA)PE.

\*

#### Answers and Comments

For your easy reference, please find hereunder answers and comments numbered in accordance to the Draft.

- DAPE Subject
1. In our opinion, the order of application between art. 7 and art. 9 should follow the hierarchy stated in the Model. The existence of a DAPE and the assessment of an AOA approach by the domestic legislation and practice entail the determination of a proper remuneration of each risk and function borne by the DAPE and not by the head office. Art. 9 will be then useful to clarify that any measurement of such remuneration (and the degree of which becomes “proper”) shall be dealt at arm’s length.
  2. Yes, we do agree with the analysis.
  3. Yes, we do agree with P&L of DAPE under Example no. 1.
  4. The conclusion should in principle be the same, since the “relevant business activity” approach (RBA) is in any case based on functions served by the (DA)PE. However, differences can arise since AOA allows the (DA)PE to gain a taxable income in Country B even if the Enterprise has incurred in a loss in its business lines (see for reference “*Report for attribution of Profits to Permanent Establishments*”, Part I, II, III – para. 70, page 25).

5. Our answer is negative. The people functions are required to establish how the (DA)PE is construed. On the other hand, the commission fee paid to SellCo may vary significantly, and people hired by DAPE could be served to functions other than the ones utilized by SellCo. In other words, it does not appear that there is an absolute connection between the people functions and the commission fee function.
6. Yes, we do agree with the P&L of DAPE under Example no. 2.
7. See under no. 4 above.
8. In our opinion, DAPE should bear such risks (inventory and credit risks) under art. 7 analysis: however, such risk would need to be adequately remunerated by Prima by paying part of the commission (paid in the example to SellCo) to DAPE. Additional “free” capital to the DAPE could also be required.
9. We think that the views of the fact under Example 2 are in line with the 2010 Guidance (see paragraph 235, where it states that “*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 DAPE but to the non resident enterprise which is the principal*”). The separation of the risks between “legal” and “functional” ownership of a risk (and the hierarchy between art. 7 and art.9 stated under our answer no. 1 above) is thus a mere consequence of the application of AOA approach, whereby the DAPE profit does not depend necessarily by the head office global profit.
10. Yes, we do agree with the P&L of DAPE under Example no. 3.
11. See under no. 4 above.
12. Yes, we do agree with the P&L of DAPE under Example no. 4.
13. Again, the risk attributed to DAPE is a tax qualification under AOA approach (which would not apply under RBA approach), and this is a consequence not of a “juridical allocation” – whereby SellCo does not take over this risk – but rather of an “economic attribution” functional to the need to share the taxing right between source and residence country.

- PE definition and “preparatory and auxiliary” nature of art. 5(4) exceptions
- 14. Yes, we do agree with the P&L of WR PE under Example no. 5.
- 15. Yes, we do agree with both Scenarios B and C of Example no. 5.
- 16. Yes, because the PE should allocate the asset in its (tax-wise) statement, and should also deduct the depreciation provided for under applicable tax law. The presence of personnel is not in our view connected with the investment return on an asset.
- 17. Yes, we think this approach is proper and correct. The investment return should be based on an arm’s length principle, thus comparing similar investment returns as existing on the applicable markets.
- 18. In our opinion, the answer depends on whether the “significant people functions” (performed by other parties) are working for the benefit of the PE or not. In positive case, it would be reasonable that these people functions are remunerated by the PE, and the PE should take the responsibility to be remunerated as well (by the WRU’s Head Office) for this activity.
- 19. In our opinion there would be no difference.
- 20. See our answer under no. 4 above. We note, however, that an RBA approach would lead – especially under Scenario B – to an higher taxable income of PE in the source country.
- 21. We think that the major concern deriving from the AOA approach derives from (i) the recognition of internal dealings by both the countries involved (Head office country and PE country); (ii) adoption of credit method for PE incomes by Head Office countries; and (iii) consequent to (ii), income qualification by the two different tax jurisdictions and foreign tax credit recognition in the residence country of the Head office.

\*

Truly yours,

Marco Abramo Lanza



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2 September 2016

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## RE: Additional Guidance on the Attribution of Profits to Permanent Establishments

Dear Sir or Madam:

The Organisation for Economic Co-Operation and Development (OECD) published final reports pursuant to its base erosion and profit shifting (BEPS) project on 5 October 2015. The reports were the culmination of the OECD's *Action Plan on Base Erosion and Profit Shifting* (hereinafter the Plan) published in 2013. The Plan set forth 15 actions the OECD would undertake to address a series of issues that contribute to the perception of tax bases being eroded or profits shifted improperly. Included in the October 2015 final reports was the report under Action 7 of the Plan, *Preventing the Artificial Avoidance of Permanent Establishment Status*. Subsequently, the OECD issued a public discussion draft under Action 7 (the Discussion Draft) on 4 July 2016, requesting comments on fact patterns that would benefit from additional guidance concerning the attribution of profits to permanent establishments (PE).

I am pleased to respond to the OECD's request for comments on behalf of Tax Executives Institute, Inc. (TEI). TEI requests the opportunity to speak in support of these comments at the public consultation to be held on 11-12 October 2016 in Paris.

### TEI Background

TEI was founded in 1944 to serve the needs of business tax professionals. Today, the organization has 56 chapters in Europe, North and South America, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting tax

policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 7,000 individual members represent over 2,800 of the leading companies in the world.<sup>1</sup>

### **General Comments**

TEI commends the OECD for providing stakeholders with the opportunity to comment on the issue of profit attribution to PEs. This opportunity is especially important because the BEPS project broadened the PE definition in Article 5 of the OECD's Model Tax Convention, which will result in cliff-like, negative tax effects of unexpected PEs of a multinational enterprise (MNE) in various jurisdictions.

TEI further appreciates the desire of the OECD Member States to use the OECD's transfer pricing principles to attribute profits to PEs, which could lead to clarity and a workable approach to such attribution if a consensus among the States can be reached. Regrettably, the additional guidance provided in the Discussion Draft regarding PE profit attribution is handicapped by the lack of consensus on underlying issues, particularly the definition and ownership of, and how to tax income from, intellectual property (IP). Thus, while use of transfer pricing methods and significant people functions to allocate revenue and assets to a PE could be viable, current and future attempts to provide additional clear guidance on predictable profit attribution standards will be muddled until fundamental definitional issues are settled. It is difficult to allocate assets based upon significant people functions if the assets cannot be identified. The incoherent tax climate and lack of consensus surrounding this issue will undoubtedly result in double taxation as tax administrators assess taxes on IP income under their own definition of IP and theories of IP taxation. For these reasons, TEI encourages the OECD to return to its efforts to define IP and devise methods of taxing the income it generates, which in turn should provide additional clarity to PE profit attribution.

Separately, while TEI appreciates the OECD's efforts reflected in the Discussion Draft, the Draft is unhelpful in many respects. While the OECD recognizes that there may be circumstances where there is no additional taxable profit attributable to a PE under the new, post-BEPS project Article 5 PE definition, the Draft only briefly mentions that there may be other consequences<sup>2</sup> and does not elaborate on their cost or administrative complexity. The varying fact patterns of complex modern business operations, combined with the newly expanded PE definition, may result in an MNE having, *e.g.*, (i) multiple PEs, in addition to its local legal entities, in a particular jurisdiction, and (ii) a combined PE in a particular jurisdiction resulting from the operations of several of its separate, non-resident legal entities. This would

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<sup>1</sup> TEI is a corporation organized in the United States under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the U.S. Internal Revenue Code of 1986 (as amended).

<sup>2</sup> Paragraph 104. (A PE with zero profit "may create filing requirements and may give rise to other tax liabilities.")

create additional filing requirements, social security, payroll tax obligations, multiple VAT registrations, *etc.* In short, the expanded definition may impose a tremendously increased compliance burden on MNEs as additional PEs arise, even if such PE do not result in any additional local country profit. This is contrary to the OECD's stated intention not to create unreasonable additional compliance obligations for international business.

A more helpful approach, if the goal is to set the "correct" level of profit in each country, would be to adjust transfer prices between related entities. This would be simpler than creating additional PEs and engaging in a profit attribution exercise with its attendant complexity and compliance burden. For example, the collection of receivables and inventory management could be remunerated as services on a cost-plus basis rather than creating a PE. Alternatively, the OECD should provide further guidelines regarding what "other tax liabilities" may arise as a result of the PE determination as the short reference to such liabilities in paragraph 104 is insufficient. A compromise approach could be that, where a new PE arises under the BEPS Action 7 definition and where the parties are already appropriately remunerated at arm's length, adjustments are instead made under Article 9; that way the theoretical PE would be ignored for all other tax purposes. We discuss this further below in response to question 18.

The Discussion Draft also regrettably reduces the complex reality of business operations to basic examples. In general, the examples are oversimplified and the accompanying analyses often over complicated. The OECD should ensure that the final guidance includes more detailed examples, as we understand that the examples in the Discussion Draft are presented to address specific concepts and are not intended as overall guidance to tax administrators or taxpayers on how to attribute profits to these PEs.

Moreover, the Discussion Draft does not address the practical issues facing MNEs with potential multiple PEs in a jurisdiction (*e.g.*, additional registration and filing requirements not just for income tax but also for social security, payroll taxes, indirect taxes, and customs purposes). While we understand that indirect taxes and customs in theory follow a separate set of rules, the interaction between those rules must not be underestimated. On the other hand, for certain taxes (*e.g.*, payroll), there is a direct link created by Article 15 of the OECD Model Tax Convention.

That said, the simple examples are helpful at a basic level because many taxpayers and tax authorities do not have extensive experience with PEs outside the context of financial institutions. The simple examples make it easier to gain a baseline understanding of the concepts, logic, and steps to follow in the PE analysis. To supplement the more simplistic analysis, TEI recommends that the OECD include a more realistic and complex example illustrating a more complex supply chain.<sup>3</sup> In addition, the analyses in the examples should more clearly state how the conclusions were reached, perhaps in a step-by-step manner, to

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<sup>3</sup> We suggest a more complicated fact pattern for use as an example, along with some questions for the OECD to potentially address regarding the fact pattern, at the end of this letter.



assist taxpayers and tax authorities in their understanding of the guidance and how to apply it outside the particular examples in the Discussion Draft.

Further, the silence of the Discussion Draft on the revolution created by the new amalgamation rules is particularly regrettable. TEI recommends that examples in final guidance should include an example of an MNE operating in Country Y through 4-5 foreign enterprises resident in countries A, B, C, D and E, each of which would not create a PE in Country Y on its own, but would create a PE in Country Y if their activities are amalgamated. The example should not only develop what profit is to be allocated to Country Y, but also how the profit to be allocated to Country Y is to be subtracted/apportioned as a profit reduction between Countries A, B, C, D and E.

Finally, TEI recommends that the OECD provide additional guidance to clarify some of the underlying assumptions applied by the OECD in the examples. These assumptions concern: (i) facts that give rise to the creation of a permanent establishment (specifically in Example 1) providing that no additional functions, assets, and risks were attributed to DAPE; (ii) remuneration of the Related Parties / Head Office / PE (*e.g.*, an incentive fee); and (iii) the proportion of attribution of risk to the head office and PE (*e.g.*, 75%, 25%). Without further background on or guidance regarding the basis for assumptions, the risk of misinterpretation by tax authorities is significant. Our concern is the assumptions may be treated as a rule or official position of the OECD, rather than merely used for illustrating other issues in the example. Therefore, TEI recommends the OECD provide additional background on how these assumptions were made. It would also be useful to emphasize that the assumptions in the examples are solely for illustrative purposes to avoid tax authorities applying them as a rule.

### **Responses to Specific Questions in the Discussion Draft**

Set forth in this section are TEI's responses to the specific questions posed by the OECD in the Discussion Draft. The lack of a response to a question should not be taken as TEI's agreement with the analysis in the Discussion Draft.

*Q1. Commentators are invited to express their views on whether 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, and what guidance should be provided on the order of application.*

In TEI's view Article 9 should apply first as a priority over Article 7 to determine the profit attributable to each associated enterprise. Should the application of Article 9 not be feasible because a PE is created without the involvement of any local related party, then Article 7 can be applied to determine the amount of profits attributable to a PE created under Article 5.

In addition, the Discussion Draft heavily leans toward application of both Article 9 and Article 7 in most cases where associated enterprises are involved. This substantially complicates the profit attribution analysis and could result in multiple PEs and additional filing requirements, including social security, payroll taxes, value added taxes, custom duties, *etc.* As

noted, this substantially increases compliance and administration costs for taxpayers and tax authorities without necessarily increasing income tax revenue. In addition, where an enterprise already appropriately attributes profits to a PE based on functions performed, assets used, and risks assumed under either Article 9 or Article 7, there is no need to apply the other Article.

That said, while TEI is open to the proposed approach in the Discussion Draft of attributing profits by using transfer pricing principles, which could be viable if a consensus is reached, the approach would still suffer from the lack of a definition of IP, of its ownership, and on how to tax the income arising from it, as discussed above. As just one example, given the generalization of the application of the significant people functions concept combined with the expanded PE definition, one issue raising debates among practitioners is whether IP (*e.g.*, know how) moves from a head office to its PE whenever a head office employee performs functions for the PE and whether there should therefore be remuneration for such an IP transfer. TEI believes that the OECD did not intend to present this issue under its Transfer Pricing Guidelines (the Guidelines), but a reading of the Guidelines certainly implies this result. The OECD should clarify whether it intends this result in final guidance.

*Q2. Do you agree with the functional and factual analysis performed in Example 1 under the [Authorized OECD Approach (AOA)]?*

No. Applying Article 9 attributes the appropriate profit to Country B. Also applying Article 7 only complicates the analysis and makes it more difficult to follow without attributing any additional profit to Country B. Such an approach would substantially increase compliance costs where an MNE operates in multiple jurisdictions. Moreover, as noted above, the analysis suffers because of the lack of a consensus OECD approach to the definition and taxation of IP.

*Q3. Do you agree with the construction of the profits or losses of the [dependent agent PE (DAPE)] in Example 1 under the AOA?*

No. Based upon the functions performed, assets used and risks assumed, it was clear that no profit should be attributed to DAPE in Country B. Therefore, to undertake the analysis to back into the numbers was unnecessary and an uneconomical use of time and resources. Moreover, because the definition of income remains under the auspices of the local jurisdiction, it has an incentive to attribute as much profit to the new PE as possible. Without a consensus approach on both the determination of income and profit attribution there is no guarantee that the MNE's headquarters jurisdiction will agree to the local country's determination, resulting in double taxation and disputes.

*Q4. 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?*

No response.



*Q5. 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 [dependent agent enterprise (DAE)] under Article 9?*

No response.

*Q6. Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?*

The facts of Example 2 should make it clearer that Sellco/DAPE are also responsible for bearing the actual inventory obsolescence/loss risks and bad debt losses. If Sellco/DAPE do not bear the actual inventory obsolescence/loss risks and bad debt losses, then Sellco/DAPE should only receive compensation for their functions and not compensation for taking on the inventory and receivable risks. This could be accomplished by emphasizing the additional profit is to compensate for Sellco/DAPE taking on additional functions as well as inventory and credit risks (e.g., it has to bear any bad debt and inventory losses).

*Q7. 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?*

No response.

*Q8. 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 the inventory and credit risks, it would only perform functions such as warehousing and determining and monitoring inventory, credits, and collection, which it should be compensated for on an arm's length basis. Thus, since Sellco is an associated enterprise in this example, this example should not be part of the commentary for attribution of profits to a PE as part of article 7, but instead be developed as a transfer pricing adjustment between related entities as part of article 9.

Should this example be developed with Sellco being a 3rd party acting as a dependent agent instead of an associated party, then this would be properly developed as part of Article 7. However, Sellco's profits have already been determined at arm's length. Thus, under this scenario, should Sellco's activities create a dependent agent PE for Prima, it is Prima's in-country activities that would be taxed as part of such PE, not Sellco's. Hence, it would be Prima's financial capacity to bear risks at issue, not Sellco's.



Separately, the example raises the issue of whether a PE can be avoided if insufficient capital is allocated to a local entity – is that what the OECD intends to imply via Example 2 and this question?

*Q9. 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?*

Whether or not economic ownership has shifted should be based on both the benefits and risks of ownership of an asset shifting to another enterprise (the DAPE), even though legal ownership still remain with the original enterprise (Prima). In Example 2, DAPE only took on bad debts/inventory losses (*i.e.*, it only took on risks of ownership of an asset); however, it did not acquire the benefits of inventory ownership (*i.e.*, none of the profits associated with the inventory are attributed to DAPE). Therefore, economic ownership of the assets should not be attributed to DAPE.

An example of economic ownership shifting would be where an enterprise (*e.g.*, Company B) enters into a research and development (R&D) cost contribution arrangement with its parent (*e.g.*, Company A). In return for sharing in the R&D costs and risks, Company B receives the exclusive right to exploit any intangibles developed in its country (*e.g.*, exclusive rights to sell, manufacture, and license any intangibles). For ease of administrating worldwide patents, *etc.*, the parent company retains legal ownership of all intangibles globally. In the above example, Company B has economic ownership of the intangibles in its country although Company A has legal ownership of the intangibles globally.

More broadly, attribution of “economic ownership” to a PE, as opposed to a separate legal entity, can be subjective, giving significant leeway to tax authorities and leading to disputes. TEI recommends that the OECD develop additional guidelines on the proper manner and method for such attribution.

With respect to paragraphs 230-245 of the 2010 Attribution of Profits Report, TEI agrees that those paragraphs support the example’s conclusions.

*Q10. Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?*

The analysis of this example is overcomplicated and faulty by assessing the economic ownership of the inventory and receivables. Once it has been determined that there is a DAPE, the analysis should simply look at functions performed (various inventory, warehousing and



credit and collection activities), assets used (vehicle) and risks assumed (inventory and bad debt losses) to determine level of compensation for the DAPE.

In addition, economic ownership of the company vehicle was attributed to DAPE (in Country B), based upon the vehicle's place of use. However, when assessing the profit and loss of DAPE, it is difficult to understand which operating expenditures relate to the costs of using the car (if any). Therefore, clarification on costs of the vehicle, if they are included in DAPE's profit and loss, would be appreciated.

*Q11. 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?*

No response.

*Q12. Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?*

Yes, although the example is simplistic.

*Q13. 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?*

TEI agrees with these statements. In general, there is a different analysis under Article 7 than under Article 9. Because of this mismatch, TEI anticipates that the two analyses will cause controversy between taxpayers and tax authorities, as well as among tax authorities. TEI recommends that the OECD assess how analyses under Article 7 and 9 can be aligned to avoid conflicting positions. This will provide for more clarity and less controversy. Further, additional clarification regarding how the OECD arrived at the underlying assumptions for remuneration, *i.e.*, 40% under Article 9 and 75%/25% under Article 7, would be helpful as there may be the risk of misuse of those percentages due to lack of further guidance by OECD on how those percentages were determined.

*Q14. Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?*

It is unclear from the example how interest costs are allocated to the PE – is it from a separate legal entity analysis? In addition, if interest costs are allocable to the PE, are there other intercompany items that can be allocated to the PE (other than those stated in the example)? With respect to the conclusion that WRU has a PE and corresponding income/expenses, a key issue is whether tax authorities in WRU's jurisdiction agree with the conclusion and allocation, as WRU, if it did not believe it had a PE, would need to amend its

home country tax return, which could lead to disputes and additional time and expense to resolve them.

*Q15. Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?*

There are a number of assumptions included in the example that make it difficult to analyze. TEI does not, therefore, necessarily agree with the analysis; in particular, it is unclear how a PE arises in these scenarios.

*Q16. 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?*

As noted above, it is difficult to analyze this example as it is unclear how a PE arises without personnel “on the ground” in-country performing significant people functions that may give rise to a PE. More broadly, however, the return to a PE should be attributable to more than significant people functions and can include return on assets used or risks assumed.

*Q17. 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?*

Again, it is unclear how a PE may arise in the example with no functions performed.

*Q18. 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.*

Once again, it is difficult to understand how the PE arises without any activities being performed. Assuming there is a PE, then profits arising from assets used and risks assumed should be attributable to a PE deemed to own such assets and assume such risks.

TEI notes that the creation of a PE with no attributable profits requires a cumbersome analysis and carries with it a potentially disproportionate compliance burden in other respects, such as registration and filing requirements, responsibility for value added taxes, payroll taxes and customs duties, among other things. A no-profit PE also creates compliance costs for tax administrators without resulting in any additional income tax due. To avoid this situation and eliminate the associated compliance burden, TEI recommends that the OECD adopt a *de minimis* rule for PEs with no or very little profit attributable to them (say attributable profits of €50,000 or less), where the creation of the PE would be ignored for all tax and related (e.g., customs) purposes, including registration and filing requirements.



*Q19. 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?*

Whether the payment goes to a third party or an associated enterprise should not affect profit allocation. In general, it would be simpler for tax authorities to challenge the compensation paid for local activities rather than creating a PE and conducting a profit attribution analysis. Creating a PE will also have unintended consequences, including the aforementioned filing requirements, value added taxes, social security, payroll taxes, etc. It should be clear to tax authorities that whenever an adjustment can be made through Article 9 rather than Articles 5 and 7 that Article 9 should be the preferred path.

*Q20. 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?*

No response.

*Q21. 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, it should be clear to tax authorities that, whenever an adjustment can be made through Article 9 rather than Articles 5 and 7, the adjustment via Article 9 should be prioritized over such adjustment via Articles 5 and 7. This would avoid unintended consequences of an adjustment via Articles 5 and 7, e.g., for social security and/or payroll taxes.

Another issue is compensating Sellco on the value of services provided within the MNE supply or value chain. Here the transactional net margin method may prove useful. More broadly, TEI generally welcomes additional guidance on PE profit attribution especially if it helps tax authorities properly apply the relevant concepts.

TEI also suggests that the OECD consider the following example, and answer the questions posed, as additional guidance on applying the PE profit attribution rules to a more complicated and realistic supply chain.

#### **ADDITIONAL SUGGESTED EXAMPLE AND QUESTIONS FOR THE OECD**

The facts in this example are the same as in Example 3 except as follows. Prima's head office is located in Country A. In addition, Prima has a marketing and sales team which operates in Country C through an office of Prima (i.e., through a PE in Country C). Prima is also the regional headquarters of Parentco, which is located in Country U. In addition, Prima deploys sales Employees to Countries B, D, E, F, G, H, I, J, K. These Prima Employees are responsible for various sales territories and perform full-time selling activities in those countries.

The allocation of Prima's income between Country A and Country C is determined using a residual profit split, and the PE profit allocation has been governed by an APA in Countries A and C for over 15 years (with periodic renewals as required). The residual profit split first remunerates Prima for assembly functions performed in Country A based on cost plus, and the residual profit is split using a ratio of 35% and 65% for Countries A and C respectively. Products are sourced from third-party manufacturers as either finished products, or semi-assembled products for final assembly by Prima in Country A. Products are consumer goods and are developed by Parentco, including R&D incurred by Parentco. Products do not need to be adapted to the specific needs of customers. The tradename is owned by Prima's Parentco and R&D/product design is performed by Parentco in Country U. Prima pays a bundled IP royalty to Parentco for the use of the tradename and R&D/product design.

1. Prima (through its PE in Country C), is responsible of signing contracts with customers.
2. Prima (through its PE in Country C), organizes an annual sales meeting where new upcoming model year product lines are showcased. Although no formal orders are placed, the customers make informal commitments for future orders.
3. Prima (through its PE in Country C), sets the sales strategy and market share targets in Countries B, C, D, E, F, G, H, I, J, K
4. Prima (through its PE in Country C), is responsible for setting the pricing policy for products, as well as for tailoring that policy to Countries B, C, D, E, F, G, H, I, J, K
5. Employees of Prima (*i.e.*, local sales agents) play a role in implementing part of the marketing strategy in their respective Countries B, D, E, F, G, H, I, J, K. However, Prima (through its PE in Country C) places all local advertising. Thus, these employees have no authority to conclude contracts and their business cards only have the business address of Prima in Country A. These employees may also perform certain administrative tasks from their home offices located in their respective Countries.
6. One of the key functions of the sales employees of Countries B, D, E, F, G, H, I, J, K is to visit and follow-up with each customer every 3 or 4 months. The sales Employees encourage the customers to place orders (based on the customer's informal commitments made during the annual sales meeting). The Employees also provide further technical explanations of product specifications, discuss differences with competitor products, and discuss product returns if applicable. Significant product returns or warranty are managed by Prima (through its head office employees in Country A or through its PE employees in Country C). Significant product returns or warranties are managed by Prima in Country A. Policies and guidelines for product returns and warranties are approved by Prima in Country A. PE employees in Country C may provide input and may implement policies and guidelines issued by Prima in Country A.

7. Prima's head office employees in Country A approve new customers through the review of the customer's creditworthiness. Customers place orders electronically using Prima's ERP system. Prima's system is tailored and managed by Parentco in Country U.
8. Prima (head office in Country A) performs all warehousing and inventory management functions. The Employees in Countries B, C, D, E, F, G, H, I, J, K are not involved in the inventory management functions, other than providing sales forecast which are used in demand planning. Prima's Head Office employees in Country A perform the demand planning functions.
9. Prima's head office employees in Country A set the parameters within which credit can be extended to customers.
10. There is no explicit approval of each sale to customers once the customer has been approved by Prima's head office employees in Country A, as long as the customer respects the credit arrangement. Prima's employees in Country A can refuse a customer's order if the customer is in arrears under the credit terms.
11. Prima's head office employees in Country A handle the collection of customer receivables.
12. The Employees covering Countries B, D, E, F, G, H, I, J, K do not have authority to conclude sales. Prima has historically taken the position that the activities performed by the employees in Countries B, D, E, F, G, H, I, J, K did not constitute a PE under the "old" OECD rules.

Questions for the OECD:

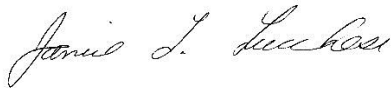
1. Could the OECD illustrate the example above if Countries B, D, and E interpret that the functions are sufficient to constitute a PE under the "new" rules. Assume that Countries F, G, H, I, J, and K interpret that the functions of Employees are not sufficient to constitute a PE under the "new" OECD PE rules. Could the OECD comment on the mechanism to obtain competent authority relief, especially considering the 1st level PE in Country C (profit split already covered by APAs)? That is, illustrate the calculations in a multi-level PE allocation?
2. Could the OECD comment and illustrate this example, assuming the IP royalty is challenged by the tax authorities of either Country U or Country B? Could the OECD comment and illustrate the ripple effect if Countries, B, D, and E interpret that a PE exists under "new" OECD rules. That is, illustrate the multi-level PE allocations. Could the OECD comment on the mechanism to obtain competent authority relief to avoid double-taxation?

**Conclusion**

TEI appreciates the opportunity to comment on the Discussion Draft regarding additional guidance on profit attribution to PEs. As noted above, TEI requests the opportunity to speak in support of these comments at the Public Consultation on the Discussion Draft scheduled for 11-12 October 2016 in Paris.

These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Nick Hasenoehrl. If you have any questions about the submission, please contact Mr. Hasenoehrl at +41 786 88 3772, [nickhasen@sbcglobal.net](mailto:nickhasen@sbcglobal.net), or Benjamin R. Shreck of the Institute's legal staff, at +1 202 464 8353, [bshreck@tei.org](mailto:bshreck@tei.org).

Sincerely yours,  
**TAX EXECUTIVES INSTITUTE, INC.**



Janice L. Lucchesi  
*International President*



UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

September 2, 2016

**VIA EMAIL**

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**Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 7 – Additional Guidance on the Attribution of Profits to Permanent Establishments (“discussion draft”)**

Dear Mr. VanderWolk,

USCIB is pleased to provide comments on the OECD’s discussion draft on BEPS Action 7 – Additional Guidance on the Attribution of Profits to Permanent Establishments (“discussion draft”).

**Executive Summary**

USCIB believes that the examples in the discussion draft reach correct conclusions in most cases. The discussion draft should, however, be modified to:

- More closely follow the AOA – the discussion draft does not identify the dealings between the permanent establishment and the non-resident enterprise, a necessary step in applying the AOA;
- Provide guidance on how the 2008 version of the AOA would apply to the examples;
- Limit the ability to adopt the PE changes as part of the multilateral instrument to those countries that accept the AOA for purposes of attributing profit;
- Clarify how economic ownership of inventory is determined -- the discussion seems to apply a significant people function test, rather than the general rule based on the place of use of the tangible property;
- Recommend the adoption of simplifying administrative practices.

## General Comments

The mandate under Action 7 is to provide additional guidance on how the rules of the Authorized OECD Approach (AOA) apply to the new forms of permanent establishment (PE) created by the BEPS changes to Article 5 without making substantive modifications to those rules.

Given this mandate, USCIB believes it is important to frame the new guidance consistently with the existing guidance provided by both the 2008 and 2010 Reports on the AOA.

The first step in applying both the 2008 and 2010 versions of the AOA is hypothesizing the PE and identifying the “dealings” between the PE and the rest of the enterprise. This requires a disciplined analysis of the functions, assets and risks that are treated as part of the PE. It is important to determine where the relevant significant people functions really take place. Once that functional analysis has been done, then the dealings between the head office and the PE need to be constructed.

The dealings are critical to the application of the AOA because the dealings form the basis for step two, determining which transfer pricing method is the most appropriate method. The most appropriate method will depend on the type of dealing that is constructed. That is, for example, whether the dealing is a sale to a distributor or the provision of a service by a contract service provider, will influence the determination of the most appropriate method.

The examples in the discussion draft seem to skip over these steps. 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 first three dependent agent permanent establishment (DAPE) examples 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 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 to the DAPE, followed by a sale by the DAPE to third parties. In some cases, the most appropriate characterization of the dealing between the head office and the DAPE may be a sale to a limited risk distributor. In other cases, the most appropriate characterization of the dealing between the head office and the DAPE would be the provision of a service and the payment of a commission to a service provider. This underscores the need to characterize the activities of the hypothesized separate entity in step one to facilitate the search for comparables in step two.

The fourth DAPE example addresses only the mechanism to split profits and losses between the DAPE and the head office, and is ambiguous whether or not the full attribution of profits analysis for the DAPE starts with external customer revenue. This ambiguity is created due to the absence of a statement of the "dealing" between the head office and the DAPE in this example.

Once the dealing is identified, the second step of the AOA is the identification of the most appropriate transfer pricing method and application of that transfer pricing method by analogy to the dealings between the DAPE and the non-resident enterprise. Again, the discussion draft glosses over the choice of transfer pricing method. The most appropriate method would involve the use of a method typically used for pricing that type of sale or service that was characterized based on the dealings in the first step. In many cases this would be an application of the transactional net margin method. In cases where customer revenue is appropriately attributed to the DAPE, the relevant comparability analysis normally would be comparable to limited risk distributors.<sup>1</sup> USCIB believes that even if relevant facts need to be assumed, it is important to articulate the choice of method because that step is a fundamental part of the analysis.

The examples' omission of the complete AOA analyses creates ambiguities. In particular, Examples 2 and 4 appear to double-remunerate risk-control functions performed by the DAE. This apparent double-remuneration may reflect conceptual errors in the examples (i.e., the Country B operations are rewarded twice for the same functions, assets and risks), or it may be attributable to omitted facts. Absent any differentiation of the activities performed by the DAE for its own account from those performed on behalf of the non-resident enterprise, one simply cannot tell. Whatever the explanation, the aggregate reward to Country B risk-control functions should reflect their value.

As discussed below, USCIB believes that the examples reach correct results in many cases. However, we also believe that the discussion draft should be revised to conform more closely to the AOA and to distinguish the DAE's activities as a principal from its activities as an agent.

USCIB also believes that if the guidance to be provided is to be useful in the greatest number of cases, it should be based upon the version of the AOA which is most likely to be applicable under bilateral treaties in the near to medium term. The discussion draft indicates that its guidance was developed 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 Profits to PEs (i.e., the so-called "full AOA"). In practice, however, the Article 7 of most bilateral treaties likely to be applicable in the near to medium term will be based on the pre-2010 MTC. The discussion draft acknowledges as much by noting

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<sup>1</sup> We note that in the DAPE context, even limited risk distributor comparables almost certainly will require adjustments, as the DAPE is allocated only assets and risks, but no functions. This is implicitly recognized in Examples 1 and 2, as the COGS amount is derived as a residual.

that relatively few treaties include the 2010 version of Article 7, a number of OECD and non-OECD countries have expressly noted their intention not to include the 2010 version of Article 7 in their treaties, and the inclusion of the 2010 version of Article 7 in the UN Model has been expressly rejected by the UN Committee of Experts on International Cooperation in Tax Matters.

For treaties with the pre-2010 version of Article 7, OECD [Council Recommendation 2008\(106\)](#) 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 (i.e., the so-called “partial AOA”). The Recommendation similarly 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. The “partial AOA” implemented under the 2008 Commentary includes most of the features of the “full AOA”.<sup>2</sup> For certain dealings, however, it retains the language of the pre-2008 Commentary, which stops short of “full AOA” treatment.<sup>3</sup>

With respect to the partial AOA as implemented under the 2008 Commentary, all OECD countries other than New Zealand agreed with the 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. Of the 30 non-OECD countries that published their positions on the 2008 MTC, a number expressed a preference for treaty text that differed from the pre-2010 Article 7, but for treaties that included the pre-2010 Article 7, only Chile and India disagreed with the conclusion that the partial AOA should be applied in attributing profits to PEs under treaties with that text.

Accordingly, USCIB believes that, as a practical matter, the discussion draft’s guidance on the attribution of profits to the new PEs would be much more useful (i.e., of much broader applicability) if it included an analysis based upon the partial AOA as implemented under the 2008 Commentary, and extending that analysis to the full AOA under the 2010 MTC. In our view, given the extent of the overlap between the partial AOA and the full AOA and the simple nature of the examples, the conclusions under both the partial AOA and the full AOA ought to be the same. Noting that would significantly expand the usefulness of the guidance.

USCIB is concerned that countries may wish to adopt the changes to the PE standard without committing to follow the AOA on profit attribution. USCIB urges the OECD to reject this position. These changes are part of a unified approach to treaty interpretation and it does not

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<sup>2</sup> For example, it expressly incorporates the AOA’s 2-step approach, including its functional analysis and the recognition and pricing of “dealings”. It acknowledges that PE accounts are a starting place for attributing profits, but confirms that the accounts must be reviewed to ensure that they align with substance and reflect arm’s length pricing. It expressly incorporates the 2008 Report’s guidance on the attribution of profits to dependent agent PEs (DAPEs). It incorporates the requirement for the PE to have adequate “free capital”.

<sup>3</sup> See, e.g., paragraphs 33-40 in relation to dealings in the form of goods, intangibles, and services.

make sense to permit the expansion of the PE definition without agreement on how profit is attributable to those activities. Thus, with respect to the expansion of the PE definition, the multi-lateral instrument should only be open to those countries that commit to the AOA.

The discussion draft does not indicate what form the final guidance on the application of the AOA to new PEs will take, nor what status it may have. 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), USCIB hopes that the new guidance will effectively become a supplement<sup>4</sup> to the existing guidance and that the Council Recommendation will be updated to reflect the incorporation of the new guidance into the existing guidance. While 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 vis-à-vis OECD Member country tax administrations, on the manner in which the AOA will be applied to the new PEs, thereby minimizing risks of double taxation. Of course, USCIB 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.

USCIB recommends that the final guidance on BEPS Action Item 7, if patterned on the discussion draft, state that it is not controlling with regard to banks, global trading operations, or insurers, i.e., sectors that were separately addressed in Parts II, III and IV of the 2010 Attribution of Profits Report. For those sectors, the 2010 Attribution of Profits Report incorporates the concept of key entrepreneurial risk taking functions (“KERTs”), which result in the economic ownership of income-producing assets (loans, derivative contracts, insurance contracts, etc.). This is distinct from the more general formulation of the AOA that applies in Part I (“significant people functions applicable to the assumption of risks” and “significant people functions relevant to the economic ownership of assets”). See 2010 Attribution of Profits Report (Part I), para. 16 (in non-financial sectors, people functions relevant to economic ownership of assets and incidence of risks may deviate; in financial sectors, they tend to be aligned with each other). While the principles that guide the AOA under Part I are the same principles that guide Parts II, III and IV of the 2010 Report, the guidance under Part II, III, and IV is tailored to the financial services industry and the conclusions of that guidance should not be revisited.

Finally, USCIB observes that the detailed P&Ls constructed even for the discussion draft’s simplified examples suggest the need for a refinement of the analysis that may be difficult for

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<sup>4</sup> USCIB believes that the guidance should be a supplement to both the 2008 Report and the 2010 Report; that the existing Council Recommendation should be updated; and the 2008 Commentary and current Commentary should be updated to refer to the updated reports.

taxpayers to implement as a practical matter in real world situations. Such a potential level of refinement may also give rise to extensive controversy and enhanced risk of double taxation.

### 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.

USCIB believes that Article 9 of the MTC, when applicable, should be applied before Article 7. For example, in cases where customer revenue will be allocated to the DAPE, in most cases the arm's length payment to the DAE will be an expense also attributed to the DAPE. Accordingly, it will be necessary to determine that arm's length payment before the tax accounts of the DAPE can be created.

USCIB also believes that countries should be encouraged to adopt simplifying mechanisms that would permit a local affiliate to file a return that reflects the total profit attributable to both the local affiliate and the PE. Applying Article 9 first would be more consistent with the simplifying approaches.

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

USCIB strongly agrees that the DAPE is not attributed risks because there are no significant people functions performed by the DAPE on behalf of the non-resident enterprise; that the DAPE is not attributed economic ownership of assets because there are no significant people functions 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.

While we agree with this outcome, we think that the analysis should be expanded. In particular, the AOA does not rely on significant people functions 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>5</sup>

Since inventory is a tangible asset, attributing the economic ownership of inventory based on significant people functions seems on its face to be inconsistent with the general presumption in both the 2008 and 2010 Reports. It seems that the OECD is implying a different rule for inventory. If that is the case, it would be useful 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

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<sup>5</sup> Paragraph 75 of the 2010 Report.

people functions are more important to the value of inventory than the place of “use”. USCIB agrees with this implied analysis as an alternative or exception for inventory to the “place of use” presumption. 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?

USCIB strongly agrees that the example reaches the correct result; that is no additional profit (beyond that which is already taxable under Article 9) is attributable to the DAPE. USCIB is not clear, however, on how the AOA was applied to reach this result. In applying the AOA, the example identifies of functions performed, assets used, and risks assumed by the PE and the attribution of free capital to the PE. This is supposed to be followed by identifying any dealings between the PE and the non-resident enterprise, and characterizing the activities of the DAPE hypothesized separate entity, before identifying the most appropriate transfer pricing method and applying that method by analogy. The example does not identify the “dealings” between the non-resident enterprise and the DAPE and does not characterize the activities of the hypothesized separate entity. Perhaps this part of the analysis is assumed – given that all of the value creating activities are occurring at the head office – perhaps there are no “dealings”, which is why no profit would be attributable to the DAPE.<sup>6</sup> However, if there are no “dealings”, then although the answer would be the same, no profit would be attributable to the DAPE, why would the starting point be third party sales in Country B? It seems that the example assumes that the dealing must be a sale by the non-resident enterprise to a low-risk distributor. If so, this should not be assumed but should be explained and justified and the activities of the DAPE appropriately characterized. In our view, another and possibly better view, would be to recognize that the “dealing” takes the form of the PE providing sales agent services to the home office, but since Sellco as a separate enterprise fully performs the sales agency functions, there is no profit left over to tax at the PE for that function; however the sales revenue would then be attributable directly to the home office.

USCIB is concerned about a possible back-door application of the “force of attraction” concept. The first example states that third party sales in Country B are 200. Presumably these are sales in which Sellco participated in some fashion although that is not explicitly stated. This should be clarified, so that the example does not lend implicit support to the force of attraction principle.

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<sup>6</sup> If there are no dealings, should there be a PE at all? USCIB is aware that the definition of a PE is beyond the scope of this discussion draft, but the difficulty of applying the AOA to this example shows the flaws of the expansive PE definition.

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?

USCIB believes that the answer would depend on the language of the particular treaty. It is, therefore, not possible to provide an answer in the abstract. However, as stated in the general comments section of this letter, USCIB believes that the OECD should consider providing guidance on whether and if so how the answer would differ if the partial AOA of the 2008 report applied. USCIB also believes that countries should be required to commit to the AOA<sup>7</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 multi-lateral 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?

Yes. The entire premise of the BEPS project has been that taxation ought to follow value creation. If the DAE is not performing “significant people functions applicable to the assumption of risks” or “significant people functions relevant to the economic ownership of assets” with respect to the nonresident enterprise, there cannot be any profit (or loss) attributable to the DAPE, as there are no assets or risks allocated to the DAPE. In that case, the only transfer pricing analysis required is to determine the arm's length return to the DAE, which would be based on its own functions, assets and risks.

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

USCIB believes that this example is flawed because the example does not delineate the transaction that is being priced under Article 9, construct the dealings that are being priced by analogy under Article 7, characterize the activities of the hypothesized separate entity, or identify the most appropriate method for determining the transfer price by analogy under Article 7.

The premise of this example is that the contract between Prima and Sellco is not respected because Prima does not in fact control the inventory or credit risk and therefore the transaction must be recharacterized before it is priced. The example does not, however, explain how the transaction would be recharacterized. In our view, because Sellco is bearing all the risk related to the sales, Sellco would be treated as a full-risk distributor. Prima would be treated as selling the inventory to Sellco in exchange for a note. If that is the proper characterization of the

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

transaction under Article 9, then query whether there is a PE at all? If Prima and Sellco had initially structured the transaction as a sale to a full-risk distributor, then there would be no PE because a full-risk distributor is not acting as dependent agent.

Assuming that there is a PE even if Sellco is treated as a full-risk distributor under Article 9, it is not clear that any additional profit should be allocated to the PE. As described in paragraphs 43 and 44, the only profit in Prima's PE relates to the funding of the inventory. If the funding decisions are made at the head office, then that profit should not be attributable to the PE, even if one exists. Funding the inventory is different from bearing the inventory risk and having the financial capital to bear this risk and there is no indication in the example that these functions (and capital) are not in Prima's head office.

In addition, Example 2 raises the risk of double counting the same profit. This is clearer in table 2 which sets forth the functional and factual analysis of example 2. Under the category of inventory risk<sup>8</sup> for purposes of Article 9, the inventory risk is allocated to Sellco. The inventory risk is also attributed to the DAPE for purposes of Article 7. This seems inconsistent. If Sellco is assuming the risk under Article 9, then it would seem those people functions are performed on its own account and not in its capacity as a dependent agent of Prima. If the functions are not performed on behalf of Prima, then the income from those activities should not be attributable to the PE.

The example does not actually double count those profits because the DAPE profits are reduced by a sales commission to Sellco, nevertheless the example includes the same income, attributable to the same activities, in the taxable income of two different entities (Sellco under Article 9 and the DAPE of Prima under Article 7). In practice this is likely to lead to confusion, double counting and double taxation.

The treatment of the funding return also creates the possibility of double counting. Under the Article 9 portion of the example Prima is entitled to a return of 2 to reflect its funding return with respect to the inventory and Sellco deducts that 2 from its Country B income. When we turn to the Article 7 portion of the analysis, the DAPE earns that funding return. If Country A and Country B take different views of the transaction, then double taxation is likely. For example, if Country A accepts that the transaction is characterized as described above and concludes there is no PE, because Sellco is a full-risk distributor and not a dependent agent, then Country A would conclude that it should tax the funding return of 2. If Country B asserts the income is taxable as described in Example 2, then both Country A and Country B would tax the funding return.

In the Article 7 portion of the analysis capital is attributed to the DAPE to support the inventory risk and the economic ownership of the inventory and the credit risk and the economic

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<sup>8</sup> This is also true for receivable risk in example 2.

ownership of the receivables<sup>9</sup>. The inventory and credit risk was attributed to Sellco because Sellco both controlled the risk and *had the financial capacity to bear the risk*. So, capital to support the risk is *already in Country B*. Attributing the risk to the DAPE along with free capital to support that risk would over allocate capital to Country B. This over allocation would result in too much profit being attributed to Country B.

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?

See the answer 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?

It is not clear from the question whether the question relates to Article 9 or Article 7. The Article 7 analysis should be relatively straight forward, that is the capital should follow the risk and the DAPE would be allocated capital to support those risks. It is not clear how the new transfer pricing guidance would resolve this issue for purposes of Article 9.

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?

USCIB's response to these questions is part of our critique of Example 2 contained in the response to question 6. To summarize, USCIB is not certain whether the conclusions are consistent with the 2010 Report. The Article 9 analysis of this example effectively says that, in substance, Sellco is acting on its own account in selling to customers, since it bears the inventory and credit risk. One might conclude that there is no PE at all, since Sellco is not acting on behalf of Prima. But even if there is a PE, footnote 10 of the discussion draft provides that:

Given that the Article 7 analysis is presented for purposes of this example as independent of the Article 9 analysis, Step 1 of the AOA does not take into account that, under Article 9, the inventory risk has been allocated to Sellco and that Prima receives a

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<sup>9</sup> While the economic ownership of both the inventory and the receivables is attributed to the DAPE, the example only computes a funding return on the inventory. USCIB believes this is correct, but considers that the OECD should explain the distinction between the treatment of inventory and the treatment of receivables.

funding return to Prima for the functions it performs in relation to inventory. 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.

This seems to be exactly opposite of the analysis contained in Example 2. USCIB believes that the footnote 10 (and footnote 11 for purposes of credit risk) are correct and therefore it is incorrect to allocate economic ownership of the inventory and the receivables to the PE and to attribute to a funding return to the PE on that basis.

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

Please see the comments above in response to question 3. USCIB believes that an appropriate amount of profit is attributed to the PE but is concerned that the examples do not construct the dealings and do not identify the most appropriate method for determining the transfer price by analogy.

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?

See the answer to question 4.

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

Please see the comments above in response to question 3. USCIB believes that an appropriate amount of profit is attributed to the PE but is concerned that the examples do not construct the dealings and do not identify the most appropriate method for determining the transfer price by analogy.

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, USCIB agrees with this explanation. This is actually a very troubling result, not because it will lead to incorrect answers when properly applied, but because it creates a significant incentive for countries to find that some significant people function is 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 significant people functions when the taxpayer was of the view that those functions were not significant.

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

In this particular fact pattern, with no significant people functions occurring at the PE, USCIB agrees with the conclusion that the net profit for the PE is only a routine return for the service, including a funding return for the ownership of the warehouse. It is not clear to us, however, that AOA was properly applied to reach this result. In Example 5A, the non-resident WRU in Country A performs all significant people functions with respect to its warehouse located in Country W. WRU has employees in Country W which operate the warehouse but have no specialized knowledge. The example assumes that a permanent establishment exists, consisting of a fixed place of business and the business of WRU is partly carried out through that fixed place of business. The example attributes the economic ownership of the warehouse to the PE, citing paragraph 75 of the 2010 AOA Report for allocating the economic ownership of tangible assets to the location of use rather than to the location of the people functions making the decisions relevant to the economic ownership. This attribution is consistent with the 2010 Report.

The example does not construct the “dealings” between the PE and the non-resident enterprise. Rather, the example proceeds to calculate the profit of the PE on the assumption that the PE receives all the revenue from the third party customer and pays WRU in Country A for services and intangible rights and then takes deductions for its depreciation and other expenses. It is important to note that the example claims that it is allocating WRU’s “profit” from the warehouse services, but since that number has not been reduced by the labor or depreciation or interest allocation, the starting point is really WRU’s customer revenue for the warehouse services.

The initial critical question is what is the dealing between the head office and the PE? Is the service remuneration properly viewed as (a) paid by the third party customers to the PE, with the PE deducting notional payments to the head office or (b) paid by the third party customers to the head office, with the head office making service payments to the PE? The terminology used in paragraph 92 is not helpful in this regard, referring to “the profits of WRU” rather than “the revenue”. If the proper characterization of the dealing is that third party customers make payments to the PE and the PE makes notional payments back to the head office for know-how, software, services, investment advice, and potentially rent for the warehouse premises,<sup>10</sup> then we believe the correct phrase should be “the revenue of WRU”. However, this is not necessarily the correct “dealing”. It might be more appropriate to characterize the dealing as the receipt of revenue from third party customers by the head office with the PE receiving a fee

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<sup>10</sup> If the acquisition and funding of the warehouse premises were controlled from the head office, then the most appropriate dealing could be a lease of the premises to the PE. If the acquisition were controlled by the PE in a way that the PE was considered the owner of the premises, then depreciation expense would be allocated to the PE.

for its services and a return attributable to the economic operation (if the premises were considered leased) or ownership (if the premises were considered owned) of the warehouse.

Correctly identifying the “dealings” and characterizing the activities of the PE is important because the identification of the “dealings” and characterizing the activities leads to the choice of the most appropriate transfer pricing method and its application by analogy. Identifying the “dealings” in this case as provision of warehousing services by the PE and the use of an asset owned or leased by the PE, should lead to the same result, but may simplify the transfer pricing analysis.

In the prior examples, the economic return was allocated to the location with the control functions. In this case, the control functions for both making the decision on the warehouse itself and the inventory in the warehouse are performed at the head office. This would seem to indicate that the economic return for the warehouse and inventory should be located at the head office and not the PE.

However, paragraph 75 of the 2010 AOA Report states “there was a broad consensus among the OECD member countries for applying 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.” As a result, the use of the warehouse in Country W attributes the economic ownership to the PE rather than to the head office.

USCIB believes that it is important to note that the internal dealings between the PE and other parts of the enterprise are postulated solely for the purpose of attributing the appropriate amount of profit to the PE. (See paragraph 173 of the 2010 AOA Report.) Thus, internal dealings between the PE and other parts of the enterprise are not subject to withholding taxes because there can be no royalty or any other payments between a head office and a PE because they are simply parts of the same entity. To the extent that some countries participating in the BEPS project do not accept this answer, then structuring the dealings to minimize these disagreements would further the goal of consistent interpretation of these BEPS guidance.

Finally, we think that the examples should point out 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.

***Scenario B - Warehousing as an internal function of the business***

***Scenario C - Warehousing as an internal function of the business carried out by a separate enterprise***

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

As a general comment, we would find it helpful if Example 5 Scenario B and C also showed the numerical solution, similar to Examples 1-4.

USCIB agrees with the conclusion reached in Scenario B that the net profit for the PE is only a routine return for the service and a funding return for the ownership of the warehouse.

With respect to Scenario C, there are not even routine people functions in the PE. 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.

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?

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. It is not clear what the difference is between an investment return and a funding return in this context. With respect to intangible assets, if there are no controlling functions in the PE country, those assets should be attributable to the location of the controlling functions and not the location of the PE.

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?

USCIB agrees with the streamlined approach, subject to clarification of “investment return” compared to “funding return”. In fact, we would recommend that countries be allowed to take the streamlined approach one step further and allow WRU to make a payment of that return to a local tax resident, pushing the income into an already tax compliant entity and forgoing the requirement for any additional tax compliance on the part of the hypothetical PE.

It appears that the "streamlined approach" actually is a determination made on the appropriate "dealing" in this case, without describing it as such. We suggest that this "approach" be described as a "dealing" rather than an approach which implicitly is an exception to the normal rule.

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. USCIB is not clear on the difference between the two phrases. USCIB agrees 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, if there is any difference.

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.

USCIB agrees with this conclusion.

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?

USCIB believes that there would not be any difference.

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?

See the answer to question 4.

#### **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 in our response to Question 17, USCIB believes that there are possibilities for further streamlining and simplification in this area which would benefit both tax administrations and taxpayers. We would suggest that, given the low rates of return attributable to PEs in the examples and that economic returns are being attributed to control functions in the dependent agent resident, the OECD should suggest that countries can simplify their administrative burdens and the taxpayer's compliance burden by attributing all of the income that would be allocated to the PE to the dependent agent resident entity and eliminate the need for the hypothetical PE (which now has no income) to file local tax returns. This would cut the number of tax audits in half, remove major VAT administrative complexities and double taxation risks, while maintaining the appropriate direct and indirect tax revenue for the resident state.

Sincerely,

A handwritten signature in dark ink, appearing to read 'W. Sample', with a stylized, flowing script.

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## Comments on Public Discussion Draft: “BEPS ACTION 7 - Additional Guidance on the Attribution of Profits to Permanent Establishments”

Dear All,

WTS is pleased to provide you with comments regarding the OECD Discussion Draft on BEPS ACTION 7 - Additional Guidance on the Attribution of Profits to Permanent Establishment. We appreciate the effort to provide guidance on this important topic and assess the provided draft document a very good basis for further discussions.

However, our overall impression is that the Discussion Draft seems to be very sophisticated and complex due to the fact that there are many examples included which provide guidance for generally similar cases which are only different when looking at it from a theoretical perspective.

With our comments, we would like to emphasize several subjects which seem to be most important to us. Regarding these subjects we should like to ask the OECD to rethink its opinions and amend the draft as may be appropriate.

### I. Executive Summary:

In case a MNE is carrying out its sales activities through a local entity the so-called zero-profit solution provided for under Example 1 is highly appreciated. Any profit attribution discussions for a Dependent Agent Permanent Establishment (DAPE) should be kept as a Transfer Pricing issue rather than a combined and conflicting discussion of Transfer Pricing and PE profit attribution. In such scenario a DAPE would even be obsolete.

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## **II. Comments:**

### **a) General:**

Even though the OECD requested the interested parties to only comment on the profit attribution of PEs and not on the creation of a PE on its merits, we would like to point out that in cases resulting in a zero-profit of the DAPE, the taxpayer would still face a number of formal requirements resulting from the establishment of a PE, such as registration and tax return filing etc. Apart therefrom, the taxpayer may face numerous other tax disadvantages, such as VAT and wage tax issues. For the sake of simplicity and the streamlining of administration we recommend providing for a facilitation by including a PE exception clause for zero-profit DAPes.

Our suggestion is to include a clause in Article 7 MTC equal or similar to the comment in the protocol to Article 5 of the DTA Germany-Austria saying that: 'It is understood that in case of related entities, none of these entities is treated as a DAPE of the other affiliated entity, if the respective functions are compensated by assessing an arm's length transfer price including a reasonable profit margin.' Alternatively, it could just be clarified that in such scenario a DAPE may be created, however, without an additional profit attribution to it.

### **Q 1 and 21:**

In view of the fact that the BEPS results on AP 7 and AP 8-10 are already agreed, there remains a different view which is not aligned. Therefore, the conflict remains and cannot be easily solved, neither theoretically nor by way of introducing several (complex) examples in the Comments to the MTC. We are of the opinion that the focus of this Discussion Draft should not be put to the sophisticated question of the different ways and orders of the application of Article 7 and 9 MTC. Article 9 MTC should be the more important regulation when looking at the two regulations. Looking back to the development of the Profit Attributions rules of Article 7 (OECD Report 2010) Article 9 MTC was providing the basis and guidance for the Authorized OECD Approach (AOA), which is the functionally separate entity approach. Keeping that in mind there should generally not result any conflicts if the one or the other regulation is applied. We are of the opinion that the profit attribution rules for a PE should follow the profit allocation rules provided for in Article 9 MTC. In case of conflicts which are resulting from a profit attribution according to Article 7 MTC with the profit allocation rules following Article 9 MTC, the Article 9 MTC rules should prevail. This should be included in either the wording of or the comments to Article 7 MTC. We are of the opinion that a coordinated application of Article 7 MTC and Article 9 MTC is important; if this is achieved then the complexities of the Examples 2, 3 and 4 might be reduced, leaving a Transfer Pricing issue and not both Transfer Pricing and PE issues.

## **b) Dependent agent permanent establishment (DAPE)**

### Q 2, 3 and 5:

With regard to Example 1 (questions 2, 3 and 5) we agree with the explanations given in this Discussion Draft. In situations where a multinational group of entities is operating through a locally registered Dependent Agent Entity (DAE) we agree that a DAPE that might be created through the activities of the DAE should not give rise to an additional profit to be allocated to the DAPE („zero-profit solution“), if it can be documented that the DAE is remunerated at arm's length, provided however that the functions and risks profile of the DAE and the DAPE are fully or at least almost identical. The zero-profit solution is absolutely reasonable in the situation described in Example 1. Moreover, it can be seen as a practical solution to determine the appropriate taxable income that is subject to tax in the foreign country. It is not necessary to do a sophisticated split between the DAE and the DAPE.

On the other hand, in situations where a DAE does not exist, i.e. if the dependent agent is an employee a profit would need to be allocated to the DAPE along the regulations of Article 7 MTC.

### Q 4:

We do not comment on this question dealing with the scenario where the AOA is not applied; this should in future only be relevant in rare cases from our point of view. Meanwhile the vast majority of the countries apply the AOA (approximately 70% of the countries according to the WTS Global PE study covering 62 countries, which cover most of EU, OECD and BRICS).

### Q 6 through 13:

Based on our understanding the Examples 2, 3 and 4 are not necessary in order to provide sufficient guidance for the Profit Attribution; the Examples are complex and result in a risk that in many situations the profit attribution will cause lengthy discussions although the situations are very similar to the situation described in Example 1. With regard to Article 7 MTC it should be intended to come to a zero-profit solution for a DAPE in most of the situations where the local company is remunerated at arm's length according to Article 9 MTC.

## **c) Activities not covered by specific exceptions in Article 5 (4) MTC**

### Q 14:

Scenario A: In general, we agree with the approach to allocate a small profit to the PE, particularly since just a routine function shall be remunerated. However, the calculation should have been done the other way round. The profit of the PE should

be determined based on a cost-plus calculation on the basis of the total costs incurred by the PE, leaving the residual profit with the Head Office. (In the example the 5% mark-up might be applied, in order to indicate that a routine warehouse function can also be treated as a low-value adding service.)

In this alternative third party sales would need to be credited against the targeted remuneration. This would simplify the approach described in the Discussion draft and would ensure a cost-plus remuneration. In this regard it might be recommendable to insert a statement that the remuneration for the PE could be documented based on a pro-forma invoice stating that the profit has been determined applying the cost plus method.

Q 15 through 20:

With regard to Scenario B and Scenario C we agree with the approach of profit attribution taken in the Discussion Draft.

However, in case the warehousing activities are carried out by a locally registered entity of the MNE we find it reasonable not to allocate any profit to the PE; see our comments regarding the DAPE above (Q 6 through 13).

Overall we should like to ask the OECD to revise the Discussion Draft and keep the focus of this Report at a higher level in order to provide for a clear and simple guidance allowing more standardization and less complexities and discussions, in order to avoid increasing compliance costs and additional double taxation risks for the taxpayers carrying out business internationally.

Kind regards,

WTS Steuerberatungsgesellschaft mbH

Torsten Hopp  
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**Subject: Comments on the Public Discussion Draft on BEPS Action 7 "Additional Guidance on the Attribution of Profits to Permanent Establishments"**

Dear Mr. VanderWolk,

First and foremost, we would like to congratulate the OECD for the excellent work achieved on the Public Discussion Draft on BEPS Action 7 "Additional Guidance on the Attribution of Profits to Permanent Establishments" (hereinafter the "Discussion Draft"), issued on 4 July 2016. We are grateful for the opportunity to provide comments and we hope that our suggestions might provide valuable inputs for future improvements.

**1. Introduction**

The Public Discussion Draft on BEPS Action 7 "Additional Guidance on the Attribution of Profits to Permanent Establishments" (hereinafter the "Discussion Draft") proposes amendments to the work on attribution of profits to permanent establishments (hereinafter "PEs") related to the following topics:

- a) Dependent agent PEs, including those created through commissionaire and similar arrangements; and
- b) Warehouses as fixed places of business PEs.

We would like to take this opportunity to provide our comments on the Discussion Draft, with specific reference to the amendments related to topic a) above. These comments are of a general nature (see section 2, below), and also refer to the specific questions raised in the Discussion Draft (see section 3, below).

## **2. General comments**

### **2.1. The post-BEPS understanding**

In general, the introduction of the principles expressed by the AOA has aimed at aligning the outcome of the application of the arm's length principle under Article 7 and Article 9. However, one major potential difference is still left between the application of the arm's length principle under the two articles, namely the missing of contractual arrangements in case of a PE. This difference is a natural one, since an enterprise cannot enter into legally binding contracts with itself. Therefore, there exists the question of whether the absence of contractual arrangements in the PE context, *does* and/or *should* lead to different results in the application of the arm's length principle under Article 7 and Article 9, or if it even leads to two different arm's length principles. When analysing the application of the two articles, it seems that the application does lead to different results, whereas it is doubtful whether the purpose of the two articles should lead to different results. However, this difference can be seen to be on a conceptual basis in the pre-BEPS era.

In a post-BEPS world, the drawn conclusions become even more evident, when analysing the newly introduced guidance on the interpretation of the arm's length principle under the work on BEPS Actions 8-10. In this respect, aspects like the delineation of the actual transaction, the analysis of risk factors, the entitlement to intangibles related returns, the impact of group synergies or the impact of location savings and other local market features, either tend to narrow the conceptual gap between the outcome of an arm's length result under Article 7 and Article 9 or require further guidance with respect to profit attribution to DAPes.

For instance, if rather than a formalistic approach of sticking to contractual arrangements but a more substance-based approach of relying on the actual conduct of the parties is promoted, the difference between contractual arrangements and dealings tends to become neglectful. However, the new guidance on the analysis of risk in commercial and financial relations, the new developments on the entitlement to intangibles related returns (and on the DEMPE analysis), the new considerations on the impact of group synergies as well as on the impact of location savings and other local market features will most probably need to be reflected in the new developments on the topic of attribution of profits to DAPes. Moreover, the impacts between the two Articles can also work vice versa, which means that the current guidance on Article 7 could also eventually impact the future BEPS work related to Article 9.

### **2.2. General conclusion**

The current and future work of the OECD on the attribution of profits to DAPE under BEPS Action 7 should further clarify that the existence of a DAPE in the source state does not *per se* lead to more taxable profits in the source state. The question whether a PE exists or not

has to be seen as only the first step to justify taxing powers by the source state related to business profits. The second stage, then, deals with the assessment of the taxable profits, which can either be based on Article 9 or Article 7. To this end, a mixture between Article 9 and Article 7 (e.g., in the light of the currently applicable dual-taxpayer approach) appears to not necessarily be the best way to ensure taxing rights and the proper arm's length remuneration. In this respect, further clarification might be required concerning the question of whether there is a need for further assessing the existence of a DAPE in the source state in the cases the DAE has already been remunerated at arm's length under the new OECD guidance. Moreover, it should be clarified if and when the existence of a DAPE could eventually entitle the source state to additional taxing rights, even though the DAE was properly remunerated. From an overall perspective, the assessment of the existence of a DAPE might lead to numerous compliance issues and administrative burdens for the taxpayer and might also cause exhaustive administrative efforts for the tax administrations, without, at least in the majority of cases, necessarily leading to substantial tax increases in the source state when the DAE is remunerated at arm's length. Consequently, both taxpayers and tax administrations might challenge the application of the dual-taxpayer approach. Hence, a reconsideration of the OECD's view on the single-taxpayer approach, within the upcoming work on profit attribution to DAPes, could in our view reduce administrative burdens for both taxpayers and tax administrations.

Since a reconsideration of the preference for the dual-taxpayer approach is herewith suggested, the OECD's work on BEPS Action 7 should also try to align the outcome of the application of the arm's length principle under Article 7 and Article 9. This alignment would eventually avoid distorting views (e.g., are there two arm's length principles? Is the outcome of Article 7 and Article 9 the same?) and would further also avoid potential tax arbitrage as well as promote neutrality and consistency of transfer pricing systems in international tax law. In order to align the application of Article 7 and Article 9 with respect to transfer pricing, the current understanding of the concepts of "significant people functions" and "actual conduct of the parties" should be further narrowed down to avoid misunderstandings in its application and minimize a potential gap between the respective articles. When it comes to risk, the current OECD work on BEPS Action 7 should head more towards the direction of introducing the notions of "control over risk" and "financial capacity to assume risks" into the AOA, so that doubts about differentiating outcomes of the risk analysis under Article 7 and Article 9 will be minimized. Concerning assets, the choice of entering a market via an associated enterprise or via a PE should not make a difference in terms of profit attribution in general. However, even though the allocation of assets under Article 7 and Article 9 might differ, as "significant people functions" and "contractual arrangements" are not necessarily the same, the newly developed understanding of a more substance-based approach (which seeks for the actual conduct of the parties) should close the gap between remunerations based on Article 7 and Article 9. As highlighted above, the alignment of the two notions should be the focus. With respect to capital allocation, the decision making process should be based rather on corporate finance methodologies than on inflexible rules derived by various allocation principles. In this respect, the further guidance provided in Article 7 could simplify the currently applied standards.

Indeed, new questions and challenges due to the OECD's work on BEPS Actions 8-10 and Action 7 have arisen, which have to be further analysed. In this respect, a reconsideration of the entire wording of the AOA appears as useful in order to align it with the changes provided under BEPS Actions 8-10.

In conclusion, given the historical background and the evolution of Article 7 and Article 9, the potential application of the AOA on different types of double tax treaties and the main goal of establishing arm's length remuneration among MNEs, it is questionable whether the application of the two articles should lead to different results. In light of the new developments due to BEPS Actions 8-10 (especially with respect to the guidance on the analysis of risk in commercial and financial relations, the developments of the entitlement to intangibles related returns, the considerations on the impact of group synergies and the impact of location savings and other local market features), further work on the profit attribution to DAPes should be aligned in order to avoid differences between the outcome of arm's length remunerations under Article 7 and Article 9. In this respect, it might also be possible that the current work on Article 7 could affect the future work related to Article 9.

In general, it is our understanding that the application of Article 7 and Article 9 should be based on the same arm's length principle. In this respect, differences caused by the fact that there are two different articles in place could only be avoided if they would be merged into a single article, as was originally the case. However, besides those "natural" differences (e.g. credit rating issues), the pure fact of slightly different purposes of the articles cannot justify different outcomes. As a result, differences in the application should be the exception rather than the rule, thus being a recommendation for a common understanding of the overall goal of the OECD current and future work on the two articles.

### 3. Specific comments

This section deals with the specific questions posed in the Discussion Draft for public commentators. In this respect, the OECD's chosen order of examples will be followed. The first question raised by the OECD deals with the order in which the analyses are applied under Article 9 and Article 7, and whether this order can affect the outcome and what guidance should be provided on the order of application. Since the first question is not directly linked with the OECD's examples, it will be answered prior to the following sub-sections.

Question 1: From our point of view, the order of application of the analysis under Article 7 and Article 9 does not (and should not) necessarily affect the outcome of the arm's length remuneration of the DAE or the DAPE, if the arm's length principle is properly applied. However, for practical reasons, in DAPE cases we propose to apply Article 9 first and predominantly (as long as both articles are not fully consistent).

#### 3.1. Example 1

##### 3.1.1. General answers

Example 1 describes the case where a principal (non-resident enterprise) performs activities in a source state via a DAE, which eventually gives rise to a DAPE under Article 5, paragraphs 5 and 6. According to the case, either the DAE or the principal perform functions, assume risks and employ assets in order to carry out the associated business. However, an important fact of the case is that the DAE does not perform significant people functions on behalf of the principal. Due to this lack of significant people functions at the level of the DAE, the OECD concludes that no profits can be attributed to the DAPE, which

means that the source state is only entitled to tax the profits of the DAE. In order to comply with the arm's length principle, these profits have to be derived based on an arm's length assessment of the transactions between the contracting parties (principal and DAE) in light of Article 9.

The OECD's proposal in this example is in line with the currently applicable AOA principles and the dual-taxpayer approach. In this respect, the example and the derived conclusions perfectly point out the importance of the consistency between contract and actual performance of the contracting parties. Accordingly, the drawn conclusion of no extra-profit for the DAPE is perfectly true in a situation where the functional analysis of the given transactions is in line with the contractual arrangement and the DAE is appropriately remunerated in light of Article 9. However, given the fact that the source state is only entitled to tax the (arm's length) profits of the DAE and no extra-profit can be attributed to the DAPE (thus no extra-tax revenue for the source state), the existence of the DAPE in the source state due to Article 5, paragraphs 5 and 6 only leads to further administrative burden for the principal, without increasing the tax revenues of the source state. Moreover, the situation might also prove disappointing for the tax administration, since they have to spend time and resources in order to verify whether a DAPE exists or not, without even having the possibility of any additional taxable profit. Accordingly, it might be concluded that the dual-taxpayer approach only leads to negative (on the administrative side) or no effects (on the taxable base) for all parties concerned in this situation, thus being a questionable outcome. Based on these arguments, the application of the single-taxpayer approach would eventually lead to a considerable reduction of administrative burden for both taxpayer and tax authorities, thus being a viable solution in times of tight national budgets and comprehensive information exchanges.

### 3.1.2. Specific Answers

Question 2: Yes. Based on the facts of the case, the DAE and the DAPE, respectively, do not perform significant people functions and do not bear any significant risk. Accordingly, the arm's length remuneration should not lead to a taxable base in the host country.

Question 3: Yes. Based on the facts of the case, we agree with the construction of the profits (or losses) of the DAPE.

Question 4: Depending on the version of the OECD Model adopted in the conclusion of the applicable tax treaty (and the specific wording of the latter), the applicable Commentary, as well as their interpretation, the profit attribution to the DAPE might be dealt via different approaches. In this respect, the profits attributable to the DAE and to the DAPE might not be necessarily the same as when applying the AOA. For example, based on the application of paragraph 4 of Article 7 of the 2008 OECD Model, the profits to be attributed to the DAPE might be determined by means of a formulary apportionment. This should not be the case and the application of the arm's length principle should lead to the same results suggested by the application of the AOA. In practice, however the existence or non-existence of the significant people function requirement (AOA versus prior versions) may lead to differences.

Question 5: Yes, the conclusion seems correct. However, even in cases where the DAPE performs significant people functions on behalf of the non-resident principal, the profits attributable to the DAPE should match the appropriate fee payable to the DAE under Article

9 (new guidance), in order to consistently comply with the arm's length principle under both Articles.

## 3.2. Example 2

### 3.2.1. General Answers

Example 2 is similar to Example 1 in general. However, modifications in terms of risks are made. Accordingly, the principal contractually assumes the inventory and the customer credit risk, whereas the DAE controls those risks and also has the financial capacity to assume them. In the end, this leads to the result that the source state might tax more profits than in Example 1, due to the higher level of risk of the DAE. However, the relevant risks undertaken by the DAE are divided into two different layers. The first layer contains risks, which are undertaken by the DAE on its own account, whereas the second layer contains those risks, which are undertaken by the DAE on behalf of the principal. Since the DAE performs significant people functions on behalf of the principal in this example, there is a need for a proper attribution of assets and risks in order to comply with the principles of the AOA. Based on those aspects, the OECD concludes that the remuneration associated to the two aforementioned layers has to be partially attributed to the DAE (first layer) and to the DAPE (second layer).

The conclusion drawn by the OECD in Example 2 is in line with the currently applicable principles of the AOA and the dual-taxpayer approach. However, as already highlighted in the general answer to Example 1, Example 2 especially emphasizes the importance of consistency between contractual arrangements and actual conduct of the parties. Since the contract and the actual conduct are not fully in line in the example, there is a need for an attribution of extra-revenues (and extra-costs) to the DAE in order to align the remuneration with the functions, risks and assets in light of Article 9. This approach is perfectly in line with the new guidance provided by the work on BEPS Actions 8-10. However, up to now only the relation between the principal and the DAE has been analysed. When it comes to the DAPE, the same question as in the previous example remains open, namely whether the dual-taxpayer approach leads to the best solution in such (or similar) situations. In this respect, the existence of the DAPE only leads to a few extra-profits, which are mainly derived from the DAE's remuneration for the funding functions. Accordingly, the same negative side-effects of having extra administrative burden without substantially increasing the taxing right of the source state occur due the application of the dual-taxpayer approach. However, by applying the single-taxpayer approach these extra administrative burdens could be reduced. In this respect the source state would not lose any taxable income, since the extra-remuneration that was assigned to the DAPE could still be allocated to the source state by a proper application of Article 9 between the principal and the DAE. Since the DAPE's extra-remuneration generally derives from the activities, which are performed by the DAE on the account of the principal (like a service), it is questionable whether the distinction leads to the best result. If there is no distinction between the DAE's activities performed in its own account and those performed on the account of the principal,

the source state would be entitled to tax the same income, without administrative burdens for both, taxpayer and tax administration.

### 3.2.2. Specific answers

Question 6: Based on the currently applicable dual-taxpayer approach, the underlying construction of the profit and losses of the DAPE is in line with the principles of the AOA. Based on the facts of the case and the new guidance provided by BEPS Actions 8-10, the example shows that a transfer pricing adjustment should be done to the DAE, in situations when the actual conduct of the parties is not perfectly in line with the contractual arrangements in order to align the remuneration with the functions, risks and assets; thus, complying with the arm's length principle. However, it is questionable whether the dual-taxpayer approach is the best solution for the underlying case. Indeed, this approach leads to extra administrative burden for the taxpayer as well as for the tax administration, without substantially increasing the taxing rights of the source state. The DAPE's extra-profits solely derive from the remuneration received by the DAE for the funding function. Therefore, by alternatively using the single-taxpayer approach, the administrative burden would be reduced, while keeping the tax base of the host country. Indeed, the extra-remuneration of the DAPE could still be allocated to the source state, by remunerating the activities performed by the DAE. In fact, if there were no distinction made between the activities performed by the DAE on its own account or on the account of the principal, an arm's length compensation would lead to the same taxable income in the host state.

Question 7: Similarly to Question 4, the outcome might depend on the version of the OECD Model adopted to conclude the applicable tax treaty (and the specific wording of the latter), the applicable Commentary, as well as their interpretation. As a result, the outcome of the underlying analysis might not be necessarily the same (see answer to Question 4, above).

Question 8: If the DAPE does not have the financial capacity to assume inventory as well as credit risk, the principal will most probably assume those risks. In this case, the funding result cannot be attributed to DAPE.

Question 9: The fact that the same functions are taken into account under Article 9 and Article 7 naturally derives from the way the two articles interact and from the current application of the arm's length principle to PEs, based on the abovementioned dual-taxpayer approach. The same is true for the fact that the inventory and credit risk are (legally) attributed to the DAE and the economic ownership of inventory and receivables are attributed to the DAPE, since this is in line with the idea of a hypothesized separate legal entity, thus complying with the principles of the current AOA. In this respect, the conclusions presented in Example 2 seem to be in line with the current guidance. However, as already mentioned above, the use of the single-taxpayer approach might provide a similar outcome in these situations, with much less administration.

### 3.3. Example 3

#### 3.3.1. General answers

Example 3 presents a modified case. This time the principal does not engage a DAE in the source state at all. The principal rather decides to send an employee to the source state in order to perform those activities, which were performed by the DAE in Example 2. The OECD draws the conclusion that the source state is entitled to tax the same profits as in Example 2. However, this time the profits are solely derived from the activities performed by the DAE and not by a combination of profits of DAE and DAE.

The attribution of profits to the DAE is in line with the currently applicable principles of the AOA and the dual-taxpayer approach. Additionally, it is worth noting that the aforementioned differentiation between single-taxpayer approach and dual-taxpayer approach (see Example 1 and Example 2) is not relevant in Example 3, as the transactions do not involve the DAE anymore. Considering the source state is entitled to tax the same profits as in Example 2 (based on the performance of the same activities on the territory of the source state) the assessment of the existence of a DAE is of key importance. In this respect, the critics on the dual-taxpayer approach in Example 1 and Example 2 must not be understood as an argumentation against the need of Article 5, paragraphs 5 and 6. However, the area of application of these paragraphs should, in our view, not be widened to situations where activities in the source state are performed by a DAE. If there is no DAE in the source state, Article 5, paragraphs 5 and 6 are the one and only viable solution to ensure the taxing rights of the source state. In this respect, the substantial amount of additional tax revenues that can be generated due to the existence of a DAE also justifies the extra administrative burden for the taxpayer as well as for the tax administrations. As a result, the suggested solution to Example 3 does not contradict those of Example 1 and Example 2.

### 3.3.2. Specific answers

Question 10: The conclusions drawn in Example 3 are in line with the principles of the AOA and the dual-taxpayer approach. However, in Example 3, there would be no difference between the application of the single- or the dual-taxpayer approach, since the DAE is not engaged in the activities of the principal. As a result, the source state would be entitled to tax the same amount of profits as in the previous example.

Question 11: The answer to this question would be in line with the ones provided to Questions 4 and 7, above.

## 3.4. Example 4

### 3.4.1. General answer

Example 4 is based on a slight modification of Example 2. This time, the focus of the example lies on the customer credit risk and the connected activities related to the credit provision by the principal and the DAE. In general, the principal contractually assumes the customer credit risk. However, both the principal and the DAE have control over those risks and the financial capacity to assume them. Similar to Example 2, the facts of the case lead to the conclusion that the source state is entitled to tax more than just the (sales) profits of the DAE, due to the higher level of risk assumed. This is again mainly caused by the fact that the risk has to be divided into two layers. Whereas layer one contains the risk

undertaken by the DAE in its own account, layer two again includes the risk undertaken by the DAE on the account of the principal. Due to the fact that the DAE performs significant people functions, assets and risks should be attributed to the DAPE. Accordingly, the OECD's conclusion is again based on the dual-taxpayer approach, thus leading to a remuneration for the DAE based on Article 9 and for the DAPE based on Article 7.

Since the dual-taxpayer approach is currently the applicable principle, the OECD's outcome is perfectly in line with the given guidance on the AOA. However, the outcome of the risk analysis in the underlying example might raise some questions. In the end, the aforementioned considerations concerning the single-taxpayer approach would also be valid for Example 4. In this respect, a non-distinction between the activities performed by the DAE in its own account and on the account of the principal (risk layer one and risk layer two), in combination with the application of the single-taxpayer approach, would eventually lead to the same taxable income in the source state, without administrative burdens.

### 3.4.2. Specific answer

Question 12: Even though the outcome of the risk analysis might raise some questions, the overall attribution of profits to the DAPE complies with the principles of the AOA and the dual-taxpayer approach. In this respect, the OECD's conclusions drawn in Example 4 are consistent with these principles. Similar to the comments provided to Question 6 concerning the activities performed by the DAE, the application of the single-taxpayer approach, in combination with a non-distinction between the activities performed by the DAE in its own account and those activities performed on the account of the principal, would eventually lead to the same tax base in the source state as proposed in Example 4. As previously mentioned, this approach would lead to less administrative burden (e.g. the need to access the existence of a DAPE) for the taxpayer and the tax administration, without generating base erosion in the host state.

Question 13: The chosen approach of solely basing the attribution of risk between two separate enterprises is just one viable way to derive an arm's length result in the underlying case. An allocation of risk based on the significant people functions under Article 7 would in principle lead to the same result, thus being at arm's length as well. This also has to be understood in combination with the preliminary statement (see answer to Question 1, above) that the order of the application of the analysis under Article 7 and Article 9 should not necessarily affect the outcome of the arm's length remuneration of the DAE or the DAPE. However, in practice the order will affect the remuneration as long as the standards are not consistently defined and implemented.

## 4. Conclusion

From our point of view, the application of Article 7 and Article 9 should be based on the same understanding of the arm's length principle, even though some differences might be generated due to defined reasons (e.g. credit rating issues). However, these differences have to be understood in light of the historical development of the two articles and the related guidance, thus being only "natural" consequences of minor importance for the overall understanding of the arm's length principle. A potential way to minimize or avoid these differences could be to align the wording of the two articles and the respective

guidance (or even merge them to a single article/guidance as it was intended in the first edition of the Draft Model Convention for the Prevention of Double Taxation and Evasion).

However, even though such a change might be unrealistic, different outcomes between the application of Article 7 and Article 9 should be an exception rather than a rule. From our point of view, this could be seen as kind of guidance for the current and further work on the issues of profit attribution to PEs and transfer pricing in general. In this respect, the following three criteria should be considered or further enumerated in order to minimize or even close the gap between the application of Article 7 and Article 9:

- It has to be better clarified under the guidance of both Article 7 and Article 9 that the separate legal entity approach, without any deviation, is the core principle, which has to be followed.
- Moreover, it has to be further clarified that the substance-over-form approach is followed under both articles in the same way. In this respect, there is a need to highlight more intensively that the contract is just the starting point of the analysis, which is only relevant as long as it reflects the actual conduct of the parties. If this is not the case, the transaction has to be delineated according to the conduct. However, if this conduct is not in line with the arm's length principle, the overall transaction could eventually be non-arm's length on the merits (see comments on Question 8). If the actual conduct of the parties is strictly followed under Article 9, the potential for differences to the application of Article 7 tends to be close to nil, since the actual conduct of parties and the performance of significant people functions show a close teleological similarity.
- Furthermore, the capital allocation between associated enterprises and in a PE context should follow considerations related to corporate finance methodology rather than inflexible rules.

Accordingly, the guidance provided by the AOA on the topic of profit attribution to DAPes should be revisited, mainly with regard to the dual-taxpayer versus single-taxpayer approach and maybe (although this seems a "utopian" aim) the wording of the entire guidance should be amended to ensure the semantic and pragmatic similarity between the application of Article 7 and Article 9.

Faithfully yours,

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