

# 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

4 October 2017





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15 September 2017

Dear Sir,

**Discussion draft on BEPS Action 7 – Additional guidance on the attribution of profits to permanent establishments**

AFME<sup>1</sup> and UK Finance<sup>2</sup> welcome the opportunity to respond to the OECD’s discussion draft entitled “BEPS Action 7 - Additional guidance on the attribution of profits to permanent establishments”, published on 22 June 2017 (the June 2017 discussion draft).

We welcome that the OECD is again consulting with business on its proposals. We believe that this approach is to the benefit of both policymakers and business and helps to avoid any unintended consequences arising from the OECD’s proposals. We are pleased that specific consideration has been given to the financial services sector in the discussion draft, and we would be pleased to contribute to the development of further OECD guidance for the sector if that would be helpful.

AFME and UK Finance<sup>3</sup> previously submitted comments on the OECD discussion draft published in May 2015 entitled “BEPS Action 7: Preventing the artificial avoidance of permanent establishment status” (the May 2015 discussion draft). In the AFME/UK Finance letter to the OECD on 12 June 2015 (attached again at Appendix 1 for reference)

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<sup>1</sup> AFME represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society. AFME is registered on the EU Transparency Register, registration number 65110063986-76.

<sup>2</sup> UK Finance is a new trade association which was formed on 1 July 2017 to represent the finance and banking industry operating in the UK. It represents around 300 of the leading firms providing finance, banking, markets and payments-related services in or from the UK. UK Finance has been created by combining most of the activities of the Asset Based Finance Association, the British Bankers’ Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association.

<sup>3</sup> Formerly the British Bankers’ Association (BBA)

in response to the June 2015 consultation, we made recommendations to address our concerns with respect to the proposed lowering of the threshold for establishing a permanent establishment (PE) for dependent agent PEs. Specifically, we were concerned that arrangements which are generally considered to be part of the ordinary course of business of financial institutions, and which do not lead to base erosion or profit shifting, could be caught by the proposed new test in Article 5(5) of the OECD's model double tax convention. We noted that this could lead to a significant number of new PEs arising in situations where the activities and taxable profits are already fully recognised (which would be unhelpful for both tax authorities and taxpayers).

To address these concerns, in our letter to the OECD on 12 June 2015, we recommended the following steps:

- a) It should be made clear that where a group's transfer pricing policy appropriately provides for income, which is recognised and taxed by an appropriate entity taxable in the relevant jurisdiction, the recognition of a further PE is not required. In these cases, the income recognised should be consistent with approved transfer pricing policy. For banks, reference should be made to the principles contained in the OECD's 2010 report on the attribution of profits to PEs<sup>4</sup>.
- b) Further guidance should be developed on the meaning of the terms "habitually" and "concludes contracts, or negotiates the material elements of contracts" and how they should be interpreted in the context of regulated banking activities. We should be pleased to contribute to the development of such guidance.

We welcome that the OECD has included in the June 2017 discussion draft the recommendation detailed in point (a) above. However, we believe that further guidance would still be very helpful on the meaning of the terms "habitually" and "concludes contracts, or negotiates the material elements of contracts" and how they should be interpreted in the context of regulated banking activities. In addition, we would appreciate guidance on the meaning of the term "without material modifications".

In addition, we welcome the following points in the June 2017 discussion draft.

- a) In the introduction, the OECD confirms that there is a need for *additional guidance* on how Article 7 of the OECD Model Tax Convention will apply to PEs.
- b) In Paragraphs 8 and 10, the OECD notes that a 'deemed' PE must pay an arm's length fee for an intermediary's services when determining the taxable profits of the PE.
- c) In Paragraph 9, the OECD notes that a deemed PE should be treated as a *separate* and *independent* enterprise for the purposes of determining its profits. This should apply regardless of whether the country of the PE has adopted the

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<sup>4</sup> Available [here](#)

authorised OECD approach as outlined in the OECD's 2010 report on the attribution of profits to PEs.

- d) In Paragraphs 17 and 18, the OECD notes that 'significant people functions' for the purposes of the authorised OECD approach and the 'risk control function' for the purposes of attribution for Article 9 of the OECD Model Tax Convention may not be aligned. However, the OECD states that where they are aligned, the functions should not be allocated to the intermediary and also attributed to the PE.
- e) In Paragraph 19, the OECD states that the attribution of profits to 'deemed' PEs may be *minimal* or even *nil*.
- f) In Paragraphs 20 and 21, the OECD refers to approaches which may be taken to enhance simplification and reduce the administrative burden involved. In particular, in Paragraph 21, the OECD refers to instances where a country collects tax only from the 'intermediary' even though the tax is calculated by reference to the activities of both the 'intermediary' and the PE.

Once again, we are pleased to provide comments on the OECD's June 2017 discussion draft. If you have any questions on the above comments, please let us know.

Yours sincerely,



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15 September 2017

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

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

We welcome the opportunity to comment on the OECD's discussion draft containing additional guidance on the attribution of profits to permanent establishments, issued on 22 June 2017.

While the scope of the discussion draft is relatively limited and does not add significantly to the existing guidance on the attribution of profits to permanent establishments, there are one or two useful clarifications, which are to be applauded.

Nevertheless, we have a fundamental concern that this latest discussion draft was issued so soon after the initial signing by 68 countries on the 7<sup>th</sup> of June this year of the BEPS Action 15 Multilateral Instrument ('MLI'), and is not responsive enough to the outcome of that signing. This concern arises because the stated positions of a significant number of those MLI signatories were that they would not be introducing the BEPS Action 7 changes to the dependent agency permanent establishment ('DAPE') provisions of Article 5(5) of the Model Tax Convention ('MTC'). Yet the Action 7 changes to Article 5(5) are the significant focus of the current discussion draft. Would it not, therefore, have been advisable firstly to analyse the MLI positions, and then to have issued a discussion draft that addresses those aspects of Action 7 of most relevance to the largest number of countries? Had this been done, it would certainly have been the case that the discussion draft would have placed more emphasis on providing guidance on the Action 7 changes to fixed place of business ('FPOB') permanent establishments.

***Application of principles***

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

It is to be welcomed that the draft confirms (at paragraph 9) “*the basic principle that the profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions*” and that “*This principle applies regardless of whether a tax administration adopts the authorized OECD approach (“AOA”) contained in Article 7 in the 2010 version of the MTC as outlined in the 2010 Report on the Attribution of Profits to Permanent Establishments (“2010 Profit Attribution Report”), or any other approach used to attribute profits under a previous version of Article 7 of the MTC.*”

It is also helpful that the draft (at paragraph 12) confirms that “*the order in which Article 7 and Article 9 are applied should not impact the amount of profits over which the source country has taxing rights as a result of the activities of the intermediary on behalf of its associated non-resident enterprise in the source country*” and stipulates that “*any approach to the application of Articles 7 and 9 to cases of deemed PEs under Article 5(5) must ensure that there is no double taxation in the source country, i.e., taxation of the same profits in the hands of the PE (under profit attribution rules) and in the hands of the intermediary (under transfer pricing rules).*”

The draft further specifies that “*jurisdictions are expected to have in place within their domestic legal and/or administrative systems the necessary principles, doctrines, or other mechanisms to eliminate double taxation in the source country*”, and this practical direction is to be strongly welcomed.

However, the observation concerning the order of application of Article 7 and Article 9 that “*The approach adopted by a jurisdiction should be applied consistently and could be made public for purposes of transparency and certainty for taxpayers*” appears somewhat lacking in commitment and we would therefore encourage the OECD to compile and issue firmer recommendations to jurisdictions in this respect.

### ***Administrative simplification***

At paragraphs 20-21 the draft raises the fundamentally important issue of ‘*Administrative approaches to enhance simplification*’ and provides the simplification example of collecting tax only from the resident intermediary by reference to the activities of both the intermediary and the Article 5(5) permanent establishment of the non-resident enterprise.

We believe that simplification recommendations can be taken further. The authorised OECD approach is already to apply the arm’s length principle of Article 9, as articulated in the Transfer Pricing Guidelines, to the attribution of profit to a permanent establishment using the arm’s length principle under Article 7(2). The principle applied in the first three examples concerning the creation of DAPes through the activities of related intermediaries is consistent with this and therefore we can address all three examples by focusing on the first.

In passing, it is worth noting that *Example 3: Procurement of Goods (Related Intermediary)* is a useful reminder that a DAPE can arise in circumstances other than those involving sales (or sales-related) activities.

The first situation, whereby a permanent establishment is created by virtue of the activities of a related-party intermediary, Sellco, starts from the basis that the revenues of TradeCo's permanent establishment equal the sales of goods to customers. The Transfer Pricing Guidelines are then applied to determine the amounts to be deducted from the permanent establishment's profits. Thus, the arm's length principle is applied to determine TradeCo's profits in line with the functions, assets and risks related to the sale of the goods.

Similarly, the arm's length principle is applied to determine the costs of the permanent establishment and the arm's length remuneration of SellCo. If the arm's length principle is properly applied, it is hard to see how this could ever result in any surplus profit attributable to the permanent establishment over and above the remuneration of SellCo, in so far as it is SellCo's role that creates the permanent establishment of TradeCo.

That this should be the result should indeed be a self-evident consequence of the application of the authorised OECD approach ('AOA') of the OECD's 2010 *Report on the Attribution of Profits to Permanent Establishments*. However, far from all bilateral tax treaties adopt Article 7 (Business Profits) of the 2010 MTC, to which the AOA applies. This is, for example, the case with China. We recognise, therefore, the significant challenge in developing workable guidance capable of being applied in any meaningful fashion to the various Business Profits articles in existing treaties, and this no doubt accounts for the absence of numerical examples in this discussion draft, as compared with the July 2016 discussion draft.

Nevertheless, it is to be welcomed that the discussion draft spells out more clearly than hitherto the absence of any further profit attributable to a permanent establishment where an intermediary's activities create the permanent establishment, and that the draft explicitly recognises that the same profits should not be taxed both in the permanent establishment and in the intermediary.

While the lack of priority of application of an Article 7 analysis or an article 9 analysis seems to us irrelevant, given that the outcome is not foreseeably different no matter in which order the analysis is performed, if there are circumstances, as in the example above, where application of the arm's length principle is always likely to see no extra profit attributed to the permanent establishment of Tradeco, it seems to us sensible to recognise from an administrative perspective that only one analysis is necessary.

Given that this is the case, it would be useful to have some guidance that would allow administrative simplification in cases where it is recognised that only one analysis need be applied.

Further, Example 4 provides an example under the new anti-fragmentation rule at Article 5(4.1) of the creation of two geographically separate permanent establishments with a fixed place of business (one for warehousing, the other for a merchandising office), each of which necessitates separate and distinct calculations of attributable profit. While there can be little argument with the technicalities of this approach, the draft fails to take the opportunity to suggest what practical measures could be applied in the source country, Country S, to simplify the administrative burden associated with the existence of two permanent establishments.

Given that the OECD has itself identified the critical importance of simplifying the administrative procedures applicable to permanent establishments, the encouragement offered in the draft that “*nothing in this guidance should be interpreted as preventing host countries from continuing or adopting the kind of administratively convenient procedure mentioned*” (see paragraph 21) is of no particular use. Instead, we would strongly encourage the OECD itself to develop recommended simplification guidelines (capable of adaptation, as appropriate) in sufficient detail to assist countries with implementing reasonable simplification measures.

#### **Further work**

Certainly, we welcome any convergence in principle of the authorised OECD approach, as applied to Article 7, and the Transfer Pricing Guidelines, as applied to Article 9, that will result in administrative simplification. It is surely consistent with the focus on profits following value creation that permeates the BEPS Project that the mere legal form of an entity should not be determinative per se of its profitability. In other words, all other things being equal, whether it is a legal entity or a permanent establishment performing an identical role should not determine the level of profitability.

Hence, with this thought in mind, we believe that there remain areas still to be addressed. The discussion draft acknowledges that one cannot draw the conclusion that the concept of “significant people functions” for attributing risk assumption and economic ownership of assets to a permanent establishment in the AOA is aligned with or can be used interchangeably with the notion of “risk control functions” as outlined in the Transfer Pricing Guidelines. We do not see that it is useful to be applying two separate concepts for essentially the same goal and we urge that attention be given to reconciling these approaches.

Similarly, and perhaps not unnaturally given the fact that a permanent establishment is postulated as a hypothetical enterprise separate from the enterprise of which it is a permanent establishment, whereas in an Article 9 case the enterprises being examined are actually legally separate, the attribution of free capital in the AOA has no equivalent in the Transfer Pricing Guidelines. This therefore remains another main difference to be reconciled.

The goal of this would be administrative simplification, which brings us back to our earlier comments on the desirability of the development of further guidance to this end.

We would also welcome additional guidance on profit attribution with respect to the new FPOB PE provisions of Article 5(4), and the anti-fragmentation rule at Article 5(4.1).

We trust that you find our comments constructive and look forward hopefully to further developments to build on this promising draft.



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## Comments on attribution of profits to PEs

Thank you for the invitation to comment on the discussion draft of 22<sup>nd</sup> June 2017 on the additional guidance on attribution of profits to permanent establishments. These comments reflect my personal views and have not been prepared on behalf of or at the request of any other person or organisation.

### **Introductory comments on the usefulness of the conceptual framework and unfulfilled remaining policy objectives**

Whereas the previous discussion draft of 4<sup>th</sup> July 2016 tried to explore the principles of profit attribution through detailed step-by-step examples, assisted by numerical illustration, the latest draft provides a conceptual framework. The usefulness of the conceptual framework in determining practical attribution depends on the accuracy with which the concepts are described and the consistency with which they can be interpreted. My concern is that the description of the conceptual framework is open to different interpretations with the potential to conclude that there will never be any profits to a PE or that there will be significant profits attributable to a PE depending on interpretation. The guidance seems to depart from the 2008 and 2010 OECD Attribution of Profits Reports; it may be that the guidance will indeed need to refine or supplement aspects of these Reports, but such refinement should be explicit, while safeguarding aspects relating to financial services which enjoy widespread acceptance. If the perception of varying interpretations results from the deliberate crafting of the guidance to mask and accommodate differences of views held by stakeholders, then the outcome is confusing and not helpful. Efforts should continue to try to set out a common application of Article 7 to the scenarios covered, in conjunction with Article 9 where appropriate.

Aspects of the 2016 discussion draft may have been rejected precipitately. The 2016 draft attempted through its examples and questions to tease out important principles of profit attribution. Written comments responded to the challenge and produced some extremely thoughtful and detailed critiques and suggestions. There were points of support for the guidance in the 2016 draft, as well as points of disagreement which were illuminating and seemed capable of being worked through and resolved. The written comments did not seem to indicate that the vaguer guidance in the 2017 draft would be of greater practical use.

The 2017 draft has not capitalised on the potentially useful point that it is possible to identify the circumstances in which there would be no profits attributed to a PE. Paragraph 19 states that when the intermediary is assuming the risks of the transactions of the non-resident enterprise, “the profits attributable to the PE could be minimal or even zero,” but the statement should be bolder. If the significant risks are assumed by the intermediary, and the pricing is arm’s length, then there would never be any profits attributable to the PE. In addition, it is surely possible, given the generally supportive written comments to question 5 of the 2016 draft, to find a formulation that provides helpful guidance about minimal or zero profits in the situation where the intermediary has limited functions in relation to risks of the non-resident enterprise, appropriately defined. More generally, the current draft has not sought to advance possible streamlining of the complexities that were generally supported in the comments on the 2016 draft.

Moreover, the draft has chosen to respond inflexibly to the extensive comments querying whether an analysis under Article 9 changes the conditions relevant for determining whether a DAPE exists. A written contract that is not followed in key aspects with the result that the conduct of the parties gives a different interpretation of the purported dependent agent relationship of the parties seems very relevant

## Comments on attribution of profits to PEs

evidence for the application of Article 5, just as it is for determining the commercial or financial relations under Article 9. Since Article 9 can now achieve some of the policy objectives behind the DAPE concept and allows risks and rewards to be allocated to the source country, it would be helpful to concentrate on analysing the circumstances in which Articles 5(5) and 7 usefully fulfil any remaining policy objective. Perhaps the usefulness is restricted, where Article 9 also applies, to those countries who feel their principles of legal interpretation do not allow them to depart from the written contract.

More detailed comments on the meaning of the conceptual framework are contained in Section A of this note; Sections B and C provide more detailed comments on the facts on which Article 5(5) is predicated, simplification, and on the order of application of Articles 7 & 9.

### **A. What does the conceptual framework mean?**

1. All four examples use the same key wording to describe the framework of profit attribution in paragraphs 25, 30, 34, 48, and 49. The most problematic wording is that in parentheses in step (1) which require the PE to be attributed “ownership of the assets [of the non-resident company] related to such functions, and assumption of the risks related to such functions.” The words “such functions” seem to refer, in the commissionaire example, to the selling of goods to an unrelated party performing the same or similar activities under the same or similar conditions that the intermediary performs. The footnote indicates that the outcome is conceptually equivalent to the amount paid by the PE for the inventory “purchased” from the non-resident and which would correspond to a “dealing” under the AOA. However, the AOA is fairly clear about how to attribute assets and risks within an enterprise. The new draft guidance is far from clear. What is meant by assets and risks “related to such functions”? Does it just mean inventory and inventory obsolescence risks? If so, does it matter where the inventory is physically located, and does it matter where key decisions affecting inventory risks are taken? If not, why not, since these are among the issues that have been regarded as affecting attribution of profits. Does the guidance intend to cover a wider range of assets (and liabilities) and risks? For example, is a warehouse “related to” the sale of goods? Is a proprietary software programme governing stock replenishment “related to” the sale of goods? Is a marketing intangible related to the sale of goods? Is the necessary funding “related to” the sale of goods? If so, does it matter where the assets are located, how they were developed, and how they are managed and key risks controlled? If not, why not, since these are among the issues that have been regarded as important in determining to which part of the enterprise assets, risks, and associated profits are attributed. In summary, the meaning of this step is unclear, but it seems to have the effect of reducing the price of goods sold to the PE, and thus increasing the profits of the PE, since the assets and risks related to value creation are also automatically attributed to the PE. The framework seems to endorse treating the hypothetical unrelated party as performing a buy-sell activity, and apparently ruling out other perhaps more appropriate hypotheses taking into account the lower level of thresholds that may now apply in determining the existence of a DAPE.
2. The apparently automatic attribution of a potentially wide range of “assets and risks related to such functions” may be moderated by the deduction under step (2) of the conceptual framework. This step requires the deduction of “other expenses, wherever incurred, for the purposes of the PE.” So, if the asset is limited to inventory only, this step would presumably allow for inventory management costs incurred by the head office, for example, to be deducted. Presumably, it would also allow for

## Comments on attribution of profits to PEs

any inventory write-offs to be deducted. If the assets and risks “related to such functions” are more comprehensive, then this step might allow for deductions relating to costs of a warehouse, to software development, to marketing intangibles, or to funding. However, it would not seem to allow for an arm’s length fee, depending on how the reference to Article 9 is interpreted—see below.

3. All three steps are to be determined in accordance with Article 9 and the Transfer Pricing Guidelines. Article 9 does determine risk assumption, and so that part of Step (1) which attributes assumption of risks seems to be governed by the Transfer Pricing Guidelines. Does this mean that the attribution of risks to the PE under Step 1 is not automatic, but needs to be determined by principles analogous to the risk control framework in Chapter I? Such an approach makes sense, but if that is what the draft intends, then it could have been expressed more clearly. Step (2) refers to attribution of expenses, but the Transfer Pricing Guidelines are focussed on arm’s length pricing. There can be a significant difference between an allocation of expenses and an arm’s length price. The footnote refers to both expenses and a dealing, with a dealing being subject to arm’s length pricing. Does the requirement to use Article 9 in determining the deduction under Step (2) extend to using an arm’s length price? The combination of attributing risks under an Article 9 control framework and using arm’s length pricing for the intra-enterprise dealings will tend to have a big impact on the resulting attribution of profits, and so how Article 9 and the Guidelines are intended to apply requires explanation.
4. The same points about what the key wording means is relevant to all four examples in the draft. In particular, in Example 2 the framework seems to require that assets and risks of SiteCO are attributed to the PE where they are related to the functions of selling advertising space performed by SellCo; in Example 3 the framework seems to require that assets and risks of TradeCo are attributed to the PE where they are related to the functions of procuring widgets performed by BuyCo; and in Example 4 the framework seems to require that assets and risks of OnlineCo are attributed to the PE where they are related to the functions of storage and delivery performed by the warehouse PE or to the functions of merchandising and collection of information performed by the office PE. In all cases the scope of assets and risks to be attributed is unclear because of the imprecision in the wording, and the rationale is unstated. In the case of the warehouse in Example 4, it is unclear whether the conceptual framework would result in a different profit attribution to that in Example 5 of the 2016 draft. The difference between owning and leasing a warehouse in the two examples should not give rise to differences in principle, but the main issue is likely to be the scope of the assets and risks that are attributed to the warehouse PE under the conceptual framework.
5. Whilst the conceptual framework is not clear about the principles governing how risks and assets of the non-resident enterprise are attributed to its PE, the draft is clear that risks allocated to the intermediary under Article 9 are not available to be attributed to the PE. This important statement resolves the convolutions explored in the 2016 draft in Examples 2 and 4 arising from the possibility, in the absence of priority between Articles 7 and 9, for the same risk to be simultaneously allocated to both the intermediary and to the PE. The current draft sensibly creates the rule that “where a risk is found to be assumed by the intermediary under the guidance in Section D.1.2 of Chapter I, such risk cannot be considered to be assumed by the non-resident enterprise or the PE for the purposes of Article 7.” However, it is unclear whether the conceptual framework in the current draft would result in a different outcome to that in Example 2 of the 2016 draft, which

## Comments on attribution of profits to PEs

tended to suggest that the return to the DAPE is limited to its funding of working capital assets. The framework can be read to support this conclusion.

6. Example 4 in the 2016 draft introduced a further complication that involved the non-resident enterprise assuming risk for the purposes of Article 9, and so the risk was not allocated to the intermediary, notwithstanding the fact that the intermediary also exercised control over the risk. The significant point is whether the activities of the intermediary in relation to the risk of the non-resident would result in the risk being attributed to the DAPE of the non-resident. It is unclear whether the conceptual framework in the current draft would result in a different outcome to that in Example 4 of the 2016 draft, which tended to suggest that the risk would be shared between the DAPE and the non-resident. The framework can be read to support a different conclusion that the risk would be attributed to the DAPE entirely.
7. These observations are made not primarily from the perspective that there is a right or wrong answer (although ultimately the guidance should demonstrate how to apply a commonly accepted approach), but that these are important practical issues in the application of Article 7 that are not clarified in the current draft. However, if the stakeholders of the current draft believe such practical issues have been resolved, then the conceptual framework should be made clearer and the governing principles further explored and endorsed. One line of exploration might be that where economically significant risks are allocated to the intermediary under Article 9 neither those risks nor the associated assets can be attributed to the DAPE, and profits attributable to the DAPE are extinguished by an arm's length fee. Such an approach would also eliminate the potential for a funding return. Another line of exploration in the case of potentially split risks between the non-resident enterprise and the intermediary is to determine that the risk and associated asset should be allocated to one party based on the overall balance of important functions (and avoiding the need to determine any fine distinctions between risk control functions under Article 9 and significant people functions under Article 7).
8. Finally, it would be helpful if the current draft could provide a clearer view on the preference expressed in the OECD Attribution of Profits Reports for a dual taxpayer approach rather than a single taxpayer approach. The rule in the current draft preventing risks being allocated to more than one entity may suggest support for a single entity approach. The changes to the Transfer Pricing Guidelines allows one of the policy objectives behind the DAPE concept to be achieved through Article 9. Contrary to what the OECD Attribution of Profits Reports concluded prior to the changes to the Guidelines, the single taxpayer approach does allow risks and rewards to be allocated to the source country, even when the written contract states otherwise. More clearly adopting a single taxpayer approach and recognising the effectiveness of Article 9 to fulfil policy objectives in relation to DAPes would open up ways to reduce compliance burdens and complexity. The next section discusses more comprehensive ways to reduce compliance burdens and complexity.

### **B. The facts on which application of Article 5(5) is predicated and simplification**

9. The draft has decided in paragraph 14 that an analysis under Article 9 does not change the facts on which the application of Article 5(5) is predicated. The draft could have looked on this point in a more flexible manner, and responded more sympathetically to the extensive comments on this

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point. The draft concludes that the allocation of risks between the non-resident enterprise and the intermediary does not change the fact that the intermediary is acting on behalf of the non-resident enterprise, which is one of the necessary conditions for a dependent agent PE. The draft's logic seems open to challenge. The guidance in Chapter I of the Transfer Pricing Guidelines seeks to ensure that the actual transaction is accurately delineated. In doing so, it uses principles aligned to principles of legal construction to determine what the nature of the commercial relationship is, drawing on the evidence of formal agreements but also on other communications and having regard to the conduct of the parties. Importantly, in law the conduct of the parties is relevant to determining the terms and nature of the commercial relationship, and the commercial relationship would not be restricted to that set out in the written contract if the conduct of the parties indicated a different relationship. I believe that a lawyer determining the actual nature of a commercial relationship is likely to feel familiarity with the conclusion to 1.46 of the Guidelines: "Where there are material differences between contractual terms and the conduct of the associated enterprises in their relations with one another, the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, should ultimately determine the factual substance and accurately delineate the actual transaction." Therefore, in a situation where the factual substance of the commercial relationship is that the intermediary makes its own decisions in relation to its selling activities and the intermediary controls the associated risks, it hard to conclude for any purpose that it is acting on behalf of another party.

10. Flexibility on this point is encouraged because it would in turn enable a more helpful approach to enhance simplification than simply collecting tax arising from the PE through the intermediary, as described in paragraphs 20 and 21. A more flexible interpretation would allow measures to prevent the existence of a PE in circumstances in which the accurate delineation of the actual transaction under Article 9 allocates significant risks to the intermediary such that its profits are not determined by reference to the profits of an uncontrolled agent but by reference to an uncontrolled buyer and seller. Nothing would be lost by such an exemption since paragraph 19 helpfully states that the profits attributable to the PE could be minimal or even zero "when the accurate delineation of the transaction under the guidance of Chapter I of the TPG indicates that the intermediary is assuming the risks of the transactions of the non-resident enterprise." But much would be gained in not having to register a PE. It is very difficult to see that a party that is determined under a factual analysis to be assuming risks of the transactions of the non-resident enterprise is also acting on behalf of that non-resident enterprise.
11. In addition, the helpful statement in paragraph 18 that a risk that has been allocated to the intermediary under Article 9 (notwithstanding the written contract) cannot be considered to be assumed by the non-resident enterprises or the PE for the purposes of Article 7 does show the flexibility which is denied to Article 5. Paragraph 18 is content to authorise the overturning of the written contract for the purposes of Article 7 despite the inconsistency of insisting on the terms of the written contract, even though it is not followed in key aspects that would affect the dependent agent relationship of the parties, for the purposes of Article 5.

Comments on attribution of profits to PEs

**C. Order of application of Articles 7 and 9**

12. It appears surprising that the order of application of Articles 7 and 9 cannot be decided in paragraph 12. The conceptual framework for the application of Article 7 requires the arm's length remuneration of the intermediary, so you cannot complete an Article 7 analysis without knowing the Article 9 outcome. In addition, if you have not determined the profits on the non-resident enterprise under Article 9 before you perform the Article 7 analysis, you are likely to have to re-perform the Article 7 analysis taking into account revised profits under Article 9. Finally, if the requirement to apply Article 9 in the conceptual framework covers assumption of risks related to functions, as it seems to do, it is pointless to perform an Article 7 analysis first. The priority of Article 9 over 7 seems to be acknowledged in paragraph 18 which states that a risk assumed by the intermediary under Article 9 cannot be considered to be assumed by another party for the purposes of Article 7. Notwithstanding the statement in paragraph 12 that the order of application should not affect the amount of profits, failure to decide on the order does tend to suggest that some countries perceive they could be disadvantaged if Article 9 takes precedence. If this is the case, it would be useful to set out in the guidance the reasons and the circumstances so that the exceptions to a general rule that Article 9 takes priority could be determined.

Thank you for considering these comments. I should be happy to discuss any points you think may merit development.

With best wishes

Andrew Hickman



15 September 2017  
Tax Treaties, Transfer Pricing and  
Financial Transactions Divisions  
OECD/CTPA  
2, rue André Pascal  
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cc: Laura Beretta; Gianni De Robertis

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

Dear Sirs,

*Federazione Nazionale Imprese Elettrotecniche ed Elettroniche* ("ANIE") thanks the OECD for the opportunity to comment on the OECD Centre for Tax Policy and Administration's Discussion Draft on the second Additional Guidance on the Attribution of Profits to Permanent Establishments (the "Discussion Draft") released on 22 June 2017.

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

**Comments on the attribution of profits to permanent establishments resulting from changes to Article 5(5) and 5(6) and the Commentary**

- Based on the wording of the Discussion Draft, the determination of the attribution of profits to a PE will remain in accordance with Article 7 (and also Article 9 if there is an Intermediary) of the relevant tax treaty, regardless of whether or not a tax administration adopts the Authorized OECD Approach (the "AOA") as outlined in the 2010 Report on the Attribution of Profits to Permanent Establishments (the "2010 Report"), or any other approach used to attribute profits.

We appreciate that the Discussion Draft restates the basic principle for the determination of the profits indicated in these articles. We also appreciate the fact that the Draft recognizes the burden on taxpayers of having to produce two different tax returns and discuss administrative approaches to enhance simplification. As pointed out in our comments on the previous discussion draft, it would be preferable to find a practical way of improving coordination between Article 7 and Article 9, reducing the complexity of the allocation of profits to the PE and ensuring that the correct profit is taxed to the entity which operates in the host country, without the additional burden of a filing requirement for the PE. Therefore, it could be useful if the OECD advises or invited countries to embrace simplification and the setup of mechanisms ensuring that the entire profits are taxed only to one taxpayer (the Intermediary or PE) rather than having to be split between two different legal entities and taxpayers.

- We understand that it is the OECD's intention that any approach on how to attribute profits to a PE deemed to exist under the pre-BEPS version of Article 5(5) should be applicable to a PE deemed to exist under the new BEPS version of Article 5(5), and that the 2010 Report and the AOA are therefore still valid. However, the Discussion Draft does not fully clarify whether and how its content is fully aligned with the AOA, as there seem to be some differences in the way profits would be attributed under the AOA and under the new Chapter 1 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. In particular, there seems to be cases where, the application of the current Discussion Draft would attribute risk and consequently profit/loss to the Intermediary while the AOA would attribute them to the PE. We invite the OECD to provide further clarification on the interaction between the content of the discussion draft and the existing guidance on the attribution of profits to permanent establishments, and in particular the AOA.
- With reference to the attribution of risk assumption and economic ownership, the Discussion Draft clearly states that an identified risk should be assumed only once – by the intermediary or by the PE – consequently avoiding the risk of double taxation in the source country through taxation of the profit(s) related to the assumption of this risk. However, further simplification could have been achieved by harmonizing the concepts of Risk Control Functions (under Article 9) and Significant People Functions (under Article 7), so that the same set of functions could have been used both for the AOA analysis and for the analysis under Article 9. In the absence of such harmonization, it would be useful to provide further clarification on how the two concepts/sets of functions relate to each other.
- Based on the wording of Examples 1 and 2 of the Discussion Draft, the PE seems to be entitled to any residual profit (loss) after the intermediary and the head office have been remunerated. We do not think this is the interpretation intended by the OECD, as it would be inconsistent with what it is stated in other parts of the Discussion Draft and with the AOA. Therefore, to minimize the chances of misinterpretation we think it is important that the OECD clarify the correct interpretation of Examples 1 and 2.

In addition, it may be worth clarifying the meaning of point (1) in Examples 1 and 2, where it is indicated that "(1) the amount that ... (attributing to such party the ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)".

## Conclusions

We appreciate the work performed by the OECD in a complex area such as the attribution of profit to permanent establishments and welcome the improvements in the Discussion Draft. We thought that the Discussion Draft should suggest more simple ways of determining the attribution of profits to PEs, in order to reduce the burden of compliance on taxpayers.

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

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

Yours faithfully,

Maria Antonietta Portaluri



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## About ANIE

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

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

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

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

## **Response to the discussion draft on OECD BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments (PEs) released 22 June 2017.**

### **About the ABI**

The Association of British Insurers is the voice of the UK's insurance and long term savings industry. Our 250 [members](#) include most household names and specialist providers who contribute £12bn in taxes and manage investments of £1.6 trillion. The UK insurance industry is the fourth largest in the world (after the US, Japan and China) and the largest in the EU.

### **Introduction**

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

### **Response**

2. The ABI believes that the discussion draft is an improvement from the one that was released on 4 July 2016 and we found the analysis in paragraph 18 of where both Article 7 and Article 9 are applicable helpful. We also welcome the acknowledgement in paragraph 19 of the discussion draft that “....., the net amount of profits attributed to the PE may be either positive, nil or negative (i.e., a loss).”
3. Although the additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in the Report<sup>2</sup> apply particularly outside the financial sector, we continue to be concerned about the potential for inadvertent impacts on insurance operations. These concerns fall into two areas.

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<sup>1</sup> Discussion draft on OECD BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments released 22 June 2017.

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

4. Firstly, only Part I of the 2010 OECD Report on the Attribution of Profits to Permanent Establishments (2010 Report) is referenced in the discussion draft. In particular, paragraph 16 references Part I and that “significant people functions” are used for attributing risk assumption.
5. Risk assumption is a key component of insurance business models and the basis for attributing of profits to PEs in the insurance context is done by the location of the Key Entrepreneurial Risk-Taking (KERT) functions as set out in Part IV of the 2010 Report. We therefore believe that, to avoid inadvertent and inappropriate attributions in the insurance context, Part IV of the 2010 Report must be specifically referenced in the final guidance on Article 5(5) and 5(6) as it provides comprehensive guidance which defines and discusses risks, risk management and allocation of risk in the context of insurance businesses. We believe that this is particularly important in view of the fact that the discussion draft refers to risk control functions in its analysis of the allocation of the assumption of risk where both Article 7 and Article 9 are applicable (Paragraph 18).
6. If this is not possible to specifically reference Part IV of the 2010 Report then we would ask that the full 2010 report is referenced rather than just Part I when the attribution of profits is discussed.
7. Secondly, it will be noted from the ABI response to the last discussion draft<sup>3</sup> that virtually all PEs created as a result of the widened PE definition involve intermediaries. On a correct application of Part IV of the 2010 Report, and the analysis in paragraph 18 of the discussion draft of where Article 7 and Article 9 are applicable, there will be nil or minimal profit attributed as the functions being performed by the intermediary are non-KERT and would already be rewarded commensurate with the duties performed. We are therefore pleased the discussion draft makes reference to the 2010 Report and the ability for jurisdictions to use administratively convenient ways of collecting the appropriate amount of tax. However, we believe that the widened definition of PE is likely to create a plethora of insurance tax PEs (but not for regulatory purposes) where no or minimal profit would be attributable, thus creating an unnecessary administrative burden for business and tax authorities.
8. We are therefore strongly of the view that the final guidance on Article 5(5) and 5(6) should include a recommendation that jurisdictions should, in these circumstances, have administratively convenient ways of collecting the appropriate amount of tax to reduce the compliance burden for both business and tax authorities. An example of which is referred to in paragraph 21 of the discussion draft.

Association of British Insurers

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<sup>3</sup> OECD BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments discussion draft released on 4 July 2016

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.....

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

Dear Sir or Madam,

BDI\* refers to the OECD Discussion Draft “Additional Guidance on Attribution of Profits to Permanent Establishments” issued on 22 June 2017. The attribution of profits to permanent establishments is a notoriously difficult area and is viewed by businesses as a fundamental concern with regard to potential compliance burden and the risk of double taxation. The significant lowering of the PE threshold and very complex new guidance on the application of Article 9 of the OECD Model Tax Convention lead to a considerable increase in tax uncertainty by MNE, as room for interpretation has also increased.

.....

Therefore, BDI urges the OECD to develop further guidance on this critical issues, providing greater detail and quantitative examples. In a first step business would welcome additional clarity on the threshold issues of the OECD’s recommendations on Action 7, e.g. on the meaning of terms around the Art. 5 (5) exemptions (“plays the principal leading role to the conclusion of contracts”, “artificial splitting up of contracts”). We believe that further guidance in this regard would also help significantly to lower complexities associated with the attribution issues. In order not to render cross-border investment overly complex, much more uncertain than pre-BEPS and ultimately more costly, it is of high importance to implement and interpret the threshold as well as the profit attribution issues in a clear and consistent way. While we in principle support the high-level general principles outlined in paras 1-21 and 36-42 of the Draft we are concerned that such high-level guidance is not suited to deal with such a complex

.....

\* BDI (Federation of German Industries) is the umbrella organization of German industry and industry-related service providers. It speaks on behalf of 36 sector associations and represents over 100,000 large, medium-sized and small enterprises with more than eight million employees. A third of German gross domestic product (GDP) is generated by German industry and industry-related service.

topic and consequently will only lead to inconsistent outcomes and further tax uncertainty for MNE as well as for tax administrations.

Three further issues of concern from the business perspective include:

- The Discussion Draft lacks any explicit support for the adoption of the AOA and the consistency that this would provide in such a complex area. On the contrary, the language used e.g. in para 7 states that “any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5 (5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5 (5).” Therefore, countries may apply different versions of the AOA method (e.g. 2008, 2010) or even any pre-BEPS version of profit attribution, thus amplifying the potential for inconsistent application.
- While we welcome the initiative taken by the OECD in the Draft for the elimination of double taxation for the same profit which will arise in the host country after the attribution of profits to non-resident enterprise PEs (under profit attribution rules), and the profit adjustments for intermediaries (under transfer pricing rules), we note, however, that there is a lack of guidance for tax administrations relating to the priority of the attribution of profits or adjustments. Therefore, we would recommend that adequate guidance be included in the Draft regarding the order in which Article 7 and Article 9 should be applied in order to eliminate internal double taxation in the host country. At any rate, countries should be strongly encouraged by the OECD to share their respective approach regarding the sequencing of Article 7 and Article 9, especially if the final guidance will not include a clear order of application.
- We would welcome further guidance on administrative simplification as referenced in paras 20 and 21 of the Discussion Draft, as the modification to the threshold levels for PEs will result in a significant administrative, compliance, and financial burden both for taxpayers and tax authorities. Therefore, we would support a stronger emphasis of the benefits of administrative simplifications and an encouragement of tax administrations to find pragmatic solutions.

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

Sincerely,

Berthold Welling

Dr. Karoline Kampermann

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

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15 September 2017

Dear Sirs

**DISCUSSION DRAFT ON ADDITIONAL GUIDANCE ON ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS**

BDO welcomes the opportunity to comment on the OECD's Public Discussion Draft providing Additional Guidance on Attribution of Profits to Permanent Establishments, issued on June 22, 2017 (the "Discussion Draft").

We support the OECD's efforts to provide additional guidance on the attribution of profits to Permanent Establishments ("PE"s). We believe this will be helpful for multinational enterprises as they require more certainty with respect to the taxation of PEs.

We present below our comments with respect to the Discussion Draft. Our comments follow the same general flow as the points covered in the Discussion Draft.

**Dependent Agent versus Independent Agent - Changes to Articles 5(5) and 5(6)**

We appreciate the additional clarification that the changes to Article 5(5) and Article 5(6) act to modify the threshold for the existence of a deemed PE without modifying the nature of the deemed PE. Following that principle, you have clarified that the approach to attribute profits to the deemed PE should not vary, at all, with whether the PE was deemed to be a PE under the pre-BEPS version, or the post-BEPS version of Article 5(5).

**Attribution of Profits to PEs Resulting from Changes to Articles 5(5) and 5(6)**

We appreciate the confirmation that, once a PE is deemed to exist under Article 5(5), the profits attributable to that PE should be determined under Article 7. The underlying principle has not changed, in that the profits attributable to the PE "are only those that ... would have been derived if it were a separate and independent enterprise performing the activities that the dependent agent performs on behalf of the non-resident enterprise."

In paragraph 10 in the Discussion Draft, concerning an intermediary and a PE existing in a host country such that Article 7 may be more relevant, and in paragraph 11 in the Discussion Draft, concerning an intermediary and an associated non-resident entity, such that Article 9 may be more relevant, we question whether the additional guidance being provided by the OECD would be clearer to jurisdictions / tax administrators if the Articles in the OECD Model Tax Convention ("MTC") specifically stated that the profits attributable to the PE should always be determined using the OECD Transfer Pricing Guidelines ("TPG") even in situations where

the intermediary and the PE are not associated enterprises. In determining the profits attributable to a PE, as if it were a separate and independent enterprise, those profits should be based on a full analysis of the functions performed by the parties, the bona fide risks assumed and borne by the parties, and the assets owned, maintained and/or otherwise employed by the parties in the host country. This would require an in-depth analysis, in accordance with the TPG of the profit-related activities both in the host country and other countries.

### **OECD Examples of the Attribution of Profits to Deemed PEs under Article 5(5)**

#### *Example 1: Commissionaire Structure (Related Intermediary)*

We appreciate the analysis provided by the OECD for Example 1, including the point made in paragraph 27. Would the OECD's conclusion differ if the Services Agreement provides that the fee payable by TradeCo to SellCo is based solely on the costs incurred to provide the services to TradeCo plus an arm's length mark-up? In other words, is it the fact that the services fee is calculated based on sales in Country S that leads to the conclusion set out in paragraph 27?

Following the general principles of international tax law, a sale is made by a party if that party "negotiates" and "concludes" the sale, and the sale is properly reported in the jurisdiction within which the sale is negotiated and concluded. Is the mere absence of "material modification of the terms and conditions" of the sale by SellCo's efforts sufficient to lead to the conclusion outlined in paragraph 25 for the profits attributable to the TradeCo PE in Country S? Or, if TradeCo can support a conclusion that the sales are, in fact, negotiated and concluded outside of Country S, would the profits related to the sale then be taxable outside of Country S, despite the sales-related services being provided by SellCo?

#### *Example 2: Sale of Advertising on a Website (Related Intermediary)*

We appreciate the OECD's analysis on Example 2, as it draws out several questions that should be addressed in the additional guidance provided by the OECD, being:

1. Will the performance of "marketing activities" by an entity such as SellCo always be characterised as a "principal role" leading to the conclusion of sales?
2. What elements would distinguish "the routine conclusion of sales"?
3. The sale of some products and services do not involve a "material modification of the terms and conditions on which the customers offer to purchase". We would recommend that clearer guidance be provided with respect to the use of the words "without material modification". Would the jurisdictions / tax administrators be required to look factually at the place where the sale is negotiated and concluded?

#### *Example 3: Procurement of Goods (Related Intermediary)*

The analysis for this example falls in line with the changes to Articles 5(5) and 5(6). Can the OECD confirm that the profits attributable to the PE in this example should be determined using the most appropriate method, and that a CUP is not implied by default? This is particularly so given the potential limitations of available data for the identification of such a CUP.

We would recommend that the OECD make it clear that the profits attributable to the PE in this example may be determined using the most appropriate method in the TPG.

#### **Attribution of Profits to PEs Resulting from Changes to Article 5(4)**

We appreciate the additional guidance provided with respect to the anti-fragmentation rule outlined in new paragraph 4.1 of Article 5 to the MTC. The discussion concerning the two types of cases provides greater clarity.

#### **OECD Examples of the Attribution of Profits to Deemed PEs under Article 5(4)**

##### *Example 4: Warehousing, Delivery, Merchandising and Information Collection Activities*

As with Example 3, the analysis for this example falls in line with the changes to Article 5(4). Can the OECD confirm that the profits attributable to the PE in this example should be determined using the most appropriate method, and that a CUP is not implied by default? This is particularly so given the potential limitations of available data for the identification of such a CUP.

We would recommend that the OECD make it clear that the profits attributable to the two PEs in this example may be determined using the most appropriate method in the TPG.

#### **Concluding remarks**

The Discussion Draft provides helpful guidance with respect to the profits attributable to PEs. We appreciate the examples provided by the OECD. We have asked questions, where appropriate, to indicate areas / concepts / phrases requiring additional clarification and guidance.

We fully support the OECD's efforts to provide clear guidance on the attribution of profits to PEs, particularly deemed PEs under Articles 5(5) and 5(6).

We would like to thank the OECD again for this opportunity to comment and would be happy to expand on our responses and contribute to further stages of this Discussion Draft if required.

Please note that the responses presented above reflect the opinions of the authors and not necessarily the opinions of BDO as a whole. For clarification of any aspect of our responses presented above please contact:

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# The BEPS Monitoring Group

## Comments on the Public Discussion Draft on

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

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

We appreciate the opportunity to provide these comments, and are happy for them to be published. We would also be willing to speak at the public consultation in November.

September 2017

#### SUMMARY

A major motivator in initiating the entire BEPS project was to end BEPS motivated planning by centrally managed groups. Such planning often attributes sales to zero or low-taxed entities and separates sales through fragmentation from related core functions such as marketing, order fulfilment, and customer support performed by other group entities. Under Action 7 of the BEPS project some modest changes were agreed, so that in defined circumstances a non-resident entity could now be found to have a taxable presence (permanent establishment - PE) in a country in which it makes sales. The current proposals aim to clarify how profits should be attributed to such a PE.

We agree that attribution of profits depends on an analysis of the functions performed by the PE, but in our view this must not be done in isolation. A holistic approach should be adopted, which considers **all** the activities carried out in the country by the relevant entities **in conjunction**. Where a multinational chooses to carry out itself activities such as marketing, sales, order fulfilment, and customer support, it does so in order to take advantage of the synergies so created, thereby giving the customer a seamless experience and itself (i.e., the group) a significant market advantage. Hence, it is the **cumulative**

**importance** of all group activities that should be considered when evaluating the value which is created in the country.

Due to this cumulative importance, our view is still that article 7 should be applied prior to article 9, since this would result in both better focus by taxpayers and tax authorities, and a practical reduction in the resources needed by both tax authorities and taxpayers for compliance.

A holistic approach will also lead in some circumstances to a different transfer pricing method being the most appropriate method. In particular, where such related functions are performed by highly integrated associated entities and are viewed holistically, the profit-split method is likely to prove more appropriate than one-sided methods.

A holistic approach is also important since the DD is meant to apply to all versions of article 7 of the model convention, and whether or not a state has accepted the changes adopted by a majority of OECD states in 2010, described as the authorized OECD approach (AOA). While the AOA has some merits, it has been used to further exacerbate a fragmented approach to the attribution of profits, which (along with the independent entity principle in general) has been a principal enabler of BEPS. Adoption of the holistic approach which we suggest could, we believe, allow some of those helpful features of the AOA to be retained, while ensuring that BEPS structures are not allowed to continue due to a narrow interpretation applying the independent entity principle to an entity which is not even legally separate.

Our Specific Comments section includes a number of concrete suggestions to make the DD more internally consistent and effective in its application.

## **A. GENERAL REMARKS**

### **1. The context of these proposals**

The issues addressed in this discussion draft (DD) concern key profit shifting structures which were among the main concerns that helped initiate and drive the entire BEPS project.<sup>1</sup> These have enabled some multinational enterprises (MNEs) to pay little tax in countries where they not only have substantial sales, but also conduct related and often fundamental and core activities (such as marketing, order fulfillment and customer acquisition, development and support) through affiliates in that country which form part of the MNE corporate group. The principal changes under Action 7 of the BEPS project aim to counteract such mechanisms used by many taxpayers to avoid tax, by expanding

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<sup>1</sup> The BEPS Action Plan of 2013 pointed out (p.19) that ‘In many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this has led enterprises to replace arrangements under which the local subsidiary traditionally acted as a distributor by “commissionnaire arrangements” with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.’

the definition of a Permanent Establishment (PE) under Article 5. Following these changes

(i) a PE can be found to exist if a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related and ‘habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise’, and the contracts are either in the name of the enterprise, or for the transfer of goods or services by the enterprise; and

(ii) the activities listed in article 5(4) of the model convention as exceptions (such as warehousing) will constitute a PE unless they are each of a ‘preparatory or auxiliary character’.

In these circumstances a non-resident entity could now be found to have a taxable presence (PE) in a country in which it makes sales, and where members of the group of which it is a part are conducting related activities such as marketing, order fulfillment and customer support. Indeed, it may be one of those affiliates which could be found also to constitute a PE of the nonresident entity.<sup>2</sup>

The purpose of the current DD is to provide additional guidance on how to attribute profits if a PE is found to exist due to the new expanded PE definitions. Because it will often be read as a standalone document, we believe it important to include in the Introduction and elsewhere within the guidance some explanatory background noting the use of these structures in tax avoidance schemes and how the expansion of Article 5 and the resulting attribution of profits under Article 7 will achieve the BEPS project’s overall objective and goal of aligning profit with value creation. In particular, we suggest that these additional explanations include at a minimum examples involving BEPS schemes practiced by many groups in the technology, manufacturing (including pharmaceuticals), trading, and construction industries. Such explanation should cover the use of commissionaire and similar arrangements, fragmentation, and Article 5(4) situations.

## **2. The need for a holistic approach**

The DD points out (para. 7) that the modification of the PE threshold should not change the basic approach adopted to attributing profits to any new PEs found to exist. While we agree with this basic point, we believe that guidance must make clear the implications for attribution of profits applying a functional analysis. In particular, it should be clearly stated that a holistic approach should be applied. Such an approach will allow taxpayers and tax authorities to determine appropriate levels of aggregate profits within PEs and their related parties that reflect the group’s overall business activities within a country.<sup>3</sup>

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<sup>2</sup> Two papers which discuss the many court decisions are: J. P. Le Gall (2007) ‘Can a Subsidiary Be a Permanent Establishment of its Foreign Parent? Commentary on Article 5, par. 7 of the OECD Model Tax Convention’, *Tax Law Review* 60: 179-214, and Adolfo Martín Jiménez (2017) Preventing Avoidance of Permanent Establishment Status. *Papers on Selected Topics in Protecting the Tax Base of Developing Countries* UN Tax Committee.

<sup>3</sup> The DD specifically acknowledges this ‘aggregate’ issue repeatedly. Note paragraphs 21, 26, 31, and 35, all of which note the practical acceptability of collecting tax only from an intermediary rather than separately from both the PE and the intermediary.

As noted in sub-section 1 above, a major motivator in initiating the entire BEPS project was to end BEPS motivated planning by centrally managed groups that specifically structured sales entities that avoided PE status, and fragmented sales from related core functions such as marketing and customer support. Hence, counter-measures under Action 7 to prevent avoidance of a PE should also aim to counteract this fragmentation.

The basic approach, of course, is that the attribution of profits both to a PE under article 7 and between associated enterprises under article 9 depends on an analysis of the risks, assets, and functions that each assumes, owns, and performs. While this is a truism, the new guidance must explain and clearly demonstrate through examples that functional analyses should not be applied to each group entity in isolation. This need for avoiding 'isolation' is at the heart of some of the article 5 changes that expand the PE definition. They entail a clear rejection of the BEPS structuring conducted by many MNEs to artificially separate risks, assets, and activities into separate legal entities through intercompany arrangements that have little or no motivation or legal effect other than tax reduction.

For example, the activities of one or more intermediaries providing marketing, warehousing, and/or order fulfillment functions in a country for a foreign sales affiliate could now cause that sales affiliate to have a PE in the country. In these circumstances, just as the activities of all these group members are included in the article 5 evaluation, it is clearly important to include in the profit evaluation the functions performed in the country by all the entities of the MNE Group. The DD itself recognizes this necessity both to avoid double taxation (para. 18) and to reflect the practical administrative convenience of 'collect[ing] tax only from the intermediary even though the amount of tax is calculated by reference to activities of both the intermediary and the Article 5(5) PE' (see footnote 3 and paras. 21, 26, 31, and 35).

In our view, this guidance needs to state a clearly formulated holistic approach. A basic cause of BEPS is exploitation by MNEs of the independent entity principle, including by tax-driven fragmentation of functions. Hence, the functional analysis must consider **all** the activities carried out in the country by the relevant entities **in conjunction**.

It is inappropriate to try to distinguish, for example, between where marketing ends and sales begins, or for that matter where sales ends and customer support begins. MNEs commonly choose to perform various functions in-house in order to ensure that customers worldwide enjoy a seamless experience not otherwise achievable, and for the MNE itself to benefit from closer coordination of the different business functions. For example, activities such as marketing or customer support, if linked with sales, can provide valuable feedback to software engineers responsible for the design of a sales website or platform. Equally, operating flagship stores displaying and selling a MNE's products directly to customers may enhance reputation and branding, thereby contributing significant value by increasing sales concluded through independent third-party retailers. Hence, it is the **cumulative importance** of the activities that should be considered when evaluating the value which is created.

This 'cumulative importance' leads directly to our strong recommendation that compelling reasons dictate that article 7 should be applied prior to any application of article 9 (Section B.1. below). This order of application would result in both infinitely

better focus by taxpayers and tax authorities alike as well as a practical reduction for both in the resources they spend on compliance and enforcement.

A holistic approach will also lead in some circumstances to a different transfer pricing method being the most appropriate method. In particular, one-sided methods (especially cost-plus and the TNMM) have often been aggressively applied by MNEs when functions have been organized in a fragmented way, thereby achieving the BEPS results that motivated the initiation of the BEPS project.<sup>4</sup> Where the circumstances are such that combined activities contribute considerable value, for example generating valuable intangibles such as reputation effects, brand enhancement, comprehensive information about customers, customer lists and customer goodwill, then the profit split method may be the most appropriate method.

### **3. Application to All Versions of Article 7**

A holistic approach is also important since the DD is meant to apply to all versions of article 7 of the model convention, and whether or not a state has accepted the changes adopted by a majority of OECD states in 2010, described as the authorized OECD approach (AOA). The DD states (para. 9) that article 7 is grounded on the independent entity principle, and it is true that this principle is contained in article 7.2 of both the OECD and the UN models. Nevertheless, there have been wide variations in the interpretation of this principle, and the 2010 report adopting the AOA explicitly stated that the changes were ‘not constrained by either the original intent or by the historical practice and interpretation of Article 7’.<sup>5</sup>

Given the manner in which this new DD deals with this issue in para. 9, we would repeat the recommendations we made in our comments of 12 August 2016 to the OECD. We suggest:

The applicable OECD Working Groups should now actively liaise with the UN Committee of Experts on International Cooperation in Tax Matters, which should review its version of article 7 and commentaries, in light of the changes to article 5 resulting from Action 7. This joint work should aim to provide broader principled guidance and examples that would be of use to taxpayers and tax authorities, no matter whether a treaty is involved or not and no matter whether the AOA or a pre-AOA approach is applicable. Following such combined efforts, it would be appropriate to issue a further DD for public review and comment through the Platform for Collaboration on Tax.

In the event that the OECD Working Groups choose to forgo the above collaboration that we recommend concerning this article 7 issue, we strongly recommend that this AOA/non-AOA issue be squarely dealt with in this article 7 guidance. The suggestion expressed in paragraph 9 of the DD to simply ‘sidestep’ this entire AOA/non-AOA issue at this time is unhelpful. Tax authorities and taxpayers require guidance; the Working Groups must make the effort now to provide it. This is an issue that will not go away and is important to face. We provide in the following few paragraphs some background and

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<sup>4</sup> See Martin Jiménez (supra, note 2) at p. 7, who also argues for a holistic approach.

<sup>5</sup> OECD (2010), 2010 Report on Attribution of Profits to Permanent Establishments, para 4.

suggestions that we hope will be useful in moving towards the provision of adequate guidance.

In 2010, in addition to the paragraph 2 changes, the OECD deleted from article 7 paragraph 3 (which disallows specified deductions in calculating the profits attributed to the PE) and paragraph 4 (which allows apportionment of the profits if this has been customary). The UN Committee, which rejected the AOA, retained these paragraphs 3 and 4 in the UN model convention. Indeed, the vast majority of existing tax treaties do not incorporate the new OECD version of article 7, including recent treaties even with OECD countries.<sup>6</sup> The Inclusive Framework for BEPS now includes some 100 countries, amongst which the states accepting the AOA (although a majority in the OECD) are a small minority.

It is therefore important that consideration of this issue result in clear and frank guidance that takes into account these multiple formulations of article 7. In our view, it would be an enormous mistake to impose a strict interpretation of article 7.2 in the context of the agreed revisions to article 5. While the AOA has some merits, it has been used to further exacerbate a fragmented approach to the attribution of profits, which has been one of the main causes of BEPS. Adoption of the holistic approach which we suggest could, we hope, allow some of those helpful features of the AOA to be retained, while ensuring that BEPS structures are not allowed to continue due to a too-narrow interpretation of article 7.2.

The independent entity principle, as formulated in both article 7.2 and article 9.1, was never intended to impose a requirement that tax authorities accept the legal fiction of separate corporate personality and separate accounting within a corporate group under common ownership and control. Indeed, the first paragraph of article 9 expresses the primary aim of that article, which was to allow appropriate adjustments to the accounts of associated entities, in view of the integrated nature of their activities. A strict interpretation is even less appropriate in article 7, since the PE is not actually a separate entity. In particular, where it is found that an affiliate is also acting as a PE for another group member, so that the affiliate is found to be performing two or more related functions, it should be clear that the activities should be evaluated as a whole.

This point is of fundamental importance. The outcomes of the BEPS process so far could result in blocking some of the major loopholes in international tax rules, if rigorously applied. However, little progress has been made in agreeing clear rules for the allocation of profits according to ‘where economic activities occur and value is created’, as mandated by the G20. The changes to the PE definition agreed in Action 7 were relatively modest (although more extensive reforms might result from the continuing work on Action 1 by the Digital Economy Task Force). Yet even these would be rendered nugatory by the imposition of an approach which would apply a rigid interpretation of the independent entity principle, and apply it even in circumstances when the entity is found to be a PE and not even legally separate.

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<sup>6</sup> Reuven S. Avi-Yonah and Z. P. Tinhasa. (2014) Unitary Taxation and International Tax Rules. International Centre for Tax and Development: ICTD Working Paper 26.

## **B. SPECIFIC COMMENTS**

### **1. Guidance Concerning Order of Application of Articles 7 and 9**

Paragraph 12 of the DD includes: ‘... In any case, the order in which Article 7 and Article 9 are applied should not impact the amount of profits over which the source country has taxing rights as a result of the activities of the intermediary on behalf of its associated non-resident enterprise in the source country. The approach adopted by a jurisdiction should be applied consistently and could be made public for purposes of transparency and certainty for taxpayers. ...’

In our comments submitted on 12 August 2016, we strongly recommended that Article 7 be applied prior to any application of Article 9. In recommending this, we said:

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

We very much appreciate the new approach of paragraph 12 that acknowledges the two possible approaches regarding order of application of Articles 7 and 9. Nevertheless, we continue to believe that the conceptual and practical reasons for conducting the Article 7 analysis first are compelling. To give priority to article 9 could lead further along the mistaken path of applying a narrow interpretation of the independent entity principle, and hinder the application of the holistic approach to functional analysis which we suggest.

If Working Party 6 does not agree, we suggest that the reasons we explained in our 2016 comment letter be included either in a footnote to this paragraph 12 or as an appendix to the document. Doing so would alert tax authorities in a number of countries to the significant benefits of applying Article 7 in advance of Article 9.

Such a footnote could read:

Jurisdictions that undertake an Article 7 analysis prior to initiating an Article 9 analysis normally secure several benefits. First, it allows the initial analysis to focus solely on actual activities of group personnel and agents and real third-party contracts and dealings, ignoring the typically tax motivated intercompany agreements on which intercompany transactions are based. Second, comparing the results of the Article 7 analysis with the income reported by the intermediary may suggest in some cases that there is no practical need to conduct any Article 9 analysis. See in this regard paragraphs 26, 31, and 35 herein.

This footnote would be placed at the end of the second sentence in paragraph 12.

For your convenience, we have included as Appendix A to this letter the discussion we provided in our comments submitted on 12 August 2016.

## **2. More Balanced Guidance for Activities of Intermediary**

Paragraph 19 appropriately notes that the host country's taxing rights over the PE and intermediary, respectively, may be different. The paragraph emphasizes that where 'the intermediary is assuming the risks of the transactions of the non-resident enterprise, the profits attributable to the PE could be minimal or even zero'. We do not doubt that this is true and appropriate to include in paragraph 19.

Paragraph 19, though, to be more balanced in providing guidance to taxpayers and tax authorities alike, requires that an additional sentence be added that provides a simple example where the profits or loss attributable to the PE might be more significant. We suggest that the following sentence be added at the end of paragraph 19.

“On the other hand, when the accurate delineation of the transaction under the guidance of Chapter I of the TPG indicates that the intermediary is not assuming all significant risks of the transactions of the non-resident enterprise such that, for example, the intermediary is effectively in a more limited service business that supports the non-resident enterprise, then the profits (or losses) attributable to the PE could be significant.”

For your convenience concerning this point, we have included as Appendix B to this comment letter comments we made in an earlier comment letter that we submitted on 12 June 2015.

## **3. Application to Both AOA and Non-AOA Versions of Article 7**

The approach adopted in the examples is to assume that the analysis of functions-assets-risk should be done separately for the PE which is found to exist, and for the intermediary. Consequently, the analyses provided in examples 1 and 2 suggest attribution to the sales PE of the revenue from sales to unrelated parties, minus the expenses incurred for the purposes of the PE (to be decided by applying either AOA or non-AOA methodology, depending on the applicable treaty), and minus an arm's length remuneration to the intermediary (which would be separately taxable in the hands of that intermediary). A similar approach is applied, *mutatis mutandis*, in Example 3 concerning a purchasing entity.

While this approach is of course theoretically correct, it seems unnecessarily convoluted, especially in light of the holistic approach that we have recommended and discussed in Section A. The effect of finding that an intermediary is also a PE of its non-resident associated enterprise is that the intermediary has been found to perform a wider range of functions, all of which are significant for application of the host country tax rules. In these circumstances, a more straightforward and realistic approach would be to apply the functional analysis to the combination of functions (i.e., an application of the holistic approach). This can be done under either the AOA or non-AOA versions of article 7.

It is also important to adopt this approach because the theoretical equivalence of a holistic approach with analyses of each separate group member including only the non-resident and the intermediary will most often not result, in practice, with equivalent results. In

particular, common examples for significant differences are unrecognized group synergies and overall commercial risk faced by the group.

Once this approach has been applied, the host country can choose for administrative convenience to simply tax the intermediary on this holistically determined profit. (See footnote 3 and paras. 21, 26, 31, and 35 in the DD that repeatedly note this accepted approach.) Or, if a country desires, it can apply transfer pricing rules under its domestic law and Article 9 to determine the appropriate portions of the total profit to tax in the hands of each of the non-resident and the intermediary. Several of the DD's examples assume that the attribution of profits in the absence of a PE was based on a percentage of sales revenue. A country choosing to apply Article 9 might find that a percentage of sales revenue is appropriate. Or, it might find some other transfer pricing approach is more appropriate under the circumstances.

#### **4. Potential for Economic Double Counting of Expenses**

Paragraph 25 within Example 1 provides in the first bullet point that a reduction against revenues is allowed for 'the amount that TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S'. The second bullet point provides for a reduction of 'other expenses, wherever incurred, for the purposes of the PE'.

Both reductions are, of course, very appropriate. However, since the first bullet point focuses on an arm's length selling price, there needs to be explanation within the example (or a footnote to the example) that makes clear that the second bullet cannot include expenses that would be inconsistent with the first bullet point's approach to determining an unrelated price. Without this explanation, there is potential for economic double counting of certain expenses.

The same point applies to Examples 2, 3, and 4 in, respectively, paragraphs 30, 34, 48, and 49.

#### **5. Example 2- Services Agreement**

There are two issues concerning Example 2 for which additional guidance is necessary.

First, the current draft states: 'SellCo, an associated company resident in country S, performs marketing activities on behalf of SiteCo in Country S under a services agreement with SiteCo that provides for the fee payable to SellCo to be equal to a percentage of the sales revenue received by SiteCo from sales of advertising space to customers in Country S'.

In practice, tax avoidance strategies aimed at avoiding the creation of permanent establishments in this type of scenario have often been structured so that SellCo's activities are remunerated with a mark-up on its costs incurred. It would therefore be useful to provide an additional iteration of this example where SellCo is remunerated with a mark up on its cost incurred or to add the following wording at the end of paragraph 30:

The analysis would be the same in the example above if the facts were the same except for the following: SellCo performs marketing activities on behalf of SiteCo in Country S under a services agreement with SiteCo that provides for the fee payable to SellCo to be equal to the costs incurred by SellCo plus an appropriate arm's length mark-up.

Second, the analysis outlined in paragraph 30 requires that:

... the profits attributable to the PE in this case, would equal the amount of SiteCo's revenue from sales to customers in Country S minus (1) *the amount that SiteCo would have received if it had sold the rights to the advertising space to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of SiteCo in Country S (attributing to such party ownership of the assets of SiteCo related to such functions, and assumption of the risks related to such functions)* ... [Emphasis added.]

Under this approach, it is necessary to determine comparable uncontrolled prices or gross/net margins in comparable uncontrolled transactions.

Example 2 involves an internet-based advertising model. We understand that this type of 'comparables' analysis will be totally impractical for the vast majority of digital MNEs that fall within the remit of Example 2. Such MNEs do not sell the rights to advertising space on their own websites or platforms to unrelated parties in bulk. Hence, reliable comparable uncontrolled transactions will simply not exist. It may of course be added that the individual nature and features of each such online website or platform as well as the differing nature, size, and geographical diversity of each website/platform's body of users will mean that no two situations are close enough to allow for adjustments to achieve reliable results.

We agree that in theory, this item (1) is correct. However, in view of this practical issue for the vast bulk, if not all, of MNE situations that are within the remit of Example 2, additional guidance is required. We suggest that the existing last paragraph in paragraph 30 be expanded so that it reads as follows:

Article 9 and the Transfer Pricing Guidelines are applicable, either directly or by analogy, in determining the amounts of (1), (2) and (3). Where, as may often be the case, there are no comparable unrelated prices or transactions that will allow application of a "traditional transaction method" in determining the amount of (1), then the transactional profit split method will normally be the most appropriate method to apply.

We believe that it is very important to highlight the typical lack of comparable data and its implications for the use of the profit split method. Most if not all digital MNEs will fit the definition of highly integrated business operations.

## **6. Example 4 – Inappropriate Results**

Appendix B to these comments focuses on situations where there is a source country PE under amended Article 5 from core activities carried out in that country. Often, there can be situations where there are no local sales activities that would cause Examples 1 – 2 to

be relevant. Rather, there are just relatively fixed levels of expenses for core activities such as manufacturing, warehousing, delivery, merchandising, and information collection activities.

Our Appendix B sets out how in such situations OnlineCo (from Example 4) will have a different risk profile compared to that found when viewing solely the local Country S activities. Although Appendix B assumes two related entities, X and Y, in contrast to Example 4's OnlineCo and its two PEs in Country S, the issues are exactly the same for this purpose. Appendix B states, in part:

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

Clearly, X is in business to make profits. It believes that paying for Y's activities will allow it to make sales and a profit on sales to customers in country B. The point of course is that the value of Y's local activities to X, an overseas seller, is much higher to X since X is taking the business risk of paying Y for these local support operations irrespective of how many local sales are made. ...

The approach outlined in paragraphs 48 and 49 of the DD considers only the benefits and risks of performing the local functions and totally ignores the addition benefits and risks that OnlineCo receives and assumes from its investment of placing assets and activities within Country S. The approach set out in Example 4 should be amended to reflect this broader approach. To leave Example 4 as it is would make the expansion of Article 5 completely ineffective, which is simply unacceptable.

As a mechanism to add to Example 4, we suggest the following in place of paragraphs 48 and 49:

48. Under Article 7, the profits attributable to the warehouse PE of OnlineCo are those that represent OnlineCo's profits or losses from choosing to conduct certain core functions of its sales business in Country S. This is not just the "limited-risk" position of a Country S service provider performing only routine functions, but rather the benefits and risks to OnlineCo as a whole of its decisions concerning location and extent of core functions. In the absence of any specific approach that achieves a reasonable computation of this amount within the principles of the TPG, then the Profit-Split Method should be applied using a contribution analysis (see Section C.3.1.1). This accurately measures the profits that the PE would have derived if it were a separate and independent enterprise performing the same storage and delivery activities within the context of OnlineCo's business.

In the event that OnlineCo operates not through its own warehouse PE but rather through a closely related enterprise (ServiceCo), then OnlineCo's PE would have

profits that would equal (1) the amount determined in the immediately preceding paragraph minus:

- (2) other expenses, wherever incurred, for the purposes of the PE, and
- (3) the arm's length remuneration of ServiceCo.

The arm's length remuneration of ServiceCo would be the amount that OnlineCo would have had to pay if it had obtained the storage and delivery services from an independent enterprise in Country S (attributing to such service provider ownership of the assets of OnlineCo related to such functions, and assumption of the risks of OnlineCo related to such functions).

49. Under Article 7, the profits attributable to the office PE of OnlineCo are those that represent OnlineCo's profits or losses from choosing to conduct certain core functions of its sales business in Country S. This is not just the "limited-risk" position of a Country S service provider performing only routine functions, but rather the benefits and risks to OnlineCo as a whole of its decisions concerning location and extent of core functions. In the absence of any specific approach that achieves a reasonable computation of this amount within the principles of the TPG, then the Profit-Split Method should be applied using a contribution analysis (see Section C.3.1.1). This accurately measures the profits that the PE would have derived if it were a separate and independent enterprise performing the same merchandising and collection of information activities within the context of OnlineCo's business.

In the event that OnlineCo operates not through its own office PE but rather through a closely related enterprise (MerchantCo), then OnlineCo's PE would have profits that would equal (1) the amount determined in the immediately preceding paragraph minus:

- (2) other expenses, wherever incurred, for the purposes of the PE, and
- (3) the arm's length remuneration of MerchantCo.

The arm's length remuneration of MerchantCo would be the amount that OnlineCo would have had to pay if it had obtained the merchandising and collection of information services from an independent enterprise in Country S (attributing to such service provider ownership of the assets of OnlineCo related to such functions, and assumption of the risks of OnlineCo related to such functions).

We may add that the issue focused on through this examination of Example 4 will also be found where an MNE has set up a supply chain structure in which core activities that constitute complementary functions are part of a cohesive business operation. We suggest that either an example involving a supply chain structure be included or that mention be made of this common business model and the possible applicability of the profit split method.

**APPENDIX A – From “Comments on the Public Discussion Draft on Additional Guidance on Attribution of Profits to Permanent Establishments” Submitted 12 August 2016**

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

**Response:**

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

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

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

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

Step Two: The determination of the worldwide profits attributable to the combined activities of all MNE group members for the relevant products and services sold into or

provided to customers in that host country or that otherwise relate to activities in that country.

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

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

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

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

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

It may of course be added that there will be some cases where an MNE has contractually limited the risk of a DAE and provided a service fee based on a cost-plus or similar arrangement that protects the DAE from loss. Where the MNE has not been as profitable as expected, it may well occur that the DAE profits will exceed the Step Three profits, thereby causing a DAPE loss. In such situations, tax authorities will seldom see any need to initiate an Article 9 analysis to adjust the relative incomes of the DAPE and the DAE.

## **APPENDIX B – From “Comments on BEPS Action 7: Revised Discussion Draft on Preventing Artificial Avoidance of PE Status” Submitted 12 June 2015**

### **E. Profit attribution to PEs and interaction with action points on transfer pricing**

We of course recognize that work on attribution of profit issues related to Action 7 cannot realistically be undertaken before the work on Action 7 and Actions 8-10 has been completed. As such, we agree that this area should be the subject of follow-up work to be carried out after September 2015 with a view to providing the necessary guidance before the end of 2016.

While we understand that this area will be focused on in the months ahead, we feel compelled to cover one important issue so that it can be considered and emphasized when work on this important area begins after September 2015.

The following is from paragraph 19 of the Discussion Draft and was repeated several other times (paragraphs 28 and 54), but in all cases without any comment within the Discussion Draft either agreeing or disagreeing with the point made by the complaint.

A complaint that was also found in many comments and that was made during the consultation meeting was that these options (as well as many of the other options included in the discussion draft) would create a multitude of PEs to which no or little profits could be attributed.

This ‘complaint’ of the many MNE representatives and the legal and accounting firms that act as their paid professional advisors strongly implies that nothing should be done to broaden the definition of permanent establishment since most if not all new permanent establishments created under broadened rules would have little if any income associated with them. They are saying, of course, that if the local commissionnaire, agent, or other party whose actions create the permanent establishment has been paid an arm’s length amount, then there will be little or no additional income to be reported by the principal that is making the sales or selling services.

It has been clear from the start of the BEPS process that commissionnaire and similar arrangements have been an important part of the worst BEPS excesses; such an important part that the language of Action 7 itself is specifically concerned with ‘the use of commissionnaire arrangements’. Considering this, we believe that this representation by MNEs and their paid advisors is misinformed at best and dishonest, misleading, and disingenuous at worst.

Considering these MNE and advisor representations, *we discuss briefly below why total taxable income from an expanded definition of PE should always be higher than under non-PE treatment for situations where a PE is avoided because important functions occur within a commissionnaire, agent, or other service provider.*

Say that an MNE, resident and headquartered in country A, has separated its centrally managed operations amongst its group members so that the group member (X) making product sales to customers in country B has no local activities or employees of its own in

country B. To support its sales to country B customers, X contracts with Y, a group member resident in country B, for various support operations. These various support functions could include, for example, marketing activities, sales efforts, local warehousing and delivery, etc. Further, Y could be legally a commissionaire, an agent, or only a service provider. Under the contractual relations between X and Y, Y is at limited risk so that the commissions or service fees it receives are relatively low reflecting its low level of assumed risk. Assume for purposes of this discussion that the commissions or service fees are at arm's length.

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

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

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

Needless to say, specifically how profits attributable to the PE are determined is beyond the scope of this comment letter. However, there's one important point to make.

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

Clearly, X is in business to make profits. It believes that paying for Y's activities will allow it to make sales and a profit on sales to customers in country B. The point of course is that the value of Y's local activities to X, an overseas seller, is much higher to X since X is taking the business risk of paying Y for these local support operations irrespective of how many local sales are made. The portion of X's profits (assuming of course that X has made some sufficient level of profits) that will be attributable to its PE cannot be the same as the limited risk commissions and service fees earned by Y under its artificial limited-risk position.

In addition to the above, of course, there will also be many situations, especially for MNEs operating in the digital economy, where X is selling or providing products or services to country Y customers where that customer base itself is a relevant asset of the X PE in country B. That will further increase the profits attributable to X's PE far above any commissions and service fees paid to Y.

In short, we believe consideration should be given to making clear in future guidance why an expansion of the PE definition in Article 5 is fully expected to result in increased levels of taxable profit within the country of the PE, taking into account both the taxable income of any local commissionnaires, agents or service providers and the taxable income of the PE.

September 2017

**William Morris**  
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**September 15, 2017**

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

Dear Acting Chair and Members of Working Party No. 6,

Thank you for the opportunity to comment on the Discussion Draft: BEPS Action 7 – *Additional Guidance on Attribution of Profits to Permanent Establishments* (the “Discussion Draft”) issued 22 June 2017. The attribution of profits to permanent establishments (“PEs”) is an important and difficult area and we thank the OECD for the time and effort put into this draft guidance.

However, as we have made clear before, given changes to the PE provisions under Article 5 of the OECD Model Tax Convention by the Base Erosion and Profit Shifting (“BEPS”) project, in particular the Dependent Agent PE (“DAPE”) rules, it is crucial for tax certainty and for the avoidance of double taxation that clarity is provided on the attribution of profits. Unfortunately, we do not believe the Discussion Draft provides the detail necessary to address the complexities of profit attribution.

In particular, we disagree, for a number of reasons, with the implication that although there will be an increase in the number of PEs, the principles behind the attribution of profits have not changed. In fact, even before the BEPS project began, the PE attribution rules were acknowledged to be unsatisfactory and were in the course of being updated. Following BEPS and the combination of changes to Chapter I of the OECD Transfer Pricing Guidelines and the changes to Article 5 this need for clarity has further, and dramatically, increased. One reason is because these changes have combined to create, where the facts and circumstances determine it, a much greater attribution of profits to source countries under both Article 7 **and** Article 9, in many cases in relation to the same functions. It is a basic principle of double taxation conventions that guidance should never allocate the same income to the same country twice without a binding method of relieving what would otherwise be double taxation. So, while we welcome the progress of the Discussion Draft in conceptually addressing this point, we are not clear on how binding this solution is and are concerned that double taxation will result until further clarity is provided.

Furthermore, it is important to note that many MNEs that will be impacted have not had the volume of experience in applying profit attribution guidance in practice. The significant lowering of the PE threshold by the Action 7 report, alongside fundamentally more complex guidance on the

application of Article 9, leaves taxpayers feeling that room for different interpretation – and tax uncertainty – has grown dramatically. The administrative burden for tax authorities and taxpayers will also increase if OECD does not go further in addressing administrative approaches that enhance simplification following this lowered threshold. In an effort to assist with this issue, please find a separate detailed letter in Appendix A addressing potential administrative simplification.

In conclusion, BIAC strongly urges the OECD to further develop this guidance on the attribution of profits, providing much greater detail and quantitative examples so that this guidance can become a tool that bolsters both tax certainty and cooperative compliance in taxpayer-tax authority relationships. We also encourage WP6 to consider the impact of any proposed changes to the profit attribution guidance that may be required to remain consistent with upcoming conclusions of the OECD's follow up work on BEPS Action 1 (the tax challenges of the digital economy), and not to finalise one before the other.

Again, we thank you for the opportunity to comment on this subject, and look forward to working with you further.

Sincerely,



Will Morris  
Chair BIAC Tax Committee

## General Comments

1. BIAC acknowledges that the focus of this public consultation period is on the attribution of profits/losses to PEs and the comments below are specifically focused on this critical issue. However, we continue to believe that the threshold issues associated with the OECD's final recommendations on Action 7 are a far more fundamental concern in relation to the potential compliance burden and risk of double taxation than the attribution guidance. Therefore, we believe it is necessary to reiterate that business would greatly welcome additional clarity over the meaning of terms that apply to the Article 5(5) exemptions. Additionally, a clearer understanding of these thresholds will only help to minimize the complexities associated with the attribution guidance. Specifically, we believe that the complexity created by these rules and the need to simplify their application is evidenced in the ambiguity that remains around the following concepts:
  - a. "plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification";
    - The Action 7 report provided limited guidance on the meaning of the term "principal role". This guidance is helpful in a scenario where only one salesperson prepares all relevant offer/tender documents, decides about the content and convinces one representative of the customer to accept a contract. However, in real life scenarios the complexity of modern business models (including in particular the ease of global communications and travel) mean that deal teams (rather than a simple sales individual) are generally quite dispersed.
    - There are several business models that demonstrate this complexity and the key concerns identified are:
      - Can the "principal role" be undertaken by a group of individuals, or is there only one individual that can play the "principal role" on any deal?
      - If a group of individuals can play the "principal role", and they operate in different countries, does this mean that a PE is created in each country (and if so, how should profits be allocated between them)?
      - If only a single individual can play the "principal role" on a deal, how should it be determined which individual this is?
      - If only a single individual can play the "principal role" on a deal, is it the individual, or the local employer, or the foreign enterprise for whom they act who needs to be behaving "habitually" in any country in order to create a PE?
      - In either the case of an individual or a group of individuals, if an individual travels between several countries to habitually meet customer(s), is a PE created in all of the countries to which that individual travelled (and if not, in which country/countries are PEs created)?
      - In either the case of an individual or a group of individuals, if an individual habitually communicates from different countries, with customers from different countries (e.g. over a period of months via telepresence, telephone, email or letter), is a PE created in all of the countries in which they worked on the deal (and if not, in which

country/countries are PEs created)? Additionally, is there a difference in application caused by different methods of communication?

- Where there are several distinct legal “contracting parties” within a group (e.g. one selling an asset and the other providing ongoing services such as maintenance or financing), will this result in several PEs in the same country?
- Finally, we think a clearer definition of the term "principal" would be helpful. We assume that for most sales activities, the “principal” role in leading to the conclusion of contracts would be the salesperson.

b. “artificial splitting up of contracts” ; and

- We believe that additional guidance is required in terms of the new fragmentation clause, notably its limitation to those activities which constitute complementary functions and are part of a cohesive business operation. We would welcome a clear statement that merely being part of a cohesive business operation does not necessarily equate to value being attributable to the new deemed PE; that for groups with different business lines the anti-fragmentation are not expect to extend beyond activities within the specific business lines. The profit attribution to complementary activities should rather be determined by an analysis of the relevant facts and circumstances.
- Without greater clarity in respect of the splitting up of contracts (e.g., by providing a list of circumstances in which non-tax reasons would be assumed or accepted), the guidance will create uncertainty in respect of non-abusive commercial arrangements.
- We would also welcome detailed clarification of the consequences of an abusive structure being asserted.

c. “preparatory and auxiliary activities”.

- Clarification of the meaning of “preparatory and auxiliary” in the Model Tax Convention (MTC) commentary would provide helpful confirmation that the listed activities which are well understood to not constitute a PE still constitute a valid exclusion from the PE requirement. For example, a foreign entity which maintains a stock of merchandise for delivery, where there is no related party commissionaire arrangement in place, and where contracts were never negotiated in the host country, may now be caught as a result of this modification.
- Additional guidance would also be welcome on how to distinguish a separate aftermarket business line from a main business line. For example, a business selling equipment may also have an additional service line selling spare parts, which may have relatively limited value (e.g., less than a third of the value of the main business). It is unclear how this would be dealt with in the context of the new guidance and whether such a service line would be considered merely auxiliary.

2. BIAC strongly endorses pro-growth tax systems which facilitate cross-border trade and investment, enhancing economic growth and efficiencies in the international market place. The

guidance on the attribution of profit to PEs should support cross-border trade and investment by clarifying which jurisdiction has the right to tax income, thus ensuring that income is not subject to double taxation. Therefore, we believe the high-level general principles outlined in paras 1-21 and 36-42 for the attribution of profits/losses to PEs are encouraging. However, high-level general principles that can be interpreted in many different ways are not sufficient to provide businesses with the level of certainty over the elimination of double taxation required to facilitate cross-border trade, investment, and growth.

3. Under the pre-BEPS Article 5, businesses appreciated the certainty that activity exemptions and contract conclusion tests provided. If the new profit/loss attribution guidance is not implemented in a clear and consistent way, cross border investment as a whole will become more administratively complex, more uncertain, and ultimately more costly. As a result, businesses may either seek time-consuming and administratively costly methods of obtaining greater certainty, such as advance pricing agreements, or modify business models or limit cross border investment in order to have certainty over the taxes due (and to mitigate the risk of double taxation).
4. Therefore, BIAC strongly urges the OECD to provide more detailed guidance on the attribution of profits and losses to PEs. For example, the anti-fragmentation rule recommended in the BEPS Action 7 Report is very complex and yet the relevant guidance included in the Discussion Draft is considerably limited. The Discussion Draft provides an outline of the two cases where Article 5(4.1) may arise but does little to guide taxpayers or tax authorities on how the attribution of profits should be performed in these cases. This high-level guidance on such a complex topic will only lead to inconsistent outcomes and further tax uncertainty. Additionally, BIAC encourages the OECD to clarify the status of this guidance as it is not clear what the status of the Discussion Draft will be when it is finalised, and whether taxpayers will be able to rely on its guidance in interpretation of tax treaties.

#### **Changes to Article 5(5) and 5(6) and the Commentary**

5. BIAC encourages the OECD to strengthen its support for the Authorised OECD Approach (“AOA”) in the Discussion Draft. The Discussion Draft references the AOA in a number of footnotes but it lacks any explicit support for adoption of the AOA and the consistency that this would provide in such a complex area.
6. In particular, the Discussion Draft provides in para 7 that “any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5(5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5(5).” Not only is this language an example of where the Discussion Draft lacks the level of detail and specificity necessary to avoid inconsistent application, but we believe it is misleading in its implication that pre-BEPS guidance was sufficient and pre-BEPS application was consistent. In reality, there were a very wide range of interpretations, even within the two AOAs, and further guidance had already been identified as necessary. Additionally, and perhaps more importantly, the BEPS Project has modified the fundamental rules concerning PEs to such an extent that any reliance on a pre-BEPS approach would be misguided and likely to result in considerable misinterpretation of this guidance.

7. The potential value of the Inclusive Framework (to both businesses and tax authorities) is that greater consistency of application could be reached across 102 countries (and others that sign up to the Inclusive Framework in the future). We continue to believe that in order to achieve this consistency, there must be recognition that a single approach is desirable, and that all future guidance should have the aim of encouraging adoption of this approach. Para 7 actually encourages the opposite, and the rest of the Discussion Draft fails to provide certainty that consistency is either intended or achieved.
8. Additionally, the language of para 7 implies that countries may apply the 2010 AOA method, 2008 AOA method, or indeed any pre-BEPS version of profit and loss attribution as there is no discussion of what methods are actually being applied, thus amplifying the potential for inconsistent application. The Discussion Draft fails to adequately explain that different versions of Article 7 may require somewhat different approaches to profit attribution (and why), but it also fails to provide clarity on how treaties with versions of Article 7 based on the 2008 or 2010 OECD Model should be interpreted.

**Attribution of Profits to Permanent Establishments Resulting from Changes to Article 5(5) and 5(6) and the Commentary**

9. BIAC believes that the language included in para 8 of the Discussion Draft represents a departure from the analysis under the AOA. Specifically, para 8 provides that “[o]nce it is determined that a PE exists under Article 5(5), one of the effects of para 5 will typically be that the rights and obligations resulting from the contracts to which Article 5(5) refers will be properly allocated to the permanent establishment.” This language appears to eliminate the AOA analysis by replacing the functional analysis with factual assumptions. The AOA requires hypothesising the PE and identifying its dealings with the rest of enterprise to determine where the relevant significant people functions take place. These important steps are overlooked in the language of the Discussion Draft, and as a result many of the recommendations are not compatible with the objective of aligning taxing rights with value creation. As previously mentioned, BIAC urges the OECD to support the universal adoption of the AOA but at a minimum we would expect the Discussion Draft to avoid a full departure from the AOA.
10. BIAC also believes that the language included in para 8 - 19 do not make it sufficiently clear that the analysis may result in losses being attributable to a PE.
11. The Discussion Draft provides in para 12 that “the order in which Article 7 and Article 9 are applied should not impact the amount of profits over which the source country has taxing rights as a result of the activities of the intermediary on behalf of its associated non-resident enterprise in the source country.” Some BIAC members are concerned that there could be a different attribution of profits depending on the ordering used, particularly where the DAPE’s profits are dependent on gross levels of costs, or where the jurisdiction in question is not following the AOA. If any differences were to arise, this would be a difficult situation for taxpayers and tax authorities, so we would welcome stronger confirmation that no double taxation (or double attribution) should arise if the OECD cannot endorse an order.
12. Para 18 indirectly recognises this point, but does not resolve it. In seeking to reconcile how the concepts of significant people functions (under Article 7) and risk control functions (under Article 9) should not result in double taxation in the source country, there is recognition that there is

overlap that could result in double attribution. Whilst we welcome the acceptance that there should be no double taxation within the source country as a result of this, we find it peculiar that there is no recognition of the need to eliminate double taxation between the source and the residence countries (the very concept that double taxation treaties are supposed to ensure) and encourage the OECD to make a recommendation or proposal on the method to eliminate this double taxation.

13. Para 17 notes that significant people functions (under Article 7) and risk control functions (under Article 9) cannot be aligned or used interchangeably for purposes of Article 7 and Article 9. Further work on aligning the analysis under Article 7 and 9 would be appreciated. The draft stops short of reconciling the concept whereas it is not clear what stands behind the non-alignment. In any case, the current guidance could be improved by illustrating how such functions might differ. It also fails to address the consequences of drawing such a conclusion and would appear to further the need for a designated order of application or further alignment between Article 7 and Article 9. An example may be helpful in making this distinction clearer.

Furthermore, it is not clearly explained, how post-BEPS changes resulting from Action 8-10 influences risks allocation alignment for the purposes of Article 9 and Article 7. Therefore, we would welcome further clarification of Paragraph 17 (on correlation between Significant People Function versus control over risk concept).

14. BIAC agrees with the basic premise that if there is a dependent agent PE (“DAPE”) then a taxpayer should (i) undertake an Article 9 analysis to determine the income and expenses of Company A and Company B, then (ii) undertake an Article 7 analysis to determine the income and expenses of Company A Head Office and Company A DAPE. We believe that this sequencing not only provides the most clarity, on a basis consistent with the Action 7 objectives and principles, but may also be either necessary or of assistance, if local consolidated filing options are to be pursued. Additionally, this sequencing appears consistent with the language in para 18 of the Discussion Draft that a risk cannot be considered to be assumed by the non-resident enterprise or the PE for the purposes of Article 7 where that is risk is found to be assumed by the intermediary under the guidance in Section D.1.2 of Chapter I. Therefore, BIAC strongly urges the OECD to mandate this sequencing in the final guidance to avoid any uncertainty regarding the order of application.

15. As a practical matter we would suggest starting with a functional analysis of the activities undertaken in Country B and whether, within the context of the extended Action 7 PE concepts, that should be viewed as a domestic Article 9 supply to a DAPE which is thereby created, or as a cross-border supply to Country A (i.e. one which creates income in country B and expense solely in Country A, rather than expense in a Country B DAPE of the Country A host). It is not clear to us that there cannot be the “mirror image” domestic to domestic Country B supplies from the DAPE to the DAE (because local functions are carried on by the DAE), but if there can be such mirror image domestic functions, then those should also be identified. We would suggest that a logical sequence to subsequently follow is:

- a. Make all Article 9 charges other than these domestic Country B to Country B charges;
- b. Make an Article 7 determination as to what taxable profits are, in aggregate, properly attributable to Country B before considering domestic Article 9 charges within Country B. For this purpose all functions performed in Country B are treated as if they are performed by the Company for whom the Article 7 analysis is being performed; and

- c. Make Article 9 charges within Country B so as to separate local taxable profits/losses between local entities or presences.
16. Alternatively, before the order of Article 9 and Article 7 analyses are considered, it may be worth providing taxpayers with the option of the performance of a broader functional analysis of DAE/DAPE (potentially leveraging the presumed Article 5 analysis). This analysis could be beneficial in terms of both efficiency and consistency (i.e. if no activities/risks were attributed to DAPE there would be no need for any Article 7 analysis and if activities/risks were attributed to DAPE it could be ensured that they differed from those attributed to DAE). The aim would be to avoid double counting of activities and/or risks in Country B and ensure that the activities/risks of DAPE are rewarded under Article 7 and those of DAE are rewarded under Article 9.
  17. The Discussion Draft also noted in para 12 that “[t]he approach adopted by a jurisdiction should be applied consistently and could be made public for purposes of transparency and certainty for taxpayers.” While BIAC commends the OECD for its attempts at supporting transparency and consistency in this area, we believe this language should be much stronger. BIAC urges the OECD to strongly encourage countries to share their respective approach regarding the sequencing of Article 7 and Article 9. This is especially necessary if the final guidance will not include a clear order of application.
  18. BIAC welcomes the OECD’s acknowledgment that administrative approaches to enhance simplification are important. However, the administrative complexity surrounding the existence of a PE under Article 5(5) requires a much stronger push from the OECD for countries to introduce domestic legislation that will allow for administrative simplicity and considerable more detail into the analysis that is necessary. Given the importance of this topic, we have attached as Appendix A an additional comment letter solely focused on administrative approaches to enhance simplification in this area. We are hopeful that a separate detailed letter on this topic will highlight the importance of this issue and help to find a solution that will alleviate the compliance burdens facing both taxpayers and tax authorities.

### **Examples**

19. BIAC urges the OECD to include numerical examples in the final report. We understand that numerical examples have not been included to avoid drawing conclusions from this guidance on the level of profitability of the intermediary or the PE. However, BIAC believes that the examples included in the Discussion Draft lack clarity and completeness, and the addition of quantified examples would make the examples considerably more useful for taxpayers and tax authorities and could be drafted in a manner to continue avoiding conclusions being drawn on the level of profitability. For example, Examples 1 and 2 require more detail as to what should be expected regarding the arm’s length remuneration of SellCo. Without numbers, it is difficult to understand what profits could be attributed to the PE where a local entity receiving an arm’s length remuneration already exists.
20. We are concerned that in every example (however simplified) it is assumed that a PE exists and a profit/loss attribution calculation must be performed. We believe this is a fundamental departure from the previously held practice that companies could opt to incorporate local subsidiaries and undertake robust transfer pricing analyses to limit the risk of PE challenge when operating overseas. It would be helpful to have a threshold example or, at least, an example

showing exactly where a PE would not exist for the purposes of this guidance.<sup>1</sup> Additionally, each of these examples should explicitly reference that a determination of whether a PE exists will require a case-by-case and country-by-country analysis of all facts and circumstances including consideration of each country's position regarding Articles 5(5) and 5(6) of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI"). This is necessary not only to ensure there is no inconsistency in the way that countries use functional analyses to assert PEs under Article 5, but also as the fundamental starting point for an Article 7 analysis.

21. We do not believe that creating PEs wherever a subsidiary exists was the intention of the revised wording for Article 5 of the MTC, and would welcome additional examples of where a related enterprise does not create a PE in order to remove uncertainty in this respect. This is important given that Article 5.7 establishes that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company.
22. In addition to strengthening its support for the AOA approach, we would welcome OECD to provide examples illustrating the main differences between profit/loss attribution to PE under the AOA and any other approaches used to attribute profits, especially when taking into consideration Article 7 (3) of the UN Model Tax Treaty, under which no deduction shall be allowed in respect of amounts, paid by the permanent establishment to the head office of the enterprise or any of its other offices. The difference in attribution of taxable base under each scenario may question whether taxation actually follows economic substance and value creation in each situation.
23. BIAC would also encourage the OECD to alter the facts in additional examples to include circumstances where local marketing and/or sales support is remunerated on a cost plus basis. Each of the examples included in the Discussion Draft envision a commissionaire agreement which provides limited guidance for MNEs operating in a different arrangement.
24. In Example 4 we would welcome an OECD clarification whether the proposed simplified approach is applicable separately to each of the PE or whether it should be considered collectively as part of a larger set of business activities conducted in the source country.

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<sup>1</sup> BIAC would recommend WP6 working closely with WP1 to develop more comprehensive guidance in this regard.

## **Appendix A – Administrative Simplification**

The BEPS Action 7 Report (“Action 7 Report”) made changes to Article 5(5) and 5(6) of the OECD Model Tax Convention (MTC) which substantially lower the threshold for the existence of a deemed PE and will result in a significant increase in the number of PEs in territories where taxpayers already have established legal entities. While BIAC commends the OECD for providing additional guidance on the issue of attribution of profits to PEs (and also encourages further guidance on the thresholds themselves), there is a significant void with regard to the guidance on administrative simplification referenced in the Discussion Draft.

The Discussion Draft notes in para 20 that “there may be administratively convenient ways of recognising the existence of a PE under Article 5(5) and collecting the appropriate amount of tax resulting from the activity of the intermediary”. Additionally, para 21 provides that “the potential burden on a non-resident enterprise of having to comply with host country tax and reporting obligations in the event it is determined to have an Article 5(5) PE cannot be dismissed as inconsequential, and nothing in this guidance should be interpreted as preventing host countries from continuing or adopting the kind of administratively convenient procedure mentioned above.” BIAC welcomes these references to administrative simplification but believes they fall considerably short of addressing and providing practical solutions for what is a significant obstacle facing all MNEs.

Example 1 of the Discussion Draft notes in para 26 that “[f]or reasons of administrative convenience, the tax administration in Country S may choose to collect tax only from SellCo even though the amount of tax is separately calculated by reference to the tax liability of SellCo and the PE.” BIAC strongly supports this single taxpayer method but this language is significantly lacking in commitment and detail. BIAC believes that the message from the OECD should be much stronger than to simply provide a possible option that a tax administration *may* adopt. This undermines the importance of finding a solution that will work for tax authorities and tax administrations.

There is a considerable risk that without additional detailed guidance on this single taxpayer method tax administrations may adopt such an approach without a full understanding of the nuances that will need to be addressed or will forego such an approach due to the lack of guidance. Adoption of a simplified approach without the necessary guidance could be as detrimental as no approach at all. For instance, there is no discussion on the framework that will need to be adopted by jurisdictions for taxpayers and tax authorities to agree on the appropriate amount of profit attributable to the DAPE. The language in para 26 also does not provide any guidance for a tax administration seeking to apply this approach that may have a separate corporate income tax rates (for example due to BEPS Action 6 compliant preferential regimes, or different sized companies). While this may seem to be an issue that could be easily addressed, any guidance provided by the OECD is expected to be relied on by all members of the Inclusive Framework and some developing countries may not have the experience necessary to navigate these questions.

Lastly, the language in para 26 does not address a significant portion of the anticipated compliance burden which is the added registration requirements that will occur for VAT/GST and legal purposes. Again, this added compliance obstacle provides no benefit to tax administrations but comes at a considerable cost for taxpayers.

BIAC anticipates that the modifications to the threshold levels for PEs as well as the anti-fragmentation rule will result in a significant administrative, compliance, and financial burden for taxpayers and tax authorities alike. Given the vastly different business models of different industries, this is likely to hit some taxpayers or industries worse than others. Specifically, many MNEs expect to have PEs in countries without that company being physically present (“non-present PE” or “NPPE”). This will undoubtedly lead to taxpayers and tax authorities needing to address issues such as (but not limited to):

- (i) registration requirements for large (but unknown) numbers of NPPEs, including choice of address, branch registration, local governmental registration filings, and complex correspondence;
- (ii) determination of balance sheet and income statement of NPPE;
- (iii) audit and other administrative requirements (*e.g.*, books and records kept locally in accordance with local language and accounting standards);
- (iv) knock-on effects from registration (*e.g.*, VAT compliance);
- (v) policing and monitoring of compliance requirements; and
- (vi) allocation of internal resources and human capital.

Whilst it is not within the OECD’s remit to mandate administrative simplification methods, BIAC believes it is important for the OECD to strongly communicate the benefit of administrative simplification to tax administrations and encourage pragmatism in their domestic legislation. We are aware of the difficulties that many tax administrations face with regards to resources. Additionally, the IMF/OECD Report for the G20 Finance Ministers on tax certainty noted that tax uncertainty often derives from a poor relationship between business and the tax authority which is partly due to administrations seeing taxpayers as aggressively pursuing tax minimization. BIAC believes that administrative simplification provides an opportunity to address both of these issues.

By limiting the amount of resources that tax administrations will need to allocate to monitor and address the considerable number of new DAPEs, tax administrations will be able to efficiently allocate resources to other critical initiatives such as Country-by-Country Reporting. Perhaps more importantly, the adoption of administratively convenient ways to collect the appropriate amount of tax resulting from the existence of a PE under Article 5(5) would significantly improve the relationship between tax administrations and taxpayers. This is not an issue of aggressive tax minimization. Without administrative simplification, this financial and compliance burden will simply work against the larger common goal of promoting tax certainty as a tool for enabling cross-border trade and investment.

### **Suggested scope of work in finding solutions**

The OECD noted in the Action 7 Report that “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”. The Discussion Draft echoes this point by noting that “[d]epending on the facts and circumstances of a given case, the net amount of profits attributable to the PE may be either positive, nil or negative (*i.e.*, a loss). In particular, when the accurate delineation of the transaction under the guidance of Chapter 1 of the TPG indicates that the intermediary is assuming the risks of the transactions of the non-resident enterprise, the profits attributable to the PE could be minimal or even zero.”

BIAC believes that this language is supportive of the idea that the issues around administrative simplification are entirely separate from any discussion on the amount of profit that should be allocated to a particular PE. The considerable drain on capital and resources, with no added benefit to taxpayers or tax administrators, will be identical whether all or none of the profits in question are attributed to a DAPE. This reality, along with the weight of the burden facing MNEs that we have mentioned throughout, should highlight the considerable need for the OECD to address this issue separately and in significant detail.

### *1. Analyse the current position*

As a starting point, BIAC would encourage the OECD to analyse unilateral actions taken by countries to address these issues. For example, Italian tax authorities have recently adopted legislation whereby a company belonging to a group with a threshold amount of worldwide turnover and Italian revenue will have the opportunity for an open discussion with Italian tax authorities as to the existence of a DAPE and the amount of income attributed such that no separate PE filing obligation or registration for VAT purposes would be required. As a minimum this would be useful for other tax authorities in developing unilateral solutions.

### *2. Develop innovative multilateral solutions or best practices*

However, multilateral or an agreed best practice bilateral or unilateral solutions would be preferred. To this end, the OECD should investigate the merits and disadvantage of the approaches identified, and innovate solutions that may be true best practices. A discussion draft on this topic with an opportunity for stakeholders to provide commentary would not only bring this significant issue to light but would also represent a tremendous step in arriving at a solution that works for both taxpayers and tax authorities. Our members would be happy to support this study, and have already identified some potential solutions that could be further developed.

A survey of our members suggested the following options that could be considered by the OECD in tandem with a single taxpayer approach:

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

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

- a. The transfer pricing policy sufficiently rewards the parties to the controlled transaction based on the functions performed, risks assumed and assets owned/utilised;
- b. The controlled transaction is accurately delineated;

- c. The transfer pricing outcome is aligned with the economic activity that produced the profits (including SPFs), rather than the contractual allocations; and
- d. The transactions are sufficiently documented in accordance with Action 13.

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

### *3. Support tax authorities' efforts to audit effectively*

Finally (or simultaneously) the OECD could comment on how taxpayers and tax authorities will deal with the auditing of the potentially greatly increased number of PEs. The taxable basis of a PE is not easy to define and, in order for any PE to be properly audited, management accounts are usually used. Although we note that the link between management accounts and local accounts is not always easy to demonstrate, it is important that the OECD makes clear tax administrations should not seek to audit the entire P&L of an entity when only a small part of that entity gives rise (or potentially gives rise) to a PE. Any work that the OECD Forum for Tax Administrations (FTA) is doing to improve auditing, tax compliance and work relating to cooperative compliance, should be taken into account and consider opportunities to improve the increased PE related compliance. Risk based approaches and triages should be considered in this respect, when considering the limited resources tax authorities may have, especially many members of the Inclusive Framework.

We hope that these observations will constitute the start of a dialogue, rather than being viewed as a standalone submission. We believe that the OECD must take the lead in providing participating countries with innovative, pragmatic, and consistent solutions regarding domestic implementation of administrative solutions and the OECD is ideally suited to do this. We would welcome the opportunity to discuss these matters in more detail (either formally or informally).



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## **BUSINESSEUROPE position on the Public Discussion Draft on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments**

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

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

BUSINESSEUROPE welcomes and supports the objective of the Draft to provide guidance on the attribution of profits to the permanent establishments that arise from the revisions to Article 5(5) and 5(6) of the Model Tax Convention (MTC) made by the Report on Action 7 that was finalised in 2015, with that guidance being relevant for all countries and applying principles that are agreed by all countries. While the Draft sets out high-level general principles, its usefulness to both tax administrations and tax payers would be significantly increased if there was more detailed guidance, with more examples to illustrate some of the more complex circumstances and outcomes.

While BUSINESS EUROPE appreciates the comment in the introduction to the draft that numerical examples have not been included "to avoid drawing conclusions from this guidance on the level of profitability of the intermediary or the permanent establishment." it is unfortunately inevitable that the outcome is a lack of insight or guidance from the simple and non-numeric examples that are used, and the purpose of the examples is obscured where numbers would have made the purpose much clearer. On balance, BUSINESS EUROPE would therefore recommend the reinstatement of numeric examples, and the inclusion of more examples to illustrate particular issues.

BUSINESSEUROPE welcomes confirmation in Paragraph 7 that the changes made to Article 5(5) and 5(6) have not modified the nature of a PE that is deemed to arise under either the pre-BEPS or post-BEPS versions of the Article: it would be helpful if specific reference to this was included in the updated Commentary on the Model Tax Treaty, a draft of which was published on July 11.



Although specific reference to this additional guidance in the Commentary to the Model Tax Convention would be helpful, a particular challenge of the BEPS project and the involvement of the Inclusive Framework in future changes to international tax agreements, combined with the implementation of the Multilateral Instrument (MLI), is that all countries that may in future implement changes to the equivalent of Articles 5(5) and 5(6) in their bilateral tax treaties will not be members of the OECD or otherwise committed to the OECD guidance and interpretation of tax treaties. In this future international tax environment, where increasing numbers of countries may amend tax treaties in line with the Action 7 recommendations and the MLI allows more rapid implementation of treaty changes, the status of guidance on the attribution of profit to PEs becomes more important to both tax payers and tax administrations. It is not clear what the status of this Draft will be once it is finalised, and whether tax payers will be able to rely on its guidance in interpretation of tax treaties: clarification of its future status would therefore be of great benefit.

A particular difficulty with the interpretation of the guidance in the Draft is caused by the lack of a clear support for the Authorised OECD Approach (“AOA”) under Article 7. Unless all participating countries can agree to adopt the AOA, this potentially valuable guidance on the attribution of profits to PEs will not be useful in practice and will contribute to creating further confusion. BUSINESSEUROPE would therefore strongly encourage the OECD to make explicit its support for adoption of the AOA and the consistency that this would provide in this difficult area.

The Draft states in paragraph 7 that *“any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5(5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5(5).”*; This statement implies that guidance in the Commentary to the MTC before the BEPS project was sufficient, consistent and unambiguous. This was not the experience of BUSINESSEUROPE members, and the need for clarification and further guidance to reconcile very divergent interpretations had been identified prior to the BEPS project.

The language of paragraph 7 also suggests that countries may apply any previously used profit attribution method, including the 2010 AOA method, 2008 AOA method, or any other pre-BEPS method. The value of the Inclusive Framework (to both businesses and tax authorities) should be that greater consistency of application could be reached across all 102 countries and we would recommend that, in order to achieve this consistency, there must be a recognition that a single approach is desirable, and that all future guidance should have the aim of encouraging adoption of this approach, based on the 2010 AOA method.

BUSINESSEUROPE is concerned that the Draft fails to address the lack of clear recommendation in the Commentary to the MTC on the order of application of Articles 9 and 7 in determining the profit attributable to a PE. Paragraph 12 concludes that the order in which Articles 7 and 9 are applied should not impact the amount of profit over which a country has taxing rights and states an expectation that jurisdictions should make arrangements to eliminate double taxation. This conclusion has no justification within the Draft, and BUSINESSEUROPE does not agree that the order of application will not, in practice, have an impact on the amount of profits over which the source



country has taxing rights. The Draft should include stronger guidance on the order of application and stress the need for transparency and consistency including publication of the approach taken by countries, particularly those which seek to apply Article 7 before Article 9.

It appears that the language included in paragraph 8 represents a departure from the expected analysis under the AOA. The statement “[o]nce it is determined that a PE exists under Article 5(5), one of the effects of paragraph 5 will typically be that the rights and obligations resulting from the contracts to which Article 5(5) refers will be properly allocated to the permanent establishment.” appears to eliminate the AOA analysis by replacing the functional analysis required under the AOA with assumptions about the rights and obligations of the parties. This is unlikely to support the OECD’s objective of aligning taxing rights with value creation. The confirmation in Paragraph 14 that “...the allocation of risks for transfer pricing purposes does not change the facts on which the application of Article 5(5) is predicated...” is particularly welcome, and it would be particularly helpful if this was also confirmed and emphasised in the Commentary to the MTC.

BUSINESSEUROPE would encourage the OECD to clarify Paragraph 17 on significant people functions and risk control functions: in its current format it is capable of different interpretations and therefore does not assist either tax administrations or tax payers seeking definitive guidance. An example may be helpful in making the meaning clearer. Paragraph 18 seeks to reconcile how significant people functions (under Article 7) and risk control functions (under Article 9) should not result in double taxation in the source country, and acknowledges that there is overlap. While this recognition is welcome, it is disappointing that the Draft does not then make any recommendation or proposal on the method to eliminate this double taxation between the source and the residence countries.

In Paragraph 19 it is recognised that the arm’s length net profit attributable to a PE could be positive, nil or negative. This recognition is significant, and it should have greater prominence to counter the assumption that is made by many tax jurisdictions that the presence of a PE carries an automatic presumption of a taxable profit.

However, this welcome recognition then appears to be somewhat negated by the next sentence that states that where an intermediary assumes risk, the profits attributable could be “minimal or even zero”, and does not acknowledge that the attributable result could be negative.

As there is acknowledgement that the PEs that are recognised under the amendments to Articles 5(5) and 5(6) introduced in the 2015 Report could result in a profit attribution that is positive, zero or negative, guidance or confirmation of how a negative outcome should be treated should also be included in the Draft.

Where non-numerical examples are used, BUSINESS EUROPE would recommend that in each example there is a short paragraph reiterating that the net profit attributable to the PE may be positive, zero, or negative



BUSINESSEUROPE welcomes the implied approval in Paragraphs 20-21 of mechanisms that achieve administrative simplification and cost reduction. To assist other countries in implementing such simplification methods, examples of good practice would be helpful and this should be accompanied by a recommendation that such practices should be adopted by all jurisdictions. *Consideration should also be given to a consistent approach on the filing of nil returns where tax payers consider that there is no attributable profit, avoiding potential penalties and statute of limitation issues.*

Paragraph 21 comments on the burden of reporting, but there is no reference to, or recommendation on the adoption of de minimis or similar approaches, where there is a practical recognition that, where a PE results in a zero or very small profit, it is in the interests of both tax administration and tax payer to agree that no reporting or other administrative burden should be undertaken where the costs of administration will permanently exceed any taxes collected. This should be distinguished from simplification of payment of tax where there is another resident tax payer.

The draft amended MTC published on July 11 includes comment on VAT registration not being evidence of the existence of a PE. This Draft should have a complementary comment that a deemed PE is not prima facie evidence of the existence of a VAT establishment

The examples use simplified assumptions, which include a presumption that relevant comparables are available. As this will not always be the case, guidance on what actions should be taken by the tax payer or tax administration in computing the attributable profit should be included in the Draft.

There is no example on the application of the anti-fragmentation rule: the inclusion of such an example would be useful guidance for tax administrations and tax payers, incorporating guidance on quantification of the attributable profit to an activity or presence that would not otherwise qualify as a PE.

There is also no helpful guidance in the examples on the allocation of risks between the head office and the PE: such guidance would be particularly useful where the PE is a Dependent Agent PE, with the sharing of risks between the head office, PE and a related party resident enterprise.

Yours sincerely,

James Watson,  
Director of Economics Department



Chartered  
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## **BEPS Action 7 - Additional Guidance on Attribution of Profits to Permanent Establishments: Public Discussion Draft Response by the Chartered Institute of Taxation (CIOT)**

### **1 Introduction**

- 1.1 We refer to the Public Discussion Draft published on 22 June on BEPS Action 7 - Additional Guidance on Attribution of Profits to Permanent Establishments (PEs). We welcome the OECD's time and effort in this very difficult area and are pleased to provide the comments below.
- 1.2 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers and tax authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.
- 1.3 In our view, objectives for the tax system should include greater simplicity and clarity, and also greater certainty, so businesses can plan ahead and make investment decisions with confidence.
- 1.4 The Discussion Draft largely adopts the approach of setting the high-level general principles in relation to the attribution of profits to PEs resulting from changes to article 5(5) and 5(6) and, separately Article 5(4) and there are some helpful points made in the relevant paragraphs of the Discussion Draft (including, for example, the acknowledgement that double taxation should be avoided in paragraph 12).
- 1.5 However, in our view more detailed guidance than that drafted would better assist taxpayers and tax authorities. In particular taxpayers brought within the rules as a result of the lowering of the PE threshold by the Action 7 report may potentially have many more PEs than previously, and may have little previous experience in applying profit attribution principles in practice. Therefore, we would like to encourage the OECD to develop this guidance further. By their very nature high-level principles can often be interpreted in a number of different ways and we suggest that further, more detailed guidance may be necessary to ensure a more certain and consistent approach to profit attribution.

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- 1.6 With this in mind, we set out below some areas, where we think it would be helpful for the OECD to develop the guidance further.

## **2 Authorised OECD Approach (AOA)**

- 2.1 We would like to see the OECD explicitly support adoption of the AOA. We think that doing so would result in more certainty and consistency. The aim should be for a consistent approach by as many tax authorities as possible and, in our view, this will be better achieved if there is support for a single approach.
- 2.2 We appreciate that some tax treaties will continue to include the ‘old’ Article 7 but assume that these will decrease over time.
- 2.3 An issue with attribution under the ‘new’ Article 7 is that the profit that may be attributed to the country of the PE may be greater than the profits of the enterprise.

## **3 Threshold**

- 3.1 We appreciate that the focus of this public consultation is on the attribution of profits to PEs. However, the threshold issues associated with the OECD’s final report on BEPS Action 7 remain a concern of businesses as a result of the potential compliance burden and the risk of double taxation.
- 3.2 In addition where a company has multiple PEs in different countries resolution of disputes will be complex. We hope this will not be a significant issue in practice – but it will be important to monitor the position – and consider what remedies might be available if needed.
- 3.3 It is difficult to provide comprehensive comments on the attribution of profits to PEs before the issues surrounding the threshold for their existence have been further developed in practice.

## **4 Administration**

- 4.1 The OECD has recognised (in its final report on BEPS Action 7) the administrative burden that may arise even in circumstances where no profits are attributable to a PE. The Discussion Draft (at paragraph 19) also recognises that the ‘profits attributable to the PE may be either positive, nil or negative (ie a loss)’. Thus, in recognition of the considerable administrative burden (with potentially no added benefit to tax authorities or taxpayers) we would like to see the OECD go further in encouraging countries to introduce domestic legislation that would reduce the administrative burden.
- 4.2 It would be helpful if the OECD were to develop a best practice in this area.

## 5 Examples

- 5.1 Generally, the examples would be clearer if a little more detail could be provided, and numerical examples included. In addition, while the footnotes are helpful, we suggest that it would be more helpful if they are worked into the text of the examples and expanded.
- 5.2 In particular, in Example 2 at paragraph 28 it is not clear what is meant by ‘...SellCo habitually plays the principal role leading to the routine conclusion of sales by SiteCo in country R to customers in Country S without material modification of the terms and conditions...’.
- 5.3 Assuming the terms and conditions are always the same regardless of the identity of the customer, then this example appears to be a question of whether the existing arms-length consideration of SellCo includes an element for what looks to be a relatively minimal ‘entrepreneurship’ role, given that all sales are straightforward in contract and commercial terms.
- 5.4 We suggest that the example could be more helpful with a discussion or examples of what a material modification might be – or alternatively what might be regarded as a minor modification that would be disregarded.

## 6 Acknowledgement of submission

- 6.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

## 7 The Chartered Institute of Taxation

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

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

The CIOT’s 18,000 members have the practising title of ‘Chartered Tax Adviser’ and the designatory letters ‘CTA’, to represent the leading tax qualification.

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

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

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**Contacts for follow-up. This contribution was prepared by the CMS Transfer Pricing Group and, in particular, by the following experts:**

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

**Discussion on paragraphs 11 and 12 of the Public Discussion Draft on BEPS Action 7 (“Additional Guidance on Attribution of Profits to Permanent Establishments” released on June 22 (“the Discussion Draft”))**

The Discussion Draft raises the question on whether a profit adjustment under Article 9 should precede the attribution of profits under Article 7, and concludes that the order under which these Articles are applied should not impact the amount of profits of the associated enterprise.

We welcome this comment which provides for a simplified approach for tax administrations and taxpayers: in most cases, the characterization of a deemed PE reflects the fact that the associated enterprise provided additional value compared to the initial legal arrangement, as illustrated by the reference to the “ordinary course of their business” by Article 5.6. Indeed, a dependent agent who concludes contracts on behalf of its principal who creates a PE, but if no profit can be attributed to such PE because significant people functions are performed by the head office of the principal, the only potential adjustment would be a transfer pricing adjustment for the additional value provided by the agent. Interestingly enough, one could consider that no adjustment may be applied in a similar situation when the associated enterprise is not a transparent agent but a commissionaire, since a commissionaire should be already properly compensated for its signing function.

**Discussion on paragraphs 18 and 19 of the Public Discussion Draft on BEPS Action 7 (“Additional Guidance on Attribution of Profits to Permanent Establishments” released on June 22 (“the Discussion Draft”))**

The Discussion Draft raises the point that when both Article 7 and Article 9 are applicable (i.e. the intermediary and the non-resident enterprise are associated enterprises) and the functions performed by the intermediary can qualify as significant people functions for the attribution of a specific risk to the PE and as risk control functions for the allocation of a risk under Article 9, it is important to ensure that the risk to which those functions relate is not simultaneously allocated to the intermediary (subject to the conditions laid out in Section D of Chapter I of the TPG) and attributed to the PE (under Article 7). The Discussion Draft further elaborates on the point concluding that one of the elements to determine and deduct in calculating the profits attributable to the PE is an arm's length reward to the intermediary. Depending on the facts and circumstances of a given case, the net amount of profits attributable to the PE may be either positive, nil or negative (i.e., a loss). In particular, when the accurate delineation of the transaction under the guidance of Chapter I of the TPG indicates that the intermediary is assuming the risks of the transactions of the non-resident enterprise, the profits attributable to the PE could be minimal or even zero.

We welcome this comment that is an important step to minimize the possibility of double taxation of the same income, however we wonder if in situations where there is no additional function nor risk that is not already being remunerated at the level of the intermediary, to the

point that the profits attributable to the PE could be zero, further thoughts should not be given to the need to register a PE having in mind, on one side, the additional burden put on the non-resident enterprise and, on the other, the complexity driven by the proliferation of PE for the tax administrations. In addressing this point it should be taken into account that in these situations, the transactions between the intermediary and the principal would be disclosed in the financials of the intermediary, therefore the country of residence of the intermediary would not see its ability to monitor and control them diminished in any way.

### **Discussion on paragraphs 22 through 35 (“examples illustrating the attribution of profits to deemed PEs under Article 5 (5)”) of the Discussion Draft**

§22 of the Discussion Draft states that the proposed analysis of the examples is governed by the AOA contained in the 2010 version of Article 7. A quick summary of existing guidelines is thus necessary.

OECD Commentaries (2014 version) on Article 7 provide limited guidelines on the actual computation of profits to be attributed to a PE. After presenting the undertaking of a functional and factual analysis and the comparability approach, it refers to the “application by analogy of one of the Guideline’s methods to arrive at an arm’s length compensation for the dealings between the permanent establishment and the other parts of the enterprise, taking into account the functions performed by and the assets and risks attributed to the permanent establishment and the other parts of the enterprise” (§20-21-22 of the Commentaries on Article 7, 2014 version). No specific guidelines are provided by the Commentaries.

Reference is made by the Commentaries to the 2010 Report on allocation of profits to permanent establishments (“the Report”). The Report (§185-186) provide guidelines on the application of transfer pricing methods to attribute profits, explaining that for a PE being deemed to operate a sales activity, “the CUP method might be used to determine the price at which the PE would have obtained the products had it been a “separate and independent enterprise”. The Report further indicates that where a CUP is unavailable, other methods described in the Guidelines could be used, with a focus on the resale minus method.

The Report specifically refers to Dependent Agent PEs (paragraphs 227 through 245) with a focus on dependent sales agents: should inventory risk or creditors risk be managed by employees of the dependent agent enterprise, the associated profit (or loss) for such risks would be allocated to the PE.

Examples 1 and 2 presented in the Discussion Draft refer to dependent sales agents, and Example 3 refers to a buying agent which would create a PE because procurement is not an auxiliary or preparatory activity. Because the method for computing the profits allocable to the corresponding PEs is the same for the three examples in the Discussion Draft, a global commentary can be provided for these examples.

These examples suggest using a CUP method in order to identify a similar transaction with unrelated distributors (EX1+2) or suppliers (EX3), and then allocate expenses incurred for the purposes of the PE by the non-resident company, and subtract the arm's length compensation of the related party creating the PE.

This approach is disputable for several reasons:

- It is unlikely that it would be possible to identify a comparable transaction in order to apply the CUP method;
- The approach does not take into account the outcome of the functional analysis identifying economic ownership of assets;
- Reference to an arm's length compensation of the associated enterprise compounds the complexity of the exercise.

We suggest that paragraph 22 presenting the three examples indicates that the CUP method is only one of the methods available to attribute profits to the deemed Pes. In this respect, it seems that a direct allocation method be presented, using a TNMM approach. An illustration of the method presented in the Report (paragraphs 240 through 245) would be helpful.

For instance, when a commissionaire creates a PE for its principal, profit could be attributed to the deemed PE with respect to the management of inventory and receivables, using external comparable data. This approach would also be more appropriate to ascertain cases where no profit should be attributed to the PE, for instance where a commissionaire does not manage any of the assets of the principal; it is uncertain whether the approach presented in the Discussion Draft would be appropriate to reflect such a situation.

The same approach would be applicable to Example 4 where the purpose of the analysis is to determine the arm's length profit of a logistic services provider and of a merchandising service provider: a TNMM approach would certainly be more efficient than a CUP approach.

Furthermore, the CUP approach is likely to create double taxation since the source country will start by considering that all local sales constitute taxable income, and will likely be very cautious in allowing deductible expenses at the level of the deemed PE. A TNMM approach is more appropriate when the question at stake is "allocating profits".

Finally, a discussion based on examples may not be appropriate in itself: it may lead tax administrations to consider that all situations comparable to the examples will necessarily constitute a Permanent Establishment, without reviewing in detail all relevant facts and circumstances, namely the analysis of economic ownership of assets.

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15 September 2017

Mr Jefferson VanderWolk  
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Dear Jefferson,

**OECD Discussion Draft on BEPS Action 7 – Additional Guidance on Attribution of Profits to Permanent Establishments**

Thank you for the opportunity to provide comments on the BEPS Action 7 – Additional Guidance on Attribution of Profits to Permanent Establishments issued on 22 June 2017 (“the revised discussion draft”).

**Background**

By way of background, I have specialised in the area of international transfer pricing and the attribution of profits to permanent establishments for more than 24 years, first at the Australian Taxation Office (ATO), then as a director with KPMG and from October 2015 through Damian Preshaw Consulting Pty Ltd.

While at the ATO, I was an Australian delegate to the OECD’s Committee on Fiscal Affairs’ Working Party No.6 (Taxation of Multinational Enterprises) (“WP6”) and to WP6’s Steering Group on Transfer Pricing from September 1994 to June 2003. During this time I was closely associated with the development of the Authorised OECD Approach for the attribution of profits to permanent establishments (AOA), including the various discussion drafts issued by the OECD with respect to Parts I-III during the 2001 to 2003 period and the public consultation held with business in April 2002 in Paris.

**Context**

The Report on Action 7 of the BEPS Action Plan (Preventing the Artificial Avoidance of Permanent Establishment Status) (the Report) concluded that the changes to the definition of a PE in Article 5

of the OECD Model Tax Convention (OECD MTC) do not require substantive modifications to the existing rules and guidance concerning the attribution of profits to a PE under Article 7 of the OECD MTC but that there was a need for additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in the Report. The Report mandated the development of additional guidance on how the rules of Article 7 of the OECD MTC would apply to PEs resulting from the changes in the Report.

The existing rules and guidance concerning the attribution of profits to a PE are contained in the new Article 7 of the OECD MTC and its associated Commentary, the previous version of Article 7 and its associated Commentary and the 2010 Profit Attribution report.<sup>1</sup>

Further, specific guidance with respect to the attribution of profits to a DAPE is provided in Sections B-6 and D-5 of Part I, Section D-3 of Part III and Section B-5 of Part IV of the 2010 Profit Attribution report and in paragraph 26 of the Commentary to the previous version of Article 7. Curiously, there is no specific guidance in the Commentary to the new Article 7 in relation to how profits should be attributed to a DAPE and no equivalent paragraph to paragraph 26 of the Commentary to the previous version of Article 7.

Irrespective of whether the new Article 7 and its associated Commentary or the previous version of Article 7 and its associated Commentary is the relevant version of Article 7 to consider, attribution of profits to a PE (or to a DAPE) involves application of a “two-step analysis”. At its most fundamental level this entails:

- Performing a functional and factual analysis to determine the functions undertaken by the PE and the assets and risks to be attributed to the PE; and
- Attributing profits to the PE (DAPE) on the basis of those functions, assets, risks and capital.

The “two-step analysis” is summarised in paragraph 44 of Section B-5 of Part I of the 2010 Profit Attribution report and is reflected in paragraphs 21 and 22 of the Commentary to the new Article 7 and in paragraph 17 of the Commentary to the previous version of Article 7. The “two-step analysis” underpins the AOA and amongst other things seeks to ensure that profits are taxed where economic activities take place and value is created.

## **Summary**

The revised discussion draft has not proposed any changes to the existing rules and guidance for attributing profits to a PE (or to a DAPE) under Article 7 of the OECD MTC. As such, the following conclusions would seem reasonable:

- The existing rules and guidance for attributing profits to a PE (or to a DAPE) under Article 7 of the OECD MTC are considered adequate; and

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<sup>1</sup> Paragraph 9 of the Commentary to the new Article 7 states that “The current version of [Article 7] therefore reflects the approach developed in the [2010 Profit Attribution Report] and must be interpreted in light of the guidance contained in it.”

- The examples in the revised discussion draft simply provide illustrations of how the existing rules and guidance for attributing profits to a PE (or to a DAPE) would apply to the particular fact patterns under consideration.

In light of the first conclusion above, this submission has focused on the four examples in the revised discussion draft.

In their current form, the examples in the revised discussion draft do not satisfy the mandate to develop additional guidance on how the rules of Article 7 of the OECD MTC would apply to PEs resulting from the changes in the Report. Fundamentally, this is because the examples are not firmly grounded in the “two-step analysis” which underpins the AOA.

The examples should be reviewed so that each example addresses (at a minimum) the following matters:

- The analysis of each example should be firmly grounded in the “two-step analysis” underpinning the AOA;
- Having regard to the fact pattern under consideration, the examples should address what assets and risks of the non-resident enterprise and of the dependent agent enterprise where a DAPE arises should be attributed to the PE based on where the relevant significant people functions are performed;
- The examples should clearly identify the internal dealing(s) between the non-resident enterprise and its PE (Example 4) and the hypothesised dealing(s) between the non-resident enterprise and the dependent agent enterprise (Examples 1-3) to which Art.7 applies; and
- The examples should finally provide guidance with respect to determining a notional arm’s length price for the identified dealing(s) under step two of the “two-step analysis”.

Detailed comments on the examples are provided below.

## Detailed comments

### EXAMPLE 1 (COMMISSIONAIRE STRUCTURE)

The following observations are provided in relation to Example 1:

- The analysis is not grounded in the two-step analysis underpinning the AOA. Instead, the example takes a short-cut approach and conflates without examining the first and second steps of the “two-step analysis”.<sup>2</sup>
- There is no analysis with respect to the words in brackets in paragraph 25(1): “(attributing to such party ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)” which is a key part of step one of the “two-step analysis”. As such it is unclear what assets and risks of TradeCo might be attributed to its deemed PE in Country S and why.
- The analysis has not identified the correct dealing between TradeCo and its PE in Country S to which Art.7 applies. The explanation in footnote 6 that “the amount paid by the PE for the inventory ‘purchased’ from TradeCo” corresponds to a dealing under the AOA is not correct. Under the AOA, a dealing within a single legal entity is not something which is self-evident but is a construct, the existence of which is inferred solely for the purposes of attributing the appropriate amount of profit to the PE (paragraphs 173 and 176 of Part I of the 2010 Profit Attribution Report). However, unlike the situation where a PE distributes a product manufactured by its head office where an internal dealing is readily identifiable (see example in Paragraph 185 of Part I of the 2010 Profit Attribution Report and Section D-2(vi) of Part I and paragraph 26 of the Commentary to the new Art.7), in situations involving dependent agent PEs, there is no internal dealing in the sense of an intra-entity dealing. Rather, a dealing needs to be hypothesised between the non-resident enterprise and the PE that arises from the activities performed by the dependent agent enterprise after attributing to the DAPE 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 (paragraph 232 of Part I of the 2010 Profit Attribution Report). Establishing the terms of the hypothesised dealing is based on the functional and factual analysis in step one of the “two-step analysis”.

Once a dealing has been recognised, the factual and comparability analysis will attribute a price or profit in respect of the dealing by reference to comparable transactions between independent enterprises (paragraph 193 of Part I of the 2010 Profit Attribution Report). As noted in paragraphs 47 and 55 of the Commentary to the new Art.7, “For the purpose of determining the profits attributable to the permanent establishment under paragraph

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<sup>2</sup> As noted above, irrespective of whether the AOA under the new Article 7 and associated Commentary or the previous version of Article 7 and associated Commentary is the relevant Article, attribution of profits to a PE (and to a DAPE) involves a two-step analysis.

2, a dealing must be recognised and a notional arm's length price must be determined for that dealing.”

- Paragraph 26 provides no useful guidance with respect to how to attribute profit to the deemed PE and should be deleted.

## EXAMPLE 2 (SALE OF ADVERTISING ON A WEBSITE)

The following observations are provided in relation to Example 2:

- The analysis is not grounded in the “two-step analysis”. Instead, the example takes a short-cut approach and conflates without examining the first and second steps of the “two-step analysis”.<sup>3</sup>
- There is no analysis with respect to the words in brackets in paragraph 30(1): “(attributing to such party ownership of the assets of SiteCo related to such functions, and assumption of the risks related to such functions)” which is a key part of step one of the “two-step analysis”. As such it is unclear what assets and risks of SiteCo might be attributed to its deemed PE in Country S and why.

In particular, the example does not consider how any intangibles, such as SiteCo's ownership of rights in a website, should be taken into account consistently with the AOA for purposes of step one. The guidance in Sections D-2(iii)(c) (Intangibles) and D-3(iv)(b)(2) (Internal dealings relating to use of an intangible) of Part I of the 2010 OECD Profit Attribution Report are relevant in this respect.

- The statement in line 4 of paragraph 30 that “the profits attributable to the PE in this case, would equal the amount of SiteCo's revenue from sales to customers in Country S minus [...]” together with the associated explanation in footnote 8 that “(t)his is equivalent to attributing to the PE the sales revenue resulting directly or indirectly from the contracts to which Article 5(5) refers” does not follow, as a matter of course from the AOA. Under the functional and factual analysis carried out in step one, the PE is only attributed those rights and obligations of the enterprise of which it is a part which arise out of that enterprise's transactions with separate enterprises as are properly attributable to the PE (paragraph 98 of Part I (“Attributing rights and obligations to the PE”) and also paragraph 44 of Part I and paragraph 21 of the Commentary to the new Art.7). As further noted in paragraph 98 of Part I, this involves identifying those of the enterprise's transactions with separate enterprises which should be hypothesised to have been entered into by the PE (ie based on where the significant people functions are performed).

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<sup>3</sup> As noted above, irrespective of whether the AOA under the new Article 7 and associated Commentary or the previous version of Article 7 and associated Commentary is the relevant version of Article 7, attribution of profits to a PE (and to a DAPE) involves a two-step analysis.

- The analysis has not identified the correct dealing between SiteCo and its PE in Country S to which Art.7 applies. The explanation in footnote 9 that “the amount paid by the PE for the rights to the advertising space from SiteCo” corresponds to a dealing under the AOA is not correct. On one level, this is because no amount is actually paid by the PE to SiteCo for the rights to the advertising space from SiteCo. Under the AOA, a dealing within a single legal entity is not something which is self-evident but is a construct, the existence of which is inferred solely for the purposes of attributing the appropriate amount of profit to the PE (paragraphs 173 and 176 of Part I of the 2010 Profit Attribution Report). In situations involving DAPes, there is no internal dealing in the sense of an intra-entity dealing which can be postulated. Rather, a dealing needs to be hypothesised between the non-resident enterprise and the PE that arises from the activities performed by the dependent agent enterprise after attributing to the DAPE 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 (paragraph 232 of Part I of the 2010 Profit Attribution Report). Establishing the terms of the hypothesised dealing is based on the functional and factual analysis in step one of the “two-step analysis”.

Once a dealing has been recognised, the factual and comparability analysis will attribute a price or profit in respect of the dealing by reference to comparable transactions between independent enterprises (paragraph 193 of Part I of the 2010 Profit Attribution Report). As noted in paragraphs 47 and 55 of the Commentary to the new Art.7, “For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, a dealing must be recognised and a notional arm’s length price must be determined for that dealing.”

- Paragraph 31 provides no useful guidance with respect to how to attribute profit to the deemed PE of SiteCo and should be deleted.

### **EXAMPLE 3 (PROCUREMENT OF GOODS)**

The following observations are provided in relation to Example 3:

- The analysis is not grounded in the “two-step analysis” underpinning the AOA. Instead, the example takes a short-cut approach and conflates without examining the first and second steps of the “two-step analysis”.<sup>4</sup>
- There is no analysis with respect to the words in brackets in paragraph 34: “(attributing to such supplier ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)” which is a key part of step one of the

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<sup>4</sup> As noted above, irrespective of whether the AOA under the new Article 7 and associated Commentary or the previous version of Article 7 and associated Commentary is the relevant version of Article 7, attribution of profits to a PE (and to a DAPE) involves a two-step analysis.

“two-step analysis”. As such it is unclear what assets and risks of TradeCo might be attributed to its deemed PE in Country S and why.

- The explanation in footnote 11 that “the rights and obligations associated with the procurement of widgets” should be attributed to the PE does not, as a matter of course, follow from application of the AOA. Under the functional and factual analysis carried out in step one, the PE is only attributed those rights and obligations of the enterprise of which it is a part which arise out of that enterprise’s transactions with separate enterprises as are properly attributable to the PE (paragraph 98 of Part I of the 2010 Profit Attribution Report and also paragraph 44 of Part I and paragraph 21 of the Commentary to the new Art.7). As further noted in paragraph 98 of Part I of the 2010 Profit Attribution Report, this involves identifying those of the enterprise’s transactions with separate enterprises which should be hypothesised to have been entered into by the PE (ie based on where the significant people functions are performed).
- The analysis has not identified a dealing between TradeCo and its PE in Country S to which Article 7 applies. The conflating of “such profits” with “the amount that TradeCo would have had to pay” in line 6 of paragraph 34 is confusing with neither amount corresponding to a dealing for purposes of the AOA. As noted in paragraphs 47 and 55 of the Commentary to the new Art.7, “For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, a dealing must be recognised and a notional arm’s length price must be determined for that dealing.”
- Paragraph 35 provides no useful guidance with respect to how to attribute profit to the deemed PE of TradeCo and should be deleted.

#### **EXAMPLE 4 (WAREHOUSING, DELIVERY, MERCHANDISING AND INFORMATION COLLECTION ACTIVITIES)**

The following observations are provided in relation to Example 4:

- The analysis is not grounded in the “two-step analysis” underpinning the AOA. Instead, the example takes a short-cut approach and conflates the first and second steps of the “two-step analysis”.<sup>5</sup>
- The example does not provide any guidance with respect to the words in brackets in paragraphs 48 and 49: “(attributing to such service provider ownership of the assets of OnlineCo related to such functions, and assumption of the risks of OnlineCo related to such functions)” which is a key part of step one of the “two-step analysis”. As such it is unclear what assets and risks of OnlineCo might be attributed to the warehouse PE of OnlineCo and to the office PE of OnlineCo in Country S and why.

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<sup>5</sup> As noted above, irrespective of whether the AOA under the new Article 7 and associated Commentary or the previous version of Article 7 and associated Commentary is the relevant version of Article 7, attribution of profits to a PE (and to a DAPE) involves a two-step analysis.

In particular, the example does not consider whether, and if so how, any intangibles, for example, OnlineCo's online platform or the IT system underpinning the business operations of the warehouse PE of OnlineCo, should be taken into account consistently with step one of the AOA. The guidance in Sections D-2(iii)(c) (Intangibles) and D-3(iv)(b)(2) (Internal dealings relating to use of an intangible) of Part I of the 2010 OECD Profit Attribution Report are relevant in this respect.

- As both the warehouse PE of OnlineCo and the office PE of OnlineCo are fixed place of business PEs under Art.5(1) either directly or by virtue of Art.5(4.1) (unlike Examples 1, 2 and 3 which relate to dependent agent PEs under Art.5(5)), the analysis in Example 4 should closely follow the analysis in Part I of the 2010 Profit Attribution Report and the Commentary to the new Article 7.
- The key issue for consideration is how to take into account the potential effect on profits attributable to the warehouse PE of OnlineCo and the office PE of OnlineCo of the level of integration between the relevant activities. This issue is highlighted in both paragraphs 41 and 42 of the revised discussion draft in relation to each of the two types of cases to which Art.5(4.1) is intended to apply. However, this issue has not been addressed in Example 4.
- The explanation in footnotes 13 and 15 that “the rights and obligations associated with the purchase of storage and delivery services” and “the rights and obligations associated with the purchase of merchandising and collection of information services” should be attributed to the warehouse PE of OnlineCo and the office PE of OnlineCo respectively does not, as a matter of course, follow from application of the AOA. Under the functional and factual analysis carried out in step one, the PEs are only attributed those rights and obligations of the enterprise of which the PEs are a part which arise out of that enterprise's transactions with separate enterprises as are properly attributable to the PEs (paragraph 98 of Part I of the 2010 Profit Attribution Report and also paragraph 44 of Part I and paragraph 21 of the Commentary to the new Art.7). As further noted in paragraph 98 of Part I of the 2010 Profit Attribution Report, this involves identifying those of the enterprise's transactions with separate enterprises which should be hypothesised to have been entered into by the PEs (ie based on where the significant people functions are performed).
- Footnotes 13 and 15 incorrectly refer to Article 5(5).
- The analysis has not identified a dealing between OnlineCo and the warehouse PE of OnlineCo or a dealing between OnlineCo and the office PE of OnlineCo. The conflating of “such profits” with “the amount that OnlineCo would have had to pay” in lines 3-4 of paragraphs 48 and 49 is confusing with none of these amounts corresponding to a dealing under the AOA. As noted in paragraphs 47 and 55 of the Commentary to the new Art.7, “For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, a dealing must be recognised and a notional arm's length price must be determined for that dealing.”

## **A way forward**

With a view to being constructive, the examples should be reviewed so that each example covers, at a minimum, the following:

- The analysis of each example is firmly grounded in the “two-step analysis” underpinning the AOA;
- Having regard to the fact pattern under consideration, each example should address what assets and risks of the non-resident enterprise and of the dependent agent enterprise where a DAPE arises should be attributed to the PE based on where the relevant significant people functions are performed;
- The examples should clearly identify the internal dealing(s) between the non-resident enterprise and its PE (Example 4) and the hypothesised dealing(s) between the non-resident enterprise and the dependent agent enterprise (Examples 1-3) to which Art.7 applies; and
- The examples should provide high-level guidance with respect to determining a notional arm’s length price for the identified dealing(s) under step two of the “two-step analysis”.

## **Other comments on the revised discussion draft**

### *Paragraphs 9, 15, 22 and 43*

It is unusual for an OECD discussion draft to defer to a tax treaty between two Contracting States, as has been done in paragraphs 9, 15, 22 and 43, as distinct from referring to Art.7 of the OECD MTC.

### *Paragraphs 12 and 18*

There is a flavour creeping into the revised discussion draft that Art.7 and Art.9 provide the relevant taxing powers for countries (see for example the first sentence of both paragraph 12 and paragraph 18). Countries do not normally tax under Art.7 and Art.9 but under domestic tax law. Art.7 and Art.9 allocate taxing rights between the treaty partners. Further, the guidance in Art.7 and Art.9 is in large part to assist in resolving MAP cases (see paragraphs 15-17 of the Preface to the 2017 OECD TP Guidelines in relation to Art.9).

### *Paragraph 18*

The concern expressed in the final sentence of paragraph 18 is warranted. However, the revised discussion draft does not refer to the legal mechanism that exists to support the statement in the penultimate sentence and therefore to prevent a risk being found to have been assumed by an intermediary (for purposes of Article 9) and also considered to be assumed by the non-resident

enterprise or the PE for the purposes of Article 7. The legal mechanism to achieve the intended outcome should be referred to.

*Paragraph 43*

The first sentence should be deleted. As noted in the section 'Context' above, the conceptual framework with respect to the attribution of profits to PEs deemed under Art.5(1) is contained in the new Article 7 of the OECD MTC and its associated Commentary, the previous version of Article 7 and its associated Commentary and the 2010 Profit Attribution report.

\* \* \* \* \*

Please do not hesitate to contact me if you would like to discuss any aspect of this submission in further detail.

**Damian Preshaw**

**Company Director**

VIA EMAIL: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

September 15, 2017

Mr. Jefferson VanderWolk  
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FRANCE

Re: Comments on *Public Discussion Draft on BEPS Action 7 Additional Guidance on Attribution of Profits to Permanent Establishments (22 June – 15 September 2017)*

Dear Mr. VanderWolk:

Deloitte Tax LLP (“Deloitte Tax”), a subsidiary of Deloitte LLP<sup>1</sup> (“Deloitte”) appreciates the opportunity to submit comments regarding the Organization for Economic Cooperation and Development’s (OECD’s) Public Discussion Draft on BEPS Action 7 *Additional Guidance on Attribution of Profits to Permanent Establishments* (the “Discussion Draft”).

Deloitte Tax recognizes and appreciates the extent of the work performed by the OECD since last year on this topic.

The OECD’s mandate under Action 7 of the BEPS Action Plan was intended to provide taxpayers and tax administrations with additional guidance on how the rules of the Authorized OECD Approach (AOA) apply to the new permanent establishments (PEs) created by the changes to Article 5 of the Model Tax Convention on Income and on Capital (MTC), without making substantive modifications to those rules.

The 2016 Discussion Draft on BEPS Action 7 *Additional Guidance on Attribution of Profits to Permanent Establishments* explored through a number of numerical examples potential differences that may result from attributing profits to these new PEs under the AOA *versus* under Article 9 of the MTC.

The Discussion Draft moves away from such approach, and does not provide guidance that is informed by the lessons learned from the 2016 Discussion Draft. Although exploring the differences between the AOA and Article 9 in attributing profits to a PE through a few examples may have been viewed as being of limited use because of the lack of generality intrinsic to such

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<sup>1</sup> Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of our legal structure.

an approach, the approach was helpful because of the complexities of the topic involved, and the lack of a common set of concepts and language between the AOA and Article 9.

More specifically, the AOA relies on the concept of significant people functions (SPF) to allocate assets and risks to the PE hypothesized at step one of the AOA, whereas Article 9 relies on the risk control framework of Chapter I of the OECD 2017 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017 OECD TPG).

Understanding how these differences between the AOA and Article 9 translate into profit attribution could thus have been seen as the first step towards the issuance of additional guidance that satisfied the OECD's mandate under Action 7.

This is not what the Discussion Draft does. The Discussion Draft enunciates a number of high-level principles that are so general that the Discussion Draft, if adopted by the OECD as the final word on the matter, will not be particularly helpful in guiding taxpayers and tax administrations in attributing profits to a PE in real world situations.

The resulting uncertainties about how to correctly attribute profits to a PE would result in inevitable controversy and may create situations of double taxation.

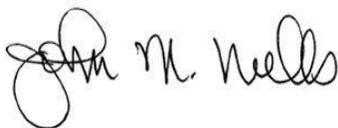
Instead of commenting on the specifics of the Discussion Draft and on the general principles enunciated therein, Deloitte Tax is taking this opportunity to suggest that the comprehensive and robust risk control framework of Chapter I of the 2017 OECD TPG makes it relatively easy to clarify the AOA, with minimal modifications, to achieve the policy objective of Article 7 and attribute to a PE the exact same profit it would have achieved had it been operating as a separate legal entity operating at arm's length in its various dealings with the rest of the enterprise.

We appreciate this opportunity to share our views on this issue and hope you find our comments valuable to the discussion.

We look forward to continued collaboration with the OECD on this and other transfer pricing initiatives. Please feel free to contact Philippe at +1 202 220 2601, or [ppenelle@deloitte.com](mailto:ppenelle@deloitte.com), should you have any questions about this submission.

Very truly yours,

DELOITTE TAX LLP



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## Glossary

- TPG:** Generic reference to the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.
- 2017 OECD TPG:** The 2010 OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* as amended by the October 5, 2015, OECD BEPS final reports and further conforming adjustments adopted by the OECD Committee on Fiscal Affairs.
- OECD:** Organization for Economic Cooperation and Development.
- BEPS:** Base erosion and profit shifting.
- WP6:** Working Party 6.
- Discussion Draft:** Additional Guidance on The Attribution of Profits to Permanent Establishments, 22 June – 15 September 2017.
- 2010 OECD TPG:** The 2010 OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.
- PE:** Permanent establishment.
- AOA:** Authorized OECD approach.
- MTC:** Model Tax Convention on Income and on Capital.
- MNE:** Multinational enterprise.
- 2010 Report:** OECD, Report on Attribution of Profits to Permanent Establishments (2010).

## Article 7 and Article 9 Concepts

### Relevant Authorities

*ARTICLE 5 OF THE MTC*—The BEPS final report of October 5, 2015, revised the language in Article 5 of the MTC that defines at paragraph 5(5) when an enterprise is deemed to have a permanent establishment in a Contracting State, and at paragraph 5(6) provides an “independent” agent exception to paragraph 5(5).

*ARTICLE 7 OF THE MTC*—Paragraph 2 of Article 7 enunciates the general principle governing the attribution of profits to a PE.

*2010 REPORT ON ATTRIBUTION OF PROFITS TO PE*—Paragraph 22 of the 2010 Report on Attribution of Profits to Permanent Establishments relates the concept of “significant people functions” to risk assumption in the first step of the Authorized OECD Approach (“AOA,” see also paragraphs 10 and 11).

*2017 OECD TRANSFER PRICING GUIDELINES*—Paragraph 1.49 of the 2017 OECD TPG addresses how transfers of value occurring either in transactions that have not been identified as such by the MNE, or in transactions that have been identified as such by the MNE but are not supported by written contracts are to be dealt with, insofar as their accurate delineation is concerned. Paragraph 1.60 of the 2017 OECD 2017 outlines the six-step process required to accurately delineate a transaction. Paragraph 1.61 of the 2017 OECD TPG provides a definition of risk management. Paragraph 1.63 of the 2017 OECD TPG provides a definition of risk assumption. Paragraph 1.65 of the 2017 OECD TPG provides a definition of risk control. Finally, paragraph 1.71 of the 2017 OECD TPG provides a definition of risk for transfer pricing purposes.

The relevant authorities are fully or partially reproduced below.

#### Paragraph 5(5)

*“Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal 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 a right to use, or*
- c) For the provision of services by that enterprise*

*that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provision of that paragraph.”*

#### Paragraph 5(6)

“

- a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to*

*be an independent agent within the meaning of this paragraph with respect to any such enterprise.*

- b) *For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 percent of the beneficial interest in the other (or, in the case of a company, more than 50 percent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or is another person possesses directly or indirectly more than 50 percent of the beneficial interest (or, in the case of a company, more than 50 percent of the aggregate vote and value of the company's share or of the beneficial equity interest in the company) in the person and the enterprise."*

#### Article 7(2)

*"Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated herein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."*

#### Paragraph 10 (2010 Report on Attribution of Profits to PE)

*"...Under the first step, the functional and factual analysis must identify the economically significant activities and responsibilities undertaken by the PE..."*

#### Paragraph 11 (2010 Report on Attribution of Profits to PE)

*"The hypothesis by which a PE is treated as a functionally separate and independent enterprise is a mere fiction necessary for purposes of determining the business profits of this part of the enterprise under Article 7. The authorized OECD approach should not be viewed as implying that the PE must be treated as a separate enterprise entering into dealings with the rest of the enterprise of which it is a part of for purposes of any other provisions of the Convention."*

#### Paragraph 22 (2010 Report on Attribution of Profits to PE)

*"...The significant people functions relevant to the assumption of risks are those which require active decision-making with regard to the acceptance and/or management (subsequent to the transfer) of those risks. The extent of the decision-making will depend on the nature of the risk involved."*

#### Paragraph 1.49 (2017 OECD Transfer Pricing Guidelines)

*"Where no written terms exist, the actual transaction would need to be deduced from the evidence of actual conduct provided by identifying the economically relevant characteristics of the transaction. In some circumstances the actual outcome of commercial or financial relations may not have been identified as a transaction by the MNE, but nevertheless may result in a transfer of material value, the terms of which would need to be deduced from the conduct of the parties..."*

#### Paragraph 1.60 (2017 OECD Transfer Pricing Guidelines)

*"The steps in the process set out in the rest of this section for analysing risk in a controlled transaction, in order to accurately delineate the actual in respect to that risk, can be summarised as follows:*

- 1) Identify economically significant risks with specificity (see Section D.1.2.1.1).*
- 2) Determine how the specific, economically significant risks are contractually assumed by the associated enterprises under the terms of the transaction (see Section D.1.2.1.2).*

- 3) *Determine through a functional analysis how the associated enterprises that are parties to the transaction operate in relation to assumption and management of risks, and in particular which enterprise or enterprises perform control functions and risk mitigation functions, which enterprise or enterprises encounter upside or downside consequences of risk outcomes, and which enterprise or enterprises have the financial capacity to assume the risk (see Section D.1.2.1.3).*
- 4) *Steps 2-3 will have identified information relating to the assumption and management of risks in the controlled transaction. The next step is to interpret the information and determine whether the contractual assumption of risk is consistent with the conduct of the associated enterprises and other facts of the case by analysing (i) whether the associated enterprises follow the contractual terms under the principles of Section D.1.1; and (ii) whether the party assuming risk, as analysed under (i), exercises control over the risk and has the financial capacity to assume the risk (see Section D.1.2.1.4).*
- 5) *Where the party assuming risk under step 1-4(i) does not control the risk or does not have the financial capacity to assume the risk, apply the guidance on allocating risk (see Section D.1.2.1.5).*
- 6) *The actual transaction as accurately delineated by considering the evidence of all the economically relevant characteristics of the transaction as set out in the guidance in Section D.1, should then be priced taking into account the financial and other consequences of risk assumption, as appropriately allocated, and appropriately compensating risk management functions (see Section D.1.2.1.6)."*

#### [Paragraph 1.61 \(2017 OECD Transfer Pricing Guidelines\)](#)

*"...The term "risk management" is used to refer to the function of assessing and responding to risk associated with commercial activity. Risk management comprises three elements: (i) 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, (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 decision-making function, and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation."*

#### [Paragraph 1.63 \(2017 OECD Transfer Pricing Guidelines\)](#)

*"Risk management is not the same as assuming a risk. Risk assumption means taking on the upside and downside consequences of the risk with the result that the party assuming a risk will also bear the financial and other consequences if the risk materialises..."*

#### [Paragraph 1.65 \(2017 OECD Transfer Pricing Guidelines\)](#)

*"Control over risk involved the first two elements of risk management defined in paragraph 1.61; that is (i) 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 decision-making function. It is not necessary for a party to perform the day-to-day mitigation, as described in (iii) in order to have control of the risks..."*

#### [Paragraph 1.71 \(2017 OECD Transfer Pricing Guidelines\)](#)

*"There are many definitions of risk, but in a transfer pricing context it is appropriate to consider risk as the effect of uncertainty on the objectives of the business..."*

## ANALYSIS AND DISCUSSION

Under Article 7, a PE of an MNC is treated as a separate legal entity for purposes of determining the profits that are attributable to that PE.<sup>2</sup> The arm's length principle of Article 9 forms the basis for such attribution of profits. The use of the arm's length principle -- as opposed to formulary apportionment -- to attribute profits to PEs has been subject to intense debate and disagreements. For example, Professor Kobetsky notes in his 2011 book that "The 2008 Report and 2010 Report adapt the Transfer Pricing Guidelines for associated entities to attributing profits to permanent establishments. But this approach is flawed because it is based on a fundamental fiction as a matter of law, and, in reality, there cannot be transactions between parts of one enterprise...The European Commission is looking at moving to unitary formulary apportionment, under which the profits of an international enterprise are allocated between European Union (EU) countries on the basis of an agreed formula..."<sup>3</sup>

Deloitte Tax's comments contained herein are not meant to address disagreements that may exist between countries participating in the work of WP6 with regard to the attribution of profits to PEs insofar as the use of the principles of Article 9 and the arm's length principle is concerned. Instead, our comments are intended to assist the OECD in making a minimal amount of adjustments to the guidance provided in the 2010 Report of Attribution of Profits to Permanent Establishments to implement the policy objective of Article 7(2) of the MTC.

Notwithstanding the aforementioned, Deloitte Tax strongly supports the application of the AOA to determine the attribution of profits to a PE because the AOA is the best known method to ensure that the taxable profits will be the same if the operations are conducted through a separate legal entity or through a PE. The AOA therefore achieves the policy objective of Article 7.

Such policy objective means that whether a home office operates in a host country through a separate legal entity subject to Article 9 (arm's length principle), or through a PE subject to Article 7 and the AOA (attribution of profits to PE), the resulting taxable income of the separate legal entity and of the PE is the same.<sup>4</sup>

This parity in taxable income result can be achieved by appropriately clarifying the language in the first step of the AOA where notional transactions requiring the assumption of risks by the PE in its dealings with the home office or with the rest of the enterprise are hypothesized. Such language clarifications should be provided to align the assumption of economically significant risks resulting from the significant people functions (AOA) with the assumption of economically significant risks resulting from the accurate delineation of the hypothesized transactions pursuant to Chapter I of the 2017 OECD TPG (Article 9).

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<sup>2</sup> All articles cited herein refer to articles of the OECD Model Tax Convention on Income and on Capital (in short, the MTC).

<sup>3</sup> Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy*, Cambridge Law Series, Cambridge University Press, 2011.

<sup>4</sup> The 2010 Report (see Part I, para. 55; Part II, A para. 4; and Part III, para. 25) recognizes that, in certain circumstances, there might be economic differences between a PE and a separate legal entity that would justify different profits being recognized by each. Notwithstanding this observation in the 2010 Report, more likely to be relevant when free capital plays an important role, *because* the hypothesized PE is a fiction constructed by reference to how it would have operated as a standalone legal entity, its construction itself, in most cases, will not result in material economic differences between the hypothesized PE and a separate legal entity, and hence result in parity of returns.

The approach outlined below introduces one conceptual change to the AOA. As currently written, step 1 of the AOA relies on a functional analysis to hypothesize the transactions of the PE. Instead, Deloitte Tax suggests that step 1 of the AOA first start by identifying the economically significant risks involved in the dealings of the PE with the rest of the enterprise (paragraph 10 of the 2010 Report), consistently with step 1 of the accurate delineation of the transaction provided at paragraph 1.60 in Chapter I of the 2017 OECD TPG, directly followed by an application of steps 2-5 to determine the assumption of such risks (paragraph 22 of the 2010 Report). Step 2 of the AOA would remain unchanged.

Since under both Article 7 and Article 9 no taxable income can meaningfully be attributed to a PE or to a separate legal entity without the performance of the relevant first step (step 1 of the AOA under Article 7, and accurate delineation of the transaction under Article 9), a necessary and sufficient condition for an application of the AOA under Article 7 and of the arm's length principle under Article 9 to result in the same taxable income attributed to a PE and to a separate legal entity respectively is *parity under both Articles in risk assumption*.

Deloitte Tax believes that the expansive and robust risk control of Chapter I of the 2017 OECD TPG provides a framework that makes it easier to achieve such risk assumption and taxable income parity than was the case under the 2010 OECD TPG.

More specifically, Chapter I of the 2017 OECD TPG deals explicitly with exchanges of value between separate legal entities that are either (i) not recognized as transactions by the MNE, or (ii) recognized as transactions by the MNE *but not supported by written contracts* expressing the commercial and financial relationships between the participants to the transaction. Paragraph 1.49 of the 2017 OECD TPG clearly indicates that in such cases the standard to be used to accurately delineate the transaction, whether recognized as such by the MNE or not, is *deduction from the conduct of the parties*.

In the case of a PE, none of the PE's dealings with the rest of the enterprise are recognized as transactions, and no written contracts exist to accurately delineate these non-existent transactions. Notional transactions are to be hypothesized as the first step of an application of the AOA. Using the same standard of *deduction from the conduct of the parties* to hypothesize the transactions the PE would have had with the rest of the enterprise in its dealings with the rest of the enterprise had it operated as a separate legal entity therefore ensures that the resulting allocation of risks (and therefore of taxable income) to the PE will be consistent with the accurate delineation of the transaction (and therefore of taxable income) had this PE operated as a separate legal entity.

The modifications to the AOA required to effectuate this strategy are minimal. The language used at paragraphs 10 and 22 of the 2010 Report is conducive to aligning the outcome of step 1 of the AOA and of the accurate delineation of the transaction by mere clarification.

More specifically, paragraph 10 of the 2010 Report provides that "...Under the first step, the functional and factual analysis must identify the economically significant activities and responsibilities undertaken by the PE..."

Critical to the accurate delineation of a transaction under Chapter I of the 2017 OECD TPG is step 1 (Section D.1.2.1.1. Step 1: Identify economically significant risks with specificity), namely the identification of the economically significant risks involved in the transaction. In the context of a PE, no transactions exist; however, dealings between the PE and the rest of the enterprise do exist. Whether these dealings are recognized as transactions in the first place or hypothesized as such, the economically significant risks involved are the same, and paragraph 22 of the 2010 Report controls, under the AOA, the assumption of these risks. See discussion below.

Deloitte Tax therefore suggests amending the language at paragraph 10 of the 2010 Report to read as follows: “...Under the first step, the functional and factual analysis must identify the economically significant risks involved in the dealings of the PE with the rest of the enterprise, within the meaning of paragraph 1.71 of the 2017 OECD TPG and consistently with the guidance provided at Section D.1.2.1.1...”

This suggested change to the language in paragraph 10 of the 2010 Report ensures the alignment of the specific risks considered under the AOA as relevant for profit attribution purposes with those considered under Article 9 as relevant for the accurate delineation of the transaction.

Once economically significant risks involved in the PE’s dealings with the rest of the enterprise have been identified, and after ensuring through the suggested changes in language at paragraph 10 of the 2010 Report that the same economically significant risks would have been identified under step 1 of the accurate delineation of the transaction had the PE operated as a separate legal entity, the guidance at paragraph 22 of the 2010 Report applies to determine whether the PE or other parts of the enterprise assume those risks.

Paragraph 22 of the 2010 Report provides that “...The significant people functions relevant to the assumption of risks are those which require active decision-making with regard to the acceptance and/or management (subsequent to the transfer) of those risks. The extent of the decision-making will depend on the nature of the risk involved.”

The concept of significant people functions described at paragraph 22 of the 2010 Report clearly refers to functions that require “decision-making” with regard to the “acceptance and/or management” of “those risks”. With the suggested changes to the language at paragraph 10, “those risks” are now defined as the economically significant risks within the meaning of paragraph 1.71 of the 2017 OECD TPG. Therefore without further modification of the language at paragraph 22 one would characterize the significant people functions as those functions involving the acceptance or management of the economically significant risks, which then result in the assumption of risk by one or more of the parties to the hypothesized transaction (dealing) involving such risk.

Although the words “assumption of risk,” “decision-making,” and “acceptance and/or management” of risks are the same or very similar to the words used in Chapter I of the 2017 OECD TPG to accurately delineate a transaction, explicit references to the definitions of those words, and in the guidance provided to effectuate them (steps 2-6, paragraph 1.60) in Chapter I of the 2017 OECD TPG, would not only eliminate any ambiguity as to what they mean in the context of the AOA, it would also ensure parity in the conclusion as to which party assumes which economically significant risks under Article 7 and Article 9.

Deloitte Tax therefore suggests amending the language at paragraph 22 of the 2010 Report to read as follows:

...The significant people functions relevant to the assumption of the economically significant risks, within the meaning of paragraph 1.63 (assumption of risk) of the 2017 OECD TPG, are those functions which require control over those economically significant risks identified at paragraph 10 above, where control over risk is within the meaning of paragraphs 1.65, 1.94, 1.95, and Section D.1.2.1.5 of the 2017 OECD TPG. Guidance to analyze the significant people functions within the meaning of this paragraph is incorporated herein by reference to Sections

D.1.2.1.2, D.1.2.1.3, D.1.2.1.4, and D.1.2.1.5, complemented by paragraph 1.49 of the 2017 OECD TPG.

The language clarifications suggested above for paragraph 22 of the 2010 Report maintain the concept of significant people functions as central to the application of the AOA. If, for example, an economically significant risk in the dealings of a PE with its home office concerns the setting of a price, applying paragraph 10, as modified above, will identify price setting as an economically significant risk. Applying paragraph 22, as modified above, will identify the people performing the sales and price negotiation functions that give rise to that economically significant risk. Further application of paragraph 22, as modified above, will then determine the assumption of that economically significant risk (PE or home office, or other part of the enterprise) by reference to the party managing and controlling the associated operational and financial decisions, following the risk control framework of Chapter I of the 2017 OECD TPG.

Additional conforming adjustments to the AOA are necessary to ensure that the guidance provided by the OECD in the AOA be consistent throughout. Deloitte Tax is intentionally limiting the scope of its suggestions to language modifications to the two key paragraphs of the AOA that (i) constitute the starting point of an allocation of profits pursuant to the AOA and, (ii) to the determination under the AOA of risk assumption.

Although Deloitte Tax is not providing comments on the four examples provided by the OECD in the Discussion Draft, we believe that examples illustrating the application of the AOA, as modified from the 2010 Report as a result of BEPS Action 7, would be extremely helpful and should be provided.

15 September 2017

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Dear Jeff

**BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments  
(June 2017 Discussion Draft)**

Thank you for the opportunity to comment on the public discussion draft *BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments* published on 22 June 2017 (the 'Discussion Draft'). Our comments are written from the perspective of the UK.

It is essential that businesses and tax authorities have a clear understanding of how profits and losses should be attributed to permanent establishments. More permanent establishments are expected to arise under the revised definitions set out in the *G20/OECD Final Report on BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status*. It is particularly important to provide clear guidance for businesses outside of the financial services sector who, in general, have no or limited experience of attributing profits to permanent establishments.

The statement of the principle that "the profits attributable to a permanent establishment are those that the permanent establishment would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions" (paragraph 9) is a helpful reconfirmation of the long-standing approach taken under the business profits articles of double tax treaties. In particular, it is helpful that the guidance specifically confirms that "This principle applies regardless of whether a tax administration adopts the authorized OECD approach ("AOA"), contained in Article 7 in the 2010 version of the MTC as outlined in the *2010 Report on the Attribution of Profits to Permanent Establishments ...* or any other approach used to attribute profits under a previous version of Article 7 of the MTC". It is essential that, irrespective of the position taken by a jurisdiction in relation to Article 7, all parties understand and continue to apply this principle.

The advantage of the numerical examples included in the 2016 Discussion Draft which have been removed from the 2017 Discussion Draft was that they introduced specific clarity on the calculations. The example that included no additional profit being attributed to the permanent establishment on the basis of the existing transfer pricing return to the dependent agent was particularly relevant given the work on BEPS Actions 8-10 and the consequences for ensuring appropriate pricing of risk and functions. The current Discussion Draft lacks this level of clarity as businesses and tax authorities will have to draw conclusions from broad general principles. This increases the possibility of differing interpretations of the principles and consequently the likelihood of disputes between businesses and tax authorities, as well as between different tax authorities. It also increases uncertainty for businesses, which does not align with the G20/OECD's ongoing tax certainty agenda.

Because the Discussion Draft leaves much to interpretation, it is likely that many more businesses will want to obtain Advance Pricing Agreements ('APAs') in relation both to the existence (or not) of a permanent establishment, and the amount of profit to be allocated to it. Currently an APA will often deal with the quantum of profits but not with the question of whether a permanent establishment exists, and not all countries have an APA programme. It will be important for tax authorities to address both questions within an APA programme and for them to have sufficient resources to meet the needs of businesses. Similarly, it will be essential to eliminate any double taxation arising where tax authorities in different countries do not share the same view of the profits attributable to a permanent establishment. Countries should continue to be encouraged to adopt mandatory binding arbitration in double tax treaties – and this should not be limited to transfer pricing matters under Article 9.

The Discussion Draft does not recommend new ways of mitigating the considerable compliance and administrative costs of creation of new permanent establishments, including those with zero or very limited profits attributed.

Please see the appendices below for our comments on specific sections of the Discussion Draft along with circumstances where the provision of further examples would reduce uncertainty.

If you would like to discuss any of the points raised in this letter, please do not hesitate to contact either John Henshall ([jhenshall@deloitte.co.uk](mailto:jhenshall@deloitte.co.uk)), Alison Lobb ([alobb@deloitte.co.uk](mailto:alobb@deloitte.co.uk)) or me ([bdodwell@deloitte.co.uk](mailto:bdodwell@deloitte.co.uk)).

We would be happy to speak on this topic at the Public Consultation meeting in November 2017 if it would be helpful.

Yours sincerely



**W J I Dodwell**  
Deloitte LLP

## **Appendix 1 – Detailed comments**

### *Order of application*

As set out in paragraph 12, it is logical and appropriate to apply the transfer pricing rules under Article 9 to determine the profits and losses of each enterprise, before considering the application of the permanent establishment rules under Articles 5 and 7.

In order to calculate the outcome of a profit attribution analysis under Article 7, it is first necessary to understand the effect of related party transactions as required by Article 9. This will determine the amount of profit or loss of all companies, before hypothesising how that profit or loss should be split between the head office and the permanent establishment. Having clear guidance that transfer pricing rules should be applied first to situations involving group dependent agents would provide businesses with certainty over the approach to take.

This is particularly important in situations involving 'triangular' arrangements, for example where a group company in a third country transacts with the sales agent or principal and this affects the level of profit. It is also helpful that this will provide a starting point based on rules that have international consensus, before moving to the more difficult and perhaps contentious permanent establishment analysis (taking into account countries' differing views on new Article 7 and the *2010 Report on the Attribution of Profits to Permanent Establishments*). This will assist with reducing complexity and minimising unnecessary disputes and double taxation of trading profits (either cross-border or even within the same country).

It is helpful that the guidance specifically refers in paragraph 18 to the need to ensure that trading profits are not taxed twice as a result of application of the permanent establishment and transfer pricing rules.

### *Application of different approaches*

If, because of the wording of Article 7 in the applicable tax treaty, an approach other than the Authorised OECD Approach applies there may be significant differences in the attribution of profits and losses to permanent establishments. Differences are likely to arise in connection with the recognition of 'dealings' for the use or transfer of intangibles or rights in intangibles between a head office and a permanent establishment that would require a country to take account of 'notional' payments.

### *Attribution of nil, minimal or negative profits to a permanent establishment (para 19)*

In particular, when the accurate delineation of the transaction under the guidance of Chapter I of the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* indicates that the intermediary is assuming the risks of the transactions of the non-resident enterprise, the additional profits attributable to the permanent establishment are likely to be zero. This is a consequence, in particular, of applying the BEPS Action 8-10 work on the transfer pricing of risk.

It is essential that the guidance includes a clear example that a permanent establishment (including those arising under the new Article 5) can exist but have no profits attributable to it. Where the threshold for a permanent establishment is crossed it does not automatically follow that there are additional profits to be taxed in the country of the permanent establishment.

Examples which illustrate that losses can be attributed to a permanent establishment where there are profits in the head office, and vice versa, would also be welcomed.

### *Administrative approaches to enhance simplification*

It is expected that as a result of the BEPS changes to Article 5 the number of permanent establishments with no or minimal profits or losses attributable to them will increase. This will require the filing of a corporate income tax return showing nil or a very small amount of tax to pay by non-resident entities. This will cause a significant increase in the administrative burden for businesses and a corresponding increase in administration for tax authorities, with no or little change in tax revenues for each country. This administrative burden will be exacerbated in some cases such as, for example, partnerships where all individual partners could be required to file local tax returns if the activities of the partnership create a permanent establishment.

In the interest of reducing barriers to international trade, the G20/OECD should recommend that countries consider options for minimising this burden where little or no additional tax will become payable, such as:

- Domestic exemptions for permanent establishments where there are no significant people functions locally;
- A simplified tax registration and annual notification process for entities and partnerships with permanent establishments that have nil or limited profits;
- The option for the overseas enterprise to nominate a locally incorporated group entity to account for and pay the tax of the permanent establishment on behalf of the overseas enterprise. This will help by removing the requirement for the non-resident entity to have a local bank account.

Any simplification measures should make sure that the tax paid legally remains that of the non-resident entity to facilitate credit in the head office country. It should be clear that any simplification measures facilitate the payment of tax, but do not alter the method by which the amount of tax is calculated.

#### *Impact of BEPS Actions 8-10 on the 2010 Report on the Attribution of Profits to Permanent Establishments (2010 Report)*

The BEPS Action 7 work highlighted the fact that the 2010 Report was written with the financial services sector in mind. Whilst Part I of the 2010 Report does deal with general principles, almost all of the examples relate to the financial services sector. Particular difficulties arise in relation to the attribution of interest costs and the concept of 'free capital'. The Report acknowledges that outside of regulated sectors these concepts can be difficult to apply and different countries take different views on what is arm's length.

As part of the modernisation of the international tax system the 2010 Report should be updated to align the treatment of tangible assets (paragraph 75) with the treatment of risks and intangibles, consistent with the arm's length principle under Article 9. This would ensure that profits are attributed on the basis of significant people functions and would align better with the new analysis of risk under BEPS Actions 8-10, in particular around the control of risk. In some cases, the significant people functions making decisions about tangible assets are not in the same location as the asset. This gives an illogical answer in view of modern transfer pricing principles (and indeed was only ever a shortcut for ease put forward in the 2010 Report). Not only does this appear to be the right answer on principle, it would also prevent the compliance cost for businesses and administrative burden for tax authorities in dealing with low profit permanent establishments which have no significant people functions. This does not mean that, for example, a warehouse in a location with significant employees to meet the local market needs is not attributed to a significant people function that the employees in the market would constitute in such circumstances.

#### **Examples- General**

The provision of examples is a helpful starting point but further examples are required and the analysis should be expanded fully. The analysis is currently incomplete.

Each example should follow the approach set out in paragraph 12 and accurately delineate the actual transaction between the non-resident enterprise and the intermediary before determining the basis on which the profits are attributable to the permanent establishment of the non-resident enterprise.

The examples should discuss which transfer pricing methods should be applied as most appropriate to the case and illustrate the consequences of applying a range of methods. In order to do this, a functional analysis of the risks, assets and significant people functions is required.

Each of these steps should be clearly set out within the examples and illustrative numbers provided, including how to build a profit and loss account for the permanent establishment.

The provision of examples should increase clarity but Example 1 has a potentially misleading description of the legal implications of *commissionnaire* arrangements and some of the examples involve the conclusion of contracts, which would create a permanent establishment under current treaties absent any of the new Article 5 changes. We have included a list in Appendix 2 of examples which would enhance the usefulness of the guidance.

In relation to the dependent agent permanent establishment examples, a key consideration is the correlation between the allocation of risk to the location of the people that control the risk under BEPS Actions 8-10 and the attribution of risk to significant people functions under the Authorised OECD Approach in the 2010 Report. To the extent that there are no risk-controlling functions in the country of the permanent establishment, the return for taking risk will be in the head office country and not the permanent establishment. To the extent that risk is controlled by the people in the dependent agent (e.g. SellCo in Example 1), then the dependent agent will already have been attributed the return for taking risk under transfer pricing and there is no further return to provide to the permanent establishment. Under either factual position there is no additional profit in the permanent establishment. The analysis for attribution of assets will work similarly. As a result, the creation of new dependent agent permanent establishments will not attract additional local profits and tax. Instead, businesses and tax authorities should devote resources to ensuring that control over risks has been properly delineated such that profit is in the right location. This is a question of fact.

*Deductions to the permanent establishment's income for 'other expenses wherever incurred, for the purposes of the PE.'*

All of the examples include a deduction for 'other expenses, wherever incurred, for the purposes of the PE'. The examples should be expanded to provide guidance as to how these costs should be identified and calculated and what they are likely to constitute in practice.

*Attribution of capital and interest bearing debt*

Under the Authorised OECD Approach, capital and interest bearing debt should be attributed to the permanent establishment based on the assets and risks also attributed to it. A detailed analysis and conclusion is needed on the level of capital and interest-bearing debt which should be attributed to a permanent establishment and the conclusion should be reflected in the profit and loss accounts. There are significant challenges to doing this for businesses outside the regulated financial services sector and guidance will be needed. The current examples do not provide any guidance on this area.

#### **Example 4**

In many cases, no permanent establishment would have arisen prior to the changes to the specific activity exemptions and therefore a number of detailed examples are required to illustrate different fact patterns.

## **Appendix 2**

Particular areas that would benefit from further guidance, and for which additional examples would be useful include:

- toll manufacturing;
- storage of stock for use by a single customer, such as suppliers to OEM manufacturers;
- multi-year scenarios where the level of profits and losses vary on a year-by-year basis;
- the amount attributable to a permanent establishment is nil; and
- the amount attributable to a permanent establishment is a loss.



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

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

15 September 2017

Dear Sir / Madam,

By means of this letter, EY would like to share its comments on the public discussion draft on “BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments” (the Discussion Draft) as released by the OECD on 22 June 2017. We appreciate the opportunity to provide comments and to contribute to the public consultation and discussions regarding the guidance on the attribution of profits to permanent establishments (PEs). This letter presents the collective view of EY’s global international tax network.

Rather than expand upon the previous guidance released by the OECD on 4 July 2016 (the 2016 Discussion Draft), the Discussion Draft replaces the previous draft, and is significantly shorter both in terms of content and examples provided. We are concerned that in its current state, the Discussion Draft does not provide any additional clarity on the application of Article 7 of the OECD Model Tax Convention (MTC), which is disappointing, considering that there will be an increase in the number of, as well as in the types of, PEs as a result of the changes to Article 5 of the MTC. We are also concerned that the Discussion Draft provides much more room for differences in interpretation, which in combination with the subjectivity of the new rules, will lead to a greater risk of controversy and double taxation.

Even prior to the pre-BEPS version of Article 5 of the MTC, there already were wide differences in country positions regarding the attribution of profits to PEs. The Authorized OECD Approach (AoA) is the only available analytical approach on profit attribution to PEs that was developed at an international level. However, this approach is not generally adopted, with jurisdictions instead adopting domestic approaches which are not uniformly defined, and vary from country to country. The difficulties for countries to come to an agreement on the profit attribution to PEs in relation to the (seemingly rather simple and common) activities captured by the new BEPS PE rules mark the fundamental nature of the problem that exists in the area of profit attribution to PEs. Given that the thresholds for deeming a PE to exist are lower because of the new BEPS guidance, and the interpretation of whether a threshold has been met is much more subjective, the level of uncertainty for multinational groups will grow significantly compared to the existing uncertain situation.

As mandatory and binding arbitration is only adopted by a minority group of countries, taxpayers have little certainty for the elimination of double taxation. We therefore urge the members of the Inclusive Framework on BEPS Implementation to either develop clear rules on the attribution of profits in relation to the PEs, or to provide a guarantee for the resolution of double taxation by either introducing mandatory and binding arbitration for these cases, or another procedure that guarantees that the double taxation is resolved.

Moreover, EY is convinced that if a thorough analysis is performed under the new risk analysis guidance of Article 9 of the MTC, the only conclusion is that BEPS risks relating to Article 5(5) PEs involving associated entities are greatly diminished, if not nullified. EY appreciates that the new Article 5 rules are still relevant for commissionaire arrangements between independent parties, where Article 9 cannot be applied. However, we believe that the introduction of changes to both Article 9 and Article 5 creates a double barrier for arrangements between associated entities, which is unnecessary and leads to excessive burdens on taxpayers as many zero-profit PEs will have to be declared. As both changes to Article 9 and Article 5 are introduced, the interaction between the two new sets of rules should be very clear to prevent double taxation. As a result, we strongly advocate clarity on the order in which an Article 7 and Article 9 analysis should be applied, in combination with pragmatic measures such as the introduction of treaty rules that stipulate that no PE should be recognized in the case of zero-profit PEs.

As to the order in which application of an analysis under Article 7 and Article 9 is performed, we are convinced that a sound analysis would first require the application of Article 9 to determine the total profits of the enterprise, after which Article 7 can be used to determine if and how much profit should be attributed to a PE. We believe that if the Article 9 analysis is performed appropriately, this will mean that the profits to be attributed to a commissionaire PE which results from the activities of an associated enterprise should, in the great majority, if not almost all, cases be marginal or nil. In our opinion this is the only reasonable conclusion to be drawn, given the fact that the Article 9 analysis which determines the profits to be allocated to the enterprise performing the sales functions is based on the same notions of people functions as in Article 7. These profits should not be taxed twice. However, if the members of the Inclusive Framework believe that relevant profits may be attributed to such PEs, countries should be willing and able to provide their analyses on the specific situations in which such PEs could be attributed relevant profits, in particular also if these analyses are based on non AoA approaches.

In addition, while we understand the reason for the removal of numerical examples is to avoid drawing conclusions on potential profitability of the intermediary or PE, we feel this is a step backward from providing essential clarity that can be achieved with the use of numerical examples, and urge the OECD to reintroduce numerical examples.

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

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Yours Sincerely,  
*On behalf of EY*

Ronald van den Brekel

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

Paragraph 12 in the Discussion Draft states “... the order in which Article 7 and Article 9 are applied should not impact the amount of profits over which the source country has taxing rights as a result of the activities of the intermediary on behalf of its associated non-resident enterprise in the source country.” Although such a result would very much be welcomed, we are however skeptical that this is an achievable result in practice. In our opinion, it is essential to perform an analysis under Article 7 and Article 9 in the correct order to be able to determine the right amount of profit to be allocated, first to the enterprise, and then following from that analysis, to the PE. We are concerned of possible negative side effects that may arise if a tax administration may disagree, or arrive at a different conclusion, when applying a singular analysis under either Article 7 or Article 9 of the MTC without considering the overall outcome that would result if an analysis under Article 7 and Article 9 of the MTC is performed in parallel, e.g., when a tax administration adjusts the profit of an intermediary without correspondingly adjusting the profit of the PE.

Therefore, in order to provide more certainty to taxpayers and to avoid double taxation, we recommend:

- ▶ **The OECD should prescribe a certain order in which an analysis under Article 7 and Article 9 is performed, which in our view an Article 9 analysis should precede an Article 7 analysis.**

Paragraph 12 of the Discussion Draft acknowledges that many jurisdictions already find it logical and efficient to first perform an Article 9 analysis on a transaction between an intermediary and the non-resident enterprise, however the Discussion Draft also states that some jurisdictions may decide to begin with an Article 7 analysis first. From an analytical perspective, we do not see the benefit of performing an Article 7 analysis first. In our view, it is logical for an Article 9 analysis to precede an Article 7 analysis in all cases, as it is essential to first establish the total profits of an enterprise according to Article 9, before attributing profits to a PE. This may be best illustrated by the following example: A multinational group has two enterprises, Company A and Company C. Company A is resident of country A and performs research and development activities in both country A and country B. In country B, Company A has a PE. Company C is a resident of country C. Company C is the legal owner of the intangibles developed by Company A. An outsourcing agreement is in place between Company A and Company C, which remunerates Company A with a service fee. However, Company C cannot control the risks associated with the legal ownership of its intangibles, while Company A has the ability to, and does, control these risks. Therefore the arm's length nature of the service fee paid to Company A may be in question. In this situation, it would only make sense to perform an analysis under Article 9 (i.e. to establish a proper allocation of risks to Company A), prior to performing an analysis under Article 7 which is necessary to then determine the amount of profits to be allocated by Company A to its PE in country B. We believe that most governments would agree to this line of reasoning for this specific situation, and therefore we urge the OECD to prescribe the order of performing an Article 7 and Article 9 analysis. We note that this should not differ depending on the type of PE under analysis.

In addition, taxpayers would welcome a consistent application in cases where they may have PEs across several countries.

- ▶ **If the OECD chooses not to prescribe an order, the order in which countries perform an Article 7 and Article 9 analysis should be made publically available.**

While Paragraph 12 mentions that the approach adopted by a jurisdiction should be applied consistently and could be made public to taxpayers, we feel that this is an area that the OECD should be more firm on its guidance. Tax administrations have an interest to make public the order in which the application of an Article 7 and Article 9 analysis will be performed to avoid potential controversy with taxpayers during an audit or examination procedure. We also believe that tax administrations should be consistent in their application of the rules, and not apply any differences in the order of performing an Article 7 or Article 9 analysis depending on the type of PE, or depending on whether the post-BEPS Article 5 rules are included in a treaty or not.

- ▶ **The OECD should define the situations in which (relevant) profits would be attributable to Article 5(5) PEs resulting from activities by associated parties.**

As previously stated as to the order of application of Article 7 and Article 9, we are convinced that a sound analysis would first require the application of Article 9 to determine the total profits of the enterprise, after which Article 7 can be used to determine if and how much profits should be attributed to a PE. If the Article 9 analysis is performed appropriately, this will mean that the profits to be attributed to a commissionaire PE which results from the activities of an associated enterprise, should in the great majority, if not all cases, be marginal or nil. In our opinion, the “control functions”, which is the key concept underlying the allocation of risks and returns under Article 9, applies to the same activities as the concept of “significant people functions” under Article 7. As a consequence, Article 5(5) PEs that result from activities by associated companies will not generate any risk related returns if the Article 9 analysis is performed properly. The next question is whether any asset related returns should be attributed to the PE. Such asset related returns may be attributable to the PE if the Article 7 analysis leads to the attribution of equity to the PE. Even if it could be defended on technical grounds that such attribution of equity may be warranted under Article 7, we strongly believe that there are no reasons to attribute such equity, given that the Article 9 analysis has already shown that the associated enterprise performing the activities has the financial capacity to assume all the risks allocated to it, including the sales related risks. Therefore, we believe there are no sound policy reasons to attribute profits to Article 5(5) PEs in cases where these PEs are created from activities by the associated enterprise. However, if members of the Inclusive Framework believe that relevant profits could be attributed to such PEs, for example because they do not apply the AoA, or because they believe the AoA should be applied differently, countries should be willing and able to provide their analyses on the specific situations in which such PEs could be attributed relevant profits.

- ▶ **It should be stipulated that tax administrations are required to perform a parallel examination under Article 7 and Article 9 prior to proposing a tax adjustment to either the PE or intermediary.**

The OECD should expressly state that tax administrations should never singularly apply either an Article 7 or an Article 9 analysis upon their examination of the profits to be attributed to a either a PE or the intermediary, but instead that they should perform a coordinated and parallel examination prior to proposing any tax adjustments to taxpayers. We are concerned about the possible negative side effects in the form of double taxation that may arise if a tax administration may disagree, or arrive at a different conclusion, when applying a singular analysis under either Article 7 or Article 9 and does not consider the overall outcome which would result if an analysis under Article 7 and Article 9 is performed in parallel. We envisage such situations arising where a tax administration

performs an audit on only a PE of a non-resident entity, and as a result of that audit, an upward adjustment to that PE's profits is assessed. Meanwhile, the intermediary may have reported an arm's length reward under Article 9 of the MTC, however, since the focus of the audit was only on the PE, the enterprise will suffer from the effects of double taxation.

- ▶ **Double taxation arising from the order of application of an Article 7 and Article 9 analysis should be prevented.**

Although Paragraph 12 the Discussion Draft acknowledges that the amount of profits available to tax in a source country should not be affected by the order in which Article 7 and Article 9 are applied, in the same paragraph it states that *"any approach to the application of Articles 7 and 9 to cases of deemed PEs under Article 5(5) must ensure that there is no double taxation in the source country, i.e., taxation of the same profits in the hands of the PE (under profit attribution rules) and in the hands of the intermediary (under transfer pricing rules). Therefore, jurisdictions are expected to have in place within their domestic legal and/or administrative systems the necessary principles, doctrines, or other mechanisms to eliminate double taxation in the source country."*

The Discussion Draft anticipates that double taxation could arise as a result of the order of application of an Article 7 and Article 9 analysis, and recommends that jurisdictions have mechanisms in place to eliminate double taxation. Instead, we believe that jurisdictions should be expected to have mechanisms in place to prevent double taxation from happening at all in cases where a jurisdiction has taxing rights simultaneously over an intermediary and a PE. Taxpayers should be guaranteed access to all available dispute resolution mechanisms, and not be barred from dispute resolution for reasons such as a reversal of burden of proof or incorrect corporate income tax filing claims that may arise from a disagreement in the application of either Article 7 or Article 9.

## **2. Situations involving the application of a pre-2010 Article 7**

Paragraph 9 of the Discussion Draft makes a statement that the profits attributable to a PE are to be in accordance with Article 7 of the relevant tax treaty, regardless of whether a tax administration adopts the AoA contained in the 2010 version of Article 7, or any other approach used to attribute profits under a previous version of Article 7.

The Discussion Draft does not provide further guidance on this. Few countries have adopted the 2010 version of Article 7 in their treaties, and the OECD acknowledged this in the preamble to the 2016 Discussion Draft. Therefore, further clarification as to the meaning and application of the statement in the Discussion Draft would be welcomed to avoid any inconsistent interpretations. We would also strongly recommend that the OECD provide enhanced (numerical) examples illustrating different possible approaches to applying a pre-2010 Article 7. We discuss the relevance of this in our comments below in Section 4.

## **3. PEs which no profits are attributable (so-called zero-profit PEs)**

The lowered PE threshold of Article 5 of the MTC is expected to result in an increase in situations where a taxpayer will be deemed to have created a PE. Paragraph 7 of the Discussion Draft states *"... any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5(5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5(5)."* While this statement is theoretically correct, we believe that the OECD should go further and take a firm position on PEs which no profits are attributable (so-called zero-profit PEs).

We support the guiding principle that the attribution of profits to PEs should be based on people functions. From a policy perspective, no profit should be attributed to a PE without people functions and therefore these situations should be exempted from PE status to prevent the proliferation of zero-profit PEs that do not benefit the taxpayer or the tax administration. However, the concept of zero-profit PEs is hardly mentioned in the Discussion Draft. Outside of paragraph 19 which states that “...net amount of profits attributable to the PE may be either positive, nil or negative...” and “...the profits attributable to the PE could be minimal or even zero...”, there is no more discussion of a zero-profit PE. This is a step backward from the 2016 Discussion Draft, which had illustrated the application of a zero-profit PE with (numerical) examples.

The Discussion Draft in Paragraphs 20 and 21 makes note of administrative simplification, but in our view this should be expanded and the OECD should make firm recommendations urging countries to adopt mechanisms to reduce / eliminate the additional compliance burden and / or the collection of taxes in their jurisdictions. It is in the best interest of both tax administrations and taxpayers to reduce / eliminate the additional compliance burden that will result from the increased number of zero-profit PEs. This increased compliance burden is not limited to taxpayers only, but also creates additional resource constraints on tax administrations that have to deal with the increased administrative burden in return for little or no additional taxable profits. In addition, in many cases, the increased existence of zero-profit PEs will create unintended consequences in the form of VAT registrations / obligations as well as other, unnecessary administrative duties for taxpayers. In addition to a clear need of examples describing a zero-profit PE in terms of both factual situations and numerical examples, the OECD should consider pragmatic approaches for dealing with zero-profit PEs. Such approaches could include:

- ▶ Provide for an exemption to the recognition of a PE if it is clear that no profit would be attributable to such PE under Article 7 of the MTC. In other words, a zero-profit PE should not be considered a PE, and therefore not trigger any filing or other administrative requirements (these should be waived in cases of zero-profit PEs). If this matter will not be solved by a further modification to Article 5 of the MTC, we urge the OECD to encourage tax administrations to address this by allowing an exemption for zero-profit PEs unilaterally through their domestic tax legislation. Such an action does not contradict the focus of the OECD’s overall BEPS project and would reduce the barrier on cross-border trade and investment created by the lowered threshold for the recognition of PEs under Article 5 of the MTC.
- ▶ Introduce a mechanism for local tax administrations to allow an existing resident taxpayer to specify or “elect” in its tax return that a PE of a non-resident entity has been created in its jurisdiction and that the related entity has assessed that no profit is attributable to the PE. This election could override a local income tax return obligation for the PE and ensure that penalties (non-filing or compliance) would not be applicable if the election is made.
- ▶ Bilateral efforts between tax administrations should be encouraged to introduce an exemption to the recognition criteria of Article 5(5) PEs which would be created as a result of the activities performed by the intermediary, subject to the intermediary being rewarded at arm’s length. Such a clause can already be found in the protocol to the current Austria - Germany Income and Capital Tax Treaty.

#### 4. The recognition and characterization of dealings

Paragraph 8 of the Discussion draft states *“once it is determined that a PE exists under Article 5(5), one of the effects of paragraph 5 will typically be that the rights and obligations resulting from the contracts to which Article 5(5) refers will be properly allocated to the permanent establishment.... ”*

This statement seems to imply that step one of the AoA (i.e., where the PE is hypothesized as a separate and independent entity and a factual and functional analysis is performed ) should be ignored and that certain attributes, such as the contracts that give rise to an Article 5(5) PE, should be immediately attributed to the PE. This departure from step one of the AoA seems to be underscored by Examples 1 - 3 of the Discussion Draft, where absence a factual and functional analysis under step one of the AoA, the conclusion is drawn that rights and obligations of the contracts are assigned to the PE, which is then used to determine the arm's length remuneration of the PE under step two of the AoA. If however, this result is intended to be in line with the AoA, then the OECD should make clear that this is not a desirable result and should not negate the existence of a zero-profit PE arising in such situations.

Specifically, Example 1 in the Discussion Draft, which describes an intermediary (SellCo) acting as a commissionaire of a non-resident enterprise (TradeCo), states (in Paragraph 27) that the analysis would be the same if the facts were the same if SellCo performed activities under a services agreement with TradeCo (i.e., as a sales agent). The result of this conclusion (see footnotes 5 and 6 of the Discussion Draft) is that the corresponding construction of the profit and loss statements of the PE presumes that the dealing be characterized as a buy-sell transaction. Examples 2 and 3 come to similar conclusions in immediately assigning the rights and obligations to the PE without performing a factual and functional analysis under step one of the AoA.

We find it difficult to understand the line of reasoning followed in the Discussion Draft, and request clarification on how the dealings were characterized, specifically for those examples relating to Article 5(5) PEs. Although it appears plausible to attribute an external sale (or external purchase) to the PE under the right facts and circumstances, it is also equally possible under other facts and circumstances to hypothesize the PE as a sales agent (given that the step one of the AoA requires hypothesizing the PE as a separate entity) especially with the lowering of the PE threshold under Article 5(5) to include entities taking the principal role in negotiations.

In our view, if the intermediary “walks, talks and acts” like a sales agent, then hypothesizing the PE as a sales agent would be in line with the AoA. If unrelated parties can have sales agent arrangements, then under the AoA, a PE should also be able to have this arrangement as well. Moreover, the 2010 Attribution of Profits Report (paragraph 230 - 245, in particular paragraph 244) does not include any reference to a mandatory attribution of the external sale to a dependent agent PE.

The OECD should provide more guidance on the attribution of the external sale (or purchase, in the case of Example 3 of the Discussion Draft) to the PE, as this is critical for three reasons:

- ▶ The attribution of the external sale (or purchase) determines the profit and loss construction of the PE, and hence the construction of profits. It is technically doubtful whether the profit of a PE can ever be zero if the PE is hypothesized as a buy-sell entity, while the local agent entity is for example, a sales agent or procurement agent.
- ▶ Some countries require a full accounting set-up even for a PE. Costs for implementing and running a full transactional accounting set-up for a (hypothesized) buy-sell entity are significantly higher than for a (hypothesized) sales or procurement agent.

- ▶ Characterization of the dealing between the head office and the PE is a prerequisite for applying the second step in the AoA, i.e., determining which transfer pricing method is the most appropriate method for setting the arm's length price for the dealing. Additionally, the characterization is very important in cases when applying a pre-2010 version of Article 7. For example, if an external sale is attributed to a PE, in cases where the subsequent internal dealing for the sales related costs between the head office and PE includes elements of intangible related expenses, then it is plausible that this would not lead to a deduction of the corresponding intangible related expenses at the level of the PE when applying a pre-2010 version of Article 7.

## 5. Use of examples

The four examples illustrated in the Discussion Draft do not provide enough clarity on the mechanisms for profit attribution to PEs. As already stated, we understand the background for the removal of the numerical examples is to avoid conclusions from being drawn on the level of profitability of the intermediary and / or PE, but in our view the removal of the numerical examples only creates more uncertainty to the level of profitability and gives room for various conclusions to be drawn, which will undoubtedly lead to unnecessary controversy between taxpayers and tax administrations. The use of numerical examples also helps illustrate the various issues we have described in this letter, such as the interplay between performing an Article 7 and Article 9 analysis, and as well as the characterization of the dealings.

In addition, the examples should provide a more detailed description of the facts and assumptions used, rather than immediately assume a PE is created. While we understand that the focus of the Discussion Draft is not on the creation criteria of PEs, we are afraid that wrong conclusions may still be drawn from the fact patterns described in the examples. Creation of a PE will depend ultimately on the tax treaties in place between the countries of the non-resident enterprise and the intermediary for purposes of Article 5(5) and 5(6). In the meantime since the 2016 Discussion Draft, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) has been signed and many countries have adopted varying positions with respect to Article 12 of the MLI concerning Article 5(5) of the MTC. Therefore, we recommend that the examples clarify that a case by case analysis first be done, before assuming that the facts and circumstances automatically create a PE.

The Discussion Draft should also include additional examples illustrating how profits should be attributed to other forms of PEs. For examples:

- ▶ PEs that provide services under ongoing contracts. In particular, the examples should demonstrate if profits should be attributed for periods following the period that the initial PE was created. The OECD should clarify the approach over the period of the service provision and whether the PE may be deemed to have ceased to exist after the initial recognition criteria for the PE has been met under Article 5(5) of the MTC;
- ▶ PEs created by an intermediary that centrally performs activities on behalf of / for multiple non-resident entities. The Discussion Draft focuses on an intermediary acting on behalf of / for a single non-resident entity and thereby creating a PE. However, multinationals are characterized by their global organizational structures whereby certain activities will of course be performed on behalf of multiple non-resident entities;
- ▶ Potentially new Article 5(5) PEs created by sales personnel employed by the non-resident enterprise who reside in the country. Such personnel travel to client premises as part of their job and only rarely work from their home office such that the home office is not

considered a fixed place of business PE of the non-resident enterprise. Apart from these sales personnel, the non-resident has no other presence in the country. The sales personnel receives a salary and reimbursement of expenses incurred in connection with carrying out his/her employment activities. In such cases, it would be helpful to know how the dealing should be characterized and correspondingly, how profits (if any) should be attributed to such PEs.

## 6. Other comments/questions

### Clarification on the goal of the Discussion Draft

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

### Application of the profit attribution guidance to the financial sector

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

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August 3, 2017

***VIA EMAIL -- TransferPricing@oecd.org***

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

Re: Attribution of Profits to Permanent Establishments

Dear Sir / Madam,

We appreciate the opportunity to provide comments and to contribute to the public consultation and discussions on the Public Discussion Draft concerning “BEPS Action 7: Additional Guidance on Attribution of Profits to Permanent Establishments” as released by the OECD.

The new discussion draft provides helpful high-level guidance for the attribution of profits to permanent establishments (PEs) in the circumstances addressed by the BEPS Report on Action 7, however, some of the attribution of profits changes in the new discussion draft raise serious concerns.

The determination of the profits attributable to the PE is governed by the rules of Article 7. Under Article 7, the profits attributable to a PE are those that it would have derived if it were a separate and independent enterprise performing the activities that the dependent agent performs on behalf of the non-resident enterprise. This principle applies regardless of whether a tax administration adopts the AOA contained in Article 7 of the 2010 version of the multinational tax treaty.

Example 1 raises serious concerns because it restructures the transaction. SellCo, a related company resident in Country S, performs marketing and sales activities on behalf of TradeCo (a Country R resident) as a commissionaire. Under Article 7, the profits attributable to the PE are those that the PE would have derived if it were a separate enterprise performing the activities that SellCo performs on behalf of TradeCo. In this case, states the discussion draft, the profits would equal the amount of TradeCo’s revenue from sales of goods to customers in Country S, minus: (1) the amount that TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S (but “*attributing to such party ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions*”); (2) other expenses, wherever incurred, for the purposes of the PE; and (3) the arm’s length remuneration of SellCo.

Thus, the example restructures the transactions so that SellCo (or the PE) is treated as operating as a buy/sell subsidiary with the buy/sell profits in excess of the commissionaire commission constituting income of the PE.

This approach raises important legal issues. Where does the tax administrator in Country S, SellCo's country, get the authority to restructure the TradeCo-SellCo transactions? Article 9 provides no authority for recharacterizing an associated-enterprise transaction. Neither does Article 7.

The example not only restructures the parties' transactions, but equally importantly, it also moves assets and income producing functions and activities owned and performed by TradeCo in Country R and treats them as though they were hypothetically owned and performed by a PE in Country S. Where is the authority that supports changing the taxpayer's actual facts? These functions are performed in Country R and the income from the functions is rightfully taxed by the Country R tax authorities.

The discussion draft, referring to OECD Model Tax Treaty, correctly states that "the profits to be attributed to the [PE] in accordance with Article 7 are only those that the [PE] would have derived if it were a separate and independent enterprise performing the activities that the dependent agent [SellCo] performs on behalf of [TradeCo]." However, those functions and activities are already fully compensated to SellCo and the related income is already reported by SellCo and taxed by Country S.

The example, however, then moves functions from TradeCo to the PE. It states that the hypothetical third party in Country S (the PE) is treated as owning "the assets of TradeCo related to such functions, and [having assumed] the risks related to such functions." But those assets (presumably including at least the relevant accounts receivable and inventory) don't belong to that hypothetical third party. They belong to TradeCo in Country R, and TradeCo has the risks regarding those assets.

The discussion draft crafts a new rule that restructures transactions and moves assets and risk from one country to another to invent/create income in the PE. However, this violates the language in Article 7 of the OECD's Model Income Tax Convention as many countries have adopted it.

In crafting this new rule, the discussion draft's footnote 6 says that this is "conceptually equivalent to the amount paid by the PE for the inventory 'purchased' from TradeCo. This would correspond to a 'dealing' under the AOA." Reliance on the AOA was a problem with the OECD's last PE discussion draft since most treaties don't contain an AOA provision, and many never will. Moreover, the new discussion draft seemingly purports to be discussing rules that would apply "regardless of whether a tax administration adopts the [AOA] contained in Article 7 in the 2010 version of the MTC as outlined in the 2010 Report on the Attribution of Profits to [PEs]..."

Yet the discussion draft's writers needed the AOA, with an additional "conceptual" stretch, as the basic unpinning for the proposed new PE profit attribution rules in order to move assets and taxable income into the PE.

Moreover, if this were the rule, as the discussion draft proposes, TradeCo's taxable income in Country R would need to be reduced by the migration of its assets and risks from its home country to Country S. Perhaps as an affirmative planning matter it could report on its Country R tax returns less taxable income, asserting that it has a PE in Country S and that its assets and risks must be removed from Country R and imported to Country S. The Country R tax authorities presumably would not be pleased with this shift in income out of Country R contrary to Country R's treaty with Country S. Nonetheless, this could create interesting tax-shelter planning opportunities.

As an alternative, TradeCo could assert that under a full application of AOA principles, it must charge a royalty to the PE in Country S, and that at arm's length, it needs to bill the PE for a required service charge and allocate home-office Country R overhead to the PE. Country S might not get much extra profit in the PE to tax, after all.

This concern is also present in the discussion draft's other examples. Example 2 involves the sale of advertising on a website through a related intermediary and like Example 1 restructures the actual transactions in order to attribute profits to the PE. Example 3 involves the procurement of goods and also attributes profits to the supplier (the PE) and the ownership of the assets related to these functions. Here, too, the transaction is recharacterized as though it were a buy/sell transaction involving BuyCo, with the excess profits treated as earned by the PE.

Example 4 involves warehousing, delivering, merchandising and information collection activities. In addition to restructuring the actual facts, this example also involves multiple PEs in a given country. This, of course, was the very concern expressed by the Tax Executives Institute and many others when they submitted comments on the "anti-fragmentation" rules. The rules can apply when there are absolutely no BEPS concerns and a multinational company is simply trying to operate its business.

We think that as a *practical matter* (something that sometimes seems missing in BEPS Reports), multiple PEs ought to be avoided. Further, in Example 4, there would seem to be *needless* multiple PEs, since absent changing the actuals facts and applying the AOA rules, there likely will be no extra PE profits to tax anyway.

We would be pleased to discuss any of the points raised in this letter, please do not hesitate to contact James Fuller ([jpfuller@fenwick.com](mailto:jpfuller@fenwick.com)) or Larissa Neumann ([lneumann@fenwick.com](mailto:lneumann@fenwick.com)).

Sincerely,

FENWICK & WEST, LLP



James Fuller  
Tax Partner



Larissa Neumann  
Tax Partner



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

To: Tax Treaties, Transfer Pricing and Financial Transactions Divisions, OECD/CTPA  
(TransferPricing@oecd.org)

### **Introduction**

The OECD released a public discussion draft on its additional guidance on attribution of profits to permanent establishments ("Draft") with comments invited by 15 September 2016. The comments provided below are prepared by the author as representative of Gazprom Marketing & Trading Ltd.

### **General overview**

Overall we are generally supportive of the additional guidance in relation to the attribution of profits to permanent establishments ("PE"). The application of most of the principles outlined in the paper in relation to PEs resulting under the new defragmentation rules and change of "preparatory and auxiliary" exemption, follow the same logic as existing approaches, such as the authorised OECD approach ("AOA"); the consistency in approach is welcomed by us.

However, we believe that the draft paper still fails to address the complications that arise due to the need to apply principles of Article 7 of the Model Tax Convention ("Article 7") together with principles of Article 9 of the Model Tax Convention ("Article 9") in case of a dependent agency PE ("DAPE"). In brief, we suggest the following:

- Simplify the rules for allocation of profits to DAPE, recognising the fact that if relationships between a principal and a local company are priced at arm's length, no profit should be allocated to DAPE.
- Clarify the common tax base approach suggested in Para 20 of the Draft, including clarification of whether such approach is applied for payment of tax or for calculation of tax base with further clarification of each scenarios.

### **Allocation of profit to DAPE**

In the case of a DAPE, there is already an existing relationship between a company resident in a country (say country R as described in Example 1 of the guidance) and its related intermediary resident in another country (country S). These relationships are governed by the arm's length principle, outlined in Article 9 and described in detail in the updated OECD Transfer Pricing Guidelines ("TPG").

At the same time, after a DAPE is recognised in country S, the draft suggests performance of additional analysis in accordance with Article 7, which in most cases refers to the AOA. This creates a new set of dealings between a DAPE and the principal, which need to be priced again.

While we are aware that the principles in Article 7 currently do not fully coincide with the principles of Article 9, we strongly believe that after the OECD performed significant work on revising the TPG, including transaction delineation, risk analysis, intangibles, etc. the economic rationale behind both approaches is, and should be, the same.

In particular, the SPF analysis which Article 7 relies on should be included in the analysis of function, assets and risks, as well as people managing the risk and capital assumed for risk taking abilities, in line with the guidance on functional analysis under the TPG.

Therefore, we strongly believe that if the transfer pricing arrangement between a principal and a local company is in line with the arm's length principle (Article 9), there should never be any profit to be allocated to a DAPE (under Article 7).

Having a separate set of methods and separate analysis creates an additional administrative burden for companies, which will have to map dealings between the principal and DAPE again and apply transfer pricing principles, as example 1 suggests.

In addition, we anticipate significant technical issues for companies that try to apply the analysis similar to the one outlined in the Draft in practice.

For example, in most cases the commissionaire structure (described in Example 1) is used for trading and distribution activity; this activity assumes sale of goods to third party customer in Country S. This arrangement is usually structured either as a sales and marketing service (priced based on costs of SellCo plus a mark-up) or as commissionaire (priced as a commission on sales).

Following the logic of Article 7, Example 1 assumes that SellCo would need to delineate all dealings between TradeCo and DAPE. In particular, SellCo will be deemed to be buying goods from TradeCo and will need to apply transfer pricing principles to this dealing. However, transfer pricing principles in this situation would mean that SellCo is a distributor, buying goods from a third party and selling them to the market. To price the transaction, a company would normally apply either the resale minus method (testing the gross margin) or the transactional net margin method (testing the operating margin) using distributor companies as comparables.

- If TradeCo is classified as a distributor, analysis under Article 7 and Article 9 should bring the same result.
- If it is not (for example, it could be a sales agent), then Article 7 artificially increases the profit of the DAPE based on the inherent assumption that SellCo activity is that of distribution, disregarding its actual functional profile.
- If a company tries to use another method to price a dealing on buy-sell of goods between the principal and DAPE, in practice it may only rely on CUP, which can only be applied in very limited amount of circumstances.

Therefore, we believe that such approach creates a significant administrative burden for MNEs and increases risks of challenges from tax authorities, increasing profits allocated to DAPE disregarding limited functional profile of local entities.

We suggest that the approach should be simplified, and that the TPG should be used to define pricing of the arrangement between a principal and a company which forms DAPE, rather than to the principles of Article 7.

The suggestion above would also eliminate another problem, rightfully addressed by the OECD; the administration of a PE in parallel with the legal entity itself (Para 26 of the Draft). As the adjustments would be made only under Article 9, this issue would not even arise, as no additional profits would need to be attributed to a DAPE and all adjustments would be made through the transfer pricing adjustments of transactions between TradeCo and SellCo.

If the OECD insists on application of both principles in parallel, we also suggest that the guidance makes it more clear whether the principle described in Para 20 of the Draft is limited only to the collection of tax or also to the calculation of local tax liabilities of the DAPE.

If the principle only applies to collection of tax liabilities, it is not clear how foreign tax credits could be applied in order to offset the additional tax liabilities of a DAPE against the tax liabilities of the principal.

If the principle applies to the calculation of tax liabilities, we would welcome more clarity on how the tax obligations of the DAPE in country R can be offset against the tax obligation of the SellCo in the same country. As we understand, the principle should allow offset of losses and profits arising in the local company and those attributed to the DAPE for the tax base calculation.

These comments have been prepared by:

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## Generali

### **Response to OECD discussion draft on BEPS Action 7 – Additional guidance on attribution of profits to permanent establishments**

In principle, we generally agree with the concern that the proposed rules concerning permanent establishment would result in the creation of additional insurance permanent establishments with low additional profits attributed to them.

However, considering the fact that the changes to permanent establishment definition contained Art. 5, paras. 5 and 6, of the OECD Model and the OECD Model Commentary thereon have already been approved in the Final Report on BEPS Action 7 in October 2016, we believe that the focus of the current discussion should be on the attribution of profits to such additional permanent establishments under Art. 7 of the OECD Model.

In particular, we strongly believe that additional guidance is needed in order to prevent double taxation when calculating profits attributable to such permanent establishments under Art. 7 of the OECD Model (both in the case of related parties and third parties) and administrative approaches to enhance simplification.



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15. September 2017

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

Dear Sir or Madam,

Thank you for the opportunity to comment on the Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments (hereinafter referred to as: "the Discussion Draft") issued on 22 June 2017.

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

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

The following statements follow the order of the paragraphs as given.

### **I. General Remarks**

Bundessteuerberaterkammer welcomes that the OECD is consulting with public on its profit attribution guidance. Clear guidance will assist tax authorities and taxpayers as well as their advisors applying the Changes to Article 5 (5) and 5 (6).

The Discussion Draft limits itself to high-level general principles illustrated on the basis of a small number of straightforward examples. It is to be welcomed that the Discussion Draft 2017 also provides a clear example on Article 5(4) permanent establishments. Unfortunately, guidelines and examples on cases that are more complex, or on variations on the cases given, are lacking. Moreover, the Discussion Draft would benefit if the functional and risk analysis as discussed in the previous version was revisited, bringing in transfer pricing reasoning with respect to dealings between the permanent establishment in the resident state and that in the

source state. This holds in particular for cases where the division of activities that are attributable to an agent permanent establishment or the intermediary is difficult, and misapplication can easily lead to double taxation.

## II. Attribution of Profits to Permanent Establishments resulting from Changes to Article 5(5) and 5(6) and the Commentary

- Paragraph 12

Regarding the order in which Article 7 and Article 9 are applied, it should be taken into account that the operations carried out by a permanent representative are not only relevant for determining their functional profile, but also need to be considered when identifying the functions, assets and risks to be attributed to the agent permanent establishments. Therefore, these operations have to be determined prior to the attribution of profits according to either Article 7 or Article 9 in any case.

- Paragraph 21

As far as collecting tax from the intermediary is concerned, administrative approaches to enhance simplification are helpful and therefore are to be welcomed. However, the acceptability should depend on the details of each specific approach. If, for example, the approach is to adjust the transfer price towards the representative, this may lead to the result that the proper allocation of profits between the taxpayers (not the countries) will no longer meet the arm's length principle.

## III. Example 1: Commissionaire Structure (Related Intermediary)

- Paragraph 25

The analysis as set out under example 1 provides clear guidance to the determination of profits in the agent permanent establishment setting, and makes clear how the transfer price for dealings between the permanent establishment in the resident state and the agent permanent establishment is to be determined (see in particular footnote 6 and the associated text section). However, the Draft is not explicit on the underlying attribution of assets, functions and risks. Rather, the way the transfer price is identified suggests that, in the example presented, the goods are to be attributed to the agent permanent establishment. It would be helpful if, in their examples, the OECD could provide more detail on the relevant transfer pricing analysis (as was the case in the previous draft).

- Paragraphs 31 and 35

The 2017 Draft leaves open the question in which capacity SellCo is being treated upon collection of the tax with respect to sale of advertising on a website and procurement of goods. Unlike the guidance in paragraph 26, where liability of both SellCo and the PE is stated, in paragraphs 31 and 35, SellCo may be required to pay the tax "separately calculated by reference to the activities of both SellCo and the PE". The question remains whether SellCo can ultimately be held liable for the total amount of tax payable or can be required to pay tax on behalf of the agent permanent establishment.

Seite 3



**Bundessteuerberaterkammer**  
KÖRPERSCHAFT DES ÖFFENTLICHEN RECHTS

Yours sincerely,

i. V. Claudia Kalina-Kerschbaum  
Geschäftsführerin

i. A. Madeleine Menzel  
Referentin

Milan, 15 September 2017

Tax Treaties, Transfer Pricing and Financial Transactions Division  
Centre for Tax Policy and Administration (CTPA)  
Organization for Economic Cooperation and Development (OECD)

**RE: OECD Discussion Draft on Additional Guidance on Attribution of Profit to Permanent Establishments.**

Dear Sirs,

Giovannelli e Associati, an Italian independent law firm, welcomes the opportunity to contribute to the public consultation and discussions regarding the the attribution of profits to permanent establishments (PEs) and to provide some comments on the discussion draft on *"BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments"* (the Discussion Draft) as released by the OECD on 22 June 2017.

**Example 1: Commissionaire structure.**

The example might give rise to some doubts. Indeed, while paragraph 25 of the Discussion Draft concludes that *"TradeCo has a PE in Country S as SellCo habitually concludes contracts there on behalf of TradeCo for the sale of goods by TradeCo and SellCo does not do so as an independent agent"*, paragraph 83 of the 2017 Draft Commentary to article 5(5) clarifies that *"It would not have been in the interest of international economic relations to provide that any person undertaking activities on behalf of the enterprise would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned"*. It is our impression that facts and circumstances of the example do not offer evidence of further functions, risks and assets to be attributed to the PE whose effective dimensions should be the guide in the comparability analysis, and that the example leads to the conclusion that any commissionaire always constitutes a PE<sup>1</sup>. In connection to the foregoing, the hypothesis of a "zero profit PE" becomes legitimate.

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<sup>1</sup> Such a conclusion puts itself against case law of some civil law countries, according to which *"contracts concluded by a commissionaire, even though they are concluded for the account of its principal, do not bind the latter directly vis-à-vis the counterparties of the commissionaire"* but *"...unless it appears either from the express terms of the*

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Focusing on the profit calculation proposed in the example, it may be agreed that the PE's profit could be equal to the revenues from sales minus the amount that TradeCo would have received "if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S" and other costs, but the third element of the calculation should be more clearly associated to functions, risks or assets that the PE would need to assume to perform any further than the commissionaire's, such as marketing, after sale assistance to customers, warehousing expertise, financial capability to sustain warranty risk insurance, etc. In practice, the main difficulty relies upon the proper and effective identification and attribution of the people functions for the purpose of conducting an affordable comparability analysis; and in absence of functions, assets or risks deriving from the activity performed in the source Country, the actual outcome might be a "zero profit PE" or a double taxation in the source Country which is not admitted in paragraph 12 of the Discussion Draft.

Also the "crucial condition" mentioned at paragraph 94 of the 2017 Draft Commentary to article 5(5)<sup>2</sup> seems unsatisfied in the example. In fact, should the "condition" be satisfied, both the legal transfer of ownership of the widgets and their material transfer are performed by the head office abroad and its personnel. In such circumstance, the involvement of TradeCo in business activities in the source Country, required by paragraph 86 of the 2017 Draft Commentary<sup>3</sup>, does not seem to reach the particular extent entailed by the new article 5(5).

#### **Example 2: Sale of advertising on a website (related intermediary).**

The considerations reported in commenting example 1 may be replicated here. In fact, in this example, allocating a greater amount of profit in Country S than what already attributed to SellCo could result in a duplication of the tax claim. Such greater amount is justified only if the PE plays some role in the development or enhancement of the website; but if these activities are all performed outside Country S, or the risks and financing of the research activities are attributed only to the head office (legal and economic owner of the

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*contract of commission, or from other factual elements relating to the arrangement, that despite the 'commission' title given by the parties to the contract between them, the principal is personally bound by the contracts concluded with third parties by his commissionaire who must, therefore, for this reason, be regarded as his representative and constitute a permanent establishment" (Zimmer case in France; see also Dell Products (Europe) BV v Skatt Øst in Norway and Boston Scientific SpA in Italy).*

<sup>2</sup> Draft Contents of the 2017 Update to the OECD Model Tax Convention, paragraph 94: "The crucial condition for the application of subparagraphs b) and c) is that the person who habitually concludes the contracts, or habitually plays the principal role leading to the conclusion of the contracts that are routinely concluded without material modification by the enterprise, is acting on behalf of an enterprise in such a way that the parts of the contracts that relate to the transfer of the ownership or use of property, or the provision of services, will be performed by the enterprise as opposed to the person that acts on the enterprise's behalf".

<sup>3</sup> Draft Contents of the 2017 Update to the OECD Model Tax Convention, paragraph 86: "A person is acting in a Contracting State on behalf of an enterprise when that person involves the enterprise to a particular extent in business activities in the State concerned..."

IP), it is quite hard to attribute some further profit to the PE exceeding the arm's length remuneration of SellCo. Indeed, the new OECD TP Guidelines (TPG) on intangibles (especially at paragraphs 6.32 ff.) clarifies that it is the contribution to the development and enhancement of the intangible that justifies a higher arm's length remuneration rather than a legal or formal right to it.

Under the AOA of the separate entity, the same reasoning must hold true with the effect that in the "market State" no significant remuneration is due in the absence of any contribution to the creation of the website. The result should be that the PE does not have any entitlement to further remuneration than what it has already been attributed to the intermediary. And also in this case the risk of giving place to a "zero profit PE" arises.

**Example 3: Procurement of goods (related intermediary).**

Like the previous examples, also here the difficulty is to identify the people functions different from those performed by the intermediary in the source Country.

If "*the profits attributable to the PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that BuyCo performs on behalf of TradeCo*", the only case for allocating some profit to the PE is where the BuyCo's remuneration is not at arm's length considering the "hidden" inventory risks attributable to the PE. But such risk is not contemplated in the facts (paragraph 32, Discussion Draft), whereas it is introduced in the analysis (paragraph 34, Discussion Draft) for the purposes of calculating the PE profit.

Lastly, we imagine that a typo is contained in paragraph 35, where in the end reference is made to SellCo instead of BuyCo.

**Example 4: Warehousing, delivery, merchandising and information collection activities.**

Assuming that more than one PE belonging to the same enterprise may exist in the same source Country, as far as the new negative list rule of article 5(4) and the anti-fragmentation rule of article 5(4.1) are concerned, the main difficulty in their application seems to be the identification of the "cohesive business operation" of the enterprise, or of the associated enterprises, in the source Country.

In the example, if the two locations (warehouse and office) are considered part of the same cohesive business operation of OnlineCo for the purposes of identifying a PE under the anti-fragmentation rule, it is unclear why paragraph 47 of the Discussion Draft states the existence of two PEs as if each location were autonomously conducting a business operation.

# GIOVANNELLI E ASSOCIATI

STUDIO LEGALE

Another unclear issue arises with the method of calculation of the profit attributable to the two PEs in the example. According to the Discussion Draft, after having identified the existence of two PEs in the source state, the calculation of profits attributable to them is conducted separately as if the two businesses were not complementary nor cohesive.

Lastly, the relationships between the activities performed in the two locations is not as immediate as it is made in the 2017 Draft Commentary to Article 5, paragraph 81, example B.

Yours sincerely,

Eugenio Romita



Mauro Manca



## GFIA response to the OECD discussion draft on BEPS Action 7

### General Comments

GFIA welcomes the opportunity to respond to this revised discussion draft and continues to support the aims of the OECD BEPS Action Plan to address weaknesses in the international tax environment. GFIA is of the view that the revised discussion draft is an improvement compared to the one released for consultation last year.

GFIA's main concern with the proposed PE rules has always been that, for some insurance business models, PEs would be recognised for tax but not for regulatory purposes with nil or minimal additional profit being attributed to them, resulting in a disproportionate compliance burden for insurers, as well as for tax authorities. GFIA is of the view that **only the presence of Key Entrepreneurial Risk-Taking (KERT) functions in a jurisdiction should create a PE for tax purposes** and be relevant for the attribution of profits. The 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) ("Part IV") recognised that the main KERT function of insurers is the assumption and management of insurance risk/business (i.e. underwriting).

### Specific Comments on the Paper

GFIA has the following comments on the contents of the discussion draft:

- GFIA welcomes the OECD's explanation in paragraph 18 of how double taxation can be avoided when both Articles 7 and 9 of the Model Tax Convention apply (i.e. when both the intermediary and the non-resident enterprise are associated enterprises).
- GFIA is of the view that Part IV should be referenced in the final guidance on Article 5(5) and 5(6). This is because Part IV includes comprehensive guidance which defines and discusses risks, risk management and allocation of risk in the context of the insurance businesses. As mentioned above, risk assumption is the essential component of insurance business models and therefore profits should be attributed to insurers' PEs only if this KERT function is present there. This is clearly set out in Part IV. Given that paragraph 18 of the OECD discussion draft makes reference to risk control functions in its analysis of risk allocation when both Article 7 and Article 9 are applicable, making a specific reference to Part IV here seems particularly relevant and important.

- The OECD's discussion draft references Part I of the 2010 Report in paragraph 16 which states that the notion of "significant people functions" is used for attributing risk assumption and economic ownership of assets to a PE. If an additional reference to Part IV is not added in paragraph 18, GFIA recommends that the full 2010 Report be referenced in the discussion draft, instead of just Part I.
  
- GFIA is of the view that a widened definition of PE which includes intermediaries would result in the creation of a potentially large number of insurance PEs with nil or minimal additional profit being attributed to them. This is because, by applying Part IV of the 2010 Report and the reasoning in paragraph 18 of the current discussion draft, the functions performed by the intermediary will be non-KERT. GFIA therefore welcomes:
  - the OECD's recognition in paragraph 19 that *"depending on the facts and circumstances of a given case, the net amount of profits attributable to the PE may be either positive, nil or negative (i.e., a loss)"*.
  - the OECD's reference in paragraph 20 to the 2010 Report and to *"administratively convenient ways of recognising the existence of a PE under Article 5(5) and collecting the appropriate amount of tax resulting from the activity of the intermediaries"*.
  
- GFIA is concerned that the creation of many such PEs with no or minimal profit attributed would create an entirely unnecessary administrative burden for insurers and tax authorities. Therefore, GFIA is strongly of the view that the final OECD guidance on Article 5(5) and 5(6) must include an explicit recommendation that jurisdictions should, in these circumstances, have administratively convenient ways of collecting the appropriate amount of tax to reduce the compliance burden for both business and tax authorities. A good example of how this can be achieved is provided in paragraph 21 of the OECD's discussion draft.

**GFIA contact:**

Peggy McFarland, Chair of the GFIA Taxation Working Group ([pmcfarland@clhia.ca](mailto:pmcfarland@clhia.ca))

**About GFIA**

Through its 41 member associations, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 62 countries. These companies account for around 87% of total insurance premiums worldwide. The GFIA is incorporated in Switzerland and its secretariat is based in Brussels.

# Grant Thornton discussion draft response

BEPS Action 7

Additional Guidance on Attribution of Profits to Permanent Establishments



Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft on the additional guidance on attribution of profits to permanent establishments issued on 22 June 2017. We appreciate the work that the OECD has undertaken on the wider BEPS project and would like to make the following comments on this further guidance.

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14 September 2017

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

22 June to 15 September 2017

Following the earlier discussion draft released in July 2016, we appreciate further clarification on the attribution of profits to permanent establishments. We understand that the aim of this draft is to provide more clarification on attribution of profits to permanent establishments (PEs) and that comments are sought solely on this issue rather than on definitional changes. However, we consider in light of the fact that not all countries have adopted the wider definition at this point in time, it is all the more important that there is clarity and where possible consensus on the attribution of profits once a PE is recognised. It is therefore surprising that the OECD does not wish present numerical examples as part of this guidance to “avoid drawing conclusions on the level of profitability of the intermediary or the permanent establishment”. We agree with the concept that taxpayers should take a pragmatic, rather than formulaic, approach in attributing profits to PEs and consider the facts and circumstances of each case. However, the lack of any numerical or algebraic elements in the examples leads to a serious concern that there will be a lack of clarity for taxpayers and potentially many more instances of double taxation.

Furthermore, the potential proliferation of deemed PEs in circumstances where there may already be an “intermediary” subject to tax locally on profits that are sufficient to cover the activities in that country of the [new] PE and the intermediary combined, indicates that an approach is needed whereby the source country only taxes the correctly attributable total profits (or losses) and not more. In this regard, we welcome the explicit statement in paragraph 12 that there must be no double taxation in the source country.

We consider the wording in paragraph 10 as being rather loose, and it may suggest that article 7 somehow ‘trumps’ article 9: “The arm’s length reward to the intermediary for the services it provides to the non-resident enterprise is one of the elements that needs to be determined and deducted in calculating the profits attributable to the PE under Article 7”. The order of events should be that the transaction between two legal persons is determined first and then, only if there is additional profit or loss to be attributed to the PE, does article 7 come into play. We agree with the suggestion that it can be considered “logical and efficient first to accurately delineate the actual transaction between the non-resident enterprise and the intermediary and to determine the resulting arm’s length profits” (para 12) but we disagree with the suggestion in that paragraph that the order does not matter, and the implication that the profits (or losses) will always be the same. Indeed, paragraph 17 (inter alia) acknowledges that they may not. Similarly, we are concerned about the apparent carte-blanche for countries to decide for themselves how they think profits (or losses) should be calculated (see paragraph 9). We believe more guidance from the OECD is needed, and in particular, we would welcome an explicit statement that the AOA separate enterprise principle (2010 version) **should** be applied.

This clarification would avoid the confusion engendered by some of the wording in the discussion draft – if the PE has significant people functions whereby those people control some of the key risks of the enterprise, then the PE can be allocated profit or loss in the same way as a separate independent enterprise would. The first sentence in paragraph 8 appears potentially incorrect and should, we submit, be deleted: “Once it is determined that a PE exists under Article 5(5), one of the effects of paragraph 5 will typically be that the rights and obligations resulting from the contracts to which Article 5(5) refers **will be properly allocated** to the permanent establishment”. Alternatively, different wording could be adopted, such as: “Once it is determined that a PE exists under Article 5(5), one of the effects will typically be that an arm’s length part of profits (or losses) derived from the contracts should be attributed to the PE under articles 7 and/or 9”.

We also note that the attribution of profits (or losses) to PEs has been problematic for some time, with some countries taking a fairly specific formulaic approach and others a more generic principles-based approach. The specific adoption of the AOA should help to reduce these mismatches.

Clarity on definition of terms would also be welcomed. When performing functional analysis we come across many job descriptions with “VP” or “head of” in their titles that are for roles that do not appear to us to be SPFs (these should be fairly high level control functions). There is a danger of potential arguments over tiny amounts of profits, which would add to the ever increasing burden on taxpayers.

We are however pleased to see specific reference to losses in paragraph 19 as in our experience tax authorities are often more enthusiastic about tracking down potential PEs when they think there may be profits at stake than they are about accepting there may be losses. Consistency is key here, and it would help if every time profits are mentioned the mirroring words “or losses” also appeared.

We welcome the commentary around administrative convenience in paragraphs 20 and 21 and whilst we appreciate they cannot be mandated, ideally a clearer steer from the OECD endorsing these approaches would be helpful, again, to avoid placing onerous burdens and costs onto businesses.

In relation to the examples, we would suggest that the initial premise and their conclusions are more clearly stated. It is not clear to us what the difference is expected to be, if any, between the “arm’s length remuneration of SellCo/BuyCo” and the revenue minus the totals of items (1) (2) and (3). This could suggest a double counting of profits through (1) and (3). In order to avoid this problem it may be instructive (i) to clearly state that in certain circumstances one can consider that (1) and (3) overlap and to (ii) to modify (3) as follows: “the arm’s remuneration of SellCo/BuyCo if not already embedded in (1) above”. Again, some illustrative numbers may help, with the usual caveat that much depends on the specific facts and circumstances. Additionally, or as an alternative, it would be helpful to explain in more detail how the arm’s length remuneration for SellCo/BuyCo should be calculated.

On behalf of the global network of Grant Thornton International Member Firms, with the contribution of our colleagues, Wendy Nicholls, Wayne Pisani, Chaid Dali-Ali, Charles Marais and Thomas Jepson we respectfully submit our response to the Discussion Draft on BEPS Actions 7: Additional Guidance on the Attribution of Profits to Permanent Establishments.

We are grateful for the opportunity to comment and would be pleased to discuss or clarify our response. Please contact the undersigned or any of the contacts below.

Yours Faithfully,



Francesca Lagerberg  
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15 September 2015

Dear Sirs

We welcome the opportunity to comment on the Discussion Draft: BEPS Action 7 – Additional Guidance on Attribution of Profits to Permanent Establishments <http://www.oecd.org/tax/transfer-pricing/beps-discussion-draft-additional-guidance-attribution-of-profits-to-permanent-establishments.pdf> (the “Discussion Draft”) issued 22 June 2017.

The attribution of profits to permanent establishments (PEs) is an important and difficult area and we thank the OECD for the time and effort put into this draft guidance.

The discussion draft implies that although there will be an increase in the number of PEs the principles behind the attribution of profit to PEs has not altered.

We believe that the combination of changes to PE definitions under BEPS plus changes to Chapter I of the OECD Transfer Pricing Guidelines and the changes to Article 5 will create enormous uncertainty and there will need to be greater clarity in the guidance and better ways for taxpayers and tax administrations to handle potential disagreements in this area.

Yours faithfully

Ian Young  
ICAEW Tax Faculty  
International Tax Manager

## Response to OECD discussion draft on BEPS Action 7 - Additional guidance on attribution of profits to permanent establishments

Our reference:	ECO-TAX-17-044	Date:	5 September 2017
Referring to:	<a href="#">Discussion draft</a> on OECD BEPS Action 7: Additional guidance on the attribution of profits to permanent establishments		
Contact person:	Alexandru Ciungu, Policy Advisor, Macroeconomics & Taxation	E-mail:	Ciungu@insuranceeurope.eu
Pages:	3	Transparency Register ID no.:	33213703459-54

### Comments

Insurance Europe welcomes the opportunity to respond to this revised discussion draft and continues to support the aims of the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) action plan to address weaknesses in the international tax environment. Insurance Europe believes that the revised discussion draft is an improvement compared to the one released for consultation last year.

As noted in previous submissions to the OECD, Insurance Europe's main concern about proposed rules on the attribution of profits to permanent establishments (PEs) is that, for some insurance business models, PEs would be recognised for tax but not for regulatory purposes with nil or minimal additional profit being attributed to them. This would represent a disproportionate compliance burden for insurers, as well as for tax authorities.

Insurance Europe maintains its view that only the presence of key entrepreneurial risk-taking (KERT) functions in a jurisdiction should create a PE for tax purposes and be relevant for the attribution of profits. The main KERT function of insurers is the assumption and management of insurance risk/business (ie, underwriting). This is recognised by the 2010 OECD Report on the Attribution of Profits to Permanent Establishments Part IV (Insurance) ("Part IV").

With this in mind, Insurance Europe has the following comments on the discussion draft:

- Insurance Europe welcomes the OECD's explanation in paragraph 18 of how double taxation can be avoided when both Article 7 and Article 9 of the Model Tax Convention apply (ie, when both the intermediary and the non-resident enterprise are associated enterprises).
- As pointed out in previous submissions, Insurance Europe believes that Part IV should be referenced in the final guidance on Article 5(5) and 5(6). This is because Part IV includes comprehensive guidance which defines and discusses risks, risk management and allocation of risk in the context of the insurance businesses. Indeed, risk assumption is the essential component of insurance business models and therefore profits should be attributed to insurers' PEs only if this KERT function is present

there. This is clearly set out in Part IV. Given that paragraph 18 of the OECD discussion draft refers to risk control functions in its analysis of risk allocation when both Article 7 and Article 9 are applicable, making a specific reference to Part IV here seems particularly relevant and important.

- The OECD's discussion draft references Part I of the 2010 report in paragraph 16, which states that the notion of "significant people functions" is used for attributing risk assumption and economic ownership of assets to a PE. If an additional reference to Part IV is not added in paragraph 18, Insurance Europe would suggest that the full 2010 report be referenced in the discussion draft, instead of just Part I.
- Insurance Europe believes that a definition of PE widened to include intermediaries would result in the creation of a potentially large number of insurance PEs with nil or minimal additional profit being attributed to them. This is because, by applying Part IV of the 2010 report and the reasoning in paragraph 18 of the current discussion draft, the functions performed by the intermediary will be non-KERT. Insurance Europe therefore welcomes:
  - The OECD's recognition in paragraph 19 that "depending on the facts and circumstances of a given case, the net amount of profits attributable to the PE may be either positive, nil or negative (ie, a loss)".
  - The OECD's reference in paragraph 20 to the 2010 report and to "administratively convenient ways of recognising the existence of a PE under Article 5(5) and collecting the appropriate amount of tax resulting from the activity of the intermediaries".
- However, Insurance Europe is concerned that the creation of many such PEs with no or minimal profit attributed would create an entirely unnecessary administrative burden for insurers and tax authorities. Therefore, Insurance Europe strongly believes that the final OECD guidance on Article 5(5) and 5(6) must include an explicit recommendation that jurisdictions should, in these circumstances have administratively convenient ways of collecting the appropriate amount of tax to reduce the compliance burden for both business and tax authorities. A good example of how this can be achieved is provided in paragraph 21 of the OECD's discussion draft.

Insurance Europe is the European insurance and reinsurance federation. Through its 35 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income.



Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 200bn, directly employ over 985 000 people and invest nearly €9 900bn in the economy.

## INTERNATIONAL ALLIANCE FOR PRINCIPLED TAXATION

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September 15, 2017

### VIA E-MAIL

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**Re: Comment on 22 June 2017 Discussion Draft on BEPS Action 7 (Additional Guidance on the Attribution of Profits to Permanent Establishments)**

Dear Tomas,

This letter is submitted on behalf of the International Alliance for Principled Taxation (IAPT or Alliance) to provide you with the IAPT's comments on the 22 June 2017 Discussion Draft on BEPS Action 7 (Additional Guidance on the Attribution of Profits to Permanent Establishments). We appreciate the opportunity to comment on the Discussion Draft.

The IAPT is a group of major multinational corporations representing a variety of business sectors.<sup>1</sup> The group's purpose is to promote the development and application of international tax rules and policies based on principles designed to prevent double taxation and to provide predictable treatment to businesses operating internationally. The group participated actively as a stakeholder in the discussions leading to the October 2015 final reports from the OECD/G20 BEPS Project.

As we indicated in comments we submitted previously to the OECD (in October 2013, January 2015, June 2015, and September 2016), the IAPT fully supports the OECD initiative to develop clear and

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<sup>1</sup> The current membership of the IAPT is made up of the following companies: AB InBev S.A.; Facebook, Inc.; Microsoft Corporation; Procter & Gamble Co.; Repsol S.A.; and Tupperware Brands Corporation.

consensus guidance on the application of existing principles for attributing profits to permanent establishments (i.e., the “Authorised OECD Approach” or “AOA”) to the new forms of permanent establishment created under Action 7. We believe such guidance is crucial to the goal of minimizing costly and contentious disputes, and that it should be important to governments’ decisions about whether to adopt the changes recommended by Action 7.

The group’s comments are set forth in the Annex to this letter. We very much appreciate the willingness of the delegates to consider them as they continue their deliberations on the attribution of profits to the Action 7 permanent establishments. I look forward to discussing these comments with the delegates at the consultation to be held in November.

Sincerely yours on behalf of the Alliance,

A handwritten signature in black ink that reads "Mary C. Bennett". The signature is written in a cursive style with a long horizontal flourish extending to the right.

Mary C. Bennett  
Baker & McKenzie LLP  
Counsel to the Alliance

## ANNEX

### **IAPT Comments on the 22 June 2017 Discussion Draft on BEPS Action 7 (Additional Guidance on the Attribution of Profits to Permanent Establishments)**

#### **I. Executive Summary**

1. The IAPT does not support the approach of the DD to provide “high-level general principles” that would be “relevant for all countries, regardless of their approach to attributing profits to permanent establishments”. Instead, we wish to reiterate our 2016 recommendation that the final guidance use the partial AOA as its primary reference point, while also including a discussion of the outcomes under the full AOA. Any attempt to state conclusions on how profits would be attributed outside the framework of the AOA principles should be expressly limited to situations where the text of Article 7 in the relevant treaty varies materially from either the 2008 or 2010 OECD Model or where the relevant treaty partner has publicly rejected any application of AOA principles in its interpretation of Article 7.
2. At least for purposes of providing certainty as to the commitment of OECD member countries to a particular interpretation, the final guidance to be provided on the attribution of profits to Action 7 PEs, even if otherwise published as a free-standing Report, should effectively be treated as a supplement to the AOA Reports, and should be the subject of an updated version of Council Recommendation C(2008)106.
3. A mechanism should be provided in connection with the final guidance through which non-OECD countries participating in the Inclusive Framework (IF) will be required to express publicly their level of commitment to applying the new guidance in interpreting their treaties, including their commitment to applying the AOA (whether the full or partial AOA, as appropriate) in interpreting their treaties that contain an Article 7 based on the 2010 or pre-2010 MTC. The expression should relate not only to the new AOA guidance being developed under Action 7, but also to the entirety of the full or partial AOA.
4. The prohibition against double source country taxation through the interaction of the analyses under Articles 7 and 9 is such an important point that it should be enshrined in guidance which has appropriate status to ensure it will be followed by all countries.
5. We recommend deletion of DD paragraph 14 from the final guidance (relating to whether reattribution of risk pursuant to Article 9 can result in a finding of no PE).
6. The IAPT recommends that the OECD and the IF rededicate themselves to trying to find an administratively convenient mechanism they can endorse to simplify the host country tax and reporting obligations faced by nonresident enterprises found to have Article 5(5) PEs.
7. Any example in the final guidance should include an articulation of what principles apply to inform the characterization of dealings between the PE and the rest of the enterprise and the manner in

which those principles apply to the particular case. Identifying the character of the dealing is critical to the ability to identify appropriate comparables to price the dealing. The example should also include a rationale for the characterization under different types of new PEs created by the changes to Article 5(5).

8. Any examples in final guidance should include a reference to one or more specific versions of Article 7 that are likely to correspond with the language found in a large number of actual treaties, ideally the version of Article 7 found in the 2008 OECD Model Tax Convention, if not also the version found in the 2010 OECD Model.

9. Any example in the final guidance should include some discussion of how to resolve the key issues that arise in applying Article 7, including attribution of risks and assets, selection of transfer pricing method, and attribution of expenses.

10. While the IAPT supports the concept of including in the final guidance an explanation of how the PE profit attribution rules will apply to PEs engaged in purchasing activities, we recommend that such guidance include sufficient explanation about the foundational issues of when purchasing can give rise to a PE not to mislead readers into thinking that will inevitably be the case.

11. Since the pre-2010 Article 7(5) language appears in many hundreds if not thousands of treaties currently in force, we believe it would be prudent for the final guidance to alert readers to the fact that even if purchasing activities do give rise to a PE under the new version of Article 5, a very commonly applicable version of Article 7 may nevertheless preclude the attribution of any profits to such a PE.

12. The IAPT recommends deletion of the sentence at paragraph 41 which refers to “profits derived from the combined activities” and “the potential effect on those profits of the level of integration of these activities”, since those references create misleading impressions about the applicability of profit split methods to PE profit attribution and are unaccompanied by any explanation of their significance.

13. Example 4, like the previous examples, should not imply a characterization of the “dealing” between the PE and the home office which is not supported by the facts of the example and which is not based upon the functional analysis required by the AOA.

14. The final guidance should not provide ambiguous statements about the principles governing the allocation of expenses to PEs, but should instead explain the principles that apply under the partial and full AOA and the circumstances under which each set of principles applies. It should also explicitly confirm the principle that in determining the profits of a PE, there shall be allowed as deductions expenses which are incurred for the purposes of the PE, including executive and general administrative expenses so incurred, whether in the State in which the PE is situated or elsewhere.

15. If the final guidance is going to include guidance on PE profit attribution issues that arise under the new anti fragmentation rule of Article 5(4.1), it should have an example that involves the newly affected situations (i.e., where a PE is found based on activities of a separate enterprise) and should address the variety of new questions that arise when a source country is attributing profits under that rule to the PEs of separate enterprises.

## II. Introductory Comments

16. As indicated in our prior comments, the IAPT appreciates the opportunity to provide comments on the discussion draft (DD) on additional guidance on the attribution of profits to permanent establishments (PEs). The development of clear and consensus guidance on this issue will be crucial to minimizing the risk of costly disputes and will also be important to help governments decide about the desirability of following the Action 7 recommendations. In these introductory comments, we would like to address some over-arching concerns about the DD's proposed guidance.

### A. Reference Framework of PE Profit Attribution Principles

17. One of the most striking aspects of the DD is its assertion that it is intended to develop "guidance that would be relevant for all countries, regardless of their approach to attributing profits to permanent establishments". This is in sharp contrast to the July 2016 Discussion Draft (2016 DD), which had based its analysis of various fact patterns on the version of Article 7 found in the 2010 OECD Model Tax Convention and the accompanying guidance in the 2010 Attribution of Profits Report (i.e., on what we referred to in our prior comments as the "full AOA").

18. Our prior comments had recommended that rather than using the 2010 "full AOA" as its exclusive reference point, the final guidance be expanded to include a discussion of the outcomes using the more generally applicable 2008 "partial AOA" (i.e., the interpretation set out in the Commentary on Article 7 in the 2008 version of the OECD Model Tax Convention) as the primary reference point, while also retaining the discussion of the outcomes under the 2010 "full AOA". The point of our recommendation was two-fold.

19. First, we agreed with the conclusion of the Action 7 final report the existing rules of Article 7 of the OECD Model Tax Convention and the guidance concerning the attribution of profits to PEs thereunder did not require substantive modification as a result of the Action 7 changes but that further guidance was necessary on how *those rules* would apply to the new PEs created by Action 7. In other words, we believe it is useful for the new guidance to be anchored in an identifiable framework of PE profit attribution principles, particularly a framework that is already as well developed as the AOA (whether the partial or full version). We repeatedly stressed, and we continue to believe, that it would not be possible for the new guidance to provide definitive answers on how profits would be attributed under principles that varied from the AOA. Indeed, the AOA itself was developed to address the problem that the pre-AOA practices of OECD and non-OECD countries regarding the attribution of profits to PEs and their interpretations of Article 7 varied considerably. The very widespread embrace of the partial AOA, by OECD and non-OECD countries alike, reflected in the 2008 OECD Model Tax Convention (as evidenced by OECD countries' official Recommendation thereon and non-OECD countries' publicly recorded positions thereon) represented a major step forward in international harmonization of the principles for interpreting the most commonly used text of Article 7.

20. Second, in light of the simple fact that the vast majority of treaties in force contain a version of Article 7 that pre-dates the version found in the 2010 OECD Model (with most being based either entirely or much more closely on the version of Article 7 found in the 2008 OECD Model), we thought the new

guidance would have much greater usefulness as a practical matter if it included an explanation of how profits would be attributed under principles based on the partial AOA (i.e., the interpretation of Article 7 set out in the 2008 Commentary).

21. The new DD takes a radical step away from the certainty we hoped would be achieved by our recommendation of basing its guidance on the most widely embraced version of the AOA. Instead, it purports to set out “high level general principles” that would be “relevant for all countries, regardless of their approach to attributing profits to PEs”. The result is the creation of substantial new uncertainty, particularly since the DD’s guidance does not always seem aligned with either the partial or full AOA and it contains no explanation of how its publication might affect, if at all, countries’ previously announced acceptance of AOA principles for interpreting an Article 7 based on the OECD Model (whether the 2010 or earlier version of the Model). Moreover, the DD creates great uncertainty by its seemingly contradictory statements about the applicability of its guidance, in one breath saying that it contains “high level general principles” that would be “relevant for all countries, regardless of their approach to attributing profits to PEs”,<sup>2</sup> and in the next breath saying that while the analysis in its examples is based on the full AOA, “the approach to the attribution of profits to a PE, including the applicability of the AOA, in any particular case will be governed by the applicable tax treaty”.<sup>3</sup>

22. ***Suggestion:* Accordingly, we reiterate our 2016 recommendation that the final guidance use the partial AOA as its primary reference point, while also including a discussion of the outcomes under the full AOA. Any attempt to state conclusions on how profits would be attributed outside the framework of the AOA principles should be expressly limited to situations where the text of Article 7 in the relevant treaty varies materially from either the 2008 or 2010 OECD Model or where the relevant treaty partner has publicly rejected any application of AOA principles in its interpretation of Article 7.**

#### **B. Form and status of the guidance**

23. Like the 2016 DD, the DD does not address the question of the form the final guidance will take, nor what status it will have. We note that the 2008 and 2010 Reports were developed, like the *Transfer Pricing Guidelines*, as consensus documents and were both the subject of Council Recommendation C(2008)106, reflecting the strong political commitment OECD member countries expressed in favor of applying the Reports’ guidance in interpreting their treaties based on either the 2008 or 2010 version of MTC Article 7.

24. ***Suggestion:* The IAPT recommends, at least for purposes of providing certainty as to the commitment of OECD member countries to a particular interpretation, that the final guidance to be provided on the attribution of profits to Action 7 PEs, even if otherwise published as a free-**

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<sup>2</sup> DD, introductory box.

<sup>3</sup> DD, paragraph 22. See also DD, paragraphs 15 (“The mechanism to determine the attribution of risk assumption to a PE will depend on the applicable tax treaty in a given case.”) and 16 (“The AOA uses the notion of ‘significant people functions’ for attributing risk assumption and economic ownership of assets to a PE.”).

**standing Report, should effectively be treated as a supplement to the AOA Reports, and should be the subject of an updated version of Council Recommendation C(2008)106.** It would also make sense for an appropriate reference to the final guidance to be included in updated Commentary to Article 7, including both the current version of Article 7 and the pre-2010 version preserved in current editions of the MTC.

25. The IAPT recognizes that with the participation of so many non-OECD countries in the development of the Action 7 guidance through the BEPS Project's inclusion of non-OECD G20 and other countries, particularly under the Inclusive Framework (IF), an OECD Report, Council Recommendation, and MTC Commentary update may not provide an appropriate mechanism for allowing non-OECD countries to express their level of commitment to the final guidance's conclusions. Nevertheless, it will obviously be important to know the positions of those countries, not only to give certainty to taxpayers but also to allow those countries' treaty partners to know what the implications might be of agreeing to include the new Action 7 definitions of PE in their treaties with those countries. Indeed, as direct participants in the development of the new guidance, members of the IF should be considered to have undertaken a moral and political commitment to follow the guidance, or at the very least to be transparent as to their position vis-à-vis the guidance. A core feature of the OECD's traditional contribution to improved conditions for international trade and economic growth has been its practice of having member countries publicly state their political commitment to abide by the standards they have participated in developing or otherwise agreed to adopt. The creation of the IF offers a great promise that this type of consensus-building will have a much wider positive impact on the world economy. But that promise will be fulfilled only if the IF members are willing to adopt similar commitments to consistency and transparency as has traditionally been the case for OECD countries. The finalization of the Action 7 guidance should be viewed as an important early signal of whether the IF represents the desired strengthening, or a worrying erosion, of the OECD's long-standing institutional advantages.

26. ***Suggestion:* The IAPT suggests that a mechanism be provided in connection with the final guidance through which non-OECD countries participating in the IF will be required to express publicly their level of commitment to applying the new guidance in interpreting their treaties, including their commitment to applying the AOA (whether the full or partial AOA, as appropriate) in interpreting their treaties that contain an Article 7 based on the 2010 or pre-2010 MTC. The expression should relate not only to the new AOA guidance being developed under Action 7, but also to the entirety of the full or partial AOA.<sup>4</sup>**

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<sup>4</sup> If countries are not clear about their position vis-à-vis the application of the basic AOA principles, it is likely that significant (and otherwise unnecessary) disputes could arise as to whether a PE which exists post-Action 7 would also have existed under the pre-Action 7 version of Article 5.

### **III. Comments on the General Principles for Attributing Profits to PEs Resulting from Changes to Article 5(5) and 5(6) and the Commentary**

27. As indicated in our introductory comments, we believe the “high-level general principles” laid out in paragraphs 8-21 of the DD should be replaced by a reference to the partial and full versions of the AOA. That being said, we would like to comment on a few points covered in those paragraphs.

#### **A. Interaction of Analysis under Article 7 and Article 9**

28. In response to a question raised in the 2016 DD, the IAPT’s September 2016 comments said we had doubts that it should make a difference to the ultimate outcome whether one applies first the Article 9 analysis or the Article 7 analysis, but we believed it made much more sense, and was more faithful to the principles of the AOA and of general application of treaties, to do the Article 9 analysis first. We continue to hold that view, and we were particularly concerned by Example 2 of the 2016 DD, which appeared to treat certain risks as allocable to a separate local affiliate under Article 9 but also allocable to the foreign enterprise’s local PE under Article 7, which resulted in double allocation of related profit to the PE country.

29. We were therefore disappointed that the new DD did not resolve the question of which analysis should be done first, but left it to countries to decide. We were nevertheless pleased to see that the new DD states at paragraph 12 that “any approach to the application Articles 7 and 9 to cases of deemed PEs under Article 5(5) must ensure that there is no double taxation in the source country, i.e., taxation of the same profits in the hands of the PE (under profit attribution rules) and in the hands of the intermediary (under transfer pricing rules).”<sup>5</sup> That being said, this prohibition against double source country taxation is such an important point that our view is that it should be enshrined in guidance which has appropriate status to ensure it will be followed by all countries.

30. ***Suggestion: See our comments above on the recommended form and status of the final guidance.***

#### **B. Effect of Article 9 Analysis on Existence of a PE under Article 5(5)**

31. In our September 2016 comments on the 2016 DD, we had raised the point that an attribution of risk under an Article 9 analysis away from the foreign enterprise that may bear that risk as a formal matter under the relevant contracts to a local affiliate that is found to bear that risk in substance could call into question whether the local affiliate would ultimately be treated under Article 5(5) as acting “on behalf of” the foreign enterprise – a condition for the finding of a PE under Article 5(5) – as opposed to acting on its own behalf. We note that paragraph 14 of the DD rejects the notion that the risk reallocation recognized as necessary to properly apply Article 9 could have any effect on the application of Article 5(5).

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<sup>5</sup> This concept is effectively reinforced by paragraph 18 of the DD, which states: “where a risk is found to be assumed by the intermediary under the guidance in Section D.1.2 of Chapter I, such risk cannot be considered to be assumed by the non-resident enterprise or the PE for the purposes of Article 7.”

32. With respect, we suggest that paragraph 14 purports to arrive at a legal conclusion regarding the application of Article 5(5) which is likely outside the scope of the mandate for the Action 7 work on clarifying PE profit attribution principles under Article 7 and which also may very well be in conflict with legal principles (including, e.g., substance over form principles) that apply in various countries for purposes of their tax law, including such principles as apply for purposes of those countries' interpretation of their treaties. Contrary to what is stated at paragraph 14, such principles may require a legal conclusion for tax purposes in such countries that the local affiliate is not in fact acting "on behalf of" the foreign enterprise, notwithstanding the form of the contracts.

33. ***Suggestion: We therefore recommend deletion of DD paragraph 14 from the final guidance.***

### **C. Administrative Approaches to Enhance Simplification**

34. In its comments filed on the 2016 DD, the IAPT welcomed the invitation in that document to suggest mechanisms to provide additional coordination for the application of Articles 7 and 9. Our comments specifically recommended consideration of a mechanism that would allow foreign enterprises that would otherwise have a PE in a Contracting State because of the fact that a related party in that State causes them to have a dependent agent PE or fixed place of business PE to elect out of PE status if the related person elects to be taxable in that State on the sum of: (i) the profits that would otherwise be taxable to that related person and (ii) the profits that would otherwise be taxable to the PE. We provided specific suggestions for treaty language to implement this suggestion, along with a detailed explanation of the mechanics, and we also offered to work with the delegates to refine that mechanism or develop an appropriate alternative administrative approach to enhance simplification in such cases. We suggested that finding an administratively convenient way to deal with such cases, which would often involve little or no profit attributable to the PE, would be to the benefit of both tax administrations and taxpayers in reducing the compliance burdens of both.

35. We were therefore sorely disappointed that the DD, at paragraphs 20-21, paid no more than lip service to the notion of finding an administratively convenient procedure to simplifying taxpayers' compliance with tax obligations related to the existence of a PE in the source country. The DD simply reiterated a decade-old statement from the original PE Profit Attribution Report which says that a number of countries actually collect tax only from the intermediary even though the amount of tax is calculated by reference to activities of both the intermediary and the Article 5(5) PE. The DD provided no new information on which countries those might be or how such a procedure might work, and then in a resoundingly weak statement it noted that nothing in the DD should be interpreted as preventing host countries from continuing or adopting that kind of administratively convenient procedure.

36. ***Suggestion: The IAPT recommends that the OECD and the IF rededicate themselves to trying to find an administratively convenient mechanism they can endorse to simplify the host country tax and reporting obligations faced by nonresident enterprises found to have Article 5(5) PEs.***

#### IV. Comments on the Examples Illustrating the Attribution of Profits to Deemed PEs under Article 5(5)

37. We note that the introduction to the examples relating to Article 5(5) states that their analysis is based on the full AOA, but that “the approach to the attribution of profits to a PE, including the applicability of the AOA, in any particular case will be governed by the applicable tax treaty.”<sup>6</sup> This raises serious questions about the extent to which the examples provide any useful guidance for how profits would be attributed under any treaty that does not include the 2010 OECD Model Tax Convention version of Article 7 (i.e., the overwhelming majority of treaties currently in force around the world). This simply underscores the very real practical need for the final guidance to be anchored to a framework of PE profit attribution principles that is well understood and widely (if not universally) applicable, as we recommend above.

38. Before addressing the individual examples, we would like to mention some common issues that these examples pose. The 2016 DD examples were deficient in that they did not make any serious attempt to characterize the “dealings” that were taking place between the PEs and the rest of their enterprises, a critical step under the AOA to determining the PE profits. The examples in the new DD are somewhat better in that they seem to implicitly characterize those dealings (by describing the way in which the PE profits will be measured), but without providing any guidance on the principles that would be applied in identifying and characterizing those dealings.

39. ***Suggestion:*** The final guidance should include a better articulation of how dealings in particular cases are characterized and what principles govern the determination of the characterization that applies. Identifying the character of the dealing is critical to the ability to identify appropriate comparables to price the dealing. The example should also include a rationale for the characterization under different types of new PEs created by the changes to Article 5(5).

40. The DD’s examples posit the applicability of a treaty under which “the profits attributable to a PE are the profits that the PE would have derived 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 PE and through other parts of the enterprise”. What is interesting about this description is that it does not faithfully describe either the 2010 or the 2008 version of Article 7 in the OECD Model Tax Convention (and therefore fails to correspond to most treaties actually in existence). The formulation is more similar to the 2010 version of Article 7 with its explicit reference to functions, assets, and risks (i.e., familiar buzzwords from the *Transfer Pricing Guidelines*), but it lacks that version’s explicit reference to the profits the PE would make “in particular in its dealings with other parts of the enterprise”.

41. ***Suggestion:*** Any examples in final guidance should include a reference to one or more specific versions of Article 7 that are likely to correspond with the language found in a large

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<sup>6</sup> DD, paragraph 22.

**number of actual treaties, ideally the version of Article 7 found in the 2008 OECD Model Tax Convention, if not also the version found in the 2010 OECD Model.**

42. As outlined below, the examples in the DD are also very lean if not completely lacking in any articulation or analysis of key issues that arise in any effort to apply Article 7 to PEs, including how to attribute risks to the PEs, how to attribute assets to them, how to determine the transfer pricing method applicable to pricing “dealings” between the PE and the rest of the enterprise, and how to determine the category and amount of expenses attributable to the PE. The lack of guidance on these key points is a direct result of the decision to strip the revised guidance of any detail comparable to that found in the examples contained in the 2016 DD. Consequently, the new DD’s guidance amounts to little more than a restatement of the treaty language governing PE profit attribution.

**A. Example 1 – Commissionnaire Structure (Related Intermediary)**

43. This example implicitly characterizes the “dealing” taking place between the home office of TradeCo and the dependent agent PE created by the activities of SellCo acting as TradeCo’s commissionnaire as a deemed sale of widgets to the PE, followed by a resale of the widgets by the PE to the actual customers. The effect is to place all the customer sales revenue into the PE and to begin the PE profit calculation from there. The example provides no explanation of what principles would allow a determination that the dealing should take that form (as opposed to, for example, a resale of selling services by the PE to the home office). For example, it does not provide any basis for determining whether the PE created by SellCo’s activities is undertaking functions, assuming risks, or using assets that would suggest it is acting as an entrepreneur in purchasing and reselling widgets.

44. Moreover, the example asserts that the analysis would be the same if SellCo was not acting as a commissionnaire but was instead acting as a sales agent for TradeCo. This assertion likewise is devoid of any analysis on why a sales agency PE necessarily must be characterized as a buyer-reseller for Article 7 purposes.

45. ***Suggestion:* As indicated above, any example in the final guidance should include an articulation of what principles apply to inform the characterization of dealings between the PE and the rest of the enterprise and the manner in which those principles apply to the particular case. It should also include a rationale for the characterization under different types of new PEs created by the changes to Article 5(5).**

46. This example is also remarkably devoid of any analysis of other key issues that would arise in attempting to apply Article 7 to this type of arrangement, such as: (i) where risks (e.g., with respect to inventory and receivables) would be allocated as among the head office, the PE, and SellCo; (ii) where economic ownership of assets (e.g., inventory, receivables, marketing intangibles) should be attributed; (iii) what transfer pricing method should govern pricing of the dealing; and (iv) how to attribute expenses to the PE.

47. ***Suggestion:* Any example in the final guidance should include some discussion of how to resolve the key issues that arise in applying Article 7, including attribution of risks and assets, selection of transfer pricing method, and attribution of expenses.**

**B. Example 2 – Sale of Advertising on a Website (Related Intermediary)**

48. As in the case of Example 1, Example 2 implicitly characterizes the “dealing” between SiteCo’s home office and its PE as a deemed sale of advertising space, which the PE is then deemed to resell to third party customers with the marketing assistance of its affiliate, SellCo. Also as in the case of Example 1, the DD provides no explanation of how it reaches that characterization (as opposed to, for example, a dealing in the nature of the provision of marketing services). This is particularly an issue where the sale by SiteCo is not actually concluded by SellCo or the PE in Country S but is instead concluded at SiteCo’s home office in Country R.

49. Similarly, Example 2 does not address most of the key issues that would be likely to arise in respect of attributing profit to a PE in this scenario, such as: (i) where risks (e.g., market, receivables risks) are allocated as between the home office, the PE, and SellCo; (ii) where economic ownership of assets (e.g., receivables, marketing intangibles, website rights) is attributed; (iii) what transfer pricing method should govern pricing of the dealing; and (iv) how to attribute expenses to the PE.

**C. Example 3 – Procurement of Goods (Related Intermediary)**

50. Example 3, which involves a deemed PE ostensibly created by BuyCo’s activity in Country S as a buying agent on behalf of TradeCo, raises a number of different issues and questions.

51. An initial question is whether the widget purchase contracts concluded by BuyCo on TradeCo’s behalf constitute the type of contract that gives rise to a deemed PE under Article 5(5). The Commentary on Article 5 clearly states that not all contracts concluded by a dependent agent on a foreign principal’s behalf will give rise to a deemed PE under Article 5(5). See, for example, paragraph 33 of the Commentary, which states:

The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person’s activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only.

52. This raises the question of whether purchase contracts, which by definition are not revenue-generating, can ever constitute the “business proper” of the enterprise, even in the context of an enterprise that is engaged in trading. If the purchase of widgets can create a PE for a trading company, can it do the same for a manufacturing company that will use the widgets as a component in finished products it will later sell, or for a services company that will use the widgets as part of the equipment or supplies it needs to provide services to customers? If the hiring of employees is not the type of contract that can trigger Article 5(5) (apparently even in the case of an enterprise that may employ those individuals in the course of its provision of services to customers), why would the purchase of widgets trigger an Article 5(5) PE? Example 2 should not immediately jump to the conclusion that a deemed PE is created on its facts without addressing these foundational questions.

53. Similarly, Example 3 provides no explanation of why it is assumed that BuyCo's activity in the nature of purchasing goods for TradeCo exceeds the "preparatory or auxiliary" threshold that activity would have to pass under the new Article 5(4) in order to create a deemed PE for TradeCo, other than a bald statement that "TradeCo "has as its core business the procurement and sale of widgets". The new Commentary on Article 5(4) will say that the purchasing exception "will typically not apply in the case of a fixed place of business used for the purchase of goods or merchandise where the overall activity of the enterprise consists in selling these goods and where purchasing is a core function in the business of the enterprise". However, the Commentary does not shed light on whether purchasing constitutes a "core function" of a trading company other than through an example which refers to "experienced buyers who have special knowledge of this type of product and who visit producers in State S, determine the type/quality of the products according to international standards (which is a difficult process requiring special skills and knowledge) and enter into different types of contracts (spot or forward) for the acquisition of the products". The clear implication of this Commentary language and example is that purchasing is not a core function for every trading company, and that special circumstances must exist to make it so.

54. ***Suggestion:*** While the IAPT supports the concept of including in the final guidance an explanation of how the PE profit attribution rules will apply to PEs engaged in purchasing activities, we recommend that such guidance include sufficient explanation about the foundational issues of when purchasing can give rise to a PE not to mislead readers into thinking that will inevitably be the case.

55. We note that Example 3 contains no reference to the fact that the pre-2010 version of the OECD Model Article 7 included a paragraph 5 which said: "No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise."

56. ***Suggestion:*** Since the pre-2010 Article 7(5) language appears in many hundreds if not thousands of treaties currently in force, we believe it would be prudent for the final guidance to alert readers to the fact that even if purchasing activities do give rise to a PE under the new version of Article 5, a very commonly applicable version of Article 7 may nevertheless preclude the attribution of any profits to such a PE.

57. As in the case of the prior examples, Example 3 would be improved by the inclusion of guidance on why the example implicitly characterizes the dealing as a resale of widgets by the PE to TradeCo's home office after deeming the PE to have purchased the widgets from third party suppliers (as opposed to, e.g., the provision of procurement services by the PE to the home office) and on the other types of issues that would typically arise under Article 7 (e.g., where risks such as market, inventory, payables risks are allocated as between the home office, the PE, and BuyCo, where economic ownership of assets such as inventory and purchasing expertise is attributed, what transfer pricing method should govern pricing of the dealing, and how to attribute expenses to the PE).

**V. Comments on General Principles for Attribution of Profits to PEs Resulting from Changes to Article 5(4) and Commentary**

58. Regarding the DD’s description of the general principles applicable to anti-fragmentation rule cases, we were struck by the following sentence in paragraph 41 of the DD: “Profits attributed to the PEs and subject to source taxation are the *profits derived from the combined activities* constituting complementary functions that are part of a cohesive business operation considering the profits each one of them would have derived if they were a separate and independent enterprise performing its corresponding activities, *taking into account in particular the potential effect on those profits of the level of integration of these activities*” (emphasis added). We find the highlighted language troubling on two fronts.

59. First, the anti-fragmentation rule applies to situations where activities (and related profits) are divided between two or more separate entities (which may be resident in different countries), and the profit attributed to any single entity affected by the anti-fragmentation rule will be the separately determinable profits of that PE, not some share of the combined profits of multiple entities. In other words, the anti-fragmentation does not require application of any kind of profit split between the relevant foreign enterprise’s affected PE and the affiliate whose activities are taken into account in determining the existence of a PE for that foreign enterprise. So the language referring to “profits derived from the combined activities” is potentially misleading and should be omitted.

60. Second, the DD provides no explanation of what is meant by the reference to the effect of the level of integration on the profit determination of any individual PE. There is nothing in the AOA guidance or any existing guidance under Article 7 to suggest that the attribution of profits to the individual PE of a foreign enterprise which is a member of a group will vary depending on whether or not another member of the group carries out activities in the PE jurisdiction (even though those activities may determine whether the first PE exists under Article 5).

61. ***Suggestion:* The IAPT recommends deletion of the sentence at paragraph 41 which refers to “profits derived from the combined activities” and “the potential effect on those profits of the level of integration of these activities”, since those references create misleading impressions about the applicability of profit split methods to PE profit attribution and are unaccompanied by any explanation of their significance.**

**A. Example 4 – Warehousing, Delivery, Merchandising and Information Collection Activities**

62. Example 4 says its analysis is the equivalent of “attributing to the PE the rights and obligations associated with the purchase of the storage and delivery services resulting from the contracts to which Article 5(5) relates”. We find this statement troubling, for two reasons.

63. First, the facts of Example 4 contain no reference to Article 5(5) contract activity in Country S. Instead, the Example premises its PE determination on the basis that OnlineCo’s separate office and warehouse in Country S constitute “fixed place of business” PEs under Article 5(1).

64. Second, the facts include no description of who within OnlineCo performs the significant people functions involved in leasing the warehouse, hiring independent service providers for delivery, etc. In other words, the Example implicitly characterizes the situation as if the warehouse PE leased the warehouse from the owner and engaged the third party delivery service providers, and was attributed OnlineCo's related assets and risks linked to those functions, then turned around and provided storage and delivery services to the home office. However, the facts could just as easily (if not more easily) accommodate a characterization that the home office performed the significant people functions relevant to leasing the warehouse and engaging the third party service providers, and that the PE provided only the services undertaken by OnlineCo's employees based in the warehouse. That could be a materially different risk and asset profile than the one suggested by the Example's implicit characterization of the dealing.

65. ***Suggestion:* Example 4, like the previous examples, should not imply a characterization of the “dealing” between the PE and the home office which is not supported by the facts of the example and which is not based upon the functional analysis required by the AOA.**

66. Example 4 says that for activities undertaken by the home office for the PE, the expense deduction of the PE equals “an arm's length allocation of expenses associated with these activities, or, under the AOA, a ‘dealing’ between the PE and OnlineCo (as home office) associated with OnlineCo's activity on behalf of the PE”. This statement appears to draw a stark line between a mere allocation of costs under treaties that do not adopt the 2010 version of Article 7 and an arm's length “dealing” under treaties that do, and it further seems to suggest that the “dealing” approach will necessarily involve a markup on costs.

67. In fact, however, the question of how to allocate expenses to a PE was the subject of considerable attention during the development of the “partial AOA” reflected in the 2008 Commentary on the 2008 Model version of Article 7 and the “full AOA” reflected in the 2010 Commentary on the 2010 version of Article 7.<sup>7</sup> That guidance does not come down to such a binary decision between “an arm's length allocation of expenses associated with these activities, or, under the AOA, a ‘dealing’ between the PE” and the home office. Countries following the 2008 guidance under the pre-2010 version of Article 7 will sometimes allocate expenses based on actual cost and sometimes based on pricing a “dealing” which may (or may not) involve a markup on costs or some other pricing method (depending on guidance provided by the *Transfer Pricing Guidelines*).

68. ***Suggestion:* The final guidance should not provide ambiguous statements about the principles governing the allocation of expenses to PEs, but should instead explain the principles that apply under the partial and full AOA and the circumstances under which each set of principles applies. It should also explicitly confirm the principle that in determining the profits of a PE, there shall be allowed as deductions expenses which are incurred for the purposes of the PE, including**

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<sup>7</sup> See, e.g., paragraphs 31 *et seq.* of the 2008 Commentary on Article 7 and paragraphs 40 *et seq.* of the 2010 Commentary on Article 7.

**executive and general administrative expenses so incurred, whether in the State in which the PE is situated or elsewhere.**

69. As indicated above, there is no explanation in the DD of whether the “integration” of activities under Article 5 produces a different PE profit attribution result than if each was a PE on its own. If delegates believe that the profits of either PE in Example 4 would differ based on the existence of the other PE, the Example should explain why that is the case and how that difference would be computed.

70. As with the prior Examples, Example 4 does not provide any guidance on key Article 7 issues that would be likely to arise in the situation covered (e.g., what assets or risks of OnlineCo get attributed to the PE (e.g., inventory at the warehouse and associated risks? marketing intangibles used by the office?).

71. Perhaps most surprisingly, Example 4 involves a set of facts which arguably could have resulted in the finding of multiple PEs under the pre-BEPS version of Article 5, since it involves a fragmentation of activities by a single foreign enterprise (OnlineCo) of the type that was targeted by the pre-BEPS version of the anti-fragmentation principle in paragraph 27.1 of the Commentary on Article 5. By contrast, what is new about Article 5(4.1) resulting from BEPS is that it addresses the fragmentation of activities across more than one separate enterprise within a group.

72. Because the Example involves one company only, it fails to address a number of the PE profit attribution questions that were raised during the consideration of new Article 5(4.1) including the following: (i) what if PEs arise for group members from different residence countries?; (ii) what guarantee does the MNE group (and treaty partners) have that Country S will not tax more than 100% of total profit of the multiple PEs involved?; (iii) is there a mechanism for resolving the potential disputes, with multi-country implications, that could arise?

73. ***Suggestion:* If the final guidance is going to include guidance on PE profit attribution issues that arise under the new anti-fragmentation rule of Article 5(4.1), it should have an example that involves the newly affected situations (i.e., where a PE is found based on activities of a separate enterprise) and should address the variety of new questions that arise when a source country is attributing profits under that rule to the PEs of separate enterprises.**

\* \* \* \* \*



## ICC Comments on OECD Discussion Draft on “Additional Guidance on Attribution of Profits to Permanent Establishments” – BEPS Action 7

The International Chamber of Commerce (ICC) welcomes the opportunity to comment on the OECD Discussion Draft on “Additional Guidance on Attribution of Profits to Permanent Establishments”. The revisions to the definition of permanent establishment (PE) both in the Model Tax Convention (MTC) and the Commentary under BEPS will potentially result in a vast number of artificial PEs of non-resident enterprises in host countries. In the coming years, all Tax Administrations and Multinational Enterprises (MNEs) will have to deal with more taxation and double taxation issues related to PEs. Bearing in mind that the Authorised OECD Approach (AOA) for the attribution of profits to PEs has not been accepted and adopted in the majority of the recent Double Tax Treaties (DTT), the work of the OECD in developing Additional Guidance on Attribution of Profits to PEs (AG) would be substantial. As the world business organization, we believe that it would be helpful to have practical solutions to the potential taxation problems from the current OECD initiative for the Discussion Draft on AG.

ICC appreciates that the current initiative serves as a starting point to address domestic and international double taxation problems which may arise from the newly invented artificial PEs.

In the first instance, we would like to consider the basic expectations for business with respect to the Draft AG regarding the international application of the new PE definitions both in the MTC and the Commentary. If the international business community cannot predict the potential outcome of the new developments, the new enlarged PE definitions could lead to increased uncertainty and potentially negative outcomes. Consequently, ICC would welcome practical solutions and clear examples for the international application of the new enlarged PE definitions.

In this regard, ICC would welcome a concrete response to the following question.

*What is the implication in terms of the international application of “intermediary habitually concludes contracts (or habitually plays the principal role leading to the conclusion of contracts) that are routinely concluded without material modification by the non-resident enterprise”, and “contracts are either in the name of the enterprise, or for the transfer of ownership of, or for the provision of services by the non-resident enterprise” in paragraph 14?*

We have not observed a particular explanation and/or example in the Draft AG for the solution of taxation and double taxation problems which may arise from the border line cases relating to the new PE definitions.

ICC believes that if the Draft AG does not provide adequate explanation and/or examples to exclude from the international application of the potential overstated definitions of new PEs of non-resident enterprises in the host country, then it is expected that businesses may have to deal with artificial taxation, double taxation, tax liability and tax responsibility problems domestically and internationally in everyday trade, which would be contrary to the OECD and G20 goals with the BEPS project.

It should be recognised that world trade cannot be developed or maintained at its current level unless independent intermediary activities are respected. The world business community



requires the work of intermediaries to be able to trade internationally. Intermediaries need to source potential clients for goods and services, as well as explain the merits and prices of goods and services to those clients (or even demonstrate the products, if possible). Any of the above mentioned intermediary activities involving the approach of potential clients may be interpreted as “playing the principal role leading to the conclusion of contracts”, unless the intermediary habitually concludes contracts on behalf of the non-resident enterprise in the host country.

ICC welcomes the efforts made by the OECD with respect to the development of partial attribution of profits between non-resident enterprise PE and intermediary according to the service provided by the intermediary to the non-resident enterprise in paragraphs 8-19 of the Draft AG.

However, we believe that unless the Draft AG includes specific examples for the partial attribution of profits, Tax Administrations of the host country may have a tendency to neglect to attribute any profits to intermediaries for their services provided to non-resident enterprises, and attribute all profits to the non-resident enterprise PE derived from the international trade of goods and services. The implications of such an application would necessarily lead to domestic and international double taxation for the international business community.

ICC also welcomes the initiative taken by the OECD in the Draft AG for the elimination of double taxation of the same profit which will arise in the host country after the attribution of profits to the non-resident enterprise PE (under profit attribution rules), and the profit adjustments for the intermediary (under transfer pricing rules). However, we note that there is a lack of guidance for Tax Administrations relating to the priority of the attribution of profits or adjustments and determination of arm’s length transactions. Therefore, we would recommend that adequate guidance be included in the Draft AG for the priority of profit attribution or adjustment for intermediaries in the host country in order to eliminate domestic double taxation and determination of arm’s length transactions where no similar homogenous goods are produced and no homogenous similar services are provided. Beyond this, the Draft AG should also provide guidance to eliminate double taxation in the resident country due to the complex profit attribution and adjustment of the tax administration of the host country as well as for any withholding that could be considered to be triggered by such attribution, if any.

The Draft AG refers to situations where the net amount of profits attributable to the PE may be either positive, nil or negative (i.e. a loss), subsequently it only makes reference to “minimal or even zero” profit situations. Further explanations and explicit recognition of these cases would be required in order avoid providing the misleading conception that only profits are derived from such legitimate structures.

ICC respectfully requests that the OECD includes recommendations in the Draft AG to Tax Administrations of host countries to select either attribution of profits under Article 7, or adjustments of profits under Article 9, in cases where the intermediary is also an associated enterprise of the non-resident enterprise. Otherwise, the risk allocation for the purposes of attribution of profits to the PE, and for the purposes of adjustment of profits of the PE as an associated enterprise would conflict with each other.



In conclusion, ICC considers that the explanations and examples given in the Draft AG are generally quite helpful. However, we would welcome the inclusion of further explanations and/or examples for the above mentioned problem areas to eliminate domestic and international double taxation which is expected to arise as a result of the new BEPS definitions.



## The International Chamber of Commerce (ICC) Commission on Taxation

ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy.

Founded in 1919, and with interests spanning every sector of private enterprise, ICC's global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.

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The Tax Treaties, Transfer Pricing and Financial Transactions Division  
Centre for Tax Policy and Administration  
Organization for Economic Cooperation and Development

Accounting & Tax Committee  
Japan Foreign Trade Council, Inc.

**Comments on Discussion Draft on Action 7 (Additional Guidance on 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 Public Discussion Draft on “BEPS Action 7: Additional Guidance on Attribution of Profits to Permanent Establishments” released on June 15<sup>th</sup>, 2017.

JFTC is a trade-industry association with Japanese trading companies and trading organizations as its core members. One of the main activities of the 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**

We appreciate the opportunity to comment on Discussion Draft: BEPS Action 7 – Additional Guidance on Attribution of Profits to Permanent Establishments (hereinafter referred to as the “Discussion Draft”) issued on 22 June 2017.

For the most part, we welcome the Discussion Draft’s effort to streamline the application of Article 7 and Article 9 of the MTC. We appreciate the fact that the Discussion Draft clearly states the order in which Article 7 and 9 are applied “should not impact the amount of profits over which the source country has taxing

rights,” suggesting that no income in the source country should be subject to double taxation.

However, the Discussion Draft, also points out that “the host country’s taxing rights are not necessarily exhausted by ensuring an arm’s length compensation,” meaning that the concepts incorporated within Article 7 and 9 are not always in alignment nor is it interchangeable, hence there should be differential in the recognized attributable profit for certain cases. We find this point slightly difficult to acknowledge. It is hard to visualize a situation where significant difference arises due to the approach, provided that facts and contractual terms are properly taken into consideration. In this regard, we would like to request further guidance, if not specific examples, should there be such case where misalignment is assumed to occur.

Thus, we urge the application of Article 7 to a DAPE to be exempted where the relevant DAE is sufficiently rewarded under Article 9, in order to ensure efficiency for both taxpayers and tax administrations and mitigate tax uncertainty.

### **Specific Comments**

#### **[Administrative approaches to enhance simplification]**

Though we appreciate the Discussion Draft’s effort to enhance simplification, we fear that such approach may inadvertently lead to the increase in the administrative burden for the DAE. It should especially be noted that, by integrating the non-resident enterprise’s compliance duty, the DAE is likely to be exposed to excessive administrative burden as it would be prompted to comply with the non-resident enterprise’s reporting obligations, for which it does not readily have necessary data or access thereof. In this regard, we suggest that the attribution of profit for the DAPE be exempted, where the analysis under Article 9 has been performed appropriately.

We believe that there may be cases where the tax authorities would make reckless adjustments to the profits of the DAPE through unfounded assessments made to the profits attributable to the DAE by adopting this approach. We urge that even in cases where the DAPE’s assessment is integrated to that of the DAE, a clear delineation of the rationale behind the adjustments made to each entity be

disclosed.

**[Example 1]**

According to the calculation method shown in the example, the profits attributable to the PE would equal to the amount of TradeCo's revenue from sales of goods to customers in Country S minus:

- (1) the amount that TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S (hereinafter (1) ALP)
- (2) other expenses wherever incurred, for the purposes of the PE, and
- (3) the arm's length remuneration of SellCo

However, we feel that the calculation process illustrated above does not accurately reflect the real-life business practice— it is not so much that TradeCo appoints SellCo in order to increase the total amount of revenue from customers in Country S, but rather does so merely in an effort to further its business in Country S. In such case, the arm's length remuneration to SellCo is paid from the total sum of revenue generate, which would be the same amount regardless of whether TradeCo appoints SellCo or an unrelated party performing the same or similar activities. Under the above presumption, the profits attributable to the PE would almost certainly be a negative figure and would not be an appropriate reflection of the actual conditions of business.

Also, upon ascertaining the amount of (1)ALP, it should be noted that obtaining and maintaining ready access to arm's length price would be extremely difficult in practice and applying this method transaction-wise would prove to be an excessive compliance burden for the taxpayers. We suggest that a simplified method such as entity-wise calculation be allowed as alternative.

**[Cases 2, 3]**

Please refer to the comments on Example1. (The same can be said for the difficulties in obtaining and maintaining the data for (1) ALP in Example 2 and “Amounts” in Example 3)

**[Case 4]**

Though activities carried out at the warehouse and office are treated as one single activity when defining a PE through Article 5, the two are considered to be separate activities when determining the profits attributable through Article 7, and it is concluded in this example that the warehouse and office constitute two separate PEs. The interpretations of Article 5 and 7 are inconsistent and we request the OECD to issue clear guidance on this point.

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15 September 2017

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Response from Joseph L. Andrus and Richard S. Collier

We are writing to provide our comments on the OECD Discussion Draft: BEPS Action 7 – Additional Guidance on Attribution of Profits to Permanent Establishments (the “Discussion Draft”) issued 22 June 2017. The comments in this letter represent the personal views of the authors. The letter is not submitted on behalf of any company or organization, nor have we received compensation from any person or organization for the preparation of this letter.

#### Executive Summary

This letter elaborates on the following important observations regarding the Discussion Draft:

- The Discussion Draft takes a far less detailed approach than did the 2016 discussion draft on the same topic. We understand some of the difficulties that can arise out of a detailed discussion like that in the 2016 discussion draft. In particular, we understand many of the challenges of reaching agreement in the Working Party on a detailed elaboration of the interactions between the transfer pricing rules and the rules on attribution of profits to permanent establishments. Nevertheless, our view is that the 2017 Discussion Draft is overly general and as a result does not provide sufficient guidance on how the rules under BEPS Action 7, the 2010 Report on the Attribution of Profits to Permanent Establishments, and the new transfer pricing guidance promulgated under Actions 8 – 10 of the BEPS Project can be reconciled as a technical matter.
- If the OECD nevertheless persists in taking a very general approach that focuses primarily on high level principles, we believe that it is imperative that the following high-level principles are clearly articulated as an element of the required approach in those cases involving dependent agents that are

already compensated in accordance with the transfer pricing rules of Article 9:

1. The relevant return for the functions performed by the agent should be taxed only once.
  2. Priority should be accorded to taxation of the agent/ intermediary under the transfer pricing rules of Article 9.
  3. There should be no profit to be taxed in the dependent agent PE unless that dependent agent PE is attributed functions, risks, or assets, the returns from which would not otherwise be taxable in the source country were there no PE.
- The transfer pricing rules and the rules on the attribution of profits to permanent establishments focus on properly rewarding the functions, assets and risks of the associated enterprises (and their constituent PEs). In a situation where an associated enterprise acts as an agent or intermediary for a non-resident entity in a way that causes that non-resident entity to have a dependent agent PE in the jurisdiction of the agent, functions performed by the agent in its local jurisdiction should not be rewarded twice. Hence, if the agent receives an arm's length compensation for its functions (as it should in every case), income rewarding the agent's functions should not also be attributed to the PE.
  - We understand (as discussed in greater detail below) that it is conceivable that in some limited situations a PE could properly be allocated income related to risks borne or related to assets contributed. However, the draft should make clear that a dependent agent PE should not receive a function-based reward for functions performed by the dependent agent since the agent should be rewarded for its functions under transfer pricing rules, and providing the PE with a separate functional reward would necessarily create a double reward to functional activities. We believe that if this single point were made very clearly in the Discussion Draft, very many potential disputes could be avoided.
  - We believe that since most situations where a dependent agent PE will be entitled to additional compensation beyond that received by the agent will involve risk attributions, the section of the Discussion Draft on risks is the most important section of the Discussion Draft. We believe quite strongly that that section of the Discussion Draft requires material further elaboration.

Functions, Assets and Risks

One difficulty that arises in connection with the Discussion Draft is attributable to the fact that the BEPS work on Action 7 carries with it the implication that the amended PE threshold rules in Article 5 of the OECD Model offer tax authorities a way of overcoming some of the constraints on source country profit allocations that exist under the transfer pricing rules. Inevitably, this implication has, in practice, already fueled the expansion of challenges under the new PE rules, even though there are very many cases where appropriate PE attribution rules will lead to no greater source country revenues than are collected under the transfer pricing rules.

Basic transfer pricing principles suggest that greater source country taxation can result only from the assertion that a PE exists if either the agent / intermediary, or the PE of a non-resident affiliated company deemed to exist in the source country, is attributed functions, risks, or assets, the returns from which would not otherwise be taxable in the source country were there no PE. We believe that the Discussion Draft should clearly articulate that basic principle.

#### Functions

Confusion can arise in a dependent agent PE situation over the calculation and attribution of an arm's length reward to functions performed. A dependent agent resident in the source country would be required under transfer pricing principles to receive arm's length compensation for the functions it performs in the source country irrespective of the existence of a PE of a non-resident associated enterprise. If the agent / intermediary has been properly compensated for those functions under arm's length transfer pricing principles, a second tier of source country taxation to the PE based exclusively on the agent's performance of those functions would not be appropriate. As a result, additional taxation will result from a determination that a dependent agent PE exists in the country only if the PE is attributed risks or assets that are not attributed under transfer pricing principles to the agent / intermediary in the absence of a PE. The PE cannot be allocated functional returns because those returns are already necessarily attributed to the agent / intermediary and are taxable to it in the source country.<sup>1</sup>

It would be extremely helpful for the OECD to emphasize this point with a view to making tax authority expectations more realistic, narrowing the issues that might be at stake in a given case, and heading off what might otherwise be a proliferation of disputes and a tidal wave of administrative obligations with limited upside to tax authorities.

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<sup>1</sup> We assume in making this statement, as would typically be the case in a dependent agent PE situation, that the non-resident entity's PE has no employees of its own in the source country and thus performs no functions beyond those performed by the dependent agent on its behalf.

The Discussion Draft does suggest that the reward to the agent / intermediary for its services (functions) should be deducted from any income attributed to the PE (see para. 10). This correct principle would be clearer if it were stated in terms that make clear that functional returns to the agent / intermediary which will already have been attributed to the agent under Article 9 arm's length transfer pricing principles cannot be taxed a second time on the basis of being attributed to the PE by the source country. So stating would narrow the focus of any dispute to the proper attribution of rewards to assets and especially risks.

## Assets

In a typical case involving the assertion of the existence of a dependent agent PE, the PE that is asserted to exist will not have tangible assets located in the source country. We can imagine that under certain versions of Article 7, and under certain atypical factual situations, intangibles might be properly attributed to a dependent agent PE. We note that the Discussion Draft does not discuss this possibility in any detail. Outcomes with regard to allocation of returns to intangibles in dependent agent PE situations may depend on whether the AOA has been adopted in the source country.

It would be a challenging task to describe the possible interactions between new Chapter 6 of the Transfer Pricing Guidelines and each of the various potential approaches under Article 7 (including the AOA). Because situations where intangibles might be attributed to a PE would be unusual, we would only suggest at this point with regard to assets that the Discussion Draft remain silent on the attribution of intangibles but make it clear that returns to tangible assets used by the dependent agent should go to the dependent agent and not be taxed a second time in the hands of an asserted dependent agent PE. A clear statement of this principle would also minimize potential controversy.

## Risk

In our opinion, the material in the Discussion Draft (i.e. paragraphs 13 – 19 and the related examples) dealing with risk and particularly with the application of the new BEPS transfer pricing approach to the reward for risk in a context involving a dependent agent permanent establishment is the most significant part of the guidance contained in the 22 June 2017 Discussion Draft. The new transfer pricing approach to risk, now reflected in Chapter 1 of the 2017 Transfer Pricing Guidelines, will be relevant to numerous cases involving agents or intermediaries whose activities might be deemed to create a dependent agent PE under the revised guidance in BEPS Action 7.

Under the new transfer pricing rules on risk, the compensation of an agent or intermediary will be increased in some cases to reflect its performance of functions related to the control of risks contractually allocated to the non-resident entity alleged to have a PE in the country of the agent or

intermediary. Under the provisions of new Chapter 1 of the Guidelines, such compensation can result from a re-attribution to the agent or intermediary of risks contractually assigned to the non-resident entity containing the PE.<sup>2</sup> Increased compensation of the agent or intermediary could also result from the separate compensation of the agent or intermediary for the performance of control functions even if the agent or intermediary is not deemed to “bear” the risk because the non-resident entity containing the PE performs some control functions.<sup>3</sup> In either event, the entity of which the PE is a part will have less income under the transfer pricing rules than it would if compensation for risk management or risk bearing were not allocated to the agent or intermediary, and the determination of the profits to be attributed to the PE may therefore be affected. We do not believe that the Discussion Draft adequately describes how income attribution rules should be applied when these rules on risk come into play.

As matters now stand, the new transfer pricing approach on the reward for risk presents numerous uncertainties and ambiguities in its own right and, in our view, is arguably the least sustainable part of the entire transfer pricing work carried out in BEPS. There are various aspects of the OECD’s explanation of the new approach to risk that require a lot of further clarification. There is also a substantial question whether the new approach to risk is, in fact, compliant with the arm’s length principle. This is because third parties seem in some cases to assume or bear risks in respect of which they have little or no “control” in the OECD sense of that term.<sup>4</sup> The new guidance fails to address clearly the practical reality of the sharing of risk within a MNE group given that the guidance sometimes seems to assume risk is generally borne and managed by a single party within a MNE group. Moreover, the new OECD approach to assigning and compensating risk, intended to be a staple of every transfer pricing analysis, requires highly complex factual analysis and there are major concerns whether taxpayers and tax authorities alike will have the resources to apply the approach other than in exceptional cases.

As a result, numerous ambiguities and difficulties remain. Given the nature of these ambiguities, we believe it would be preferable for the OECD to address the issues arising under the new language of Chapter 1 of the Guidelines before, in effect, exporting the difficulties into the PE arena. However, assuming, as we do, that further clarification of the transfer pricing rules on risk will not be forthcoming in the immediate future, we believe that it is essential that the Discussion Draft make a more concerted effort to work through the difficult interactions between the application of the various

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<sup>2</sup> For example, where the non-resident entity does not perform risk control functions or have financial capacity to assume risk contractually assigned to it, and the agent does perform such risk control functions and has such financial capacity.

<sup>3</sup> See, 2017 Transfer Pricing Guidelines at paragraph 1.105.

<sup>4</sup> For example, see Gregory J. Ballantine, ‘Ownership, Control, and the Arm’s Length Standard’, Tax Notes Int’l (6 June 2015).

possible approaches to Article 7 and the new rules on risk. The following discussion seeks to identify some of the issues that need to be addressed.

The Draft does recognize the similarity of the functional risk management activities that are to be rewarded under the new transfer pricing approach to risk and the “significant people functions” that are used to allocate assets and risks under the AOA. It (rightly) notes that though these may be similar they are not wholly aligned. This presumably means that the reward for risk might in some circumstances be bifurcated between a PE (applying Article 7) and the agent/ intermediary (applying Article 9). However, this point is not investigated and the commentary in the Draft is limited to the observation that where the reward for risk is allocated to the intermediary under the transfer pricing rules, it cannot also be attributed to the PE under Article 7. This seems a very limited response to a potentially complex issue or set of issues.<sup>5</sup> The minimum that seems to be required on this point is a reconciliation between the approach to the functional analysis required under the Transfer Pricing Guidelines and the functional analysis required for the attribution analysis under Article 7.

It is also noted in the Draft that transfer pricing allocations of the reward for risk do not change the “facts” on which the dependent agent test in Article 5 (5) of the OECD Model is predicated. This suggests that if the activities and decisions of the agent/ intermediary in the exercise of “control of risk” functions also themselves trigger the dependent agent rule, then presumably the “fact” of the activity can trigger the dependent agent rule of Article 5 (5) yet the reward for the activity will not be attributed to the PE thereby created but will be allocated, under TP principles, to the agent/ intermediary. It seems anomalous that the same activity is to be treated differently by the simultaneous application of legal and substance tests for two different purposes. The result is therefore that such activity might be counted for the purpose of triggering the dependent agent PE test yet ignored for the purpose of applying the PE attribution rules (in some cases this would mean there are no profits left in the PE) but this seems to be the result of the proposed OECD approach. In any event, the new transfer pricing approach to risk will tend to have the effect of making it less likely that the expansion of Article 5 (5) will bring in extra profits in PE.

All these points would benefit materially from guidance that draws on relevant illustrative examples. Four brief examples are contained in the Draft. However, unlike the 2016 Draft, the examples do not include any numerical or illustrative financial data or indeed any functional or factual analysis. This is for the stated purpose “to avoid drawing conclusions from this guidance on the level of profitability of the intermediary or the permanent establishment”. Though they are claimed to “offer a conceptual framework”, this makes the

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<sup>5</sup> For example, in suggesting that the transfer pricing approach is to take priority over the attribution approach, does the OECD intend that this also applies in those financial sector situations where there is very lengthy and industry-specific guidance on the Article 7 attribution rules?

examples of very limited use as all that is said (and said repeatedly) is that the profits of the PE and the TP profits of the agent or intermediary are to be based on the relevant facts in each case and applying Articles 7 and 9 of the relevant treaty.<sup>6</sup>

Notwithstanding that the examples are brief and generalized there is nonetheless one aspect that raises concerns. The discussion seems to imply that the process of attribution involves first attributing to the dependent agent PE all the revenues from the contracts concerned (being those concluded by the agent or in relation to which the agent “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise”) before then taking off an arm’s length return to the head office of the entity with the PE and the agent/ intermediary and any other costs of the PE.<sup>7</sup> This approach is hard to square with the authorized OECD approach to the application of Article 7 (the “AOA”) and also seems contrary to what is said about the AOA in paragraph 16 of the Draft.

Assuming appropriate arm’s length returns are applied, this approach suggested in the Draft should get to the technically right result within Article 7 of a treaty (because it results in the profits attributable to the PE being those that an unrelated party performing the same or similar activities under the same or similar conditions would make). However, where the relevant transfer pricing/ arm’s length return is disputed or unclear, taxpayers may find themselves arguing against a de facto default to a force of attraction rule being applied by the source state in which the PE is located. The risk of this happening already exists from the application of unconventional approaches to attribution in source states but the issue is arguably compounded by what seems to be implied as the procedural approach suggested by the OECD. Given that there seems little basis for any such approach - because the attribution of all revenues from the contracts the agent is involved are not automatically attributed to the PE in the way implied by the Discussion Draft - the position should be made clearer, specifically by the clarification that the starting point for the analysis is with the facts of the PE. Such clarification would be further enhanced by the articulation of the principle, described above, that income may be attributed to a dependent agent PE only when risks or assets are properly attributed to it.

The Draft raises a specific point relating to the interaction of Articles 7 and 9 in the context of the dependent agent rule, namely which Article should be applied first. The Draft gives no recommendation on the point, noting that

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<sup>6</sup> For example, in the case of example 4 (which deals with a warehouse PE and involves the new anti-fragmentation rule from BEPS), no new guidance is given on the application of that rule (the example simply assumes it applies) and there is no guidance on how profits are attributed to a warehouse other than echoing the usual refrain (at paragraph 48) that they are those that the PE would have derived if it were a separate and independent enterprise performing the same storage and delivery activities.

<sup>7</sup> See for example the first sentence of paragraph 8 of the Draft. Though less clear, the implication is repeated in the examples – see at paragraphs 25, 30 and 34.

either way around is acceptable and should get to the same result, though a consistent approach should be followed. Given the fundamental mission of the OECD to “clarify, standardize and confirm the fiscal situation of taxpayers”<sup>8</sup> it is slightly surprising that the OECD is not here advocating a more standardized approach, particularly as the matter is relevant to both source and residence jurisdictions. In relation to the ordering of the two Articles, there seem to be various reasons why it would be more logical to apply Article 9 first (these include the points that a transfer pricing adjustment may be a deduction from profits otherwise attributable to the head office or a PE of an enterprise so any transfer pricing deduction would seem logically prior to the application of Article 7 and that the application of Article 9 would seem a better fit with any “administrative solutions” that may be applied – as discussed further below. The approach of applying Article 9 first is also a better fit with the additional principles advocated at the beginning of this letter).

A further area of general concern relates to the lack of clear and reliable standards relating to the PE attribution rules. This is not a problem caused by the BEPS project, though it has been exacerbated by that project as a result of the general lowering of the PE threshold standards in Article 5 (which makes the issue more relevant in practice). The vagueness of the new wording used in the expanded version of the dependent agent test adds to the uncertainty. The very long-running OECD project on the attribution of profits to permanent establishments (which led to the AOA) was intended to remedy this situation by delivering a clearer and more disciplined approach but take-up of the AOA has been relatively limited. The issue clearly has significant practical implications because with the lowering of the PE threshold following BEPS there are very likely to be more PE disputes and if there are widely differing interpretations of attribution standards then the risk of double tax is correspondingly increased. This is particularly true as relates to the treatment of intangibles, one of the areas where, as noted above, there may sometimes be a legitimate allocation of additional income to a dependent agent PE. The Draft arguably makes the position worse as it seems positively open to a wide range of approaches to profit attribution.<sup>9</sup> Notwithstanding reliance on the AOA remains the position of the OECD for dealing with Article 7, the Draft contains only relatively modest references to the AOA and these are largely relegated to footnotes. Further, as noted above, some comments in the Draft could be interpreted as contradicting the AOA approach. It is not clear if this downplaying of the AOA arises because the OECD is finding it hard to reconcile the application of treaty interpretation principles developed by

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<sup>8</sup> OECD Model Tax Convention on Income and on Capital, Introduction, paragraph 2.

<sup>9</sup> See especially paragraph 9 of the Draft. The introductory comments to the Draft note (in the second paragraph) that many of the comments on the earlier draft “highlighted the importance of developing guidance that would be relevant for all countries, regardless of their approach to attributing profits to permanent establishments”. This is in stark contrast to the OECD’s previous concerns on the “unsatisfactory situation” of approaches to attribution operated by some states – see the 2010 PE Report at paragraphs 227 and 228.

OECD Members with the practical demands of its operation of the Inclusive Framework to implement BEPS.

If, as seems to be the case, there is a very limited appetite on the part of states to revisit the attribution rules with a view to delivering a more consistently-applied approach to those rules, the problem areas discussed above suggest it would be preferable to limit the dependent agent PE rule to cases where additional revenue will arise under the PE attribution rules as compared to the transfer pricing rules and to take positive steps, such as the clarifications suggested above on functions and assets, to clarify the limited situations where the existence of a PE can theoretically give rise to additional taxation in the source country. This would make sense for tax authorities as it would allow a better allocation of tax authority resource and better outcomes from the PE rules. It would also be better for taxpayers as it would avoid or at least reduce needless duplicative compliance obligations.

Such an approach could in principle be achieved by amending the terms of the dependent agent rule (whether in the framing of the threshold test or by means of an exemption) so that it operates only where the PE would have an amount of attributable profits under Article 7 that is greater than the amount of Article 9 profits otherwise derived by the agent or intermediary. This approach would still require taxpayers to compute any Article 7 profits and compare it with the transfer pricing position but in appropriate cases (likely to be a large proportion) it would then completely remove any PE charge and PE filing obligations.

A rather weaker possibility, though along similar lines, is the pursuit of “administrative” solutions under which any profit attributable to the PE is rolled in to the relevant transfer pricing reward to the agent or intermediary, preserving for convenience a “single taxpayer” approach in the relevant source state. The Discussion Draft mentions this (in a rather detached way) as a possible approach but makes no recommendation or proposal. There is certainly no recognition in the Draft that the nature of the discussion on the interaction of the attribution rules and the transfer pricing rules in the case of dependent agents (including the use of administrative work-arounds using non-arm’s length pricing and which render treaty provisions superfluous) is itself a strong hint that some fundamental re-thinking is required here or that the direction taken in the BEPS project may have been mistaken. In that sense, the Discussion Draft is hardly engaging with issues the OECD has created or exacerbated in BEPS by the lowering of the dependent agent threshold and the implication that the PE rules offer a way to overcome concerns with the transfer pricing rules.

It might be possible to make some level of progress here by purely administrative measures but, if that route is to be followed, it will need a much more supportive position from the OECD. However, there must be some doubt as to whether the pursuit of administrative mechanisms represents a sustainable response to the situation. Such an approach would have the

effect only of modifying filing obligations and would not alter the fact that, following the BEPS changes, potentially very many PEs will exist in circumstances where there are no additional profits given that, as the Discussion Draft makes clear, any administrative arrangement would not alter the technical position. It would also not readily help tax authorities focus on PE cases where there are additional profits over the transfer pricing return. More fundamentally perhaps, the use of administrative mechanisms has been discussed in some detail before (in the early to mid 2000s during the long-running project on the PE attribution rules) and with little enthusiasm by tax authorities due to the difficulties arising from situations such as where the agent or intermediary has tax losses or tax credits, which would absorb PE profits; the potential disconnect with the home country treatment; etc. These issues might be accommodated, but only at the price of a rather more complex administrative arrangement, potentially defeating or reducing the point of the exercise. What is needed is a material re-think of the current interaction of the transfer pricing and profit attribution rules relating to situations involving dependent agents, and this should include also the operation of the PE threshold rules in Article 5 (5) and (6) of the OECD Model. However, it is not clear that this conclusion chimes with the current direction of travel adopted by the OECD.

## Conclusions

In contrast to the more complex 2016 attempt to provide additional guidance on profit attribution, the approach taken in the current Draft yields a simpler and more accessible document. Unfortunately, it provides meagre meaningful guidance. Following the relevant BEPS changes, the interplay of Articles 5, 7 and 9 of the OECD Model is technically complex. Further, those provisions are especially relevant in the case of complex global business models and structures. All these complexities will not go away as a result of being largely ignored by OECD guidance. If it is to prove useful, the relevant technical and practical complexity and the attendant difficulties and issues need to be addressed head on in any OECD guidance on the attribution of profits and a clear effort needs to be made to eliminate cases from the controversy pool where the finding that a PE exists will not result in the attribution of additional income to the source country.

Yours sincerely

Joseph L. Andrus

Richard S. Collier



OECD/CTPA

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Copenhagen, 15 September 2017

Dear madam, sir

**Comments to the BEPS Action 7, Additional Guidance on Attribution of Profits to Permanent Establishments, Public Discussion Draft, 22 June – 15 September 2017**

Thank you for continuing to allow public input into WP6's work; it is much appreciated. I am an international tax professional and the Danish managing director for Quanterra Global, a transfer pricing boutique firm. My comments in this letter are made on personal title.

I have great respect for WP6 and the CFA's work and realise that the draft is the result of many people spending many days in drafting, discussing and redrafting; please do not see my disagreement with any points hereafter as not appreciating that process. My comments are focussed on my wish for the TP Guidelines to be internally consistent, practically applicable, and not more complicated than necessary.

I will be brief on each point, but am happy to explain any point in further depth, should you wish me to.

Taxing ghosts

1. Example 1. If fully-fledged distributor X earns 100 in taxable income in country X and is then converted into a commissionaire earning 10 in country X, country X may want to recuperate the other 90 somehow. If the 100 was an arm's length compensation based on X's functions, assets and risks in country X before conversion, and if the same functions are still performed in country X after conversion, I agree.

Example 2. Likewise, if YCo in country Y sets up a commissionaire X in country X and the same functions are performed in country X as those which fully fledged distributor X performed in example 1, under the same comparability factors, then the arm's length compensation in country X should be 100.

This is what Chapters I.D and VI of the TP Guidelines tell us.

But those functions must be performed in country X. And there must be people in country X performing those functions in country X. To do otherwise would be for country X to:

- do what chapters I.D and VI combat (the allocation of profits and risks away from functions); and
- open a wide new world of transfer pricing planning opportunities.

2. Even in this second draft, I still feel that the effort to recuperate "the other 90" is done with a disregard for chapters I.D and VI and for the actual places where actual functions (including risk control) are performed by actual people. To add insult to injury the deemed PE's of paragraph's 25 and 30 of the draft not only fail all the substance requirements of chapters I.D and VI, but they even implicitly receive the residual profits from the local sales.

I assume that paragraphs 25 and 30 refer to "(3) the arm's length remuneration of SellCo" because the authors realised the practical impossibility of treating the PE as the tested party on which a proper functional analysis can be performed.

If I am wrong about this and if the authors did mean for “SellCo” to get the residual, then please include guidance on how to calculate the routine compensation of the PE under a proper functional analysis in this paper.

## Preliminary conclusion and alternative solution

3. Criticism is easy, constructive criticism not always. I sympathise with going after part of “the other 90”, but I do not think that should be achieved through a deemed PE with a deemed presence, deemed functions and deemed risks. It should be achieved through taxing real people, performing real functions, through a real presence.
4. As a possible alternative, please add a safe harbor for commissionaire PE’s where the deemed Commissionaire PE profits equal the difference between the arm’s length compensation of the Commissionaire entity and the arm’s length compensation of a comparable limited risk distributor, selling under flash title. I believe this to be a practical, fair and economically sound approach.

## Other issues

5. Paragraph 17 of the draft makes reference to the differences between articles 7 (+ or - the AOA) and 9. Whilst I think these differences are exaggerated (especially since 2008) and unnecessarily complicating transfer pricing under the arm’s length principle, they do not influence the arguments made here above. An article 7 analysis also requires the presence of significant people and the ability of a proper functional analysis of the appropriate tested party. An exercise which is difficult to perform if there is no one in the tested party at the tested location.
6. Paragraph 34, second sentence, seems circular, especially when read as “... the profits attributable to the PE are those that the PE would have derived if it ... perform(ed) the activities that BuyCo performs ... minus ... the arm’s length remuneration of BuyCo.”  
Even if the current decision of taxing absent functions is pursued, it may help to reword this sentence to better clarify the authors’ intent.
7. Paragraphs 26, 31 and 35 suggest that the PE state may collect the PE tax from the local taxpayer instead. Would this also apply to third party local entities or are related party PE’s to be treated different from unrelated party PE’s going forward? I foresee an unwillingness of taxpayers to share their financial information with third party service providers.
8. Though this is not strictly transfer pricing, the issue has possible TP consequences and is brought up by Action 7. With reference to paragraphs 41 and 42 of the draft: say company A in country A and company B in country B have a combined article 5’4 PE in country C. Company A’s country C activities generate a taxable profit of 100 in country C and Company B’s a tax deductible loss of 100.
  - is the PE’s total taxable income 0 for both Company A and Company B in country C, or is this only the case if the deemed PE is constituted by one taxpayer only (which would generate 2 classes of PE’s for the purposes of article 23 of the model tax convention)?
  - if the PE is treated as one taxpayer, how should countries A and B apply article 23 with regard to tax exemptions/tax credits?

Yours sincerely,

*Johann H. Müller*

September 15, 2017

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

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

Keidanren is grateful for the opportunity to provide comments regarding the Public Discussion Draft on BEPS Action 7 *Additional Guidance on Attribution of Profits to Permanent Establishments*. In the near future, the broader definition of permanent establishment (“PE”) recommended in the 2015 Final Report on Action 7 will be effectively incorporated into bilateral tax treaties through a multilateral instrument and other means. The situation urgently calls for the development of guidance on PE profit attribution that is acceptable to taxpayers and tax administrations alike.

This Public Discussion Draft contains multiple points that we consider beneficial. A particularly important one is paragraph 12, which states that any approach to the application of Articles 7 (business profits) and 9 (associated enterprises) of the OECD Model Tax Convention “must ensure that there is no double taxation in the source country.” Similarly convincing is paragraph 19, which reads: “When the accurate delineation of the transaction . . . indicates that the intermediary is assuming the risks of the transactions of the non-resident enterprise, the profits attributable to the PE could be minimal or even zero.” Likewise, we welcome the administrative approaches to enhance simplification in paragraphs 20 and 21 that are newly presented taking into account countries not adopting the authorized OECD approach (“AOA”).

On the other hand, when it comes to guidance for applying these high-level concepts to individual specific cases, there is still much room for clarification and enhancement. Deeper consideration should be given to the relationship between Articles 7 and 9 of the Model Tax Convention so as to prevent taxpayers from being exposed to the risk of double taxation and to limit any increase in their compliance burden. Equally essential is to particularize the administrative approaches to enhance simplification.

Whereas this Public Discussion Draft pertains to the attribution of profits to a PE, further guidance should be provided in the future to elaborate on whether certain activities fall within the definition of PE to begin with, including the demarcation between activities deemed preparatory or auxiliary and those not deemed so.

**1. Relationship between Articles 7 and 9 of the Model Tax Convention**

Similar to the July 2016 public discussion draft, this Public Discussion Draft devotes many pages to examples in which a non-resident enterprise is deemed to have a PE in the source country due to the activities there of the intermediary that is an associated

enterprise. In those cases, the conventional double-taxpayer approach is applied to the relationship between the profits of the intermediary and those of the non-resident enterprise's PE, as seen in paragraph 19 that reads: "The host country's taxing rights are not necessarily exhausted by ensuring an arm's length compensation to the intermediary." The rationale given in paragraph 17 is that significant people functions for the attribution of risk under Article 7 are not interchangeable with risk control functions under Article 9.

This rationale does not seem reasonable from our perspective of advocating the single-taxpayer approach, a position that regards a PE determination as unnecessary in the first place provided that the intermediary's profits are properly calculated pursuant to transfer pricing rules. What should be noted here is that, according to the AOA under Article 7, the profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise, and such profits are calculated pursuant to the concepts of transfer pricing. Since it is incomprehensible and confusing to apply a concept deviating from Article 9 only to the attribution of risk, we request that conceptual consistency be established between Articles 7 and 9.

Thereafter, if the double-taxpayer approach is still to be enforced, detailed guidance should be provided concerning the difference in the positions of Articles 7 and 9 with regard to risk, including in what situations a difference materializes.

As to the order in which Articles 7 and 9 are applied, this Public Discussion Draft mentions many jurisdictions first applying Article 9 but appears to ultimately accept either order, in paragraph 12. However, if a non-resident enterprise has in the source country an intermediary that is an associated enterprise, it is only logical to undertake an Article 9 analysis first. We recommend that the final version of this guidance explicitly state that Article 9 should be applied first.

## **2. Administrative Approaches to Enhance Simplification**

This Public Discussion Draft introduces administratively convenient procedures as ways of recognizing the existence of a PE and collecting the appropriate amount of tax resulting from the activity of the intermediary. While we as taxpayers welcome this direction, those procedures entail the following issues:

The first is the necessity of more detailed guidance. As paragraph 21 rightly points out, in the event that a non-resident enterprise is determined to have a PE, the potential burden on that enterprise of having to comply with host country tax and reporting obligations cannot be dismissed as inconsequential (precisely speaking, the potential burden is significantly heavy rather than "inconsequential"). In light of that possibility, administratively convenient procedures should not be limited to simply collecting from the intermediary the tax including the amount that would be levied on a PE if it were determined to exist. Rather, such procedures should include even admitting that no PE requiring a determination exists to begin with; otherwise, the effect will be insufficient. Serious consideration should therefore be given to the aforementioned approach that regards a PE determination and its profit calculation as unnecessary provided that

transfer pricing rules are properly enforced. If this proves difficult to be agreed upon, consideration should then be given to the adoption of an approach that regards a PE determination and its profit calculation as unnecessary in cases where its profits (or revenue) are evidently not expected to exceed a fixed amount.

The second issue is the thorough enforcement of the AOA. In the event that, after taking all the above into consideration, a PE is still determined to exist, we assume that the appropriate amount of tax resulting from the activity of the intermediary will be collected pursuant to the administratively convenient procedures presented. To render this practicable, these procedures must be particularized, including what the “appropriate amount of tax” signifies. Relying solely on the insufficient explanations given in this Public Discussion Draft may invite arbitrary interpretations by the source country’s tax administration, resulting in double taxation. The final version of this guidance should explicitly require that profits attributable to PEs be calculated in accordance with the AOA only, without considering such factors as deemed profit margins and worldwide taxation. It should also include provisions that preclude tax administrations from readily conducting audits and reassessments to increase profits attributable to PEs.

It is unclear whether, under administratively convenient procedures, a foreign tax credit is available to a non-resident enterprise with regard to the amount that is corresponding to the tax attributable to the PE and is paid by the intermediary. Presumably, this matter cannot be determined by the tax administration of the source country alone, making it necessary to seek the view of the tax administration in the country of residence. We expect this matter to be clarified in a manner that ensures the elimination of double taxation.

The third issue is the strengthening of enforceability. As regards the significance of these procedures, this Public Discussion Draft merely states in paragraph 21 that countries are not prevented from continuing or adopting those administratively convenient procedures. This statement is unhelpful from the perspective of eliminating double taxation and alleviating the compliance burden. The final version of this guidance should recommend more clearly that these procedures be adopted, thereby urging countries participating in the Inclusive Framework to take concerted action. At a minimum, each country should be required to disclose whether it adopts these procedures in order to ensure predictability for taxpayers.

### **3. Examples**

In this Public Discussion Draft, the examples illustrating calculations of profits attributable to PEs are explained in text only, unlike the July 2016 public discussion draft which also presents numbers and computations. Numerical explanations may take on a life of their own at times, but figuring out the conclusion from conceptual explanations alone is quite difficult. Accordingly, it is preferable for explanations presenting numbers and computations to be reintroduced. If this is not possible, at a minimum, several additional examples should be provided to illustrate more complex cases, separating the functions and risks of an intermediary from those of the PE.

The key to calculating profits attributable to a PE is to clearly recognize internal transactions between the non-resident enterprise's head office and the PE, along with external transactions attributable to the PE. From that standpoint, we find it useful that Examples 1 to 4 individually offer analysis, but would like to provide some comments.

### **Example 1**

While we understand that this example is premised on the existence of the PE, the structure of the example appears unconvincing in that revenue from external sales is attributed to TradeCo's PE, which recognizes the cost of goods sold through internal transactions with the head office. Further, we suspect that if one performs calculations as specified in this Public Discussion Draft, the profits attributable to the PE might turn out to be zero or negative.

In addition, when calculating "the amount that TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S," necessary data is likely to be difficult to obtain, whether internally or externally. Another issue of note is the possibility that tax administrations might arbitrarily select comparables.

In respect to "other expenses, wherever incurred, for the purposes of the PE" that are deducted in the process of calculating the profits attributable to the PE, treating these as the shared expenses of the head office and the PE seems also feasible because they are direct and indirect expenses to generate the PE's revenue. We expect guidance on the specifics and calculation methods of these expenses to be enhanced.

### **Examples 2 and 3**

Overall, these examples have similar issues to Example 1. In either example, additional explanation would be helpful that sheds light on the reason why the PE is determined to exist in the first place.

### **Example 4**

In this example, while the business activities at the warehouse and those at the office are viewed as part of a cohesive business operation, two PEs are determined to exist, with the result that profits attributable to the warehouse PE and the office PE are calculated separately. As this conclusion may add to the complexity of the tasks of filing tax returns and coping with audits, we request consideration be given to a simpler method that enables profit calculations as a single PE. Additionally, unlike the previous three examples that all mention an administratively convenient procedure, no such reference is seen in Example 4. Unless there is a compelling reason not to do so, an administratively convenient procedure should be included in Example 4 as well. We also expect another example to be given to clarify whether the conclusion differs if

the warehouse operated by an associated enterprise is staffed by the employees of the same.

In this example, the business activities at the warehouse and those at the office have a commonality in the sense that these two divide roles to sell OnlineCo's products in Country S. However, there also are cases in which no commonality exists: for instance, the warehouse is tasked with delivering a product while the office is responsible for gathering information on another business. Care needs to be taken to prevent such cases from being subjected to the anti-fragmentation rule.

Sincerely,

Subcommittee on Taxation  
KEIDANREN

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

Date September 2017

From KPMG International

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Cc Manal Corwin

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

Professionals in the member firms of KPMG International (“KPMG”) welcome the opportunity to comment on the OECD’s Discussion Draft titled *BEPS Action 7: Additional Guidance on Attribution of Profits to Permanent Establishments* (the “Discussion Draft”).

The Discussion Draft is a second draft<sup>1</sup> from the OECD addressing additional guidance on the attribution of profits to permanent establishments, in light of changes to Article 5 of the Model Tax Convention (“MTC”)<sup>2</sup> and to the OECD Transfer Pricing Guidelines (“Guidelines”)<sup>3</sup>. The OECD received numerous comments from the public on the previous draft, and chose in the new draft to pursue a different approach. Specifically the new draft provides only high-level principles to be followed, in place of the detailed examples of the prior draft.

KPMG commends the OECD for its effort on profit attribution guidance, and for its recognition that changes to Article 5 and to the Guidelines create the need for additional guidance. KPMG appreciates the openness of the OECD to comments on the previous draft and recognizes the complexities of the issues. Nonetheless, we still have concerns on several key issues.

KPMG’s comments on the Discussion Draft are presented below.

### General Comments

The Report on Action 7 explicitly stated that no modifications are required to existing provisions on attribution of profits to permanent establishments. KPMG notes that, at present, tax authorities often take inconsistent approaches to the application of PE profit attribution rules. This condition has persisted for many years despite the publication of the OECD’s Reports on the Attribution of Profits to Permanent Establishments in 2008 and 2010, the accompanying revisions in 2008 to the official Commentary on Article 7 as it then stood, and the revision to both Article 7 and the accompanying Commentary in 2010. Some tax authorities avoid the Article 7 analysis altogether and focus on the arm’s length return to the intermediary under Article 9. To the extent these jurisdictions are satisfied that the intermediary has reported sufficient profit for the connected enterprise, they generally do not argue for the existence of a

<sup>1</sup> The prior draft bore the same title and was dated 4 July, 2016.

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

<sup>3</sup> Report on Actions 8-10 of the BEPS Action Plan (Aligning Transfer Pricing Outcomes with Value Creation).

PE. The expansion of the PE standard and the changes to the transfer guidelines under Article 9 might make such an approach less viable going forward. Amongst jurisdictions that attempt to apply Article 7 to a PE, the majority have not adopted the Authorized OECD Approach (AOA) to determine the profits attributable to a PE. Either way, tax authorities in these jurisdictions have inconsistent approaches to determining profit attributable to a PE or in applying the AOA to make that determination. For example, in some countries, where the tax rate for foreign companies is higher than the tax rate for domestic companies, the tax authority may take an aggressive view regarding the existence of a PE and the profit attributable to it versus the return to the intermediary. This makes some countries more prone to find a PE and more aggressive attributing profit to it than their treaty partners. We understand from government officials, moreover, that resolution of PE issues at Competent Authority is particularly difficult; both the existence of a PE and the attribution of profit to a PE present challenges greater than a typical transfer pricing double tax case. The situation, in short, is that there is still insufficient predictability surrounding how the PE profit attribution issue will be approached by tax authorities or even by a single tax authority. The revisions to Article 5, which were meant to increase tax certainty for governments and taxpayers, threaten to become one of the greatest sources of tax uncertainty for both. Accordingly, practical guidance is needed.

The objective of the Discussion Draft is to provide additional guidance addressing the impact of changes to Article 5 and to the Guidelines. Taxpayers generally understand that the changes to Article 5 will lead to significant additional PE exposure under common structures such as commissionaire arrangements. However, taxpayers face significant uncertainty regarding the amount of the associated tax exposure – how much profit would be attributed to the PE if current arrangements are left in place? This uncertainty is heightened by the related uncertainty regarding the effect of changes to the Guidelines on profit attributed to the commissionaire (or other related party intermediary) itself under Article 9, particularly around impact of revised Chapter I of the Guidelines on attribution of risk.

The prior discussion draft attempted to address these uncertainties directly by providing a number of examples illustrating how revised Chapter I and the AOA are intended to interact and how Article 7 and Article 9 should be applied to determine the profit attributable to the related party and to the PE respectively.

The new draft abandons the attempt to provide specific numerical examples and restricts itself to stating general principles. Notably the draft accepts that different tax authorities are likely to take different approaches to profit attribution in these cases, for example to the application of the AOA or to the order in which the Article 9 and Article 7 analyses are applied.

The Discussion Draft is helpful by 1) emphasizing that, whatever approach is applied, the source country should not subject profits to double taxation in the PE and in the intermediary; 2) cautioning that the same risks cannot be attributed to both the PE and the intermediary; 3) observing that if all relevant risks are attributed to the intermediary rather than the PE, then the profits attributable to the PE could be minimal or zero; and 4) acknowledging the potential administrative burdens on taxpayers associated with the potential proliferation of PEs with minimal or zero profit and suggesting that tax authorities may adopt measures to relieve that administrative burden for example by collecting taxes attributable to the PE from the local subsidiary.

However the Discussion Draft falls short of reducing taxpayer uncertainty by outlining a clear, consensus based approach to the attribution of profits to a PE. Indeed, the Discussion Draft gives the impression that the OECD is abandoning the effort to achieve consistency and standardization amongst jurisdictions in the application of these rules. Beyond the mandate that the source country should not tax the same profits in both the intermediary and the PE, the

Discussion Draft does not express sufficient concern about the impact of widely varying approaches to the attribution of profits on reducing certainty, increasing administrative burden (for taxpayers and tax administrations) and fostering controversy.

While KPMG acknowledges the complexities of these issues, we encourage the OECD to commit to further efforts to seek greater standardization and provide clearer guidance, especially as between the interaction of the AOA and the Guidelines, with a focus on the following issues:

- Consistent methodology for applying the AOA and the interaction of Article 9 and Article 7;
- The distinction between ‘control of risk’ functions and ‘significant people functions’ as currently defined in Chapter 1 of the Guidelines and the 2010 Report respectively;
- Detailed recommendations and explicit guidelines (including a model competent authority agreement) for achieving administrative simplification in connection with the application of Articles 5 and 7.

### **Specific Comments**

*Paragraph 9* states that the “separate and independent” enterprise approach applies regardless of whether a tax administration adopts the 2010 AOA “or any other approach used to attribute profits under a previous version of Article 7 of the MTC.” However some member states apply domestic law under prior versions of Article 7 in a manner that does not bifurcate income based on a hypothetical separate entity, but rather analyze whether a single item of income recognized by the nonresident enterprise should be attributed to the PE. The OECD guidance should be limited to explaining how the AOA applies after the BEPS changes to Article 5 and the changes to the OECD transfer pricing guidelines.

*Paragraph 12* indicates that tax authorities may differ regarding the order of application of Article 7 and Article 9. KPMG applauds the OECD’s statement that the order of application should not impact the total amount of profits over which the source country has taxing rights. However, paragraph 18 later provides that “where a risk is found to be assumed by the intermediary under the guidance in Section D.1.2 of Chapter 1 [pursuant to an Article 9 analysis] such risk cannot be considered to be assumed by the non-resident enterprise or the PE for the purpose of Article 7].” This application of Chapter I principles to determine whether the intermediary manages a risk for itself or on behalf of the non-resident is appropriate. To the extent the OECD wishes to avoid dictating an order to the application of these Articles, at the very least it might be useful to clarify further that, without regard to the mechanical order used to attribute profits to a PE, risk control functions associated with risks attributed to the intermediary under Article 9, cannot be deemed to be performed “on behalf” of a non-resident, and thus the associated profit cannot be attributed to the PE of a non-resident for purposes of Article 7. Further, the OECD should recognize the specific issues faced by financial services enterprises in this area and therefore the guidance should reaffirm that Parts II to IV of the 2008 and 2010 Reports continue to apply to the financial services activities they describe, including the treatment of the dependent agent enterprise and the DAPE.

*Paragraphs 13-19* address attribution of risks between the PE and the intermediary, where the activities of the intermediary give rise to a PE. While the statement in paragraph 18 that the same risks should not be attributed to both the PE and the intermediary is helpful as a general principal, it is insufficient alone to preventing divergent and inconsistent approaches to applying the AOA in conjunction with the new transfer pricing Guidelines to prevent just such a result. Recognizing in paragraph 17 that the AOA notion of “significant people functions” for

attributing risks, and the risk control functions standard used in Chapter I of the Guidelines may not be aligned, without providing specific guidance on how the concepts should be applied to prevent double taxation is contrary to the OECD's goals of improving ease of tax administration and promoting certainty for taxpayers. KPMG recommends that the OECD commit to further work to reconcile these standards. In this connection, KPMG recommends that the OECD clarify the role of capital in attribution of risk, with due consideration given to the importance of this issue in financial services and other regulated industries, where the intermediary may have neither the capital nor the regulatory authorization to bear the risks and thereby potential losses associated with attribution of risk.

*Paragraph 21* of the Discussion Draft is helpful in acknowledging that “the potential burden on a non-resident enterprise of having to comply with host country tax and reporting obligations in the event it is determined to have an Article 5(5) PE cannot be dismissed as inconsequential” and in reinforcing the value of adopting administratively convenient procedures to relieve this burden, including by collecting tax only from the intermediary. Nevertheless, the Discussion Draft does not go far enough in providing the kind of guidance necessary to address this issue. As noted in the comments KPMG submitted to the prior discussion draft on the Attribution of Profits, the OECD should prescribe a pathway for administrative relief for DAPes with little or no profit attribution. Ideally, this mechanism would have been included as part of the MLI. As that pathway was not chosen, clarity, speed, and certainty can still be achieved through the development of a model competent authority agreement that countries can adopt to agree on and implement the type of administrative relief contemplated. It would be invaluable to the goals of reducing administrative burdens, promoting certainty, and avoiding unnecessary controversy for the OECD to go farther than simply stating the general principle that administrative relief would be permitted and welcome by providing a model for achieving such relief that jurisdictions are encouraged to adopt.

### **About KPMG**

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 189,000 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.

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## MEMORANDUM

**FROM:** Paolo Ludovici – Giammarco Cottani  
**TO:** Jefferson VanderWolk – Tomas Balco  
**SUBJECT:** Comments to OECD Discussion Draft “*Additional Guidance on Attribution of Profits to Permanent Establishment*”

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**Milan, 15 September 2017**

Dear Jeff and Tomas:

We would like to thank you for providing us with the opportunity of commenting on the Public Discussion Draft on “*Additional Guidance on Attribution of Profits to Permanent Establishment*” (hereinafter referred to as the “Draft”). We appreciate the efforts by WP6 of setting the parameters for calculating the attributable profits (or losses) of a permanent establishment (hereinafter referred to as the “PE”).

Notwithstanding the above, it seems to us that the Draft may have some room for improvement in terms of enhancing its practical guidance, which can direct the development of a sound logical framework for tax administrations as well as taxpayers.

We believe the Draft could be more effective to provide a more accurate distinction of the fields of domain between article 7 and article 9 of the OECD Model Tax Convention (hereinafter referred to as the “OECD MTC”), respectively. Stated otherwise, it seems that despite the correct statement within the Draft that outlining a distinction between Article 7 and Article 9 is immaterial for purposes of profit attribution, yet some logical inconsistencies arise which made the conclusions of the Draft not always effective.

Based on the above, please find below our detailed comments addressing in particular (i) the commissionaire and (ii) the anti-fragmentation issues.

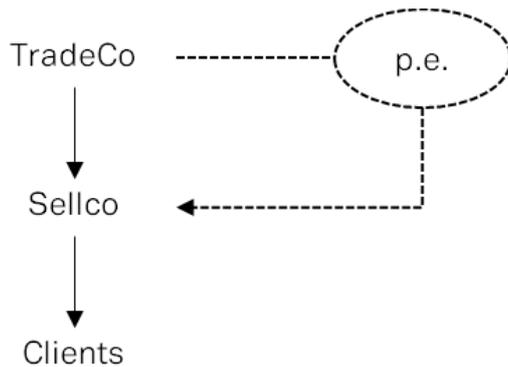
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1. As a matter of background:
  - a. Paragraph 8 of the Draft stipulates that in presence of a PE *“the rights and obligations resulting from the contracts to which Article 5(5) refers will be properly allocated to the permanent establishment”*. As far as profit attribution issues are concerned, Paragraph 8 further states that the profits attributable to the PE *“are only those that the permanent establishment would have derived if it were a separate and independent enterprise performing the activities that the dependent agent performs on behalf of the non-resident enterprise”*. This entails that the PE is deemed to perform *“the activities that the dependent agent performs on behalf of the non-resident enterprise”*;
  - b. Paragraph 25, dealing with the case of a commissionaire arrangement, argues that *“the profits of the PE would be equal to the amount of TradeCo’s revenue from sales of goods to customers in Country S minus:*
    - (1) The deemed acquisition cost of the good;
    - (2) Other expenses, wherever incurred, for the purposes of the PE; and
    - (3) The arm’s length remuneration of SellCo.

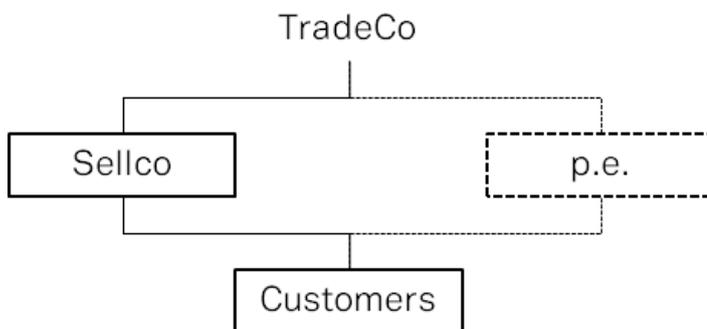
Similar wording is used in Paragraphs 30 and 34 of the Draft.

2. Based on the above, it seems that the Draft should better clarify what rights and obligations are to be considered as assumed by the PE. On one side, it seems obvious that any relationship carried on with the ultimate customers are to be attributed to the PE. Indeed, Paragraph 25, in determining the profits attributable to PE, moves from the concept whereby *“the amount of TradeCo’s revenue from sales of goods to customers in Country S”*.
3. However, there is no specific mention as to whether rights and obligations stemming from the contracts between TradeCo and SellCo are to be attributed to the PE.

4. Based on the above, three alternatives may be envisaged:
  - i. The commissionaire agreement is a contract attributable to the PE itself. In other words, the “deemed” PE leads to a “deemed” allocation to the PE itself of the actual contract entered into with the intermediary whose activity generates the PE itself;



- ii. The commissionaire agreement is still attributable to TradeCo’s head office, which maintains both (i) an actual relationship with SellCo and (ii)a “deemed” relationship with the PE;



- iii. For the sole purpose of determining the profits attributable to the PE, the commissions paid to SellCo are not regarded as deductible items of the PE income. However, in order to avoid double taxation of same income item (at the level both of the intermediary and of the PE), business income received by SellCo and recognized as a taxable item at SellCo’s level should be excluded from taxation at PE level.

5. Although the three alternatives may end up with the same economic result, the implications would differ quite materially from both a procedural and a

substantial perspective. In the following paragraphs and for the sake of simplicity we assume that the outcome of PE profit attribution is always zero and that SellCo has no other entities with respect to which it deals with other than the TradeCo and the deemed PE.

6. Below we have developed some plain-vanilla numerical examples comparing alternatives (i), (ii) and (iii) described in paragraph 2 above to better substantiate our conceptual arguments:

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**Table 1:**

		(i)	(ii)	(iii)
A	Sales proceeds	100	100	100
B	Acquisition cost	85	85	85
C	Other costs of the HO attributable to PE	5	5	5
D	Commission paid to SellCo	10	10	10
E	Cost <i>vis-à-vis</i> the HO	B+C 90	B+C+D 100	B+C 90
F	Deductible cost of the PE	D 10	/	/
G	Net taxable income (A-E-F)	0	0	10
H	Allowance for avoiding double taxation	NA	NA	10
I	Final taxable income (G-H)	0	0	0

7. In our view, alternative (iii) is likely to be the least appropriate as some countries may be reluctant to consider remedies against double taxation with respect to different taxpayers (in the case at stake, SellCo and TradeCo's PE).

However, please note that Paragraph 8 of the Draft states that the profits attributed to the PE "*are only those that the permanent establishment would have derived if it were a separate and independent enterprise performing the activities that the dependent agent performs on behalf of the non-resident enterprise*". This sentence refers to the same

amount of profits without mentioning that revenues recognized by SellCo can be deducted in determining PE's taxable income. Furthermore, in several paragraphs the Draft refers to the circumstance that "*jurisdictions are expected to have in place ... the necessary principles, doctrines or other mechanisms to eliminate double taxation in the source country*"

8. Alternative (ii) does not seem either as the most appropriate as the PE would be deemed to perform the same services performed by SellCo, and TradeCo would appear to have required the same performances to two "different" enterprises, and namely:
  - SellCo for the actual transaction; AND
  - TradeCo for the "deemed" transaction.

Moreover, Paragraph 25 of the Draft seems to imply that the remuneration received by SellCo is not included among the items mentioned in point (2) i.e. within "*the expenses borne by the home office for the benefit of the PE, but is separately mentioned*".

9. Based on the above-mentioned analysis, Alternative (i) seems to us the more reasonable approach as it would avoid having TradeCo carrying on double counting of the same "services" at the level of SellCo and of the PE. Such a position would also be consistent with Paragraph 25 of the Draft, which tends to consider the remuneration of SellCo as a deductible item of expenses directly borne by the deemed PE (see also the end of Paragraph 10 of the Draft)
10. Should the conclusion reached under paragraph 6 above be correct, it would enhance the conclusion of Paragraph 12 of the Draft whereby the question as to the order where Article 9 or Article 7 should apply would become immaterial. This is due to the fact that the actual transaction between SellCo and TradeCo is considered for tax purposes as a transaction between SellCo and TradeCo's PE., which is assumed to be established in the same State of residence of SellCo. Therefore, such a transaction becomes a domestic one no longer subject to the scrutiny referred to in Article 9 of the OECD MTC.
11. In substance, we maintain the view that as far as profit attribution issues

are concerned, Article 7 is the only relevant applicable provision and Article 9, although not directly applicable for purposes of the deemed transaction, has an impact in determining the arm's length remuneration of the PE. Such a conclusion would trigger material implications whenever SellCo is not remunerated at arm's length.

12. In developing the the example at column (i) of Table 1, assume that the actual remuneration of SellCo is 3 instead of 10, the latter figure corresponding to the arm's length amount of the transaction.

**Table 2:**

		(i)	(ii)	(iii)
A	Sales proceeds	100	100	100
B	Acquisition cost	85	85	85
C	Other costs of the HO attributable to PE	5	5	5
D	Commission paid to SellCo	10	3	3
E	Arm's length remuneration of SellCo	10	10	10
F	Upward adjustment at SellCo level (E-D)	0	7	NA
G	Net income of PE (A-B-C-D-F)	0	0	7

13. As Table 2 shows, the overall adjustment is the same in absolute terms but in one case it applies at SellCo level and on the other at the PE level. It is true that based on the authorized OECD approach States can in any event make the adjustment at SellCo level but this is just an option.

14. In this context, The Draft states e.g. at Paragraph 25 that profits of the PE shall be determined net of the **arm's length** remuneration of SellCo. We would recommend WP6 to further elaborate on this statement as:

- a. In the event SellCo is deemed to enter into a transaction with the PE it creates, Article 9 does not apply and some States would have no legal authority to adjust SellCo's taxable income; and

- b. it would further imply that any MAP procedure should be triggered first by SellCo as the determination of the profits attributable to the PE entails the prior determination of the arm's length remuneration of SellCo.

15. The proper identification of the “deemed” transaction is also relevant for determining whether any additional profit should be assumed at the PE level. Indeed:

- o from an “actual” perspective the PE does not perform any activity other than the very activity performed by SellCo and
- o should SellCo be deemed to enter into a transaction with the head office only, it is hard to understand why and for what risk and activities the PE should be further remunerated.

16. Vice versa, should the contract between SellCo and TradeCo be attributed to the PE and the latter is deemed to bear the relevant cost directly, one could consider that the PE at least performing the function of entrusting SellCo with certain duties. A third party carrying out the same activities and actually assuming the same risks would be properly remunerated through an arm's length commission fee.

17. It goes without saying that the above references are to “deemed” transactions in a manner consistent with the concept of “deemed” PE. In our view, it would appear inconsistent to focus on actual transactions in those situations where a fiction is created from a tax standpoint. In other words, a PE actually existing would require to look at actual functions and activities. On the contrary, a deemed PE would require to look at deemed functions and activities, to be consistent with its conceptual premise.

18. In any event, it seems that in the commissionaire example the “margin” attributable to the PE would not be significant and, for the sake of simplicity, one could ask whether it is necessary to identify a PE at all, in light of the administrative burden created by the need of gathering (as it is always the case with PE assessment) factual evidence and bear all the relevant formalities for such an outcome. However, it is clear to us that

it goes beyond the scope of the Draft to re-open discussions falling within the scope of application of Article 5 of the OECD MTC and addressed by Action 7 of the BEPS Project.

19. In a situation where a deemed PE arises from activities performed by one separate enterprise (in the case at stake, SellCo), the above analysis leads to the conclusion that income attributable to the PE should be nil or very low, provided that the intermediary enterprise is remunerated at arm's length.
20. The outcome would be different in those situations where the deemed PE arises from the fragmentation of activities. In this respect, two different scenarios can be envisaged:
  - a. the fragmented activities are performed by one single legal entity;
  - b. the fragmented activities are performed by different legal entities.
21. The first scenario seems not different from the commissionaire case as additional taxable income in the source country may be identified in the event the intermediary entity is not remunerated at arm's length.
22. In the second scenario, it may happen that each company is remunerated at arm's length for the activities each of them is currently performing. However, the actual value of the overall activities, once considered in their entirety may be greater than the sum of the value of any single activity on a stand-alone basis.
23. In such a situation, the outcome may well lead to the recognition of a specific income for the PE as if it were performing a "coordinating" role of the activities otherwise fragmented. Even in this case, however, one could argue that the coordination, if any, is actually performed by a group entity outside the source country (or by the Head Office itself) that should then charge the PE at arm's length, leading again to a scenario of nil or very low taxable income.

We very much hope that you find our comments useful, and we look forward to working with you on these important issues over the next months.

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Milan, 15 September 2017

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

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

Dear Sirs,

First of all we would like to thank the OECD Working Party No. 6 for the extensive work aimed at providing additional guidance on the attribution of profits to permanent establishments. Moreover, we would like to thank you for the opportunity to submit our comments on the Public Discussion Draft on BEPS Action 7 “*Additional Guidance on Attribution of Profits to Permanent Establishments*” released on 22 June 2017 (“**Discussion Draft**”).

**1. Parallel application of Article 7 and Article 9**

The Discussion Draft confirms that the determination of the profits attributable to a permanent establishment (“**PE**”) resulting from the application of the post-BEPS version of Article 5(5) of the OECD Model Tax Convention (“**MTC**”) should be governed by the rules of Article 7 of the MTC. Furthermore, it states that, where the intermediary<sup>1</sup> and the non-

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<sup>1</sup> The Discussion Draft defines the term “intermediary” as a person, whether or not an employee of the enterprise who acts on behalf of the enterprise and is not doing so in the

resident enterprise are associated enterprises, Article 9 of the MTC will apply. In particular, in calculating the profits attributable to the PE under such circumstances, it will be necessary to deduct the arm's length remuneration recognized to the intermediary for the services provided to the non-resident enterprise. The Discussion Draft highlights that the order according to which Article 7 and Article 9 are applied should not impact on the amount of the PE's profits over which the source State has taxing rights (paragraph 12).

While we agree with the above premises, it is our opinion that more detailed guidance should be provided on whether the transfer pricing analysis under Article 9 should precede or be subsequent to the analysis related to the attribution of profits under Article 7. Indeed, albeit not directly relevant for the actual quantification of the overall profits to be attributed to the PE, such clarification might have a crucial impact in those jurisdictions (such as Italy) where transfer pricing adjustments benefit from an administrative and criminal penalty regime which is more favorable than that applicable to the assessment of undeclared profits of a PE, especially where such a PE is deemed to exist as a consequence of an audit carried out by the tax administrations. Absent such additional guidance, the tax administrations might tend to qualify an adjustment concerning the transactions between the intermediary and the non-resident enterprise as an adjustment of the profits to be attributed to the PE under Article 7 – rather than as a transfer pricing adjustment under Article 9 – with the consequential application of higher administrative and criminal penalties. In our opinion this approach, which would provide tax administrations with an unbalanced degree of discretionality, should be discouraged.

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course of carrying on a business as an independent agent within the meaning of Article 5(6). For the purposes of our comments, the term “intermediary” will be used with the same meaning as the one contained in the Discussion Draft.

## 2. Interactions between BEPS Actions 8-10 and the Authorized OECD Approach

### 2.1 *Risk Management Functions vs. Significant People Functions Relevant to the Assumption of Risks*

The Discussion Draft addresses the implications that the work under BEPS Actions 8-10<sup>2</sup> may have on the determination of the arm's length remuneration recognized to the intermediary for the services provided to the non-resident enterprise and, consequently, on the profits attributable to the PE. In particular, with reference to the assumption of risks, the Discussion Draft highlights that, under the guidance provided by BEPS Actions 8-10, risks are to be allocated to the enterprise which actually exercises the control over the risk and has the financial capacity to assume it (paragraph 13).

The Discussion Draft further indicates that “[w]hile there may be functions that would be considered both significant people functions for the attribution of risk for the purposes of the AOA and risk control functions for the purposes of Article 9, the conclusion cannot be drawn that these two concepts are aligned or can be used interchangeably for purposes of Article 7 and Article 9” (paragraph 17).

In our opinion, a more thorough analysis should be conducted in the Discussion Draft on this subject. Indeed, the rules on how to allocate risks developed under BEPS Actions 8-10 seem to have moved the principles at the basis of the functioning of Article 9 closer to those of the Authorized OECD Approach (“**AOA**”) as developed in the 2010 Report on the Attribution of Profits<sup>3</sup> and incorporated in the 2010 version of Article 7 of the MTC and its Commentary. In particular, the definition of “*risk management functions*” reported in BEPS Action 8-10 and integrated in the OECD Transfer Pricing Guidelines<sup>4</sup> (“**TPG**”) evokes the words

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<sup>2</sup> OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2015).

<sup>3</sup> OECD, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD Publishing, 2010).

<sup>4</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD Publishing, 2017), para. 1.61. Risk management “comprises three elements: (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that

“significant people functions relevant to the assumption of risks” of the AOA, which “require active decision-making with regard to the acceptance and/or management (subsequent to the transfer) of those risks”<sup>5</sup>. From a logical perspective one would tend to consider such definitions as being aligned, also considering the fact that they are both grounded on fact-specific analyses which focus on the actual conduct of the parties in assuming and managing the risks rather than on a formalistic analysis of the contractual framework. It would therefore be surprising that the concept of “risk management functions” recently developed within the BEPS Project may not be applicable when dealing with the identification of the “significant people functions for the attribution of risk” for the purposes of the AOA (which should be based on the application of the TPG “by analogy”<sup>6</sup>). In our opinion, the Discussion Draft should clarify under which circumstances the above concepts could be deemed to deviate and how such differences might influence the attribution of profits to the PE.

## 2.2 Assumption of Risks

The TPG indicate that the analysis of risks for transfer pricing purposes should determine whether the party contractually assuming the risk also controls it and has the financial capacity to assume it.<sup>7</sup> In this respect, the TPG recognize that, in cases where more than one party to the transaction has the control over a specific risk, only the enterprise which has the

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*decision-making function, (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 decision-making function, and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation”.*

<sup>5</sup> OECD, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD Publishing, 2010), para. 22.

<sup>6</sup> As indicated in the OECD 2010 Report on the Attribution of Profits to Permanent Establishments (paras. 54 and 55), “[o]ne issue in applying this approach is that for the purposes of Article 7, it is necessary to postulate the PE as a hypothetical enterprise that is separate from the enterprise of which it is a PE, whereas in an Article 9 case the enterprises being examined are actually legally separate. To reflect this issue, the authorised OECD approach is to apply the guidance given in the Guidelines not directly but by analogy”.

<sup>7</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD Publishing, 2017), para. 1.90.

financial capacity to bear the risk will actually be deemed to assume it.<sup>8</sup> Based on the above, where – for example – the non-resident enterprise and the intermediary are associated enterprises and exercise together the control over a risk (*i.e.* they exercise together the “**Controlling Risk Functions**” over a specific risk, *e.g.* the risk of market development), but only the non-resident enterprise has the financial capacity to assume it, the latter will be deemed to assume the risk for transfer pricing purposes (and, consequently, it will be rewarded with an arm’s length compensation for the assumption of that risk).

When dealing with the attribution of profits to the PE, the analysis of the assumption of risks is grounded on different principles.<sup>9</sup> Indeed, under the AOA, on the one hand, the PE is attributed with all the functions that the intermediary undertakes for the non-resident enterprise<sup>10</sup> and, on the other hand, risks are allocated between the head office and the PE on the basis of their respective functions, as risks cannot be separated from functions.<sup>11</sup> As a consequence, considering the above example and assuming that the AOA is applicable based on the tax treaty between the State of the non-resident enterprise and the State where the intermediary operates, the PE of the non-resident enterprise could be attributed with the Controlling Risk Functions performed by the intermediary for the benefit of the non-resident enterprise, disregarding in this respect the analysis of the entity which has the financial capacity to bear the risk. Therefore, due to the different principles underlying the attribution of risks for AOA and TPG purposes, the risks that were exclusively attributed to the non-resident enterprise under the TPG, due to the lack of financial capacity of the

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<sup>8</sup> OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD Publishing, 2017), para. 1.94.

<sup>9</sup> See OECD, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD Publishing, 2010), paras. 68-71. In this sense, the Discussion Draft observes that “[i]n a PE context, the legal and factual position is that there is no single part of an enterprise which legally owns the assets, assumes the risks, possesses the capital or contracts with separate enterprises. The mechanism to determine the attribution of risk assumption to a PE will depend on the applicable tax treaty in a given case” (paragraph 15).

<sup>10</sup> See OECD MTC (2014), art. 5(5), according to which the “enterprise shall be deemed to have a permanent establishment in that State in respect of any activities [*i.e.* functions] which that person [*i.e.* the intermediary] undertakes for the enterprise” (that wording is not going to be amended as result of the 2017 changes to the OECD MTC).

<sup>11</sup> OECD, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD Publishing, 2010), para. 70.

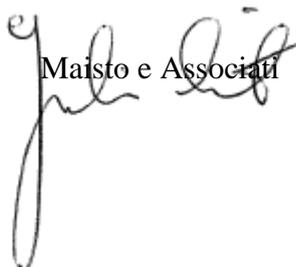
intermediary, under the AOA could be split between the head office and the PE of that enterprise “*in proportion*” to the division of the Controlling Risk Functions between the head office and the PE (the latter including the functions performed by the intermediary for the benefit of the enterprise). Moreover, based on the AOA,<sup>12</sup> the PE would be attributed with the amount of capital (which could substantially be used as a proxy of the “financial capacity”) needed to assume the mentioned risk. Thus, the profits attributable to the PE will not be reduced down to zero by the deduction of the arm’s length compensation paid to the intermediary for the service it provides, since, even in the case the functions performed by the intermediary were the same as those attributed to the PE, those functions would attract to the PE an amount of risks that, under the TPG, would have been allocated exclusively to the non-resident enterprise of which the PE is part (where the only relevant presence in the State of source were to be the intermediary).

In our opinion, the Discussion Draft should coordinate the approaches and in any event be more explicit in providing guidance with reference to cases such as the one presented above. In particular, it should include examples describing risks which, while not assumed by the intermediary based on the TPG, may be attributed to the PE under the AOA.

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Please feel free to contact us at [TP@maisto.it](mailto:TP@maisto.it) with any questions or comments concerning this letter.

Sincerely yours,

  
Maisto e Associati

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<sup>12</sup> OECD, *Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD Publishing, 2010), para. 71.



September 13, 2017

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 (2017)

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 June 22, 2017 (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 provides comments on certain language in the Discussion Draft. In general, we believe that the Discussion Draft represents a missed opportunity to bring consistent, clear, and practical guidance to this area, and to bring coherence to the work undertaken under Action 7 and under Actions 8-10. We understand that these issues can be technically complex and that there are limits to the guidance that can be provided under an accelerated timeline that is not sufficient to permit the development of a consensus among participating governments on basic points. Our comments therefore are directed at ensuring that the language in the Discussion Draft does as little harm as possible and does not contradict guidance from the Model Tax Convention, its Commentaries, or other work on profit attribution.

National Foreign Trade Council  
1625 K Street NW Suite 200 Washington, DC 20006 202-887-0278  
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[www.nftc.org](http://www.nftc.org)

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## **Conflation of Profit Attribution Standards**

Paragraphs 8 and 9 of the Discussion Draft provide that the profits attributable to a permanent establishment (“PE”), are those profits that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions. Paragraph 9 explains that this principle applies regardless of whether the relevant treaty reflects the 2010 authorized OECD approach (“2010 AOA”) or any other approach under prior versions of Article 7. The 2010 AOA, business profits are determined based on an evaluation of the PE as a functionally separate entity, giving effect to certain dealings between the PE and other parts of the enterprise. Pre-2010 AOA formulations of Article 7 were different, and in some cases operated by allocating or apportioning certain items of income or expense of the enterprise to the PE. Few existing tax treaties include the 2010 version of Article 7, and some countries have stated an intention not to follow the 2010 AOA in new treaties. It is not possible or constructive to gloss over these differences. The lack of consensus around these issues in general makes it all the more important for guidance from the OECD to follow the analytical framework of the 2010 AOA: (1) determine the functions, assets, and risks of the functionally separate entity by, among other things, appropriately characterizing the dealings between the PE and other parts of the enterprise and categorizing the PE in a manner that facilitates a search for comparables (e.g., as a buy-sell distributor in a dependent agent context), and (2) determine the profits of the functionally separate entity through a comparability analysis that considers the functions, assets, and risks in the jurisdiction of the PE.

We recommend the following changes to paragraph 8 to more clearly refer to Article 7 of the relevant treaty as providing the relevant standard. Further we recommend that paragraph 9 be deleted.

Paragraph 8. ... However, it is important to note that this does not necessarily mean that the entire profits of the enterprise to which the permanent establishment belongs resulting from the performance of these contracts should be attributed to the permanent establishment. The determination of the profits attributable to a permanent establishment resulting from the application of Article 5(5) will be governed by the rules of Article 7 of the relevant tax treaty; ~~clearly, this will require that activities performed by other enterprises and by the rest of the enterprise to which the permanent establishment belongs be properly remunerated so that the profits to be attributed to the permanent establishment in accordance with Article 7 are only those that the permanent establishment would have derived if it were a separate and independent enterprise performing the activities that the dependent agent performs on behalf of the non-resident enterprise.~~

## **Application of Article 9 and Article 7**

Paragraph 12 notes that both Article 9 and Article 7 may be relevant where a PE of an enterprise is deemed to exist under Article 5(5) due to the activities of an intermediary that is related to the enterprise. The NFTC believes that Article 9, where applicable, should be applied before Article 7. The only profits that may be attributed to a permanent establishment of an enterprise are profits of the enterprise itself that are attributable to functions, assets, and risks in the jurisdiction of the PE. It is consistent with the structure of the Model Tax Convention and its Commentaries to determine the profits of the enterprise under Article 9 before undertaking an inquiry under

Article 7 (or Article 5). This ordering is also 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 intermediary to file a return that reflects the profits attributable to the intermediary and the dependent agent PE (if any) in lieu of multiple reporting and filing requirements (see paragraphs 20 and 21). The failure to achieve consensus on this point will lead to disputes and double taxation. While we agree with the sentiments in the last two sentences of paragraph 12 (that profits should not be double counted or double taxed by the source country), those sentiments should be effectuated by providing an agreed framework or process to ensure that there is no double counting or double taxation by the source country of the same profits.

Moreover, the language of paragraphs 14, 17 and 18 should be better aligned. Paragraph 14 asserts that risk allocation under the transfer pricing guidelines is solely for the purpose of determining the taxable profits of the associated enterprises, and therefore does not change the facts on which the application of Article 5(5) is predicated. Paragraph 18 states, correctly in our view, that risk that has been allocated to an intermediary under the transfer pricing guidelines of Article 9 cannot be considered to have been assumed by the enterprise or its PE for purposes of Article 7. This conclusion is in tension with the language of paragraph 17 – while it is true that the standard for allocating risk between two enterprises may be different from the standard for allocating risk within an enterprise, the standard for allocating risk under Article 9 controls the question of risk allocation as between the intermediary on the one hand and the non-resident enterprise (and its PE) on the other. More generally, the allocation of risk under the transfer pricing guidelines should reflect the substance of the arrangement at issue, and therefore constitutes a fact for purposes of Article 7 and Article 5(5). This is consistent with applying an Article 9 analysis first to determine the substance of the arrangement and the profits of the intermediary and non-resident enterprise, and applying Article 7 and Article 5(5) following this determination.

### **Administrative Approaches to Enhance Simplification**

Paragraphs 20 and 21 note that some countries have adopted practices that simplify the administration of, and compliance with, these rules. For example, some countries collect tax only from the intermediary even though the amount of tax is calculated by reference to the activities of both the intermediary and the Article 5(5) PE. Paragraph 21 ends by stating that “nothing in this guidance should be interpreted as” preventing countries from maintaining or adopting these practices. The NFTC recommends that the OECD encourage the adoption of these practices. The BEPS project has generated two significant and relevant outcomes: (1) Action 7 has produced an expanded PE definition, which creates Article 5(5) PEs in a broader and less predictable set of circumstances; and (2) Actions 8-10 have provided new standards for the allocation of risk in the transfer pricing area, which generally permit the allocation of risk only to an enterprise that exercises risk management and control functions and that has financial capacity to assume the risk. Taken together, these developments make Article 5(5) PEs (and disputes regarding whether an Article 5(5) PE exists) much more likely to arise, and also make it more likely that such PE will have little or no profits attributable to it because returns to risk may have already been allocated to the intermediary under Article 9. In light of these developments, the NFTC believes the simplifying administrative practices should now be

available on a uniform basis across jurisdictions to promote the orderly transition to the new PE standard. The OECD is uniquely positioned to encourage this development.

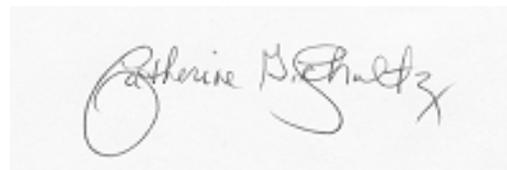
### **Examples 1-2**

The facts of Examples 1-2 are similar in that, in each case, an Article 5(5) PE is found because of the activities of a related intermediary in the source country. In each case, the example explains that the profits attributable to the Article 5(5) PE include the revenues from the relevant customer contracts minus expenses, including arm's length charges from the intermediary and from the rest of the enterprise. Each case therefore assumes dealings between the enterprise and its PE in which the PE is interposed between the customer and the rest of the enterprise. The examples should be explicit in characterizing the PE as a distributor. Note that it is also possible that the dealings between the PE and the rest of the enterprise are the provision of services by the Article 5(5) PE to the rest of the enterprise. Each of these constructs can lead to the same conclusion as to the net profits of the PE. The examples should explain the justification for the PE's net profit (if any) given that the arm's length compensation paid to the intermediary is a deduction for the PE. More generally, 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.

### **Example 3**

In Example 3, the non-resident enterprise is considered to have an Article 5(5) PE because of procurement activities performed by an intermediary in the source country. We recommend that this example be deleted. The example assumes that an Article 5(5) analysis can be applied to purchasing activities. There does not appear to be any basis for this in the text of Article 5(5), and the guidance on profit attribution should not be used to expand PE definition.

Sincerely,

A handwritten signature in cursive script that reads "Catherine G. Schultz". The signature is written in dark ink on a light-colored background.

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 to NFTC Comments on BEPS Discussion Draft of Additional  
Guidance on the Attribution of Profits to Permanent  
Establishments (2017)**

NFTC Board Member Companies:

ABB Incorporated  
Amazon  
Amgen  
Applied Materials  
Baxter International Inc.  
British American Tobacco  
Cargill  
Caterpillar Incorporated  
Chevron Corporation  
Cisco Systems  
Coca-Cola Company  
ConocoPhillips, Inc.  
Corning  
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  
HP Inc  
IBM Corporation  
Johnson Controls  
KPMG LLP  
Mars Incorporated  
Mayer Brown LLP  
McCormick & Company, Inc.

Microsoft Corporation  
Mondelez International Inc.  
Oracle Corporation  
Pernod Ricard USA  
PMI Global Services Inc.  
PricewaterhouseCoopers LLP  
Procter & Gamble  
Qualcomm Incorporated  
Siemens Corporation  
TE Connectivity  
Toyota Motor Sales, USA Incorporated  
United Parcel Service, Inc.  
United Technologies  
Visa, Inc.  
Walmart Stores, Inc.

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

September 15, 2017

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, the OECD has released on June 22, 2017, a document for public review (the “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 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 relation between (i) the profit attributable to a Dependent Agent PE (“DAPE”) under Article 7 of the OECD Model Tax Convention (“MTC”) and the (ii) profit attributable to a Dependent Agent Enterprise (“DAE<sup>2</sup>”) under Article 9 of the MTC.

We appreciate that the Draft does not comment on the precedence of Article 7 over Article 9, leaving it with the responsibility of local jurisdictions. We agree with the Draft that the arm’s length principle / the principle of separate and independent enterprise dictate that “*The order in which Article 7 and Article 9 are applied should not impact the amount of profits over which the source country has taxing rights*”<sup>3</sup>. Yet, we also believe that the order may result in different taxing rights between individual entities and hence, may result in possible double taxation (or double non-taxation). Leaving this issue open to local preferences in host and home country will certainly be a recipe that will lead to the multiplication of controversy.

Moreover, the Draft set forward that the use of numerical examples had been avoided. Numerical examples would certainly have been quite helpful in testing the validity of the conceptual framework in the context of specific cases. We are concerned that potential for different interpretations of the definition of these items and of the precedence of Article 7 over Article 9 may

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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.

<sup>2</sup> or “Intermediary” in a non-Authorized OECD Approach (“AOA”) approach

<sup>3</sup> §12, Discussion Draft

result in substantially different outcomes for the PE and the DAE and, possibly in different total taxing rights for the host country. Consequently we are not sure the examples meet their objectives to help understand the guidance and to illustrate concretely, simple situations one may refer to.

We provide further comment in Appendix A on some of the provisions of the Draft in this respect.

As a side comment, we are not certain the examples provided are useful as, by nature, they are too simplistic and rely on implicit assumptions. The key to establishing relevant facts regarding the relations between parties concerned is the recognition that factual case situations are often complex and unique. Recognizing this requires a serious functional analysis, including a value chain analysis. That feeds the identification of the potential presence of PEs, and allows establishing the appropriate allocation of profits to the subsidiary enterprise resp. the PE of the main enterprise.

In respect of the Examples, we wish to mention once more the deceptive role of simplified case descriptions such as used for the Examples. Sellco sells to buyers in country S; it does not own the products. Under “Analysis” par. 25 mentions that Sellco does not do so as an independent agent. The term apparently refers to the economic notion of independence. The analysis then continues to refer to TradeCo’s revenue from sales to customers in country S minus (item 1) “the amount ...it would have received if it had sold to an unrelated party” in the same circumstances, but “attributing to such party ownership of the assets” etc. It is unclear to us how this attribution can be the consequence of a test of unrelated transactions in the same circumstances. “No ownership of assets or stock” should mean the same in both cases.

We further note that the conceptual framework seems to consist of one equation with two unknowns: item 1 is apparently based on a CUP for the sale of goods to SellCo and item 3 is supposed to be established based on whatever method under article 9. It will not allow to reach conclusions in quite a few situations.

As a matter of practicality, we recommend that the OECD issues a clear conclusion as to whether or not Article 9 be given the precedence over Article 7 - as the OECD seems to be mutely suggesting through a number of statements.

A positive conclusion would, we think bring clarity, simplicity and certainty in the international tax landscape.

We are looking forward to further share with the OECD our views on how develop appropriate tools and concepts to come to a fair taxation when dealing with PE’s in for example more complex industries such as the digital economy through the future developments under Action 1.

Yours truly

Guillaume Madelpuech  
Principal  
Paris

Pim Fris  
Affiliated Consultant  
Paris

Amanda Pletz  
Associate Director  
London

## Appendix A. Comments on selected sections of the Draft

### A.1. Order in which Article 7 and Article 9 are applied

We understand from paragraph 12 that

*The order in which Article 7 and Article 9 are applied should not impact the amount of profits over which the source country has taxing rights<sup>4</sup>.*

We understand from this paragraph that

- #1: an analysis under Article 9 of the transaction between the Non-Resident Enterprise (“NRE”) and the DAE, where the DAE would be compensated properly for its economic role, i.e. in light of its conduct and actual economic contribution to value creation

would come to the same result as

- #2: an analysis, under Article 7, where the DAPE would be allocated, the share of the profit resulting from the DAE activity, but not attributed to the DAE under Article 9.

We are of the opinion that this situation #2 would mean that Article 9 has not been properly applied.

Similarly we note the mention by the Draft that:

*When the accurate delineation of the transaction under the guidance of Chapter I of the TPG indicates that the [DAE] is assuming the risks of the transactions of the [NRE], the profits attributable to the PE could be minimal or even zero<sup>5</sup>.*

We understand this sentence to mean that where the DAE is rightly compensated under Article 9, the profit attributable to the DAPE could be minimal or nil, and as such, comforts the interpretation worded above.

A seamless practical integration between Article 5 and 7 on the one hand, and Article 9 on the other hand is further supported by the recommendations in terms of administrative approaches to enhance simplification whereby the Draft recommends – as we understand it – that countries:

*.... collect tax only from the [DAE] even though the amount of tax is calculated by reference to activities of both the [DAE] intermediary and the [DAPE].<sup>6</sup>*

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<sup>4</sup> §12, Discussion Draft

<sup>5</sup> §19 Discussion Draft

<sup>6</sup> §21, Discussion Draft

Due to the absence of a common standard in the order the OECD opens the door to complexity, uncertainty, administrative burden and double taxation, because of possible different interpretations and practices by countries.

## **A.2. Relationship between Article 9 and Article 7 Concepts (e.g. SPFs)**

The language in the examples states that:

*Article 9 and the Transfer Pricing Guidelines are applicable, either directly or by analogy, in determining the amounts [required to determine the profit attributable to the PE]<sup>7</sup>*

In this respect we note that, under the principle of separate and independent enterprises which is at the core of Article 7, it is probably difficult to see situations where Article 9 concepts would not be appropriate for Article 7 purposes. We would tend to think that Article 7 concepts should subsume and complement Article 9 concepts but may not contradict them.

## **A.3. Exhaustion of host country's taxing rights**

Paragraph 19 states that:

*It should be noted that the host country's taxing rights are not necessarily exhausted by ensuring an arm's length compensation to the intermediary<sup>8</sup>*

We would much appreciate that the OECD develop its analysis on this particular comment.

We understand that the OECD refers to the fact that the host country's taxing rights are not necessarily exhausted by ensuring a seemingly arm's length compensation to the intermediary in case of improperly delineated transaction of the DAE. If the OECD were to confirm our understanding, we would urge it to clarify its wording as we believe that improperly delineated transaction may not result in arm's length compensation at all.

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<sup>7</sup> §25, §30, §34, §48, Discussion Draft

<sup>8</sup> §19, Discussion Draft

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Dott. Pier Luca Mazza  
Dott. Marcello Romano  
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Dott. Andrea Viani  
Dott. Francesco Zondini

Milan, 15 September 2017

## OECD Discussion drafts on the attribution of profits to permanent establishments and transactional profit splits

**By email: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)**

### Studio Pirola's observations

Studio Pirola Pennuto Zei & Associati welcomes the opportunity offered by the OECD to provide its comments to Documents: i) *“Additional Guidance on the Attribution of Profits to Permanent Establishments - which deals with work in relation to Action 7 (“Preventing the Artificial Avoidance of Permanent Establishment Status”) of the BEPS Action Plan, and ii) “Revised Guidance on Profit Splits” - which deals with work in relation to Actions 8-10 (“Assure that transfer pricing outcomes are in line with value creation”) of the BEPS Action Plan, of particular scientific and academic but also practical interest.*

Specifically, we would like to propose the following comments.

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#### *i) Discussion draft containing Additional Guidance on the Attribution of Profits to Permanent Establishments*

As a general introduction, we note that the Public Discussion Draft *“Additional Guidance on the Attribution of Profits to Permanent Establishment* appears to base most of its observations and conclusions on the AOA - the Authorised OECD Approach - contained in Article 7 in the 2010 version of the MTC as outlined in the 2010 Report on the Attribution of Profits to Permanent Establishments ("2010 Profit Attribution Report"). This approach states that the profits to be attributed to such independent entities must be determined through an analysis of the functions and risks assumed by the PE pursuant to the *“significant people function doctrine”* - SPF doctrine. 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.

In addition, please note that:

a) the AOA approach should not be intended to charge the taxpayer with more burdensome documentation requirements in connection with deemed dealings and the taxpayer should not bear costs and burdens not in line with the

circumstances. Having regard to the complexity of the matter and the lack of consistent expert opinions on the subject, the OECD's guiding principle (whether the AOA approach is adopted or otherwise) should be an approach based on documentary and administrative simplification both in the preliminary stage of the assessment of a PE and for the determination of the (possible) income attributable to it.

In the circumstances, the accounting reconstruction of the income to be attributed to a hidden PE/DAPE (based on the functions and risks assumed) becomes a key issue. Regardless of the principles adopted, such reconstruction would be a complex and not-so-obvious task which Tax Administrations should increasingly focus on, especially (as is the case in Italy) where the income relevant for tax purposes is (solely) that deriving from the results of the accounting records, for both IAS/IFRS compliant companies and companies which adopt domestic accounting principles.

b) With particular regard to the reconstruction of DAPE's profits and losses based on the AOA approach, in our opinion the Tax Administrations should coordinate the application of the rules under article 9 of the OECD Model Tax Convention (Transfer Pricing) – to be prioritized – with those under article 7 of the OECD Model Tax Convention. 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 *TradeCo/SiteCo* 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 S to the benefit of *TradeCo/SiteCo* imply per se a "fair" attribution of income to SELCO in Country S, which should neutralize the tax claims of the latter State.

In addition, we agree with the OECD position to deduct the sales commission paid by *TradeCo/SiteCo* to SELCO when determining DAPE's income in Country S: should no deduction be allowed, double taxation would arise.

c) 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. As already noted<sup>1</sup> it would probably make more sense to consider SELCO and DAPE as a single taxable person carrying on business in Country S, with the result that:

- the sales commission paid to SELCO may be deducted from the income of the single tax entity carrying on business in Country S;
- any losses realized by DAPE may be offset against SELCO's profits;
- SELCO's and DAPE's respective profits and losses can be consolidated for tax purposes in Country S.

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<sup>1</sup> Cf. Studio Pirola's Observations, September 2016.

In our opinion SELCO and DAPE should be treated as a single and indivisible taxable person, with the possibility to consolidate any opposite financial results realized by them in Country S.

*ii) Revised guidance on profit splits*

- a) First of all, we note that the revised discussion draft on profit split correctly states the difficulty in the adoption of a 'pure profit splitting method' and the preference for the approach of a residual profit split methodology, which is the most used in the practical transfer pricing evaluation. Indeed, even if a unique contribution in a transaction is identified, the remuneration is almost always made up of profits referred to (i) a routine activity (valuable with a one-side method or a traditional one, if applicable) and (ii) an extra profit referred to the intangible asset(s) or the extra profits generated through integrated transactions (i.e. the unique contribution), which should be apportioned through significant drivers, to be identified according to the specific case. This circumstance allows the use of the residual profit split method in most of the cases.
- b) Among the different drivers to be used in order to split the profit of a unique contribution transaction, we believe that the reference to the transactions of an independent comparable set is quite difficult criteria to apply, since it should be necessary to identify the "comparable extra profit" generated by independent enterprises. The identification of the unique qualifying contribution in uncontrolled transactions is almost impossible due to the lack of reliable information about the functions and the actual business activity performed by independent companies.  
Moreover, it needs to be pointed out that the purpose of the 'splitting keys' is not the evaluation of the extra contribution generated, but the allocation of the extra profit among the entities involved in the transactions. Therefore, the reference to independent comparable transactions - as well as being quite difficult to apply - is not necessary and it can lead to misleading results, since, being the contribution unique, the external comparability is excluded.

Based on this, we deem that, once identified the unique contribution to be evaluated in the controlled transactions, the asset-based and the cost-based drivers mentioned in the discussion draft should be considered the most reliable in order to split the profit, since they are based on the accounting data of the entities directly involved in the transactions, thus taking into account the effective involvement (in terms of asset, capital employed or expenses incurred) of each associated company.

- c) As reported in the discussion draft, the choice of the drivers depends on the specific case, even if it is possible (and necessary) to provide guidelines in order to establish if the reference to assets, capital employed or costs incurred is the most suitable one for the profit splitting purposes. In this respect, we would like to point out the following:

Asset-based factors

The net operating capital employed (in terms of the value of all the assets and liabilities used, excluding the net equity and the net financial position), should be selected as a reliable profit splitting key in the following cases:

- I. The companies involved in the transactions are engaged in a value added business, so that they qualify as full manufacturing companies or, in any case, are engaged in a complex production activity. Those businesses need strong investment for the development of internal key competences, through which the entity gains competitive advantage on the market. Should this be the case, the net operating capital employed should be regarded as the most reliable factor to split the profit among the associated entities.
- II. Consistently with the OECD transfer pricing guidelines on the adjustments for the distribution activity, the net operating working capital is suitable for the split of the extra profit resulting in the intercompany transactions involving simple manufacturing activities (i.e. contract manufacturing) or distribution (not including marketing intangible, for which the driver should be based on the costs actually incurred for the intangible development and maintenance).

Cost-based factors

The costs incurred should be used as profit splitting factors where marketing intangibles, generating extra profits, are involved in the transactions. Should this be the case, the marketing costs shall be considered as the most reliable factor.

It is also necessary to underline that a profit splitting factor based on headcount or employee costs should lead to unreliable results, since:

- I. The number of employees involved in the transactions is very rarely connected to the extra profit;

- II. The employee costs greatly depend on the geographic area where the company is located and in most cases they are not directly connected with the profit generation. Nevertheless, a different conclusion could be reached when highly trained and experienced resources are involved in the transaction, thus creating a 'valuable asset', to be carefully considered as a key to identify the competitive advantage based on which the extra profit should be allocated.
  
- d) Finally, we share the remarks contained in the document referred to the need to carefully identify and value the assets and the costs to be used as splitting factors. The figures used should be based on common accounting standards among the entities involved and possibly with an external certification about the fairness and accuracy of the costs accounted.

Sincerely,

Studio Pirola Pennuto Zei & Associati



Mr Jefferson VanderWolk  
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By email to: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)

19 September 2017

Dear Mr. VanderWolk,

## ***Discussion Draft 2: attribution of profit to permanent establishments***

### ***Introductory Comments***

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD's second *Public Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments* (DD2 or the paper).

The DD2 takes a change in direction from the OECD's first *Public Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments* (DD1) published for comments in July 2016. In doing so, it provides general guidance and high level qualitative examples on the attribution of profits to a Permanent Establishment (PEs) created as a result of the widened definition of a PE following OECD's Base Erosion and Profit Shifting (BEPS) Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status.

By changing to an approach setting forth general principles, taxpayers and tax administrators are left with a high level of subjectivity regarding the proper attribution of profits to PEs created under the expanded definition of a PE set forth in Action 7. This increases the prospects for inconsistent determinations and a higher potential for controversy and double taxation. We recommend that you reconsider the abandonment of the numerical examples included in DD1, reinstating them with modifications to address the comments received, together with an overlay of the general principles contained in DD2

In addition, the DD2 provides some insights into the underlying principles for the application of Article 7 and the interaction between Article 7 Model Tax Convention (MTC) and Article 9 MTC.

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However a number of key questions or collateral issues based on the guidance and examples proposed are still to be addressed as highlighted in this letter.

We have set out our comments in the following sections in line with the key aspects set out in the DD2, being general principles, administrative approaches to enhance simplification, and the four examples.

However, one overriding consideration is whether it is the right time to finalise this now. Further consideration of PEs and business models in a more digitized economy will be taking place over the coming months. Would any guidance agreed now be suitable for use if the concept of a PE were to be broadened in relation to digital presence? If there is sufficient uncertainty, wouldn't it be better to again postpone this and agree an integral approach after spring 2018?

### ***Attribution of profits to permanent establishments resulting from changes in line with BEPS Action 7***

Over circa 17 paragraphs the paper sets out additional general guidance in relation to the attribution of profits to PEs following the proposed change to Article 5 MTC in line with Action 7.

Overall we find that the additional guidance provided does not materially advance the guidance already provided in the commentary to Article 7 MTC and the OECD's 2010 Report on the Attribution of Profits to Permanent Establishments (PE Report). There are some specific observations that we would like to highlight, as follows:

- (a) BEPS Action 7 - No fundamental changes to the principles and the application of Article 7 MTC
  - We agree with paragraphs 8 and 19 of DD2 that the profits attributed to a PE resulting from changes to Article 5(5) and 5(6) are not necessarily the entire profits of these contracts, and could be minimal or zero. This is in line with the current "No force of attraction" principle as detailed in section 12 of the commentary of Article 7 Paragraph 1. As noted in our previous DD1 response, question 5, we would expect that in practice the actual profits allocated to PEs, created under the changes to Article 5(5) and 5(6) when intermediaries already exist and are compensated at arm's length under Article 9 MTC, would be minimal-to-no additional profits in the PE. The DD2 does not clarify when this may be the case and effectively leaves all interpretations open. We would welcome further examples of such PEs where distinctions in factual circumstances would make it clear when minimal-to-no additional profits would be realised compared to those that would create significant additional profits.
  - We agree with paragraph 9 of DD2 that there should be no fundamental changes proposed to the principles and application of Article 7 of the MTC i.e. that profits attributable to a PE are those that the PE would have reported if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions. We also welcome the comment that the fundamental standard applies regardless of whether the relevant treaty adopts the Authorised OECD Approach (AOA) or not.
- (b) Article 7 MTC vs. Article 9 MTC – Priority Order
  - DD2 paragraphs 10 through 12 clarify that the priority order of analysis between Article 9 and Article 7 MTC should be inconsequential to the level of total profits to be taxed in the host



country. Although we welcome this comment, from a practical perspective and in line with our comments on DD1, responses to question 1, there is a practical and administrative preference for an Article 9 analysis to take place in priority. Paragraph 234 of Part I<sup>1</sup> and paragraph 112 of Part III<sup>2</sup> of the PE Report also makes it clear that an Article 9 MTC analysis is expected before an Article 7 MTC analysis. As such we would ask that the OECD acknowledges that the profits of the associated enterprises under Article 9 MTC should be determined first before that of the head office and PE under Article 7 MTC. If such guidance were not provided, it would be beneficial to expand the examples in DD2 to reflect how the priority order of applying Article 9 MTC and Article 7 MTC does not impact the level of total profits to be taxed in the host country. In particular, the current examples in DD2 seem to take the approach of applying Article 9 before Article 7 as Article 7 is being applied by considering the arm's length compensation of relevant affiliated enterprises by applying Article 9. Therefore, we would welcome if these examples are expanded by an illustration of how one may approach the application of Article 7 before Article 9, while demonstrating that the order of applying the two articles is not influencing the level of total profits to be taxed in the host country. We note that the inconsequential outcome is stated by reference to the level of total profits in the host country (e.g. total profits of the dependent agent and DA PE) rather than the DA PE so one may assume that the DA PE attributed profits might be impacted by the order of applying the two articles. Given these points, we consider that if no clear preference is expressed for the order of applying the two articles, it would be recommended to further expand the examples to discuss both approaches and reflect the relevant impact on the total profits in the source state and in particular the profits to be attributed to the PE.

- Nevertheless under paragraph 12 it is recommended that jurisdictions apply a consistent priority approach of Article 9 versus Article 7 MTC within their jurisdiction which, at their discretion, may be made public to help provide certainty to taxpayers. The absence of a consistent international priority approach however is not in line with the BEPS objective of international coherence and will likely lead to increased international disputes e.g. where the non-resident state applies Article 9 in priority, but the source state applies Article 7, potentially leading to different conclusions for the PE and corporate taxpayer across the two jurisdictions. Where this point is particularly poignant is for example where there are varying tax regimes for PEs versus corporates or collateral tax impacts. Please refer to our comments to question 1 of the first discussion draft for further details on this point.

(c) The impact of BEPS Actions 8-10 recommendations on PE profit attribution principles

- The paper, in paragraph 17, confirms that there is an overlap of “risk control functions” under Article 9 MTC and the proposed new Commentary on the 2017 update to that following

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<sup>1</sup> Paragraph 234 Part I of the PE Report reads “In calculating the profits attributable to the dependent agent PE it would be necessary to determine and deduct an arm's length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking in to account its assets and its risks if any). Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm's length reward has been given to the dependent agent enterprise.”

<sup>2</sup> Paragraph 112 of Part III of the PE Report reads “Where, for example, one enterprise is acting as agent for a second enterprise and the activities of the first enterprise create a dependent agent PE as defined in Article 5(5), it will first be necessary to apply the guidance in Section C under Article 9 to establish the arm's length price of the transactions between the first enterprise and the agent enterprise (where the agent is an associated enterprise), and then to apply the guidance in Section D on Article 7 to attribute an arm's length amount of profits to the dependent agent PE.”



Actions 8-10 (as reflected in the OECD's 2017 Transfer Pricing Guidelines or TPG), with the concept of Significant People Functions (SPF) under Article 7 MTC, but stops short in reconciling these two concepts. This is further complicated in paragraph 19 where it is stated that the profits attributable to a PE may be positive, nil or negative **even when an arm's length compensation has been paid to the intermediary in the source state**, which suggests that there are key differences between the BEPS Action 8-10 and the Article 7 MTC approach.

- Conceptually, and to avoid double tax, it should not be possible to have an Article 9 MTC conclusion following BEPS Action 8-10 that differs to an Article 7 MTC analysis in relation to the allocation of risks. We would therefore welcome further guidance and examples to highlight when the application of these two principles, risk control functions and SPFs may lead to deviating conclusions (i.e. a positive or negative PE profit attribution).
- In paragraph 18 it is stated that risks that have already been attributed under Article 9 MTC cannot also be allocated under Article 7 MTC. This will ultimately depend on the priority order of analysis between Article 9 MTC and Article 7 MTC (see comments above). If the Article 9 MTC analysis is first undertaken then conceptually there should be no additional risks and therefore profits to attribute to the PE. If the Article 7 MTC analysis is undertaken first then it should be made clear that although under Step 1 of the AOA risks (etc.) will be allocated to the PE in order to determine the dealings between the enterprise and the PE, under Step 2 of the AOA the amount of profits attributed to the PE will be reduced by the amount of profits already allocated to the relevant intermediary so that in effect the risks (and therefore profits) are not allocated more than once. We would therefore ask for further clarity on how the OECD intends that in practice risks are not allocated more than once.

### ***Administrative approaches to enhance simplification***

Although we acknowledge that the compliance requirements of taxpayers are subject to domestic regulations, we would welcome research and recommendations by the OECD in this area to encourage international harmony and ease the administrative burden for all types of PEs, in particular Dependent Agent PEs (DA PEs), where the level of administrative burden in the source state significantly outweighs the local nexus when a DA PE is created. To illustrate, take for example an enterprise distributing products in over 50 jurisdictions through the use of an intermediary whose distribution activities are priced at arm's length under Article 9 MTC which would now also create DA PEs i.e. an additional tax presence and compliance obligation in each<sup>3</sup> jurisdiction under the expanded definition following BEPS Action 7.

Although in paragraph 21 the paper does move one step forward from the current PE Report by actively encouraging jurisdictions to adopt simplification procedures<sup>4</sup>, we do not consider this recommendation strong enough in order to provide the administrative simplification needed for taxpayers (and tax authorities) alike.

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<sup>3</sup> For simplicity in the example we have not brought in to consideration the Multilateral Instrument (MLI) signatory positions at this stage.

<sup>4</sup> The wording in the current PE Report at paragraph 246 of Part I is "Nothing in the authorised OECD approach 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 the dependent agent".



We welcome the comment that the compliance burden in the event of a DA PE cannot be deemed insignificant which is consistent with the current guidance in section 246 (footer number 12) of Part I of the PE Report.

The paper also recognises the option of tax authorities to collect the tax payable of the PE from the intermediary in the host country which again is consistent with paragraph 246 of Part I of the PE report. The paper does not however consider the collateral tax issues of doing so e.g. domestic issues such as VAT, determination of who is the taxpayer for double tax relief, loss relief and issues that arise if the home country doesn't agree with the allocation (i.e. due to the amalgamation of the PE and intermediary profits in the intermediary's tax return the home country may challenge the perceived overcompensation of the intermediary).

We would in particular welcome recommendations for administrative simplicity where a PE is created under the new Article 5 but no profits are attributable to the PE when taking into account the transfer pricing of the intermediary. This is because the potential administrative, financial, and in some cases even criminal domestic consequences of non-compliance (i.e. not filing a nil tax PE return with the local tax authorities) as well as the tax, reporting and regulatory burdens are significantly out of line with benefits to be gained by jurisdictions from nil tax PE returns. In line with our comments above, prioritising the Article 9 analysis would be one means of ensuring international consistency while alleviating the compliance burden for taxpayers, since, in most cases, there will be little or no residual income attributable to the PE created by the intermediary.

### ***Examples***

Our overall comment in relation to the four new examples provided is that they require significantly more detail in order to be able to appropriately apply the AOA two-step approach and therefore to clearly understand how in practice the AOA is expected to be applied to PEs created under Action 7.

Based on the information and analysis provided in the examples, we note the following specific points:

(a) The AOA two-step Approach – the significance of Step 1

- As you are aware the attribution of profits to a PE under the AOA is broken into a two-step chronological analysis:
  - Step 1 requires a functional and factual analysis, i.e. identification of SPFs, leading to the attribution to the PE of rights and obligations, assets, risks, other functions of the PE, recognition of dealings, and finally the attribution of capital, and then
  - Step 2 requires the arm's length pricing of dealings to be evaluated based on a comparability analysis and via application of the arm's length principles.
- The analysis of the examples in the DD2 provides limited-to-no information on Step 1 of the APA but instead focuses on Step 2. However a clear factual and functional analysis and identification of SPFs and dealings under Step 1 is vital and must be undertaken before profits can be attributed appropriately to the dealings under Step 2.



- For each example therefore we would welcome a clear and complete analysis of the Step 1 AOA to set the context in which the Step 2 analysis is undertaken.
- We also acknowledge that not all jurisdictions apply the AOA, but that the Guidance and examples are being developed for the purposes of application by all jurisdictions regardless of local AOA adoption. As such the guidance and examples should indicate how the allocation of profits would differ under the AOA, non AOA and if one country applies AOA and another country does not, and what the appropriate dispute resolution would be in such cases.

(b) Attributing revenues to the PE

- We would advise that there is not a direct read across between the creation of a DA PE under Article 5 MTC and the allocation of the third party sales revenues to the PE (in the case of sales and marketing DA PEs) under Article 7 MTC and would request for this to be clarified in the guidance and examples for the reasons listed below.
- First, the creation of a DA PE does not mean that a jurisdiction automatically has the right to tax over the entirety of the revenues generated in the source state as this would impede the arm's length analysis of the dealings and is likely to lead to an over-allocation of costs and/or revenues to a PE. Take for an example a DA PE where it has been determined that the dealing is priced at arm's length based on a mark-up of 10% of the costs of €10k attributed to the PE resulting in a profit in the PE of €1k. This analysis differs drastically when compared to a dealing whereby all the third party revenues of say €55k are attributed to the PE thus meaning that the costs attributed to the PE is the balancing number of €50k in order for the PE to earn a suitable 10% mark up on costs i.e. a profit of €5k in line with the arm's length pricing determined.
- Second, the Article 5 MTC conditions for a DA PE are based on specific functional and temporal criteria, whereas the allocation of the rights and obligations arising from transactions with other enterprises under Article 7 MTC is based on where the significant people functions are undertaken to assume and/or subsequently manage particular risks and economically own particular assets<sup>5</sup>.
- Third, examples 1 and 2 automatically allocate revenues to the DA PE based on the third party revenues. This is inconsistent with two other bodies of regulations. First, international accountancy principles, where specific thresholds must be met in order to be considered the "principal" of the sale (or purchase) and be allocated the revenues (or costs) of the third party contract. Second, the Transfer Pricing Guidelines (TPG), where it may still be the case that the arm's length pricing of the DA PE under the AOA, based on the functions performed, risks assumed and assets owned, is in the form of a commission (or even total costs plus a margin for a sales and marketing service provider), rather than attributing the full revenues of the contract (as noted in the example above).
- Finally, although we note that there are differences in the relevant industries, paragraph 16 of Part III (Special considerations for Global Trading) of the PE report specifically acknowledges

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<sup>5</sup> Paragraph 45 and 98 of Part I, OECD PE Report, July 2010



that a sales agent (in this case, a financial broker) would earn a commission income and not the full revenues associated with the contract.

(c) Comparability analysis

- All of the examples suggest that suitable comparables will be available in the source State S to price the relevant dealing. In practical terms such local comparables are unlikely to be available and per Chapter III (Comparability Analysis) of the TPG such stringent geographic comparability criteria is not necessary. We assume therefore that it is not the intention of the DD2 to introduce a more stringent comparability standard than under Chapter III TPG and would ask for this to be made clear in the guidance and examples.

(d) Suggested calculation scheme of DD2

- The examples suggest that the hypothetical dealings may be priced based on the arm's length standard but provide no guidance on how to undertake this analysis practically, or even theoretically. To elaborate, the examples do not consider the interrelatedness of revenues and costs in a transfer pricing context (for example a routine service provider may earn intercompany revenues based on their full costs plus a routine mark-up). In addition, the examples do not include the necessary quantitative information to illustrate how, after the allocation of profits to the PE and a deduction for the arm's length remuneration of the intermediary, a profit would be realised by the permanent establishment.

(e) Other comments

- Under the new PE thresholds, where an intermediary relationship exists, the main risks that **may be** reallocated following the creation of a PE are the credit and inventory risks. This is dependent on the factual and functional analysis under Step 1 of the AOA. The critical goals of greater clarity and reduced subjectivity would be served through the inclusion and enhancement of the examples included in DD1 which further explored the allocation of these risks and the resulting financial outcome based on the framework set out in paragraphs 24 and 25 of and reiterated in paragraphs 241 to 245 of Part I of the PE report<sup>6</sup>.
- Example 3 mixes the criteria for the creation of a fixed place of business (FPOB) PE with that of a DA PE as it states that the procurement of widgets is not of a preparatory or auxiliary manner. We understand that you have not requested comments on Article 5 MTC. However we would ask that any examples provided evaluate the threshold criteria of FPOB PE and DA PEs separately to avoid misunderstanding.
- In example 3 it is mentioned that Article 9 MTC may be applied in determining the amounts of the expenses of the DA PE or the arm's length remuneration of BuyCo (the procurement intermediary). We would however expect that Article 9 MTC could also be applied in determining the amount of the revenues attributable to the DA PE under this example, being

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<sup>6</sup> In these paragraphs it is stated that the allocation of inventory risk and credit risk is based on the location where the "active decision-making" in relation to these risks is carried out.



the amount that an effective buy/sell agent would recognise if it had the same functional profile of BuyCo, and we would welcome further practical guidance in this respect.

- In Example 4, the creation of two separate PEs allows taking into account possible varying taxation rates in different regions of a jurisdiction. This concept creates the situation where a cohesive business operation needs to be considered collectively in the context of Article 5 MTC, but independently for the purposes of Article 7 MTC. The implications of this have not been explored further in the paper, either in example 4 or at paragraphs 41 and 42 of the general guidance. This is an opportunity for the OECD to provide further recommendations to enhance administrative simplification and international cohesion and as aforementioned we would welcome any such recommendations.

In summary, we wonder if it would be advisable to postpone finalising this until after recommendations on PEs and mere digital presence are made in spring 2018. Otherwise, we would welcome significant further clarity and quantification of the DD2 additional guidance and examples in order to minimise misinterpretation and misunderstanding leading to significant uncertainties in both the application of the new Article 5 of the MTC (although we have been specifically not asked to comment on this) and the remuneration of the PE under the unchanged Article 7 of the MTC. The DA PE examples do not make much progress from the previous guidance in paragraphs 46-48 and 241-245 of Part I of the PE Report. Finally, we would like to reemphasise that paragraph 9 of the PE Report stipulates that the purpose of the AOA is to set a “limit on the amount of attributable profits that may be taxed in a host country”. Our fear however based on the examples provided in DD2 is that this objective of the PE Report is not being met.

For any clarification on this response, please contact the undersigned or any of the contacts below. We look forward to discussing any questions you have on the point we raise above. We would welcome the opportunity to contribute to the discussion and to speak at the public consultation meeting to be held in November 2017.

Yours faithfully,

A handwritten signature in black ink, appearing to be 'Stef van Weeghel', written over a horizontal line.

Stef van Weeghel, Global Tax Policy Leader

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**Comments on the Public Discussion Draft**

**BEPS Action 7:**

**Additional Guidance on Attribution of**

**Profits to Permanent Establishments**

August 23, 2017

Tax Treaties, Transfer Pricing and Financial Transactions Division

OECD/CTPA

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

To whom it may concern:

We are pleased to briefly comment on public discussion draft *BEPS Action 7: Additional Guidance on Attribution of Profits to Permanent Establishments* through the consultation taking place from June 22, 2017 to September 15, 2017. This document may be posted on the OECD website. Full credit goes to Robert Robillard, RBRT Inc.<sup>1</sup>

**1. General Comments**

Article 5 of the *OECD Model Tax Convention* defines a permanent establishment (PE). To allocate profits to a PE, a functional analysis is required under paragraph 7(2) of the *OECD Model Tax Convention*. The functional analysis and subsequent allocation of profits are carried out with the guidance of the *OECD Transfer Pricing Guidelines*. In comparison, article 9 of the *OECD Model Tax Convention* also requires a comparability analysis as defined by the *OECD Transfer Pricing Guidelines*.

In short, article 7 and Article 9 of the *OECD Model Tax Convention* must be applied with the guidance included in the *OECD Transfer Pricing Guidelines*. It is not a fluke that “Article 9 and the Transfer Pricing Guidelines are applicable, either directly or by analogy” in each example found in the draft to determine the “arm’s length remuneration” of the PE.

This set of facts suggest that the relevance of the “authorised OECD approach” (AOA) found in the *Report on the Attribution of Profits to Permanent Establishments*, published on July 22,

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2010, is becoming more and more questionable. It should be repealed. Corresponding changes to certain paragraphs of the draft and the commentary to article 7 of the *OECD Model Tax Convention* should be made accordingly.

We are available to discuss these suggested changes in more detail at your convenience.

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August 23, 2017

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My comments on BEPS discussion drafts on attribution of profits to PE and transactional profit splits

To the k.a. of Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

**REF.: Public Discussion Draft BEPS Action 7 - Additional Guidance on Attribution of Profits to Permanent Establishments**

Comment 1

*“12. The MTC and its Commentary do not explicitly state whether a profit adjustment under Article 9 should precede the attribution of profits under Article 7. However, many jurisdictions find it logical and efficient first to accurately delineate the actual transaction between the non-resident enterprise and the intermediary and to determine the resulting arm’s length profits while others may decide to undertake an Article 7 analysis first and then to apply Article 9 to adjust the profits of the associated enterprises (i.e. the non-resident enterprise and the intermediary). In any case, the order in which Article 7 and Article 9 are applied should not impact the amount of profits over which the source country has taxing rights as a result of the activities of the intermediary on behalf of its associated non-resident enterprise in the source country.” :*

But I’m not so sure that the effective order of application does not affect the result materially. Personally, I would prefer a rather clearer process to be indicated to jurisdictions in order that their domestic legal and administrative systems of necessary principles, doctrines and mechanisms concretely allow both to ensure certainty for taxpayers and eliminate double taxation in the source country.

Comment 2

*“41. Article 5(4.1) applies in two types of cases. First, it applies where the non-resident enterprise or a closely related enterprise already has a PE in the source country, and the activities in question constitute complementary functions that are part of a cohesive business operation. A determination will need to be made as to whether the activities of the enterprises give rise to one or more PEs in the source country under Article 5(4.1). The profits attributed to the PEs and subject to source taxation are the profits derived from the combined activities constituting complementary functions that are part of a cohesive business operation”.*

Maybe the burdens of ‘closely related enterprise’ should be definite more precisely. In practice, often the risk that in some MNE there could be some interest to not disclose properly or to not disclose at all the existence of such an operating entity is rather high. It is not unusual the probability that a company resident in a different Country from the parent’s one could perform activities on behalf of the not disclosed parent company on behalf of it but not in the name of it. And tax administrations alike may have difficulty accessing information from foreign affiliates, too.

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**.REF.: Public Discussion Draft BEPS Action 10 - Revised Guidance on Profit Splits**

Comment 1

*“40. Where the relevant profits to be split are comprised of profits of two or more associated enterprises, relevant financial data of the parties to the transaction to which a transactional profit split is applied need to put on a common basis as to accounting practice and currency, and then combined. Because account standards can have significant effects on the determination of the profits to be split, accounting standa*

*should, in cases where the taxpayer chooses to use the transactional profit split method, be selected in advance of applying the method and applied consistently over the lifetime of the arrangement. Differences in accounting standards may affect the timing of revenue recognition as well as the treatment of expenses in arriving at profit. Material differences between the accounting standards used by the parties should be identified and aligned.*

*“41. Financial accounting may provide the starting point for determining the profit to be split in the absence of harmonised tax accounting standards. The use of other financial data (e.g. cost accounting) should be permitted where such accounts exist, are reliable, auditable and sufficiently transactional. In this context, product-line income statements or divisional accounts may prove to be the most useful accounting records.*

*42. However, except in circumstances where the total activities of each of the parties are the subject of the profit split, the financial data will need to be segregated and allocations made in accordance with the accurately delineated transaction(s) so that the profits relating to the combined contributions made by the parties are identified..... The exercise may be relatively simple if the same goods are supplied to all markets, but will be more complex if different goods with different production costs or with different embedded technology, for example, are supplied to different markets...*

*62. Internal data may also be helpful where the profit splitting factor is based on a cost accounting system, e.g. employee costs related to some aspects of the transaction, or time spent by a certain group of employees on certain tasks, etc.” :*

In practice all the above requirements have to be complied with but this can be verified only relying upon the results of the internal and external statutory auditor's work and/or performing further audit work by tax authorities. So maybe it could be advisable to establish adequate procedures as to obtain a greater liaison with the audit reports and people responsible of it as well. This could take to an effective fiscal compliance as well as to increase the reliability of reporting companies, enhancing their reputation in terms of CSR, too.

## Comment 2

*“56. In practice, profit splitting factors based on assets or capital (operating assets, fixed assets (e.g. production assets, retail assets, IT assets), intangibles, capital employed), or costs (relative spending and/or investment in key areas such as research and development, engineering, marketing) are often used where these capture the relative contributions of the parties to the profits being split. Note that while costs may be a poor measure of the value of intangibles contributed (see paragraph 6.142), the relative costs incurred by parties may provide a reasonable proxy for the relative value of those contributions where such contributions are similar in nature (see paragraphs 8.27-8.28).” :*

Particular issues arise from 'Hard to Value Intangible Assets', as we know. For instance, in U.S.A. periodic adjustment rules have to address the informational asymmetry occurring when taxpayers value intangible transfers upfront, based on projections that tax administrations cannot audit at the time, and typically have a very difficult time auditing years after the fact. "For such intangibles *asymmetry between taxpayer and tax administrations*, including what information the taxpayer took into account in determining the pricing of the transaction, *may be acute and may exacerbate the difficulty encountered by tax administrations in verifying the arm's-length basis on which pricing was determined*", some author wrote.

Also because financial projections are designed not to predict the future outcome, but to average all possible future outcomes to ensure a fair exchange of *ex-ante* value, in a probabilistic sense. Instead, *Ex-post* outcomes are actual realization of one out of all the possible risk outcomes envisioned in the *ex-ante* average of all possible risk outcomes. Perhaps it would be needed a special discipline for HTVI disclosure and representation.

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September 15, 2017

**VIA ELECTRONIC TRANSMISSION**

Tax Treaties  
Transfer Pricing and Financial Transactions Division  
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**Re: Comments on June 22, 2017 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

The PDD in places makes reference to the 2010 authorized OECD approach (“*AOA*”). We do the same. To ensure the final guidance will be considered relevant to the many treaties that don’t incorporate the 2010 version of Article 7, we think it 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.

The PDD explains that if activities performed by an associated enterprise intermediary give rise to an Article 5(5) dependent agent PE (“*DAPE*”), and if functions performed by the intermediary are both (i) significant people functions for attributing a specific risk to the PE under the *AOA*, and (ii) risk control functions for allocating the risk to the intermediary under Article 9, no double taxation should arise in the source/host country by virtue of twice taxing profits related to assumption of that risk—i.e., profits related to the assumption of that risk shouldn’t be taxed in the hands of both the PE and the intermediary. The SVTDG agrees such double taxation should be avoided, and commends the OECD for clarifying any confusion on this point that might have arisen from the *2016 Discussion Draft*. The SVTDG notes, however, that the PDD seems in places confused on how such double taxation is avoided, especially in the sense of which entity—the intermediary or the PE—assumes the risk. For instance, each of *Examples 1–3* determines profits attributable to the PE by first hypothesizing it earns revenue consistent with it assuming particular risks, but then deducting from such hypothetical revenue a payment to the intermediary as if the intermediary assumed such risks. Such an approach may yield the correct profits attributable to the PE, but it violates a directive in the PDD that a risk assumed by an intermediary under the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (“*TPG*”) can’t be considered assumed by the PE for purposes of Article 7. We point out the inconsistencies and recommend the PDD be clarified to remove them.

The SVTDG recommends the *AOA* should, in the context of PEs arising from activities of associated enterprise intermediaries, be revised to better align with the current (2017) *TPG*, especially regarding risk attribution. The *2010 Profit Attribution Report on the Attribution of Profits to Permanent Establishments* (the “**2010 Profit Attribution Report**”) by its terms must comport with the post-BEPS version of the *TPG*. If the *AOA* under the *2010 Profit Attribution*

*Report* takes into account discussion of risk control in the current *TPG*, a strong argument can be made that the attribution of risks to an associated enterprise DAPE under the AOA should, in cases in which the associated enterprise intermediary has the financial capacity to assume the risks, be materially the same as the allocation of risks between a nonresident enterprise (“*NRE*”) and the intermediary under Article 9. As a consequence, in the context of attributing profits to an associated enterprise DAPE as a result of risk attribution, we believe the host country’s taxing rights in many cases will be exhausted by taxing the intermediary on income from arm’s length compensation it gets for risk it bears.

We recommend the OECD adopt a new paragraph in Article 5<sup>1</sup> allowing an 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 tax liability in the host country arising from activities conducted on the NRE’s account by the resident enterprise or at its premises.

## II. SPECIFIC CONCERNS WITH, AND COMMENTS ON, THE *PDD*

### A. The clarification in paragraph 18 on non-double taxation of profits from risk assumption is welcome, but the discussion needs refinement

Paragraph 18 of the PDD discusses situations in which the NRE and the intermediary (whose activities give rise to a DAPE) are associated enterprises, so that Articles 7 and 9 both apply. In particular, it addresses the situation in which the functions performed by the intermediary are both (i) “significant people functions” (“*SPFs*”) for attribution of a specific risk to the PE under the AOA; and (ii) risk control functions for allocation of the risk to the intermediary under Article 9.<sup>2</sup> Paragraph 18 correctly points out that no double taxation should arise in the source country by virtue of twice taxing profits related to assumption of that risk—

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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.

<sup>2</sup> Tacit in paragraph 18 is the assumption that the intermediary has the financial capacity to assume the risk. This point should be clarified.

i.e., by virtue of taxing such profits in the hands of both the PE and the intermediary. Paragraph 18 states that if conditions (i) and (ii) are met, such double taxation can be avoided as follows:

it is important to ensure that the risk to which those functions relate is not simultaneously allocated to the intermediary . . . and attributed to the PE . . . . Accordingly, where a risk is found to be assumed by the intermediary under [the *TPG*], such risk cannot be considered to be assumed by the [NRE] or the PE for the purposes of Article 7.

The SVTDG agrees that such double taxation should be avoided, and commends the OECD for clarifying any confusion on this point that may have arisen from the *2016 Discussion Draft*.

The SVTDG notes, however, that the PDD is in places confused on how—i.e., the mechanism by which—such double taxation is avoided. The SVTDG agrees that, provided conditions (i) & (ii) are met, if a risk is assumed by an associated enterprise intermediary under Article 9, it can't also be considered assumed by the NRE or the PE. So if Article 9 analysis is done first the risk is allocated to the intermediary, and such risk can't be assumed by the PE (or the NRE).

If, however, Article 7 (AOA) analysis is done first, one way of proceeding is to initially attribute the risk to the PE for purposes of determining a hypothetical revenue amount earned by the PE, but subsequently—when determining the nominally deductible payment the PE should make to the intermediary<sup>3</sup>—allocate risks to the intermediary for purposes of determining such nominal payment. This is the approach the PDD takes in *Examples 1–3*.<sup>4</sup> In theory both

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<sup>3</sup> PDD ¶ 10 (“The arm’s length reward to the intermediary for the services it provides to the non-resident enterprise is one of the elements that needs to be determined and deducted in calculating the profits attributable to the PE under Article 7.”)

<sup>4</sup> In *Example 1* the hypothetical revenue used as a starting point for determining profits attributable to the PE is “the amount of [the NRE’s] revenue from sales of goods to customers in [the source country],” equivalent to “attributing to the PE the sales revenue resulting directly or indirectly from the contracts to which Article 5(5) refers;” (PDD ¶ 25); in *Example 2* such hypothetical revenue is “the amount of [the NRE’s] revenue from sales to customers in [the source country],” likewise equivalent to “attributing to the PE the sales revenue resulting directly or indirectly from the contracts to which Article 5(5) refers;” (PDD ¶ 30); and in *Example 3* such hypothetical revenue is “the amount that [the NRE] would have had to pay if had purchased the widgets from an unrelated supplier performing the same functions in [the source country] that [the intermediary] performs on behalf of [the NRE] (attributing to such supplier ownership of the assets of [the NRE] related to such functions, and assumption of the risks related to such functions),” equivalent to “attributing to the PE the rights and obligations associated with the procurement of widgets resulting directly or indirectly from the contracts to which Article 5(5) refers.” (PDD ¶ 34). In all three *Examples* the attribution of risk to the PE to derive a hypothetical (starting) revenue is either directly or indirectly apparent.

approaches should yield the same profits attributable to the PE:<sup>5</sup> under an Article-7-first approach as described, hypothetical revenue earned by the PE reflects an amount for the risk initially attributed to the PE, but the nominally deductible payment from the PE to the intermediary (based on the risk allocated to the intermediary under Article 9) gives an equal offset. Under an Article-9-first approach, because the PE doesn't assume the risk, hypothetical revenue earned by the PE wouldn't reflect an amount for such risk, which is allocated solely to the intermediary, and so there's no nominally deductible payment from the PE to the intermediary. This contradicts the statement in the PDD that "[t]he arm's length reward to the intermediary for the services it provides to the non-resident enterprise is one of the elements that needs to be determined and deducted in calculating the profits attributable to the PE under Article 7."<sup>6</sup>

On the other hand, the Article-7-first approach as described (and as applied in *Examples I-3*) strictly contradicts the directive in the quoted passage above that a risk assumed by the intermediary shouldn't be considered assumed by the PE. An Article-7-first approach that hewed to the directive in the passage wouldn't begin with hypothetical revenue earned by the PE that reflects the relevant risk. Rather, such hypothetical revenue would be a lesser amount. But with this approach there wouldn't be a nominal deductible payment to the intermediary for its assuming the risk.

The SVTDG recommends that these points be clarified.

The Article-7-first approach carries with it the possibility the tax administration of the host country might—in determining profits attributable to a PE—impose withholding on deemed payments made by the PE. The AOA suggests the host country shouldn't withhold on such notional payments.<sup>7</sup> Nonetheless, for the above reasons, the SVTDG recommends the PDD be revised to recommend the Article-9-first approach is preferable.

The discussion in paragraph 18 assumes conditions (i) & (ii) are met—i.e., functions performed by the intermediary are both SPFs resulting in attribution of a particular risk to the PE (Article 7) and risk control functions resulting in allocation of the risk to the intermediary (Article 9). Certainly in this situation double taxation of profits associated with the risk shouldn't arise (regardless of whether Article 9 or Article 7 is applied first). The SVTDG asserts further that activities giving rise to risk control functions under Article 9 should automatically

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<sup>5</sup> This assumes, for any particular risk, that the profit attributed to a PE for such risk bearing (because of SPFs) under Article 7 equals the arm's length amount allocable to the intermediary under Article 9 for such risk bearing. The SVTDG recommends the OECD clarify this point.

<sup>6</sup> *Id.*

<sup>7</sup> AOA, ¶ 203 (“The recognition of the notional royalty is relevant only to the attribution of profits to the PE under Article 7 and should not be understood to carry wider implications as regards withholding taxes, which are outside the scope of this Report.”)

constitute risk attribution functions under Article 7. Accordingly, assumption (ii) in paragraph 18 should automatically be satisfied if assumption (i) is. We discuss this point next.

**B. The AOA should be revised to make attribution of risks consistent with guidance in the *TPG***

The PDD states in paragraph 17:

While there may be functions that would be considered both [SPFs] for the attribution of risk for the purposes of the AOA and risk control functions for the purposes of Article 9, the conclusion cannot be drawn that these two concepts are aligned or can be used interchangeably for purposes of Article 7 and Article 9.

The SVTDG respectfully disagrees with this statement, and believes these two concepts are and should be aligned—with appropriate assumptions, Article 7 attribution of risks arising from SPFs should follow Article 9 allocation of risks arising from risk control functions. For three reasons (outlined below), the SVTDG recommends the PDD be revised to explain this conceptual alignment.

At the outset we note a potential consequence of non-alignment in the context of an NRE and an associated enterprise intermediary whose activities give rise to a PE. If functions performed by the intermediary constitute SPFs for purposes of attributing a particular risk to the PE under Article 7 (the AOA), but not control functions for purposes of allocating the risk to the intermediary under Article 9, profit related to the risk will be attributed to the PE, and in determining aggregate profits attributable to the PE there'll be no deduction for a nominal payment by the PE to the intermediary in connection with such risk. The arm's length payment from the NRE to the intermediary under Article 9 wouldn't include any component for assumption of this risk by the intermediary, but the profit attributable to the PE would include such a component. More tax would likely be owing in the source country than from just the intermediary because the PE—but not the intermediary— would be subject to tax on income from this risk-related component. A source country tax administration would thus collect more tax by asserting a lower threshold for SPF attribution of risk under Article 7 than for control function allocation of risk under Article 9. The SVTDG believes the threshold under Article 7 shouldn't be lower than it is under Article 9.

**1. The AOA should, in the context of PEs arising from activities of associated enterprise intermediaries, be revised to better align with the TPG regarding attribution of risks**

The *2010 Profit Attribution Report* relies critically on the TPG in an ambulatory way<sup>8</sup>—i.e., in particular, changes made in § I.D (“Guidance for applying the arm’s length standard”) of the TPG must be reflected in how the AOA is applied. Changes to the TPG as a result of BEPS Actions 8–10 *Final Reports* reflected a mammoth multi-year, multi-country effort receiving careful public scrutiny and comment at several stages. When changes to § I.D of the TPG are taken into consideration in applying the AOA, a strong argument can be made that—in the context of associated enterprise DAPES<sup>9</sup>—attribution of risks to a DAPE under the AOA should, in cases in which the host country intermediary has the financial capacity to assume the risks, be materially the same as the allocation of risks between an NRE and the associated enterprise intermediary under Article 9.

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>10</sup> Any such shifted risks should in principle also be taken into account under the AOA.

The *2010 Profit Attribution 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

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<sup>8</sup> *2010 Profit Attribution Report*, Preface ¶ 10 (“[This *2010 Profit Attribution Report*] has been based upon the principle of applying by analogy the guidance found in the [2010 TPG] for purposes of determining the profits attributable to a PE. To the extent the [2010 TPG] are modified in the future, this [2010 Profit Attribution Report] should be applied by taking into account the guidance in the [TPG] as so modified from time to time.”)

<sup>9</sup> That is, a DAPE arising under Article 5(5) because of host-country activities performed by an associated enterprise intermediary.

<sup>10</sup> The payor of a contingent amount is insulated against the downside of possible underperformance or nonmaterialization of the item or event(s) to which the contingency is attached; the payee is insulated against the downside of possible over-performance or excess materialization of that item. This commonsense notion was observed in the 2016 OECD Public Discussion Draft on BEPS Actions 8–10 *Revised Guidance on Profit Splits*, ¶ 6.

the management of those risks to different parts of the enterprise or to other enterprises.<sup>11</sup>

That is, [1] there's an initial attribution to the PE of risks based on the PE's own SPFs; the relevant SPFs will be those performed by the intermediary on behalf of the NRE.<sup>12</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.

Under the AOA, 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>13</sup> By comparison, under the *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>14</sup> Under the *TPG*, control over risk also involves active decision-making with regard to acceptance and management of risks.<sup>15</sup> Active decisionmaking functions triggering risk assumption under the *TPG* should thus also result in risk attribution under the AOA.

Regarding [2] the subsequent shifting of risks, or the management of risks, within the enterprise, the *2010 Profit Attribution 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>16</sup>

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<sup>11</sup> *2010 Profit Attribution Report*, ¶ 21 (emphasis added).

<sup>12</sup> *2010 Profit Attribution Report*, ¶ 47.

<sup>13</sup> *2010 Profit Attribution 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>14</sup> *See, e.g., TPG*, ¶ 1.86.

<sup>15</sup> Control over risk involves “(i) 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 decision-making function.” *TPG*, ¶ 1.65.

<sup>16</sup> *2010 Profit Attribution Report*, ¶ 21 (emphasis added).

The referenced § D-2(vi) of the *2010 Profit Attribution 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>17</sup> The discussion of intra-enterprise dealings is relevant—

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 [¶¶ 1.52–1.54 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 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>18</sup>

In addressing intra-enterprise dealings that might shift risk, the *2010 Profit Attribution Report* thus references segments of the *2010 TPG*, dealing with risks, that were extensively overhauled in the current *TPG*.<sup>19</sup> Significantly, risk shifting [2] under the AOA should also align with allocation of risks (under the *TPG*) that flows from risk control activities.

The *2010 Profit Attribution 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 current *TPG* on control of risk. Control of a risk under the current *TPG* means having—

(i) 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>20</sup>

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<sup>17</sup> *2010 Profit Attribution Report*, ¶ 178.

<sup>18</sup> *Id.*, ¶ 179 (emphasis added).

<sup>19</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>20</sup> *2016 TPG*, ¶ 1.65.

These requirements for control of risk under the *TPG* are 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. The SVTDG recommends that risk attribution as a consequence of SPFs under the AOA thus should comport with risk allocation under the current *TPG*.

For an associated enterprise to bear risk under the *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>21</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 allocation of risks to the associated enterprise intermediary if the intermediary has the financial capacity to assume the risk. As noted above in § II.A, under an Article-9-first approach, risks allocated from an NRE to an associated enterprise intermediary under Article 9 should not then be attributed to the NRE’s PE under Article 7.

## **2. Practicability supports aligning the AOA with the *TPG*, to decrease the likelihood of double taxation**

The SVTDG believes risk attribution under Article 7 should be aligned with risk allocation under Article 9 (assuming the requisite financial capacity to assume the risk). Many tax administrations have much experience applying transfer pricing principles to associated enterprise transactions. The recent addition of detailed guidance in the *TPG* on risk allocation—as a result of the BEPS Actions 8–10 *Final Reports*—fits within a well understood framework of the arm’s length principle. By contrast, tax administrations generally have much less experience applying Article 7 (and even less experience applying the AOA) to attribute risk to a PE. The concept of risk attribution under the AOA is also relatively complex and somewhat subjective.

The SVTDG believes that—without further guidance signaling alignment of the Article 7 risk attribution concept with that of the Article 9 risk allocation concept—tax administrations will face significant difficulties applying these concepts. As noted above in § II.B, a perverse incentive potentially exists to collect more tax by asserting a lower activity threshold for risk attribution to a PE under Article 7 than for risk allocation to an associated enterprise intermediary under Article 9. At a minimum, we think it unlikely in practice that a tax authority could, in an unbiased way, suitably parse and apply the two standards to reach materially different outcomes. We believe application of the Article 7 risk attribution and Article 9 risk allocation concepts is unlikely to be uniform across taxing jurisdictions. Similarly, we think it unlikely in practice that two Competent Authorities applying the two standards would

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<sup>21</sup> 2010 *Profit Attribution Report*, ¶ 47.

necessarily converge on materially the same outcome. This will almost certainly lead to more competent authority disputes, with a high probability of resulting double taxation. This can be mitigated if the OECD modifies risk attribution under the AOA to comport with risk allocation under the *TPG*.

### **3. Policy supports aligning attribution under the AOA with guidance in the *TPG***

Ideally, tax outcomes shouldn't drive business decisions. But non-alignment of Article 7 risk attribution with Article 9 risk allocation will almost certainly result in business decisions taken to mitigate the uncertainty in application of the two provisions. In particular, NREs would—other things being equal—generally prefer the relative certainty of application of Article 9 in the context of an associated enterprise buy-sell model to the relative uncertainty of application of Article 7 in the context of an associated enterprise *commissionaire* model. It's rational to expect that the economic value of risk-related functions should lead to equivalent outcomes under either model. Yet non-alignment of Article 7 risk attribution with Article 9 risk allocation confounds that expectation, and it's likely to force taxpayers to choose a buy-sell distributor model, the tax outcomes of which can be determined with greater certainty. This is a bad policy outcome, and can be remedied by the recommended alignment of Article 7 risk attribution concepts with *TPG* risk allocation concepts.

The SVTDG further recommends, in conjunction with its recommendation on alignment, that the OECD signal that the tax outcome—i.e., total tax collected in a source country—under a *commissionaire* structure giving rise to a PE should in many situations be the same as the tax outcome under a buy-sell structure.

### **C. Going beyond administrative approaches to enhance simplification in cases in which MTC Articles 7 & 9 are both applicable**

The PDD acknowledges the important point that “the potential burden on a [NRE] of having to comply with host country tax and reporting obligations in the event it is determined to have an Article 5(5) PE cannot be dismissed as inconsequential.”<sup>22</sup>

The PDD points to the *2010 Profit Attribution Report* as noting there may be “administratively convenient ways recognising the existence of a PE under Article 5(5) and collecting the appropriate amount of tax resulting from the activity of the intermediary.”<sup>23</sup> The PDD also explains that countries not adopting the AOA “may also adopt mechanisms aimed at simplifying taxpayer's compliance with tax obligations related to the existence of a PE in the

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<sup>22</sup> PDD ¶ 21.

<sup>23</sup> PDD ¶ 20.

source country.”<sup>24</sup> The PDD explains that a number of countries actually collect tax only from the intermediary even though the amount of tax is calculated by reference to activities of both the intermediary and the Article 5(5) DAPE.<sup>25</sup>

Consistent with these general observations, the *Analysis* sections of *Examples 1–3*, each of which involve a DAPE, and an intermediary and NRE that are associated enterprises, each explain that “[f]or reasons of administrative convenience, the tax administration in [the host/source country] may choose to collect tax only from [the intermediary] even though the amount of tax is separately calculated by reference to the activities of both [the intermediary] and the PE.”<sup>26</sup>

The SVTDG appreciates the PDD’s acknowledgement of the not inconsequential host-country tax and reporting obligations imposed on an NRE with a PE, and the PDD’s observation of ad hoc approaches by countries to collect (only) from the intermediary any aggregate tax owing. The SVTDG believes, however, that more could be done to alleviate burdens imposed on an NRE in situations in which an Article 5(5) DAPE exists. The SVTDG respectfully suggests that no valid policy grounds are furthered, and cross-border commerce is actually hampered, by asserting the existence of a PE for the sake of primarily imposing compliance burdens (and perhaps penalties) on NREs. This situation would arise if little or no profits are attributable to a DAPE, and would also arise in situations in which tax imposable on a PE could be collected from an intermediary.

The SVTDG accordingly recommends Article 5 of the MTC be changed<sup>27</sup> to include a new paragraph 8, allowing an 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.<sup>28</sup> 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>24</sup> *Id.* The PDD further explains that adoption of such administratively convenient procedures in the host [i.e., source] country wouldn’t alter taxing rights of the home country or host country.

<sup>25</sup> PDD ¶ 21.

<sup>26</sup> See PDD ¶¶ 26 (*Example 1*), 31 (*Example 2*), & 35 (*Example 3*).

<sup>27</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.

<sup>28</sup> We made this recommendation in our *2016 SVTDG Comment Letter*.

To this end, we recommend the OECD consider adopting in Article 5<sup>29</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 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 an 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

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<sup>29</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.

[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 (intermediary) 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 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 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 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.

**D. The explanation in *Example 4* of how profits attributable are determined should be corrected or clarified**

The Analysis in *Example 4* shows the NRE has (with the given assumption) two PEs in the host country (Country S) by application of Article 5(4.1). That is, the preparatory or auxiliary exception to PE status in Article 5(4) doesn't apply to either the warehouse or the office—each of which is a fixed place of business through which the business activities of OnlineCo is (partly) carried on—because the overall activity resulting from the combination of

activities at the warehouse and office isn't of a preparatory or auxiliary character.<sup>30</sup> The Analysis conditions this result on the assumption that the business activities carried on by OnlineCo at the warehouse and the office “constitute complementary functions that are part of a cohesive business operation.”<sup>31</sup>

In determining profits attributable to the warehouse PE, the PDD begins with “the amount . . . OnlineCo would have had to pay if it had obtained the storage and delivery services from an independent enterprise in Country S (attributing to such service provider ownership of the assets of OnlineCo related to such functions, and assumption of the risks of OnlineCo related to such functions).”<sup>32</sup> The PDD footnotes that “[t]his is equivalent to attributing to the PE the rights and obligations associated with the purchase of storage and delivery services resulting directly or indirectly from the contracts to which Article 5(5) refers.”<sup>33</sup> The footnote reference to “the contracts to which Article 5(5) refers” is puzzling inasmuch as the Facts and Analysis of *Example 4* point to the existence of a fixed-place-of-business PE under Article 5(1) (in tandem with Article 5(4) and the anti-fragmentation rule in Article 5(4.1) rather than a dependent-agent PE under Article 5(5). The footnote reference to “the contracts to which Article 5(5) refers” may refer to contracts relevant to activities performed by employees staffing the warehouse—i.e., to shipment receipt, and order delivery, although such contracts aren't referred to in the Facts. If so, the SVTDG recommends the footnote clarify this. Alternatively, the footnote reference may have been an inadvertent carryover of language from *Examples 1, 2, and 3*, which did involve Article 5(5) PEs. If so, the SVTDG asks that this reference be corrected. A corresponding change should likewise be made to footnote 15, relevant to determination of profits attributable to the office PE.

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<sup>30</sup> PDD ¶ 47.

<sup>31</sup> *Id.*

<sup>32</sup> PDD ¶ 48.

<sup>33</sup> *Id.*, n. 13.

## Appendix—SVTDG Membership

Accenture  
Activision Blizzard  
Acxiom  
Adobe  
Agilent  
Amazon  
Apple  
Applied Materials  
Atlassian  
Autodesk  
Bio-Rad Laboratories  
BMC Software  
Broadcom Limited  
Brocade  
Cadence  
Chegg, Inc.  
Cisco Systems Inc.  
Dell Inc.  
Delphi  
Dolby Laboratories, Inc.  
Dropbox Inc.  
eBay  
Electronic Arts  
Expedia, Inc.  
Facebook  
Fitbit, Inc.  
Flex  
Fortinet  
GE Digital  
Genentech  
Genesys  
Genomic Health  
Gigamon  
Gilead Sciences, Inc.  
GitHub  
GLOBALFOUNDRIES  
GlobalLogic  
Google Inc.  
GoPro  
Hewlett-Packard Enterprise  
HP Inc.  
Indeed.com  
Informatica  
Ingram Micro, Inc.  
Integrated Device Technology  
Intel  
Intuit Inc.  
Intuitive Surgical  
Keysight Technologies  
KLA-Tencor Corporation  
Lam Research  
Marvell  
Maxim Integrated  
MaxLinear  
Mentor Graphics  
Microsemi  
Microsoft  
NetApp, Inc.  
Netflix  
NVIDIA  
Oracle Corporation  
Palo Alto Networks  
PayPal  
Pivotal Software, Inc.  
Plantronics  
Pure Storage  
Qualcomm  
Qualys, Inc.  
salesforce.com  
Sanmina-SCI Corporation  
Seagate Technology  
ServiceNow  
ShoreTel  
Snapchat, Inc.  
SurveyMonkey  
Symantec Corporation  
Synopsys, Inc.  
Tesla Motors, Inc.  
The Cooper Companies  
The Walt Disney Company  
Theravance Biopharma  
TiVo Corporation  
Trimble, Inc.  
Twitter  
Uber Technologies  
Veeva Systems  
Veritas  
Visa  
VMware  
Western Digital  
Xilinx, Inc.  
Yahoo!  
Yelp

# SOFTWARE COALITION

September 15, 2017

**VIA E-MAIL**

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

Dear Mr. Balco:

The Software Coalition thanks the OECD for the opportunity to provide comments on the new Public Discussion Draft on BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments, issued on June 22, 2017 (“2017 DD” or “DD”). We are pleased that the 2017 DD incorporates a number of our comments on the Public Discussion Draft released in July 2016 (“2016 DD”).

The Software Coalition is the leading software industry group dealing with U.S. domestic and international tax policy matters.<sup>1</sup> The Software Coalition was formed in 1990 and now comprises 23 international groups which operate in the software and e-commerce sectors. Software Coalition members account for approximately \$700 billion per year in total gross revenue, and employ over 2 million individuals around the globe. We respectfully submit the following comments with a view towards the goal of providing clear guidance to taxpayers and tax administrations on the application of Article 7 of the OECD Model Tax Convention (“MTC”) to the determination of the profits attributable to a permanent establishment (“PE”) under the revised PE standards of MTC Art. 5(4) and (5) arising from the OECD / G20 BEPS Project.

We would be pleased to elaborate on our comments at the public consultation to be held in November.

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<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.; Microsoft Corporation; Micro Focus International plc; Nuance Communications, Inc.; Oracle Corporation; PTC Inc.; Pivotal Software, Inc.; Salesforce.com Inc.; SAP America, Inc.; Siemens Corporation, Symantec Corporation; Synopsys, Inc.; and VMWare, Inc.

## **I. Executive Summary**

- We applaud the desire to provide guidance that will apply in the largest number of cases in the international treaty network. Given the relatively small number of treaties which so far have been amended to incorporate the MTC Art. 7 text as released after the issuance of the 2010 Report on the Attribution of Profits to Permanent Establishments describing the authorized OECD approach (“AOA”), we suggest that it might be more prudent to base this guidance on the text of Art. 7 as it existed prior to 22 July 2010. That technical foundation should provide a solid basis for consensus support for this guidance, as almost all OECD members endorsed the 2008 AOA. As this guidance will be issued as part of the Inclusive Framework (“IF”) implementation of the BEPS Project, we suggest that the Final Guidance expressly note that the guidance has been endorsed by all participating IF countries.
- There is a need for transparency on individual country positions in this project, given the variety of PE standards which will exist around the world. While we appreciate that transfer pricing guidance has not been issued in the past with indications of views which diverge from the consensus, we suggest that the mechanics of PE profit attribution guidance is the sort of technical guidance where majority and minority views, if they exist, can and should be expressed by the participating countries. We suggest that countries participating in this project at least indicate whether or not they accept the AOA.
- We are pleased that the 2017 DD includes descriptions of "dealings" in each of the examples. We observe, however, that the DD provides virtually no guidance on other essential aspects of the AOA, including critical points such as the factors which determine when an asset or risk is allocated to a deemed PE, and how the "dealing" is delineated for purposes of applying transfer pricing principles by analogy.
- We note that many groups are in the process of reorganizing their international sales structures to establish affiliates acting as resellers in many market jurisdictions. We request that an example be added to the new Article 5 Commentary to confirm that resellers of software copies and software enabled services are not described in Art. 5(5).
- The issue of whether there should be a priority rule between Article 7 and Article 9 seems to be a straightforward technical issue, and there is no reason that the OECD / IF should hesitate to provide guidance. We believe that Article 9 should be applied first, as the intercompany fee payable to an affiliated enterprise in many cases will be a deductible expense used to determine the net income attributable to a PE.
- The final guidance should include a discussion of what functions constitute "significant people functions" ("SPF"), and when those SPFs will cause an asset or risk to be allocated to a deemed PE.
- We provide comments on the technical application of the AOA in each of the Examples.
- We recommend that the OECD / IF identify concrete options of administratively convenient reporting approaches, with a view towards endorsing one or more as appropriate models.

## **II. The Need for Commitment to the 2017 DD Framework Principles**

1. The Software Coalition commends the efforts of Working Party No. 6 to provide comprehensive guidance on the attribution of profits to deemed (and actual) PEs arising under MTC Article 5. We note that countries participating in the OECD / G20 BEPS Project, including in particular members of the IF,

have committed to a consistent adoption of the BEPS Project recommendations.<sup>2</sup> Consistent implementation requires that governments commit to a consensus set of principles in the Final Guidance on profit attribution and that the Final Guidance provide sufficient detail to be useful to taxpayers and tax administrations in practice.

2. In order for this project to result in useful guidance, we believe that the Final Guidance should reflect a clear commitment by OECD / IF members to certain framework principles inherent in the AOA. These framework principles include the rules that the PE is considered to be a separate and independent enterprise, that in the case of a deemed PE assets and risks are allocated to the PE only based on SPFs as performed by the dependent agent enterprise in the host jurisdiction, that the deemed commercial relationship between the PE and the remainder of the enterprise should be defined by reference to hypothetical dealings, and that those dealings should be sufficiently delineated so as to allow the application of transfer pricing principles and the selection of appropriate comparables, if any. We hope that the Final Guidance will firmly endorse these framework principles.

3. We note and agree with the statement in Paragraph 9 of the DD that these framework principles are sufficiently universal so that differences of views between, for example, jurisdictions which accept the 2010 vs. 2008 AOA versions should not impede adoption of this guidance on a consensus basis.

4. We believe that the AOA provides a technically sound and principled set of rules for applying Art. 7. We hope that nothing in this project suggests any erosion of the commitment by OECD Members to the AOA principles. The involvement of the IF in this project creates the opportunity for IF members also to endorse the AOA.

5. We note, however, that as of today, very few treaties have incorporated the MTC Article 7 text which was released after the 2010 AOA. Accordingly, we suggest that it might be more prudent as a matter of achieving a reliable consensus, to base this guidance on the 2008 AOA, as that guidance would interpret the most common treaty text currently existing among OECD Members.

6. 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 on the application of the pre-2010 version of Article 7.

7. Under this approach, countries that have not amended or renegotiated their treaties to include the 2010 version of Article 7 (a majority of treaties fall in this category) would not have to commit to the 2010 version of the AOA by virtue of their commitment to the Final Guidance. The ultimate goal should be that despite the different commitments to the AOA, the Final Guidance is of universal applicability.

8. We believe that the fundamental principles described in the DD are equally applicable under the 2008 and 2010 AOA. In order to avoid any suggestion that this guidance is limited to jurisdictions which have adopted the 2010 AOA, however, the Final Guidance should either base its technical analysis on the 2008 Art. 7 text, or at least make it clear that the references in the DD to the 2010 text are in no way intended to limit the scope of this guidance to treaties which incorporate that text.

9. The Final Guidance could be issued as a supplement to the AOA and incorporated into the Article 7 Commentary. While Commentary amendments would be appropriate for OECD Members, that may not be the optimal form of final guidance for non-OECD countries. However the guidance is published, it should be made clear that the guidance is published as part of the implementation of the OECD / G20 BEPS Project under the IF's mandate for consistent global implementation of the BEPS package. Since

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<sup>2</sup> See Inclusive Framework on BEPS, Progress report July 2016-June 2017, p. 1 (the Inclusive Framework “reflects the global commitment to address BEPS through enhanced international co-operation”).

IF members have committed to a consensus implementation of the BEPS package, the Final Guidance should clearly note that absent a statement of dissenting position, the Final Guidance has been endorsed by all IF members.

### **III. The Need for Transparency of Positions**

1. We agree with Paragraph 12 of the DD that “[t]he approach adopted by a jurisdiction should be applied consistently and could be made public for purposes of transparency and certainty for taxpayers.”
2. We suggest that there is a greater need for transparency on individual country positions in this project than normally exists in OECD guidance projects. If complete consensus is not possible, it is better to have clearly stated majority and minority views, as long as the different views are stated transparently. Procedures similar to Observations and Positions could be useful tools in communicating each country’s positions. Given the importance of this project, we suggest that the principle be clearly expressed that the failure to object indicates that a country will follow the Final Guidance, and that any jurisdiction which has a divergent view is expected to express publicly that divergent view.
3. Transparency is particularly important given the variety of PE standards which will exist around world by virtue of the varied adoption through the MLI of the Action 7 recommendations. We believe that in the current environment of increased focus on dependent agent PEs, it is preferable for the OECD / IF to issue specific guidance which will apply in a large majority of circumstances, than to issue a watered down version of the guidance, even if the generally agreed approach is subject to some individual country reservations.
4. As a practical matter, at this stage of developing guidance in this difficult area, we suggest that the obligation to be transparent on a country’s position be limited to whether or not the jurisdiction endorses and will follow the AOA. The AOA operates as a cohesive package, so at this stage we don’t see a reason to suggest that countries may have divergent views only on certain elements of the AOA.

### **IV. Applying the "Separate and Independent Enterprise" Guidance to Deemed PEs**

1. The major improvement contained in the 2017 DD over the 2016 DD is the clearer acknowledgement that the technical application of the AOA requires an articulation of the hypothetical “dealing” between the PE and the remainder of the nonresident enterprise. The determination of the “dealing” forms one of the major elements of the technical backbone of the “separate and independent enterprise” approach to PE profit attribution.
2. That said, the DD includes surprisingly little guidance as to the factors which determine what form of dealing is to be assumed, or how the particular form of dealing was chosen in the four Examples. We believe that the DD could be enhanced by providing a more detailed technical explanation of how risks and assets are attributed to the “separate and independent enterprise” and how that “separate and independent enterprise” engages in a “dealing” with the remainder of the nonresident enterprise.
3. Further, the “dealing” must be delineated with sufficient specificity to enable the selection of the most appropriate transfer pricing method, and the identification of appropriate comparables. The DD does not provide sufficient technical guidance to define the “dealing” in order to apply transfer pricing principles.
4. Most of the DD relates to a deemed PE created through the application of Art. 5(5), as enhanced to include the rule that a deemed PE can exist if the dependent person “habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the

enterprise...". The case of a "commissionaire" is one of the examples discussed under this new PE standard.

5. In all deemed PE cases (dependent agent PE, or "DAPE"), including those of commissionaire and any other dependent person who "habitually plays the principal role", there is no fixed place of business PE ("FPOB PE") of the nonresident enterprise, if the dependent agent enterprise ("DAE") is a separate enterprise operating in the jurisdiction of the asserted PE. The conclusion that the nonresident "has" a PE in the source state is essentially merely the imposition of a tax return filing obligation on the nonresident to report a certain amount of profits which are treated as locally sourced and subject to tax under the agreed profit attribution principles.

6. In cases of a FPOB PE, the "separate and independent enterprise" concept is relatively straightforward (compared to DAPes) to apply. The separate enterprise in that case operates at the branch location through the branch personnel, and the profits attributed to the branch are those that are determined with reference to the hypothetical dealings between the branch (represented by its personnel) and the remainder of the nonresident enterprise.

7. In cases of a deemed PE, however, there is no branch, so describing the contours of the "separate and independent enterprise" is more challenging. First, it is clear that the local enterprise which conducts the activity which crosses the Art. 5(5) threshold is not itself a PE of the nonresident. It is a separate enterprise, subject to all the normal rules of taxation of the jurisdiction, including transfer pricing principles.

8. Instead, the "separate and independent enterprise" of a deemed PE describes a hypothetical enterprise which has as its functions, assets and risks only those which are attributed to it by application of the agreed profit attribution rules by reference to the SPF of the DAE.

9. Paragraph 8 of the DD seems to confuse this difference between the DAE and the DAPE. While referencing the "separate and independent" language of the current Article 7, DD paragraph 8 states that the attributable profits are those which the PE would have derived "if it were a separate and independent enterprise *performing the activities that the dependent agent performs* on behalf of the non-resident enterprise."<sup>3</sup> With respect, we believe that this articulation is not an accurate paraphrase of the Article 7 text in the context of a DAPE, as it seems to confuse the activity of the DAE with that of the DAPE. The failure to keep the two taxpayers distinct has the potential to confuse the SPF analysis.

10. The DAPE is not regarded as "performing the activities" that the DAE performs; instead, the DAPE is attributed only certain assets and risks that are treated as allocated to the PE by virtue of the SPF performed by the DAE.<sup>4</sup>

11. In contrast, we note that the expression that the PE itself is treated as performing the activities which cause it to be a PE would be accurate in the case of a fixed place of business PE arising under Art. 5(1). Paragraphs 48 and 49 are examples of this case.

12. Coalition members note that this confusion between the functions of the DAE and the DAPE frequently arises on audit. This project is a good opportunity for the OECD / IF to clarify the analytical separateness of the two taxpayers.

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<sup>3</sup> Emphasis added.

<sup>4</sup> This same confusion between the functions of the DAE and the DAPE exists in Paragraphs 34 and 39 of the DD.

13. In that light, the Final Guidance can build on the guidance already existing in the Art. 7 Commentary as to how the "separate and independent enterprise" concept is applied in the case of deemed PEs under Art. 5(5).<sup>5</sup>

- a) In cases where in fact no employees or other personnel of the nonresident are habitually present in the source state, there can be no functions relating to personnel attributed to the DAPE.
- b) The only profits which could be attributed to the DAPE, therefore, are those arising from assets or risks that are allocated to the deemed PE by virtue of the SPF performed by the DAE in the host state. The only case in which an asset or risk can be allocated to a deemed PE and result in profit attributable to that PE is if that asset or risk is not already assigned to the DAE.
- c) In all cases, since the deemed PE is treated as a separate and independent enterprise, an appropriate "dealing" needs to be articulated to define the application of transfer pricing principles between that hypothetical separate enterprise and the nonresident.
- d) That transfer pricing analysis then proceeds on the basis that the hypothetical separate enterprise can be allocated profits (or losses) only relating to the assets and risks which it has been attributed.

14. We believe that these general principles underlie the discussion and conclusions in the DD Examples relating to the assets and risks allocated to the PE. There is no reason for the guidance to be ambiguous on this analytical point.

## V. Establishment of Resellers

1. As a related point, in practice many Software Coalition members are restructuring their sales operations to establish local sales and marketing entities as resellers of products or services supplied by nonresident members of the group. These restructurings directly respond to the BEPS Project recommendation to change the PE standards in Art. 5(5). We understand that one of the unspoken policy desires of OECD / IF tax administrations is to encourage this commercial structure.
2. The new Commentary under Article 5 concerning reseller arrangements confirms that a reseller arrangement will fall outside the scope of the revised Art. 5(5). The only example in that Commentary, however, deals with a reseller of tangible property.
3. There is no reason to distinguish resellers of tangible property from resellers of services or digital goods and services. Software Coalition members distribute their software products through a wide array

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<sup>5</sup> See, para 26 of the Art. 7 Commentary, as it existed prior to 22 July 2010. "Where, under paragraph 5 of Article 5, a permanent establishment of an enterprise of a Contracting State is deemed to exist in the other Contracting State by reason of the activities of a so-called dependent agent (see paragraph 32 of the Commentary on Article 5), the same principles used to attribute profits to other types of permanent establishment will apply to attribute profits to that deemed permanent establishment. As a first step, the activities that the dependent agent undertakes for the enterprise will be identified through a functional and factual analysis that will determine the functions undertaken by the dependent agent both on its own account and on behalf of the enterprise. The dependent agent and the enterprise on behalf of which it is acting constitute two separate potential taxpayers. On the one hand, the dependent agent will derive its own income or profits from the activities that it performs on its own account for the enterprise; if the agent is itself a resident of either Contracting State, the provisions of the Convention (including Article 9 if that agent is an enterprise associated to the enterprise on behalf of which it is acting) will be relevant to the taxation of such income or profits. On the other hand, the deemed permanent establishment of the enterprise will be attributed the assets and risks of the enterprise relating to the functions performed by the dependent agent on behalf of that enterprise (*i.e.* the activities that the dependent agent undertakes for that enterprise), together with sufficient capital to support those assets and risks. Profits will then be attributed to the deemed permanent establishment on the basis of those assets, risks and capital; these profits will be separate from, and will not include, the income or profits that are properly attributable to the dependent agent itself (see section D-5 of Part I of the Report *Attribution of Profits to Permanent Establishments*)."

of related and unrelated resellers. Accordingly, we suggest that Working Party 1 should enhance the new Article 5 Commentary to include examples of resellers of software services and digital products.

## VI. Art. 7 vs. Art. 9 Ordering Rule

1. In our comments on the 2016 DD, we supported the view that, as part of the accurate delineation of the transaction between the head office and the dependent person which creates an Art. 5(5) PE, Article 9 should be applied before Article 7. This order establishes the proper compensation of the sales support entity under the arm's length principle before turning to the determination of the PE profit attribution results. This makes sense because, in many cases, the amount payable to the sales support entity would be a deduction against gross income and an expense allocable to the PE for purposes of determining net income attributable to the PE.
2. We note that the 2017 DD does not endorse a single ordering rule between Articles 9 and 7.<sup>6</sup> This is perplexing, as this interpretative question would seem to be straightforward, and is one place where guidance could be given without impacting different country interpretations of Article 7 itself. We remain of the view that there should be a clear ordering rule in the determination of profits to be attributed to the PE, with Article 9 applying first to determine whether the price charged between the dependent person and the nonresident enterprise is arm's length, followed by Article 7 to attribute profits to the deemed PE, if a PE exists under Article 5.
3. Paragraph 12 of the 2017 DD states that the order in which these articles are applied should not impact the amount of profit subject to taxation in the source country. It is hard to agree categorically with this statement, in light of Paragraph 17's admonition to taxpayers to not assume that the concepts of the "significant people functions" under the AOA and "risk control functions" under the Transfer Pricing Guidelines ("TPG") are the same.<sup>7</sup> Stating that the order should not impact the results suggests that the two concepts in fact are "aligned," if not identical, as otherwise differences could result in different income allocations to the taxing jurisdiction.
4. If the OECD / IF view indeed is that these functions are not "aligned", we suggest that the Final Guidance explain the circumstances under which these functions would not be "aligned" and the consequences of such nonalignment. The critical explanation would be to describe how SPF activities cause a risk or asset to be attributed to the deemed PE in a way different than how risk control functions determine which entity bears the risk under the TPG.
5. Given the apparent reluctance of some jurisdictions to endorse this ordering rule, we strongly endorse retaining the statement that regardless of the approach taken to apply Articles 7 and 9, the result should not be double taxation in the source country.<sup>8</sup> As rightfully identified in the 2017 DD, the main point in coordinating the order of application of Articles 7 and 9 is to prevent double taxation of the same profits in the accounts of the PE (under profit attribution rules) and in the accounts of the sales entity (under transfer pricing rules). Double taxation could result where a tax administration takes the use of an asset or risk into account for purposes of applying Article 9, without excluding the same asset or risk from an Article 7 analysis.

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<sup>6</sup> See, generally, 2017 Discussion Draft, para. 12 ("many jurisdictions" find it logical to apply Article 9 first to determine the arm's length price for the sales support activities, "while others may decide" to determine profits attributable to the PE first).

<sup>7</sup> 2017 Discussion Draft, para. 17.

<sup>8</sup> 2017 Discussion Draft, para. 12.

## VII. Need for Better Technical Guidance on "Significant People Functions" under Article 7

1. The removal of numeric figures in the 2017 DD was useful to prevent unwarranted implications as to the typical profit margins of enterprises. At the same time, however, removing the numbers contributed to the loss of most of the detail contained in the 2016 DD that provided guidance to taxpayers and tax administrations as to how a significant people function could cause an asset or risk to be attributed to a deemed PE. The asset and risk allocation point is a major element of the technical backbone of the profit attribution framework, and the application of transfer pricing principles to the "dealing" cannot be done without first determining what assets and risks are allocated to the PE. To be useful to taxpayers and tax administrations in practice, the Final Guidance should provide details of how significant people functions lead to the assumption of risk and the economic ownership of assets to be attributed to the deemed PE.
2. The first step of the two-step approach under the AOA identifies the functions performed, assets owned, and risks borne by each of the PE and the remainder of the nonresident enterprise, as if they were separate and independent enterprises. In the case of a FPOB PE, this exercise is (relatively speaking) simpler to perform, as the relevant functions are those performed by the personnel of the branch.
3. In the case of a DAPE, the exercise is much more complex, since the deemed PE itself normally has no personnel, and the relevant assets and risks are those which are attributed to the DAPE by virtue of SPF performed by personnel of the DAE.
4. The DD does not provide any direct guidance on how to assess whether a function performed by the DAE constitutes a SPF relevant to the economic ownership of an asset, or the assumption of risk, by the deemed PE.
5. Since this is such a core concept to the PE profit attribution analysis, the Final Guidance should describe how to identify a SPF which causes an asset or a risk to be treated as economically owned by the deemed PE. In that respect, the 2016 DD was more helpful, in that it indicated when inventory and credit risk, for example, could be allocated to the PE.<sup>9</sup>
6. The Final Guidance should make clear that it is not necessarily the case in all sales solicitation DAPE cases that the PE profit attribution accounts of the deemed PE should include the gross external revenue as recognized by the nonresident enterprise. That starting point would be accurate if SPF of the DAE caused the customer contracts and receivables to be allocated to the separate and independent enterprise that is the DAPE, and the "dealing" were to be regarded as a reseller dealing. It would not be accurate if the "dealing" is the provision of marketing services, for example, which will be appropriate in many cases.
7. Paragraph 8 of the DD includes a generalization that "rights and obligations" arising from contracts to which Art. 5(5) refers will "typically" be allocated to the DAPE. The Final Guidance should avoid making unsupported generalizations. Instead, the Final Guidance should describe the circumstances under which that result would, or would not, occur based on the SPF of the DAE.
8. Related to that point, we suggest that modifications are necessary to Paragraph 8 of the DD to avoid unintended inferences. Paragraph 8 provides that ". . . it is important to note that this does not necessarily mean that the entire profits resulting from the performance of these contracts should be attributed to the permanent establishment." This statement implies that it is frequently the case that "the entire profits" are attributable to the PE. If the term "profits" here refers to the nonresident enterprise's net

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<sup>9</sup> We noted in our previous letter that the 2016 DD nevertheless could be improved by providing a more complete description of which facts led to the conclusion that such assets and risks were regarded as economically owned by the deemed PE.

income (or loss) arising from transactions in which the DAPE is involved, then it is almost never the case that the "entire profits" can be attributed to the PE. As long as the nonresident enterprise performs any functions or uses any assets or risks, some part of the profit (or loss) will remain with the remainder of the nonresident enterprise. If, instead, this comment is meant to reflect the point mentioned above that even in sales solicitation DAPE cases the hypothetical accounts of the deemed PE should not necessarily include the external revenue arising from customer contracts, that point can be made here by referring to "gross sales income" instead of "entire profits".

9. We agree that costs of the head office incurred for purposes of the PE should be allocated to that PE. It may be useful to point out in the Final Guidance that whether any costs are in fact allocable to the PE in any particular case depends on how the hypothetical "dealing" between the deemed PE and the rest of the enterprise is articulated. If the deemed PE is treated as a separate and independent enterprise which is regarded as using assets and bearing risks appropriate to limited distribution functions, for example, many head office expenses will be appropriately allocated to the remainder of the enterprise, and not to the PE. If, in contrast, the deemed PE is treated as engaging in more significant activities, then appropriate head office costs could be properly allocable to the PE.

10. It also would be appropriate to clarify in the general discussion that depending on the circumstances, it is possible that no assets or risks are allocated to the DAPE. That normally would result in zero profits being attributed to the deemed PE. It would be appropriate to restore the Example from the 2016 DD which showed that set of facts.

11. Where assets and risks are allocated to the DAPE, it would be useful to note that the chosen dealing can result in the attribution of a loss to the PE.

## **VIII. Specific Comments and Clarifications to Examples 1-4**

1. As an introductory comment, we suggest that all Examples be enhanced to describe how the SPF performed by the DAE or FPOB PE personnel cause an asset or risk to be allocated to the deemed or actual PE, and that an explanation be given as to why the particular form of "dealing" was applied.

2. Example 1: Commissionaire Structure

a) We note that the text of Paragraph 25 is a somewhat loose paraphrase of the Action 7 revised Art. 5(5) standard. Paragraph 25 states that "SellCo habitually concludes contracts there on behalf of TradeCo". A more accurate reference to the revised Art. 5(5) as applicable to commissionaires would be "SellCo acts on behalf of TradeCo and habitually concludes contracts for the transfer of ownership of property owned by TradeCo."

b) As noted above, paragraph 25 also presents a loose paraphrase of the "separate and independent enterprise" concept which has the potential to confuse the SPF analysis.

c) We infer that the "dealing" in this Example is a reseller dealing, as footnote 6 of the DD explains that the deductible amount is equivalent to inventory "purchased" from TradeCo.

d) Since the characterization of the "dealing" is a critical analytical step, we suggest that the Example more clearly describe the "dealing" as a reseller relationship, and include the reason for identifying the "dealing" as a reseller arrangement. While we agree that in many cases an entity acting as a commissionaire indeed will perform the SPF appropriate to allocate the customer contracts and the associated external revenue to the accounts of the deemed PE, in many other cases of marketing support organizations it is plausible that the appropriate "dealing" could be a service arrangement.

e) It also is critical that the Final Guidance provide more detail as to how a SPF of the dependent person enterprise can attribute an asset or risk to the PE. Absent that guidance, it is not possible to determine the details of the reseller (or other) "dealing" in a way that allows the application of transfer pricing principles to set the actual profit attributable to the PE.

f) In this Example of a DAPE, the separate enterprise would perform no people functions, and would earn a profit or loss based solely on the use of assets and risks attributed to the PE. The articulation of which assets and risks are attributed to that hypothetical separate enterprise then allows the application of transfer pricing principles to the reseller "dealing" between that hypothetical enterprise and the remainder of the nonresident enterprise.

g) While we agree with the statement in Paragraph 27 that the same high-level analytical approach applies to commissionaire and "principal role" cases where the dependent person has no contract conclusion authority, we highlight that different conclusions can result in those two cases, depending on the SPF actually performed by the DAE. For example, in non-commissionaire "principal role" cases where the contract is routinely concluded without material modification by the enterprise, it may be the case that the nonresident enterprise, not the DAE, has performed the SPF of setting customer credit parameters. The Final Guidance therefore should make it clear that the actual allocation of assets and risks, and the determination of the "dealing", depends on the SPF as actually performed by the DAE in the host jurisdiction, and remove the implication that the SPF analysis is identical in all commissionaire and "principal role" cases.

### 3. Example 2: Sale of Advertising on a Website

a) This example is particularly important to the Software Coalition because it deals with the sale of items which are not tangible property. In all cases where this example might apply to members of the Software Coalition, the activity of SellCo will not involve the acquisition of rights to exploit the software or digital goods copyright, but only will involve a sales solicitation activity.

b) Paragraph 30(1) describes a hypothetical "dealing" whereby the head office "sold rights to the advertising space" to the local office. We caution that this statement potentially could be misread to imply a dealing in a broader sets of rights than what the example contemplates.

c) To avoid any implication that the "dealing" could involve any grant of IP rights, the identification of the "dealing" in this example should be improved by more precisely referring to the sale of the digital item or service. In order to provide a clear parallel to the case in Example 1 dealing with tangible personal property, the "dealing" in Example 2 should be described as the resale of the specific advertising service contract as agreed to be performed by the nonresident.

### 4. Example 3: Procurement of Goods

a) As with Examples 1 and 2, the utility of this Example would be increased if further detail can be provided as to (i) why the external purchase contracts are allocated to the PE, and (ii) what SPFs would cause any other relevant assets and risks to be allocated to the PE. Absent that step, it is not possible to define the "dealing" in a way that will allow the application of transfer pricing principles to the "dealing".

b) As noted above, paragraph 34 also expresses a loose paraphrase of the "separate and independent enterprise" concept which has the potential to confuse the SPF analysis.

5. Example 4: Warehousing, Delivery, Merchandising and Information Collection Activities

a) We suggest that the description that OnlineCo "operates" the warehouse be modified in order to clarify why a PE exists in this Example. The 2016 DD expressly noted that the head office arranged for the construction of the warehouse in the local country and was the legal owner of the warehouse and its fixtures.<sup>10</sup> While the change in facts from a case where the nonresident owns the warehouse and its fixtures to one where it leases the warehouse premises does not necessarily change the conclusion, it introduces other complexities into the Example as to whether the nonresident actually has the premises at its constant disposal. Accordingly, the better approach would be to revert to the stated facts of the 2016 DD. If a lease case is preferred, we suggest that Paragraph 44 state that OnlineCo "leases and operates" the warehouse, and that the premises are at its constant disposal under the terms of that lease.

b) We agree that the appropriate "dealing" in this example is one which does not allocate OnlineCo's contracts for external revenue to the PE.

c) The Example concludes that the profit attribution would be based on the amount that OnlineCo would have to pay to an independent enterprise if it had to obtain storage and delivery services from an independent enterprise. This Example would be a straightforward example of PE profit attribution to a FPOB PE if the "dealing" were to be only the provision of the services of the 25 warehouse employees to the remainder of OnlineCo. The analysis, however, also apparently allocates to the PE the third party delivery and warehouse lease contracts, without any explanation as to what SPFs performed by the warehouse personnel would cause those assets and risks of OnlineCo to be treated as economically owned by the PE. In normal business arrangements, it would be surprising indeed for warehouse employees involved in picking and packing duties to perform SPFs relating to major commercial contracts. Therefore, this conclusion requires a better explanation of how the PE personnel performed SPFs sufficient to allocate those contracts to the PE to be a reasonable interpretation of the AOA.

## IX. Administratively Convenient Reporting

1. We welcome that the 2017 DD continues to mention administratively convenient reporting approaches. The document recognizes the potential administrative burden on the nonresident enterprise of having to comply with host country tax and reporting obligations, especially when little or no additional profit is attributable to the PE.<sup>11</sup>

2. That said, the 2017 DD's reference to administratively convenient reporting approaches is too noncommittal. Since this recommendation has been contained in OECD profit attribution guidance for many years, a more forceful endorsement and recommendation that jurisdictions should adopt appropriate domestic legislation or administrative procedures would be appropriate.

3. Paragraph 21 notes that "[a] number of countries" apparently already follow a simplified approach to collect tax from the intermediary even though the amount of tax is calculated by reference to both the DAE and the nonresident enterprise. Perhaps those practices can be described, and the Final Guidance could provide an OECD / IF endorsement of those which are most appropriate.

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<sup>10</sup> See 2016 Discussion Draft, para. 87.

<sup>11</sup> 2017 Discussion Draft, para. 21.

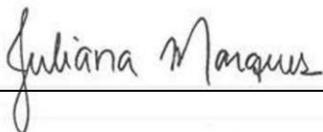
We trust that you will find these comments useful. We look forward to continue our participation in this very important project.

Sincerely,



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15 September 2017

To

Tax Treaties, Transfer Pricing and Financial Transactions Division

OECD Centre for Tax Policy & Administration

*Via email to: [TransferPricing@oecd.org](mailto:TransferPricing@oecd.org)*

**Comments on the 22 June 2017 Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments**

Dear Madam, Dear Sir,

On behalf of the Tax Policy Center ([www.unil.ch/taxpolicy](http://www.unil.ch/taxpolicy)) of the University of Lausanne (Switzerland), we are pleased to attach herewith our comments relating to the Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments released on 22 June 2017 (hereinafter “the Discussion Draft”).

As a matter of principle, we fully support the work of the OECD to develop additional guidance on attributing profits to permanent establishments within the framework of BEPS Action 7. Such guidance is indeed essential in order for jurisdictions to be able to fully assess the opportunity to include or not the changes introduced by BEPS Action 7 in their tax treaty policy, in particular through the Multilateral Instrument (MLI). Clear guidance in this area will also ensure that costly and time-consuming disputes are avoided, if not minimized. Finally, the issue of profit attribution to permanent establishments may in the future raise fundamental and broader policy challenges beyond BEPS Action 7, notably in the field of the digital economy. In order to keep the discussion within manageable proportions our comments shall however here be limited to the content of the Discussion Draft and shall thus not engage in this broader policy discussion.

We welcome the opportunity to express these comments which we shall be pleased to present and discuss during the next public consultation.

Yours sincerely,



**Prof. Dr. Robert Danon**  
(Director, Tax Policy Center)



**Dr. Vikram Chand**  
(Executive Director, International Tax  
Education, Tax Policy Center)

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## Executive Summary

In essence, our comments may be summarized as follows:

1. As is well known, tax treaties between States are currently based on either the OECD Model (various versions) or the UN Model. Further, depending on the applicable tax treaty, States may adopt AOA or non-AOA methodologies to attribute profits to a PE. We understand that the examples in the discussion draft focus on the attribution of profits in accordance with the AOA. Given the foregoing differences, we would however find it desirable to have separate detailed numerical examples on profit attribution with respect to tax treaties that follow the AOA and treaties that do not.
2. With respect to States that follow the AOA, we feel that a fundamental issue needs to be clarified. That is, whether the concepts of “*significant people functions*” (or “*key entrepreneurial risk taking*”) functions for the purpose of allocating risks under Art. 7 and the concept of “*control*” for the purpose of allocating risks under Art. 9 are similar or different concepts? The clarifications should be illustrated separately for PEs that arise under Art. 5(1), Art. 5(3) and 5(5) & 5(6).
3. With respect to DAPEs that arise for a NRE as a result of the activities of the DA (when the DA falls within the scope of Art. 9), we believe that it would be desirable to:
  - revisit the position taken on the single taxpayer approach in light of the strengthened chapter I of the TP guidelines;
  - clarify the order of application of Art. 9 and 7. Our position is that Art. 9 should be applied before Art. 7;
  - make clear that an arm’s length remuneration to the DA may extinguish the tax liability of the DAPE;
  - illustrate various examples by adding numerical facts; and
  - recommend States to exempt DAPEs from local filing requirements (and associated penalties) in nil profit situations.
4. With respect to DAPEs that arise for a NRE as a result of the activities of the DA (when the DA falls outside the scope of Art. 9), we would find it appropriate to reintroduce Example 3 of the previous discussion draft.



commentaries endorsed the AOA approach, differences did exist between both versions. The major difference related to recognition of intra-enterprise dealings i.e. deduction of dealings between the head office and PE. Also, the 2008 version included provisions that were considered not to be consistent with the arm's length principle viz., Art. 7(3)<sup>7</sup>, Art. 7(4)<sup>8</sup> and Art. 7(5)<sup>9</sup>.

8. Provisions similar to Art. 7 of the 2008 OECD Model are also contained in Art. 7 of the 2011 UN Model (with certain exceptions). However, the Committee of experts on international taxation has rejected the application of AOA approach to interpret the business profits provision of the UN Model<sup>10</sup>.

9. States conclude tax treaties with each other either by using the OECD Model (various versions) or the UN Model. Accordingly, the attribution of profits to a PE depends on the exact wording contained in tax treaties. In other words, States can follow AOA or non-AOA approaches. The examples in the discussion draft focus on the attributing profits in accordance with the AOA. Therefore, we would find it desirable to have detailed numerical examples with respect to tax treaties that follow and do not follow the AOA.

## 2. Fundamental clarification with respect to the AOA

10. The discussion draft leaves open the question as to whether the concepts of “*significant people functions*”<sup>11</sup> (or “*key entrepreneurial risk taking*”<sup>12</sup>) functions for the purpose of allocating risks

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<sup>7</sup> The provision provided for deduction of expenses for purposes of the PE, whether incurred in the PE State or elsewhere. This provision was deleted as it could have been argued that the rule is an exception to the arm's length principle in the sense of limiting the deductibility of certain charges.

<sup>8</sup> The provision allowed States to allocate profits to a PE using an apportionment method based upon various formulae up to the extent it was customary in that State.

<sup>9</sup> The provision provided that profits cannot be attributed to a PE that performed purchasing functions for the head office.

<sup>10</sup> UN (2011), Model Double Tax Convention Between and its commentary (quoted UN Commentary). See UN Commentary, Art. 7, Para. 1.

<sup>11</sup> OECD, Attribution Report, Part I: General Considerations, Para. 22.

<sup>12</sup> OECD, Attribution Report, Part II: Special Considerations for Banks, Para. 8.

under Art. 7 and the concept of “*control*”<sup>13</sup> for the purpose of allocating risks under Art. 9 are similar or different concepts?<sup>14</sup> Specifically, the question arises as to whether day to day functions, which are not necessary to determine control over risks under Art. 9, qualify as significant people functions that are necessary for the assumption of risks under Art. 7. For instance, refer to the research and development example found in Para 1.83 of the TP guidelines. Assume that Co A, instead of hiring company B, carries out the same activity through its PE. In that situation, we believe that the functions performed by the PE cannot qualify as significant people functions relevant to assumption of the development risk as they do not involve “*decision making*”. Therefore, future work should clarify the relationship between these concepts and illustrate the application of these concepts for PEs that arise under Art. 5(1), 5(3) and 5(5) & 5(6) .

### 3. Changes to Article 5(5) and Article 5(6)<sup>15</sup>

#### 3.1. Preliminary remarks

11. Some signatory countries to the MLI have adopted the amendments proposed to Art. 5(5) and Art. 5(6) while others have not.. It is indeed known that a number of jurisdictions have not favoured these changes, in particular because of concerns regarding how profit attribution should take place under this revised definition of the permanent establishment concept<sup>16</sup>These amendments provide that, depending on the facts, the activities of a dependent agent (DA) may trigger a dependent agent permanent establishment (DAPE) for the non-resident enterprise (NRE). This being said, even if a DAPE arises, we would like to point out that the profits attributable to the DAPE could be different, depending on whether the DA falls within the scope of Art. 9 i.e. it is an “*associated enterprise*” (see section 3.2) and situations where the DA falls outside the scope of Art. 9 i.e. it is not an “*associated*

<sup>13</sup> OECD (2017), OECD Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administrations (quoted OECD Transfer Pricing Guidelines). See OECD Transfer Pricing Guidelines, Para. 1.65.

<sup>14</sup> OECD (2017), BEPS Action 7, Additional Guidance on the Attribution of Profits to Permanent Establishments (quoted OECD, Discussion Draft on Attribution of Profits to a PE (2017)). See OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 17.

<sup>15</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Paras. 3-7.

<sup>16</sup> See in particular thereupon Christians Allison/Shay Stephen, Assessing BEPS: Origins, Standards, and Responses, General Report, in: IFA (International Fiscal Association), Cahiers de droit fiscal international, Vol. 120A, The Hague 2017, pp. 45-46; Danon Robert / Salomé Hugues, The BEPS Multilateral Instrument, 2017, in press, p. 20

enterprise”<sup>17</sup> (see section 3.3)

### **3.2. Situations where the intermediary (DA) is an associated enterprise<sup>18</sup>**

#### **3.2.1. Substantive issues that require further consideration**

##### **3.2.1.1. Article 9 vs Article 7 – What should be given priority?**

12. The discussion draft does not take a position to establish the relationship between Art. 9 and Art. 7 when the DA falls within the scope of Art 9. The discussion draft simply states, “*The MTC and its Commentary do not explicitly state whether a profit adjustment under Article 9 should precede the attribution of profits under Article 7. However, many jurisdictions find it logical and efficient first to accurately delineate the actual transaction between the non-resident enterprise and the intermediary and to determine the resulting arm’s length profits while others may decide to undertake an Article 7 analysis first and then to apply Article 9 to adjust the profits of the associated enterprises (i.e. the non-resident enterprise and the intermediary)*”<sup>19</sup>.

13. As we have demonstrated, in the below mentioned examples (see section 3.2.2), an Art. 9 analysis will lead to the conclusion that the DAPE will not be attributed any income or expenses and hence no profits or losses. Accordingly, we believe that an Art. 9 analysis should be applied first<sup>20</sup> (in such situations) and that future work should take a firm position on this issue. In fact, as we already have a taxpayer i.e. the DA, the creation of a hypothetical separate entity i.e. the DAPE is an unnecessary administrative burden both for taxpayer’s and tax administrations.

14. However, if one goes ahead and applies the analysis as suggested in the discussion draft (Para.

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<sup>17</sup> See Philip Baker, Richard Collier, General Report on Attribution of Profits to a Permanent Establishment, IFA Cahiers, Vol- 91B, p. 33; For a contrary opinion, see discussion by Dziurdz in Kasper Dziurdz, Attribution of Profits to a Dependent Agent PE: Different Arm’s Length Principles under Articles 7(2) and 9?, World Tax Journal, June 2014, pp. 135-167. 2) and 9?, World Tax Journal, June 2014, pp.152-153 (references in footnote 83).

<sup>18</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 11.

<sup>19</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 12.

<sup>20</sup> Several parts of the Attribution Report also make references to this position. See OECD, Attribution Report, Part I, Para. 234; OECD, Attribution Report, Part III, Para. 281.

25, 30 and 34), the DAPE will be attributed a loss. Therefore, the statements “*In any case, the order in which Article 7 and Article 9 are applied should not impact the amount of profits over which the source country has taxing rights as a result of the activities of the intermediary on behalf of its associated non-resident enterprise in the source country*”<sup>21</sup> may need to be revisited. Moreover, if this approach is kept, further clarification would then be required as how to interpret and calculate the information in the following paragraphs of the discussion draft:

Para. No	Discussion draft information
25	“ <i>the amount that TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S (attributing to such party ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)</i> ”
30	“ <i>the amount that SiteCo would have received if it had sold the advertising space to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of SiteCo in Country S (attributing to such party ownership of the assets of SiteCo related to such functions, and assumption of the risks related to such functions)</i> ”
34	“ <i>the amount that TradeCo would have had to pay if it had purchased the widgets from an unrelated supplier performing the same functions in Country S that BuyCo performs on behalf of TradeCo (attributing to such supplier ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)</i> ”

### 3.2.1.2. The impact of the new risk allocation framework under Art. 9 on Art. 7

15. The discussion draft notes that the risk allocation framework (added as a result of BEPS Actions 8-10) contained in chapter I impacts the arm’s length remuneration of the DA<sup>22</sup>. If an accurate delineation indicates that the “*contractual assumption of risks*” and the “*actual conduct*” do not coincide, in the sense that the DA performs and “*controls*” substantial risks rather than the NRE, then the DA should be attributed those risks and the corresponding returns. For example, reference is

<sup>21</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 12.

<sup>22</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 13.

made to the facts of Example 2 of the previous discussion draft<sup>23</sup>. In that example, Sellco was attributed the inventory and credit risk under an Art. 9 analysis. Consequently, the delineated facts under Art. 9 would indicate that i) Prima sells goods to Sellco (it is the buyer since it was attributed the inventory risk) and ii) Sellco sells the goods to the clients. In other words, from an economic perspective, Sellco sells in its own name and on its own behalf as opposed to selling goods in the name of Prima. If this is the case, the question may arise as to whether Prima has a DAPE in Country B under Art. 5?

16. If a position is taken that such re-characterized arrangement under Art. 9 should be the starting point to do an Art. 5 analysis then that position will save the NRE (taxpayer) from the unnecessary burden of recognizing a DAPE<sup>24</sup>. However, the discussion draft takes the position that the risk allocation framework under Art. 9 *“is solely for the purpose of determining the taxable profits of the associated enterprises and therefore does not involve any non-recognition of their transaction or the legal relationships created by their transactions with others”*. In other words, the revised transfer pricing guidance *“does not change the facts on which the application of Article 5(5) is predicated”*. We believe that it may be appropriate to reconsider this issue and, if appropriate, to substantiate it further.

17. Moreover, if a risk is allocated to the DA under Art. 9 can that risk be allocated to the NRE or DAPE under Art. 7? The discussion draft correctly states *“where a risk is found to be assumed by the intermediary... such risk cannot be considered to be assumed by the non-resident enterprise or the PE for the purposes of Article 7. Otherwise, double taxation could occur in the source country through taxation of the profits related to the assumption of that risk twice, i.e. in the hands of both the PE and the intermediary”*<sup>25</sup>. On the other hand, if an accurate delineation of the transaction under Art. 9 indicates that the NRE performs and *“controls”* economically significant risks and has the *“financial capacity”* to assume them rather than the DA, then those risks and its corresponding

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<sup>23</sup> OECD (2016), BEPS Action 7, Additional Guidance on the Attribution of Profits to Permanent Establishments (quoted OECD, Discussion Draft on Attribution of Profits to a PE (2016)). See OECD, Discussion Draft on Attribution of Profits to a PE (2016), Example 2, Paras. 40-45.

<sup>24</sup> In fact, the OECD in its work on Action 7 has clarified that distributors (in particular, limited risk distributors) fall outside the scope of the revised Article 5(5) and 5(6). See OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, Para. 9 (commentary in Para. 32.12).

<sup>25</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 18.

returns should be attributed to the NRE. However, the discussion draft does not discuss whether a risk, which has been attributed to the NRE (head office) under Art. 9 (NRE-DA relations), can be allocated to the DAPE under Art. 7 (NRE-DAPE relations)?

18. In our opinion, if the functional analysis shows that personnel in the head office perform and “control” the risks (under an Art. 7 analysis), then those risks cannot be attributed to the DAPE<sup>26</sup>. In fact, the DAPE does not have its own personnel and hence no significant people functions are performed by it. This is because the activities of the DA’s personnel, which will be compensated under Art. 9, lead to the creation of the DAPE. The OECD needs to clarify this point explicitly in its next discussion paper.

### **3.2.1.3. Does arm’s length compensation to the intermediary extinguish the taxing rights of the host State?**

19. The discussion draft states that it “*should be noted that the host country's taxing rights are not necessarily exhausted by ensuring an arm's length compensation to the intermediary*”<sup>27</sup>. Moreover, it is stated that depending “*on the facts and circumstances of a given case, the net amount of profits attributable to the PE may be either positive, nil or negative (i.e., a loss)*”. In light of the numerical facts presented in the examples (*see section 3.2.2*), it seems to us that in situations where the transactions with the DA fall under the scope of Art. 9, an arm’s length remuneration to the DA (in light of its actual functions) does indeed exhaust the taxing rights of the source State over the NRE<sup>28</sup>. Accordingly, the profits attributable to the DAPE will be nil. Moreover, if one applies the analysis of the discussion draft (Para. 25, 30 and 34), the DAPE could be attributed a loss. Therefore, future work should clarify the circumstances (if any) in which a DAPE could be attributed a profit.

<sup>26</sup> OECD, Attribution Report, Part I: General Considerations, Para. 244.

<sup>27</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 19.

<sup>28</sup> Refer to the following Court judgments: Set Satellite (Singapore) PTE Limited v. DDIT (2008) 218 CTR 452 (Bombay High Court); BBC Worldwide Ltd v. DIT (2011), 203 Taxmann 554 (Delhi High Court); TS-714-ITAT-2015 (Mumbai Tribunal). All these decisions deal with sale of advertising airtime space in India of foreign television channels through local associated enterprises. Also, see the position put forward by Philip Baker and Richard Collier in Baker, Collier, Profit Attribution, p. 33. Moreover, refer to the discussion in the following articles: Mary C Bennett, Carol A Dunahoo, The Attribution of Profits to a Permanent Establishment, Intertax, 2005, pp. 51-67; Hans Pijl, The Zero Sum Game, European Taxation, 2006, pp. 29-35.

#### 3.2.1.4. Administrative burden and penalties<sup>29</sup>

20. As discussed previously, the creation of a hypothetical separate entity i.e. the DAPE is an unnecessary administrative burden for taxpayers of States that follow the separate entity (AOA) approach. Hence, it would be desirable to recommend States to exempt NREs from local filing requirements in nil profit situations. Moreover, if a taxpayer fails to file a tax return, even if no profits are attributable to it, the tax administration of a State could impose penalties on the taxpayer for non-compliance under its domestic law. It seems to us that it would be appropriate to recommend that the taxpayer should not be exposed to any penalties under its domestic law in these circumstances.

#### 3.2.2. Analysis of the three case studies considering numerical facts

##### 3.2.2.1. Example 1: Commissionaire structure

21. Under this example, the sales related activities of a related intermediary viz., SellCo (DA) creates a dependent agent PE (DAPE) for TradeCo (NRE) in Country S<sup>30</sup>.

22. Article 9 would apply to test whether the conditions/prices between TradeCo and SellCo are at arm's length. If an accurate delineation of the transaction through a proper functional analysis<sup>31</sup> indicates that the “*contractual assumption of risks*” and the “*actual conduct*” coincide, in the sense that TradeCo performs and “*controls*” economically significant risks and has the “*financial capacity*” to assume them<sup>32</sup> (such as risks associated to sales, marketing & advertising, inventory management and credit and collection activities<sup>33</sup>) whereas SellCo bears limited operational risks, then SellCo will be characterized as a sales agent. Consequently, it will be treated as the tested party for undertaking a transfer pricing analysis given its least complex profile<sup>34</sup>.

23. Assume the following numerical facts into the case study. The total sales generated by SellCo in

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<sup>29</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Paras. 20-21.

<sup>30</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Paras. 23-24.

<sup>31</sup> OECD Transfer Pricing Guidelines, Para. 1.51-1.55.

<sup>32</sup> OECD, Transfer Pricing Guidelines, Paras. 1.60-1.109.

<sup>33</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2016), Example 1, Paras. 13-29.

<sup>34</sup> OECD, Transfer Pricing Guidelines, Paras. 3.18-3.19.

Country S on behalf of TradeCo amount to USD 1,000. As SellCo is compensated on a fixed percentage on sales basis (5% on sales), its compensation amounts to USD 50. Moreover, assume that the total operating expenses incurred by SellCo (*including the salaries of the employees engaged in the sales activities*) amount to USD 40. Consequently, as shown in Table 1A, SellCo operates on a 25% return on its total operating costs<sup>35</sup>. Furthermore, a comparability analysis indicates that unrelated parties in Country S that provide sales agency services also operate on a 25% return on their total operating costs. Accordingly, the remuneration derived by SellCo, by applying the transactional net margin method<sup>36</sup> (on the assumption that the transaction is accurately delineated and that the TNMM is the most appropriate method), can be at arm's length.

<b>Table 1A: Profit and loss statement of SellCo</b>	
<b>Particulars</b>	<b>Amount</b>
Sales service fee received from TradeCo*	50*
Total operating expenses	40
Profit**	10**
*represents remuneration of 5% on sales	
**represents a return of 25% on total operating costs which can be considered to be at arm's length	

24. On the other hand, as discussed previously, the two-step approach provided by Article 7(2) will apply to determine the profits attributable to the DAPE<sup>37</sup>. In our opinion, under the first step, the DAPE does not perform any significant people functions relevant to the assumption of risks. The significant people functions relevant to economically significant risks (such as risks related to sales, marketing & advertising, inventory management and credit and collection activities), as accurately delineated under Art. 9, are performed and controlled by personnel working in Country R for TradeCo. Thus, as the DAPE does not carry out any significant people functions, it should not be attributed any risks and consequently no profits<sup>38</sup>. Accordingly, once the intermediary has been compensated on an arm's length basis then there would not be further income attribution to the

<sup>35</sup> A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. OECD Transfer Pricing Guidelines, Para. 2.93 and Paras. 2.98-2.102.

<sup>36</sup> OECD Transfer Pricing Guidelines, Paras. 2.64-2.105.

<sup>37</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 11.

<sup>38</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2016), Example 1, Paras. 33-34; OECD, Attribution Report, Part I: General Considerations, Paras. 233-244.

DAPE.

25. However, if one applies the approach followed by the discussion draft, a different result could arise. The discussion draft<sup>39</sup> states that the profits attributable to the DAPE are equal to sales to third party customers<sup>40</sup> as reduced by (1) the amount that TradeCo would have received from the DAPE for selling the goods (2) the amount that TradeCo would have received for other activities carried out for the purpose of the DAPE<sup>41</sup> and (3) arm’s length remuneration of SellCo. As discussed previously, the information with respect to the sales to third parties and arm’s length remuneration of SellCo is already available. Moreover, let’s assume that the other expenses incurred by the head office on behalf of the PE amount to USD 100 (see **Table 1B**).

S.No	Table 1B: Profit and loss statement of the DAPE under the OECD approach	
Particulars	(Amount)	
(A) Sales to third party customers (minus)	1,000	
(1)	Purchase of goods from Head office (balancing figure)	??
(2)	Other expenses incurred by Head office for the PE	100
(3)	Arm’s length remuneration of SellCo	50
(B) Total operating expenses	??	
(C) Profit (loss)	??	

26. The question arises as to how to interpret and calculate (1)? The discussion draft provides that this represents the amount that “TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S (attributing to such party ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)”. The footnote states, “This is conceptually equivalent to the amount paid by the PE for the inventory

<sup>39</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 25.

<sup>40</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 25 (footnote 5).

<sup>41</sup> This represents the expenses to be incurred by the DAPE for the "activities undertaken by TradeCo (as home office) on behalf of the PE, this would include an arm’s length allocation of expenses associated with these activities, or, under the AOA, a ‘dealing’ between the PE and TradeCo (as home office) associated with TradeCo’s activity on behalf of the PE”. OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 25 (footnote 7).

‘purchased’ from TradeCo. This would correspond to a “dealing” under the AOA<sup>42</sup>. Although the framing of these sentences seems to be rather confusing, we believe that the DAPE, as an unrelated party, would pay USD 1,000 to purchase the inventory (the amount at which it is sold to the third party) as it does not perform any additional functions (than the functions for which SellCo has already been remunerated on an arm’s length basis). If one follows the approach of the discussion draft, we believe that the attribution exercise leads to the conclusion that the DAPE will be attributed a loss (see **Table 1C**).

S.No	Table 1C: Profit and loss statement of the DAPE	
Particulars		(Amount)
<b>(A) Sales to third party customers as reduced by</b>		<b>1,000</b>
(1)	Purchase of goods from the head office (balancing figure)	1,000
(2)	Other expenses incurred by head office for the PE	100
(3)	Arm’s length remuneration of SellCo	50
<b>(B) Total operating expenses</b>		<b>1,150</b>
<b>Profit (loss)</b>		<b>(150)</b>

27. Even if an accurate delineation of the transaction through a proper functional analysis indicates that the “*contractual assumption of risks*” and the “*actual conduct*” do not coincide<sup>43</sup>, in the sense that SellCo performs and “*controls*” substantial risks (such as risks associated to inventory and credit and collection activities<sup>44</sup>) rather than TradeCo, then SellCo cannot be characterized as a sales agent. Accordingly, pursuant to Art. 9, SellCo will need to be remunerated on an arm’s length basis for its additional functions, risks and assets that it employs. The question then arises as to whether the DAPE needs to be remunerated for the additional functions, risks and assets for which SellCo has already been remunerated? In our opinion, this should not be the case. The discussion draft correctly confirms this position<sup>45</sup>.

<sup>42</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 30 (footnote 9).

<sup>43</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 13.

<sup>44</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2016), Example 2, Paras. 40-42.

<sup>45</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 18.

### 3.2.2.2. Example 2: Online advertiser

28. Under this example, the marketing related activities of a related intermediary viz., SellCo creates a dependent agent PE (DAPE) for SiteCo (NRE) in Country S<sup>46</sup>.

29. Article 9 would apply to test whether or not the conditions/prices between SiteCo and SellCo are at arm's length. If an accurate delineation of the transaction through a proper functional analysis<sup>47</sup> indicates that the “*contractual assumption of risks*” and the “*actual conduct*” coincide<sup>48</sup>, in the sense that SiteCo performs and “*controls*” economically significant risks and has the “*financial capacity*” to assume them<sup>49</sup> (such as risks associated to sales, marketing & advertising and credit and collection) whereas SellCo bears limited operational risks, then SellCo will be characterized as a taxpayer that provides routine marketing services. Consequently, it will be treated as the tested party for undertaking a transfer pricing analysis given its least complex profile<sup>50</sup>.

30. Assume the following numerical facts into the case study. The total sales generated by SiteCo in Country S on behalf of SellCo amount to USD 1,000. As SellCo is compensated on a fixed percentage on sales basis (5% on sales), its compensation amounts to USD 50. Moreover, assume that the total operating expenses incurred by SellCo (*including the salaries of the employees engaged in the marketing activities*) amount to USD 40. Consequently, **as shown in Table 2A**, SellCo operates on a 25% return on its total operating costs<sup>51</sup>. Furthermore, a comparability analysis indicates that independent marketing service providers in Country S also operate on 25% return on their total operating costs. Accordingly, the remuneration derived by SellCo, by reference to the transactional net margin method<sup>52</sup> (on the assumption that the transaction is accurately delineated and the TNMM is the most appropriate), can be considered to be at arm's length.

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<sup>46</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Paras. 28-29.

<sup>47</sup> OECD Transfer Pricing Guidelines, Para. 1.51-1.55.

<sup>48</sup> OECD, Discussion Draft on Attribution of Profits to a PE, (2017) Para. 13.

<sup>49</sup> OECD, Transfer Pricing Guidelines, Paras. 1.60-1.109.

<sup>50</sup> OECD, Transfer Pricing Guidelines, Paras. 3.18-3.19.

<sup>51</sup> A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. See OECD Transfer Pricing Guidelines, Para. 2.93 and Paras. 2.98-2.102.

<sup>52</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Paras. 2.64-2.105.

Table 2A: Profit and loss statement of SellCo	
Particulars	Amount
Marketing service fee received from SiteCo*	50*
Total operating expenses	40
Profit**	10**
*represents remuneration of 5% on sales	
**represents a return of 25% on operating costs which can be considered to be at arm's length	

31. On the other hand, as discussed previously, the two-step approach provided by Article 7(2) will apply to determine the profits attributable to the DAPE<sup>53</sup>. In our opinion, under the first step, the DAPE does not perform any significant people functions relevant to the assumption of risks. The significant people functions relevant to economically significant risks (such as risks associated to sales, marketing & advertising and credit and collection activities), as accurately delineated under Art. 9, are performed and controlled by personnel working in Country R for SiteCo. Therefore, as the DAPE does not carry out any significant people functions, it should not be attributed any risks and consequently no profits<sup>54</sup>. Accordingly, once the intermediary has been compensated on an arm's length basis then there would not be further income attribution to the DAPE.

32. However, if one applies the approach followed by the discussion draft, a different result could arise. The discussion draft<sup>55</sup> states that the profits attributable to the DAPE are equal to sales to third party customers<sup>56</sup> as reduced by (1) the amount that SiteCo would have received from the DAPE for the advertising space (2) the amount that SiteCo would have received for other activities carried out for the purpose of the DAPE<sup>57</sup> and (3) arm's length remuneration of SellCo. As discussed previously, the information with respect to the sales to third parties and arm's length remuneration of SellCo is already available. Moreover, let's assume that the other expenses incurred by the HO on behalf of the PE amount to USD 100 (see Table 2B).

<sup>53</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 11.

<sup>54</sup> See OECD, Attribution Report, Part I: General Considerations, Paras. 233-244.

<sup>55</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 30.

<sup>56</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 30 (footnote 8).

<sup>57</sup> This represents the expenses to be incurred by the DAPE for the "activities undertaken by SiteCo (as home office) on behalf of the PE, this would include an arm's length allocation of expenses associated with these activities, or, under the AOA, a 'dealing' between the PE and SiteCo (as home office) associated with SiteCo's activity on behalf of the PE". OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 30 (footnote 10).

S.No	Table 2B: Profit and loss statement of the DAPE	
Particulars	(Amount)	
<b>(A) Sales to third party customers as reduced by</b>	<b>1,000</b>	
(1)	Purchase of services from head office (balancing figure)	??
(2)	Other expenses incurred by Head office for the PE	100
(3)	Arm's length remuneration of SellCo	50
<b>(B) Total operating expenses</b>	<b>??</b>	
<b>(C) Profit (loss)</b>	<b>??</b>	

33. The question arises as to how do we interpret and calculate (1) which represents the amount that Site Co would have received if it had sold the advertising space to an “unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of SiteCo in Country S (attributing to such party ownership of the assets of SiteCo related to such functions, and assumption of the risks related to such functions)”. The footnote states that this “is conceptually equivalent to the amount paid by the PE for the rights to the advertising space from SiteCo. This would correspond to a ‘dealing’ under the AOA”<sup>58</sup>. Although the framing of these sentences seem to be rather confusing, we believe that the DAPE, as an unrelated party, would pay USD 1,000 to purchase the advertising space (the amount at which it is sold to the third party), as it does not perform any additional functions (than the functions for which SellCo has already been remunerated). If one follows the approach of the discussion draft, we believe that the attribution exercise leads to the conclusion that the DAPE will be attributed a loss (see Table 2C).

S.No	Table 2C: Profit and loss statement of the DAPE	
Particulars	(Amount)	
<b>(A) Sales to third party customers as reduced by</b>	<b>1,000</b>	
(1)	Purchase of services from Head Office (balancing figure)	1,000
(2)	Other expenses incurred by HO for the PE	100
(3)	Arm's length remuneration of SellCo	50
<b>(B) Total operating expenses</b>	<b>1,150</b>	
<b>Profit (loss)</b>	<b>(150)</b>	

<sup>58</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 30 (footnote 9).

34. Even if an accurate delineation of the transaction through a proper functional analysis indicates that the “*contractual assumption of risks*” and the “*actual conduct*” do not coincide<sup>59</sup>, in the sense that SellCo performs and “*controls*” substantial risks (such as risks associated to marketing and credit and collection activities) rather than SiteCo, then SellCo cannot be characterized as a routine marketing services provider. Accordingly, pursuant to Art. 9, SellCo needs to be remunerated on an arm’s length basis for its additional functions, risks and assets that it employs. The question then arises as to whether the DAPE needs to be remunerated for the additional functions, risks and assets for which SellCo has already been remunerated? In our opinion, this should not be the case. The discussion draft correctly confirms this position<sup>60</sup>.

35. We would like to highlight that, even though a DAPE arises, income should not be attributed to the DAPE in the absence of significant people functions. The OECD should clarify this point in its next discussion paper. Moreover, we believe that changing the PE definition is not an adept solution to tackle the tax challenges raised by digital economy as profit attribution issues will always persist, especially, when the NRE operates on a remote basis in the market jurisdiction.

### 3.2.2.3. Example 3: Procurement entity

36. Under this example, the procurement activities of a related intermediary viz., BuyCo (DA) creates a dependent agent PE (DAPE) for TradeCo (NRE) in Country S<sup>61</sup>.

37. Article 9 would apply to test whether or not the conditions/prices between TradeCo and BuyCo are at arm’s length. If an accurate delineation of the transaction through a proper functional analysis<sup>62</sup> indicates that the “*contractual assumption of risks*” and the “*actual conduct*” coincide, in the sense that TradeCo performs and “*controls*” economically significant risks and has the “*financial capacity*” to assume them<sup>63</sup> (such as risks associated to purchase, inventory management and credit management activities) whereas BuyCo bears limited operational risks, then BuyCo will be characterized as a purchase agent. Consequently, it will be treated as the tested party for undertaking

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<sup>59</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 13.

<sup>60</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 18.

<sup>61</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Paras. 32-33.

<sup>62</sup> OECD Transfer Pricing Guidelines, Para. 1.51-1.55.

<sup>63</sup> OECD, Transfer Pricing Guidelines, Paras. 1.60-1.109.

a transfer pricing analysis given its least complex profile<sup>64</sup>.

38. Assume the following numerical facts into the case study. The total purchase made by BuyCo in Country S on behalf of TradeCo amount to USD 1,000. As BuyCo is compensated on a fixed percentage on purchase basis (5% on purchases), its compensation amounts to USD 50. Moreover, assume that the total operating expenses incurred by BuyCo (*including the salaries of the employees engaged in the purchasing activities*) amount to USD 40. Consequently, **as shown in Table 3A**, BuyCo operates on a 25% return on its total operating costs<sup>65</sup>. Furthermore, a comparability analysis indicates that unrelated parties in Country S that provide purchase agent services also operate on a 25% return on their total operating costs. Accordingly, the remuneration derived by BuyCo, by applying the transactional net margin method<sup>66</sup> (on the assumption that the other TP methods will not be applicable), can be considered to be at arm's length.

<b>Table 3A: Profit and loss statement of BuyCo</b>	
Particulars	Amount
Purchasing service fee received from TradeCo*	50*
Total operating expenses	40
Profit**	10**
*represents remuneration of 5% on purchase	
**represents a return of 25% on total operating costs which can be considered to be at arm's length	

39. On the other hand, as discussed previously, the two-step approach provided by Article 7(2) will apply to determine the profits attributable to the DAPE<sup>67</sup>. In our opinion, under the first step, the DAPE does not perform any significant people functions relevant to the assumption of risks. The significant people functions associated to such risks (such as risks associated to purchasing, inventory management and credit management activities), as accurately delineated under Art. 9, are performed and controlled by personnel working in Country R for TradeCo. Therefore, as the DAPE does not carry out any significant people functions, it should not be attributed any risks and

<sup>64</sup> OECD, Transfer Pricing Guidelines, Paras. 3.18-3.19.

<sup>65</sup> A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. OECD Transfer Pricing Guidelines, Para. 2.93 and Paras. 2.98-2.102.

<sup>66</sup> OECD Transfer Pricing Guidelines, Paras. 2.64-2.105.

<sup>67</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 11

consequently no profits<sup>68</sup>. Accordingly, once the intermediary has been compensated on an arm's length basis then there would not be further income attribution to the DAPE.

40. However, if one applies the approach followed by the discussion draft, a different result could arise. The discussion draft<sup>69</sup> states that the profits attributable to the DAPE are equal to:

- a. the “*amount that TradeCo would have had to pay if it had purchased the widgets from an unrelated supplier performing the same functions in Country S that BuyCo performs on behalf of TradeCo (attributing to such supplier ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)*”. The footnote states that this “*This is equivalent to attributing to the PE the rights and obligations associated with the procurement of widgets resulting directly or indirectly from the contracts to which Article 5(5) refers*”<sup>70</sup>. The question arises as to how do we interpret and calculate this amount. We believe that the DAPE, as an unrelated party, would receive USD 1,000 to sell the goods to the head office (the amount at which it is purchased from third party suppliers), as it does not perform any additional functions (than the functions for which BuyCo has already been remunerated).
- b. The aforementioned amount is to be reduced by (1) the amount that TradeCo would have paid to unrelated suppliers for purchasing the goods (2) the amount that TradeCo would have received for other activities carried out for the purpose of the DAPE<sup>71</sup> and (3) arm's length remuneration of BuyCo. As discussed previously, the information with respect to the purchase from unrelated suppliers and arm's length remuneration of BuyCo is already available. Moreover, let's assume that the other expenses incurred by the HO on behalf of the PE amount to USD 100. If one follows the approach of the discussion draft, we believe that the attribution exercise leads to the conclusion that the DAPE will be attributed a loss (**see Table 3B**).

<sup>68</sup> OECD, Attribution Report, Part I: General Considerations, Paras. 233-244

<sup>69</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 34.

<sup>70</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 34 (footnote 11).

<sup>71</sup> This represents the expenses to be incurred by the DAPE for the "*activities undertaken by TradeCo (as home office) on behalf of the PE, this would include an arm's length allocation of expenses associated with these activities, or, under the AOA, a 'dealing' between the PE and TradeCo (as home office) associated with TradeCo's activity on behalf of the PE*". OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 34 (footnote 12).

S.No	Table 3B: Profit and loss statement of the DAPE	
Particulars	(Amount)	
<b>(A) Sales to the head office (Balancing figure)</b>	<b>1,000</b>	
(1)	Purchase of goods from unrelated suppliers	1,000
(2)	Other expenses incurred by Head office for the PE	100
(3)	Arm’s length remuneration of BuyCo	50
<b>(B) Total operating expenses</b>	<b>1,150</b>	
<b>(C) Profit (loss)</b>	<b>(150)</b>	

41. Even if an accurate delineation of the transaction through a proper functional analysis indicates that the “*contractual assumption of risks*” and the “*actual conduct*” do not coincide<sup>72</sup>, in the sense that BuyCo performs and “*controls*” substantial risks (such as risks associated to inventory activities) rather than TradeCo, then BuyCo cannot be characterized as a purchasing agent. Accordingly, pursuant to Art. 9, BuyCo will need to be remunerated on an arm’s length basis for its additional functions, risks and assets that it employs. The question then arises as to whether the DAPE needs to be remunerated for the additional functions, risks and assets for which BuyCo Co has already been remunerated? In our opinion, this should not be the case. The discussion draft correctly confirms this position<sup>73</sup>.

### 3.3. Situations where the intermediary does not qualify as an associated enterprise for the purpose of Article 9

42. We would like to highlight that profits can indeed be attributed to the DAPE when the intermediary does not fall within the scope of Art. 9. This would typically be the case when the intermediary is the employee of the NRE<sup>74</sup>. For example, reference is made to the facts of Example 3 of the previous discussion draft<sup>75</sup>. In that example, remuneration (salary) to the employee did not exhaust the taxing rights of the source State over the NRE. We agree with the numerical analysis of that example (with the exception that depreciation/rent of the company vehicle needed to be added to the costs). Thus, we recommend the OECD to reproduce this example in its next discussion paper.

<sup>72</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 13

<sup>73</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 18

<sup>74</sup> Baker, Collier, Profit Attribution, p. 33; See discussion in Dziurdz, Attribution, pp. 152-153.

<sup>75</sup> OECD, Discussion Draft on Attribution of Profits to a PE (2016), Example 3, Paras. 58-68.

### **3.4. Single vs dual taxpayer approach – Policy suggestion**

43. The OECD favors the application of a dual taxpayer approach as opposed to a single taxpayer approach<sup>76</sup>. We would like to submit that in situations where the intermediary falls under the scope of Art. 9, the single taxpayer approach should prevail, especially in light of the new (strengthened) chapter I of the OECD TP guidelines. On the other hand, we would like to submit that in situations wherein the intermediary falls outside the scope of Art. 9, the dual taxpayer approach should continue to apply (albeit, the DA is the employee of the NRE). Accordingly, it may be desirable to reconsider the dual taxpayer approach in these circumstances.

## **4. Changes to Article 5(4)**

### **4.1. Preliminary remarks**

44. Several signatory countries to the MLI have adopted either Option A or Option B. Moreover, the anti fragmentation rule has been adopted by States that have chosen to apply either option or none of the options<sup>77</sup>. With respect discussing profit attribution to such PEs, the discussion draft contains example 4. The facts<sup>78</sup> indicate that warehousing activities and the merchandising activities of the Online Co creates two separate PE for the NRE<sup>79</sup>.

### **4.2. Example 4: Online retailer – Analysis of this case study considering numerical facts**

#### **4.2.1. Profit attribution for the warehousing activities<sup>80</sup>**

45. Applying the two-step profit attribution approach to the case at hand will lead to the conclusion that i) under the first step, the PE of the online retailer will be hypothesized (characterized) as a taxpayer which is carrying out warehousing activities that entail providing storage and delivery

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<sup>76</sup> OECD, Attribution Report, Part I: General Considerations, Paras. 239-235.

<sup>77</sup> See for instance the Covered Tax Agreement between Chile and United Kingdom.

<sup>78</sup> Action 7, Revised Profit Attribution Report, Paras. 44-46.

<sup>79</sup> Action 7, Revised Profit Attribution Report, Para. 47.

<sup>80</sup> Action 7, Revised Profit Attribution Report, Para. 48.

services to the head office and; ii) under the second step, the PE needs to be remunerated on an arm’s length basis for its storage and delivery activity by reference to transfer pricing principles. Assume that the following expenses are incurred in State S for the storage and delivery activity:

- the salary of the employees engaged in the warehousing activity (storage and delivery) amount to USD 20;
- the cost for delivering the products through independent service providers (through courier or post) is USD 5; and
- the warehouse is rented for USD 20;
- other operating costs related to the warehouse amount to USD 5.

46. Furthermore, a comparability analysis indicates that independent storage and delivery service providers in Country S operate on a total operating cost-plus basis of 10%<sup>81</sup>. Taking into consideration the foregoing facts, the profits attributable to the PE (see **Table 4A**) are as follows:

<b>Table 4A: Attribution of profits to the warehouse PE that performs storage and delivery activity</b>		
<b>Particulars</b>		<b>Profit and loss account of the PE</b>
<b>(1)</b>	<b>Income* (Balancing figure)</b>	<b>55*</b>
(2)	Rent	20
(3)	Salary	20
(4)	Delivery costs	5
(5)	Other operating expenses	5
	<b>Expenses</b>	<b>50</b>
	<b>Profit**</b>	<b>5**</b>
*represents the amount that R Co would have paid to an independent enterprise performing similar storage and delivery activities		
**represents a return of 10% on total operating costs which can be considered to be at arm’s length in light of operating margins earned by independent comparable service providers (on the assumption that the transaction is accurately delineated and that the TNMM is the most appropriate method)		

<sup>81</sup> A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. See OECD Transfer Pricing Guidelines, Para. 2.93 and Paras. 2.98-2.102.

#### 4.2.2. Profit attribution for the merchandising and information collection services<sup>82</sup>

47. Applying the two-step profit attribution approach to the case at hand will lead to the conclusion that i) under the first step, the PE of the online retailer will be hypothesized (characterized) as a taxpayer which is providing merchandising and information collection services to the head office and; ii) under the second step, the PE needs to be remunerated on an arm's length basis for its activity by reference to transfer pricing principles. Assume that the following expenses are incurred in State S for the merchandising and information collection services:

- the salary of the employees engaged in the merchandising and information collection services amount to USD 20;
- other operating costs related to the merchandising and information collection services amount to USD 5; and
- the office is rented for USD 20;

48. Furthermore, a comparability analysis indicates that independent service providers in Country S operate on a total operating cost-plus basis of 10%<sup>83</sup>. Taking into consideration the foregoing facts, the profits attributable to the PE (see **Table 4B**) are as follows:

<b>Table 4B: Attribution of profits to the PE that performs merchandising and information collection activity</b>		
<b>Particulars</b>		<b>Profit and loss account of the PE</b>
<b>(1)</b>	<b>Income* (Balancing figure)</b>	<b>55*</b>
<b>(2)</b>	Salary	20
<b>(3)</b>	Other operating expenses	5
<b>(4)</b>	Rent of the office	25
<b>Expenses</b>		<b>50</b>
<b>Profit**</b>		<b>5**</b>
*represents the amount that R Co would have paid to an independent enterprise performing similar merchandising and information collection activities		
**represents a return of 10% on total operating costs which can be considered to be at arm's length		

<sup>82</sup> Action 7, Revised Profit Attribution Report, Para. 49.

<sup>83</sup> A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. See OECD Transfer Pricing Guidelines, Para. 2.93 and Paras. 2.98-2.102.





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**RE: Additional Guidance on Attribution of  
Profits to Permanent Establishments**

Dear Mr. Vanderwolk:

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* (the Report).

On 4 July 2016, the OECD issued a public discussion draft under Action 7 entitled *Additional Guidance on the Attribution of Profits to Permanent Establishments* (Prior Discussion Draft or Prior Draft). On 22 June 2017, the OECD issued another public discussion draft under Action 7 entitled *Additional Guidance on Attribution of Profits to Permanent Establishments* (Discussion Draft or Draft). The Discussion Draft requests comments from stakeholders on the application of Article 7 of the OECD's Model Tax Convention (the MTC), regarding 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 also requests the opportunity to speak in support of these comments at the public consultation to be held in November 2017 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>

### **TEI Comments**

TEI welcomes the Discussion Draft's objective to provide guidance on the attribution of profits to PEs arising from the revisions to Article 5 of the MTC set forth in the Report. While the Draft presents high-level general principles, the OECD could increase its usefulness to both taxpayers and tax authorities by including more detailed guidance and additional examples to illustrate more complex circumstances and outcomes. Regrettably, the absence in the Draft of the more detailed – although still too general – examples from the Prior Discussion Draft can only be interpreted as a lack of consensus at the OECD. The lack of clarity resulting from the Draft will likely result in tax authorities asserting unwarranted PEs, leading to unnecessary controversy and expense. In addition, while TEI understands the reasoning behind the OECD's decision not to include numerical examples, "to avoid drawing conclusions from this guidance on the level of profitability of the intermediary or the permanent establishment," the inevitable, and regrettable, outcome is a lack of insight and guidance from the simple, non-numeric examples in the Draft. This also obscures the purpose of the examples where numbers would make the purpose much clearer. TEI recommends, therefore, the reinstatement of numerical examples and the inclusion of additional detailed and complex examples in final guidance to illustrate particular issues.<sup>2</sup> In particular, missing is a situation where no additional profit is allocated to a deemed PE. If numerical examples are not included, a less favorable alternative would be to reference this situation in non-numeric examples by including the statement "if the analysis shows that there is no additional profit to attribute to the deemed PE" or something similar.

TEI also welcomes confirmation in Paragraph 7 that the changes made to Article 5 have not modified the nature of a PE that is deemed to arise under either the pre-BEPS or post-BEPS versions of the Article. It would be helpful, however, if specific reference to this view was included in the updated Commentary on the MTC, a draft of which was published on July 11, 2017. Even if this recommendation is accepted, the BEPS project includes non-OECD countries under the "Inclusive Framework" and addresses changes to bilateral tax treaties through the Multilateral Instrument (MLI) developed under BEPS Action 15. Thus, the helpfulness of referencing the unchanged nature of a PE in the Commentary is undermined because not all

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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> We comment on the examples in the Discussion Draft below.

countries who may change the equivalent of Article 5 in their bilateral tax treaties will be members of the OECD or otherwise committed to the secondary OECD guidance on the interpretation of tax treaties (*i.e.*, the Commentary). In this future international tax environment, where increasing numbers of countries may amend tax treaties in line with the Action 7 recommendations and where the MLI permits rapid ratification of treaty amendments, the status of guidance on the attribution of profit to PEs becomes more important to both taxpayers and tax authorities. It is not clear what the status of the Discussion Draft will be once it is finalized, and whether taxpayers can rely on its guidance in interpretation of tax treaties, so clarification of its status would be of great benefit.

An additional issue with the Discussion Draft's guidance is the lack of clear support for the Authorised OECD Approach ("AOA") under Article 7. Unless all participating countries can agree to adopt the AOA, this potentially valuable guidance on the attribution of profits to PEs is unlikely to be useful in practice and indeed may create further confusion. TEI strongly encourages the OECD to make explicit its support for the AOA's adoption and the consistency it would provide in this difficult area.

The Draft states in Paragraph 7 that "any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5(5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5(5)." This statement suggests that the Commentary to the MTC before the BEPS project provided sufficient, consistent, and unambiguous guidance to taxpayers and tax authorities regarding PE profit attribution. This was not the experience of TEI members when interacting with tax authorities across jurisdictions. Indeed, the need for the OECD to clarify and provide additional guidance to reconcile these divergent interpretations was identified prior to the BEPS project.

Paragraph 7 also suggests that countries may apply any previously used profit attribution method, including the 2010 AOA, 2008 AOA, or any other pre-BEPS method. The primary value of the Inclusive Framework (to both taxpayers and tax authorities) is the potential for consistent application of the standards developed during the course of the BEPS project across all 102 participating countries. To achieve this consistency there must be a recognition that a single approach is desirable, and TEI recommends that all future guidance aim to encourage the adoption of the approach based on the 2010 AOA.

As noted, Paragraph 7 states that the changes made to Article 5 have not modified the nature of a PE that is deemed to arise under either the pre-BEPS or post-BEPS versions of the Article and any approach to how profits are attributed to the pre-BEPS version of Article 5 should be applicable to a deemed PE under the post-BEPS version of the Article. It is unclear to TEI, however, that this blanket statement holds in all cases. For example, suppose two associated companies, A in Country A and B in Country B, each have preparatory activities in Country C. In addition, B has two different types of preparatory activities in Country C. While the anti-fragmentation rule could establish a PE of B in Country C through combining its two distinct activities, would the rule draw in the activities of A? And if a PE was found that

included A's activities, how would profit be attributed, when the whole is greater than the sum of the parts? Clarifying guidance on this fact pattern is necessary to address this and similar situations.

Paragraph 8 contains a welcome statement that the existence of a PE under Article 5 does not mean that the entire profits from the relevant contracts must be attributed to the PE. Given the lack of existing guidance, it would be helpful to have a similar confirmation for all PEs, in particular those resulting from other changes to Article 5, such as the anti-fragmentation rule.

That said, the language included in Paragraph 8 seemingly represents a departure from the analysis under the AOA. Paragraph 8 states “[o]nce it is determined that a PE exists under Article 5(5), one of the effects of paragraph 5 will typically be that the rights and obligations resulting from the contracts to which Article 5(5) refers will be properly allocated to the permanent establishment.” This appears to jettison the AOA by replacing its required functional analysis with assumptions about the rights and obligations of the parties. This is unlikely to support the OECD's objective to align taxing rights with value creation

TEI is also concerned that the Discussion Draft does not address the absence of a recommendation in the MTC Commentary on the order of application of Articles 9 and 7 when determining profits attributable to a PE. Paragraph 12 concludes that no matter the order, it should not impact the amount of profit over which a country has taxing rights and states an expectation that jurisdictions should make arrangements to eliminate double taxation. TEI believes the Discussion Draft should include stronger guidance on the order of application and stress the need for transparency and consistency, including publication of the approach taken by taxing jurisdictions, particularly those which seek to apply Article 7 before Article 9. In this regard, TEI recommends countries apply Article 9 before Article 7 and the OECD state a preference for this approach for the sake of clarity, consistency, and efficiency. If all states adopt the same approach it will facilitate timely resolution of disputes between taxpayers and tax administrations. States who do not wish to adopt this ordering could make a reservation in the final report. Further, applying Article 7 first may have collateral effects on employee taxation under Article 15, loss relief, and create VAT issues. While from a strictly theoretical perspective the order of application may not matter, the issue of deemed PEs is confusing to many taxpayers and tax administrations and specific guidance would benefit both in understanding the position a taxpayer has taken and resolving possible disputes. Finally, the final guidance should state that arrangements to eliminate double taxation apply to all PEs, however they may arise.

Paragraph 13 references the work under BEPS Action 8-10 on transfer pricing and states that, under the revised OECD Transfer Pricing Guidelines, “where the party contractually assuming the risk does not control the risk or does not have the financial capacity to assume the risk, that risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.” It is unclear from this statement how to apply the approach in the

Discussion Draft to a situation where control of the risk is in an entity that does not have the financial capacity to bear it and the allocation of the risk is in an entity that has the financial capacity to bear it but no control over the risk. In that case, does an entity's financial capacity to bear the risk along with a contractual allocation of the risk to that same entity result in profit attribution to that entity in relation to the risk? Or is some other outcome warranted? Clarification on this particular set of facts would be helpful.

The confirmation in Paragraph 14 that "the allocation of risks for transfer pricing purposes does not change the facts on which the application of Article 5(5) is predicated" is particularly welcome. TEI recommends that this conclusion also be confirmed and emphasized in the MTC Commentary.

With respect to Paragraph 17, TEI encourages the OECD to provide additional clarity on the difference and similarities of significant people functions for the attribution of risk under Article 7 and risk control functions under Article 9. In TEI's view, where the actual functions performed are identical, the evaluation of those functions and the profit associated with performing these functions should be identical. The current language of Paragraph 17 is susceptible to differing interpretations, however, and therefore does not assist tax administrations or taxpayers seeking definitive guidance. An example would be particularly helpful here to make the meaning clearer.

Paragraph 18 acknowledges that significant people functions (under Article 7) and risk control functions (under Article 9) can overlap and seeks to ensure that the overlap does not result in double taxation in the source country. While this recognition is welcome, it is regrettable that the Discussion Draft does not propose a method to eliminate double taxation between the source and the residence countries. TEI recommends the OECD suggest such a method in final guidance.

Paragraph 19 states that the arm's length net profit attributable to a PE could be positive, zero, or negative (*i.e.*, a loss). This recognition is significant, and it should have greater prominence to counter the assumption made by many tax jurisdictions that the presence of a PE carries a presumption of taxable profit. However, this welcome recognition is then undermined by the next sentence stating where an intermediary assumes risk, the profits attributable could be "minimal or even zero" but does not acknowledge that the attributable result could be negative, which should also be noted. The Discussion Draft should then include guidance or confirmation of how a negative profit should be treated. In addition, where non-numerical examples are used, TEI recommends that each example include a short statement reiterating that the net profit attributable to the PE may be positive, zero, or negative.

TEI welcomes the implied approval in Paragraphs 20-21 of methods to achieve administrative simplification and cost reduction. To assist countries in implementing such methods, the final guidance should include real world examples of such methods implemented in practice by tax jurisdictions and be accompanied by a recommendation that such practices be adopted by all jurisdictions. The OECD should also provide examples of where a PE is created

by the combination of the activity of many subsidiaries of a multi-national enterprise in a single country under the anti-fragmentation rule and indicate how one would select the company that should declare the PE and ensure that there is no double taxation in the other jurisdictions.

Paragraph 21 comments on the burden of reporting, but there is no reference to, or recommendation on the adoption of, a *de minimis* or similar approach. Such a recommendation would recognize that, where a PE has zero or a very small profit, it is in the interests of both tax administrators and taxpayers to avoid the administrative and compliance burden where the costs of administration exceed the taxes collected. Moreover, the existence of a PE and its attendant filing obligations may give rise to other uncertainties and increased audit exposure. In particular, smaller multi-national enterprises may have resource constraints and face difficulties complying with the increased administrative burden that comes with a PE, which may distort competition.<sup>3</sup> In addition, host jurisdiction taxing authorities will likely need to dedicate additional resources to the review, audit, and controversy resulting from the additional PE compliance requirements, which again may be unnecessary if there is little or no tax due. Tax authorities in developing countries are particularly likely to face resource constraints, and their lower level of sophistication may cause them to misallocate such limited resources and frustrate potential investors in those countries. If the OECD determines that there should be a filing in *de minimis* cases rather than an exemption, then it should recommend a simplified filing only for taxes attributable to the PE that would start the running of the relevant statute of limitations. Finally, TEI notes that a *de minimis* approach should be distinguished from simplification of payment of tax where there is another resident taxpayer.

As another possibility to alleviate the administrative burden of small PEs, the OECD should consider recommending the “single taxpayer approach” referenced in paragraphs 235 to 239 of its *2010 Report on the Attribution of Profits to Permanent Establishments*.<sup>4</sup> This would create certainty, add administrative simplicity, and reduce the possibility of disputes. In that approach, tax administrators would collect tax from the dependent agent enterprise/intermediary only, but still tax the arm’s length profit resulting from the combined activities of the deemed PE and the dependent agent enterprise/intermediary. While this may not appear to be an attractive approach from the standpoint of traditional concepts of PEs and deemed PEs, the approach would in fact treat activities performed in a host country through a PE exactly the same as when the same activities are performed by a dependent agent enterprise/intermediary and a deemed PE is created under Article 5. That is, there will be only one entity subject to tax and the amount of profit subject to tax will be determined by reference to the functions performed, assets used, and risks assumed/controlled in that country without the need to delineate these between the deemed PE and dependent agent enterprise/intermediary.

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<sup>3</sup> For example, smaller multi-nationals may refrain from entering markets merely because of the administrative and compliance burden even though they it may be otherwise profitable for them to do so.

<sup>4</sup> 22 July 2010, available at <https://www.oecd.org/ctp/transfer-pricing/45689524.pdf>.

The draft amended MTC Commentary published on July 11 includes a comment on VAT registration not being evidence of the existence of a PE. TEI recommends the Discussion Draft include a complementary comment that a deemed PE is not prima facie evidence of the existence of a VAT establishment.

#### Comments on the Examples in the Discussion Draft

The examples in the Discussion Draft utilize simplified assumptions and include a presumption that relevant comparables are available. As this will not always be the case, guidance on what actions taxpayers or tax administrators should take when computing the attributable profit should be included in the Draft.

With respect to the Discussion Draft's examples, TEI has the questions set forth below and requests the OECD address them in final guidance.

*Example 2.* Is the fact that the customers are in Country S significant? Would the analysis be different if Sellco's activities (in Country S) result in sales of advertising space by Siteco to customers in Country R and/or third countries? If it is not possible to find unrelated parties purchasing advertising space and performing the same or similar activities as Sellco, how would you determine the amount Siteco would have received, as noted in Paragraph 30(1)?

*Example 3.* Is the fact that unrelated suppliers are in Country S significant? Would the analysis be different if the suppliers are in Country R and/or other countries? In addition, we note that because there are no sales in Country S in the example and assuming BuyCo is compensated at arm's length, it is unclear why there should be a PE.

*Example 4.* In this example, it would be helpful if the final OECD guidance provided an explanation of whether the OECD's analysis would be the same or different if:

- a) Warehouse is operated by a related company in Country S, and inventory is owned by OnlineCo;
- b) Warehouse is operated by a third party logistics provider (unrelated), and inventory is owned by OnlineCo;
- c) Office in Country S is actually a separate related company incorporated in Country S and performs the same functions as OnlineCo office;
- d) Office in Country S is a separate unrelated company incorporated in Country S, which has a service agreement with OnlineCo, and with other unrelated companies;
- e) Same as (d) except that OnlineCo is the sole customer of the unrelated company in Country S which operate the office; and
- f) A combination of (a) or (b) and (c) or (d) or (e).

#### 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 to be held in November 2017 in Paris.

These comments were prepared under the aegis of TEI's European Direct Tax Committee, whose Chair is Giles Parsons. If you have any questions about the submission, please contact Mr. Parsons at +44 1455 826561, [parsons\\_giles@cat.com](mailto:parsons_giles@cat.com), 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.



Robert L. Howren  
*International President*

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

Tremonti Romagnoli Piccardi e Associati appreciates the opportunity to submit these comments to the OECD on the Public Discussion Draft BEPS Action 7: Additional Guidance on Attribution of Profits to Permanent Establishments, published on 22 June 2017.

We provide hereinafter our observations and comments in relation to the issues raised in the discussion draft.

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**Introduction**

While we appreciate the effort made in the discussion draft to provide for further guidance for the attribution of profits to permanent establishments, we are concerned that the additional guidance leaves an excessively high level of uncertainty.

Indeed, the guidance does not seem to fully consider the circumstances in which digital economy operators and their potential PEs carry out their activity.

Furthermore, since the guidance does not (clearly) take into account the "intangible driven" business model shared by all the MNEs that operate in the digital economy, our advice would be that some punctual instruction be provided to better specify how to deal with the hefty impact of the costs borne by the PEs for the use of the intangibles (which are generally owned by the MNEs at the head office level) in determining the attribution of profits to the same PEs.

This issue is dealt with in more detail in the following paragraph.

**The intangible driven business model**

We believe that it is firstly necessary to highlight in brief some of the key factors which characterize the digital economy.

Regardless of the various examples of business models provided for under the discussion draft (e.g. Sale of advertising on a website, warehousing, delivery, merchandising and information collection activities) we

assume that they all share common characteristics that contribute to the above mentioned ambiguity in the guidance provided by the discussion draft. It is our view that such characteristics can dramatically influence the attribution of profits and should therefore be adequately pondered especially when assigning taxing rights to the income-source country.

In further detail, the following may be envisaged:

i) Peculiarities of the digital market.

In the digital market MNEs can operate in conditions of natural leadership, as a result of the so-called "network economy". In some situations the natural leadership results in economic conditions of sale of services and information that differ from the general free market conditions.

ii) "Intangible driven" business models.

In the digital market MNEs operate by means of "intangible driven" business models which grant a competitive advantage over the other operators in the market. Given the scalability of the market, the competitive advantage leads, at least in the short term, to the exclusion of competitors, allowing in some cases the relevant MNE to reach high profitability levels.

iii) Research and development costs.

The "intangible driven" business models are characterised by a significant amount of R&D expenses. These expenses are generally borne by MNEs (*rectius*: by the head office) in countries where the R&D function is carried out, this circumstance - if not accurately weighted - may lead to distortions in the process of allocating economic results.

iv) The "routine functions".

Given the specificity of "intangible driven" business models in the digital market, the costs related to the "routine functions" are not significant, since the physical presence of a PE is in most cases negligible.

In light of the above, we would expect that the guidance should:

- a) clearly state that the profit and loss account of the PE should be drafted following the "functionally separate approach" pursuant to the directions of Article 7 of the MTC, on the basis of which the profits that the PE *"might be expected to make, in particular in its dealings with other parts of the enterprise, as 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 PE and through the other parts of the enterprise"*;
- b) outline that such profit and loss account should accurately include the remuneration of the key intangible.

In other words, the profit and loss account of the PE in question be prepared computing the following figures:

- 1) revenues should be determined having regard to the agreements concluded in the country in which the PE operates; the computation of the relevant revenues should be opportunely coordinated with the "significant presence criteria" proposed by BEPS - Action 1;
- 2) operational costs should be assumed to be equal to those effectively borne by the PE; together with
- 3) the costs for the use of intangibles (brand, software, algorithms, "key-data", etc.), which should be determined pursuant to the directions provided for by the cited Action 8-10 to be legitimately included in the profit and loss account of the PE, taking into account the peculiarities "sub" i - iv.

Operating in this way, the EBITDA (gross of the cost for the use of intangibles "sub" 3) of the PE should then be virtually in line with the EBITDA (gross of the R&D costs) of the MNE. This relies on the reasonable assumption that the costs related to the "routine functions" of the "intangible driven" business models are generally negligible.

In essence, the income of the PE should largely depend on the cost chargeable to the PE by the MNE (rectius: by the head office) for the use of the intangibles in question.

In other words, based on the directions provided by Action 8-10, the cost for the use of the intangibles should be charged to the PE in an amount in line with the EBITDA of the PE, net of the remuneration - under fair market conditions - of the "routine functions".

Therefore, the attribution of profits to the PE should mostly depend, on one hand, on the estimate of revenues generated in the country in which the PE operates, and on the other hand, on the calculation of the remuneration, under fair market conditions, of the intangibles virtually granted to the PE by the MNE.

Revenues of the PE	100
Operational costs	30
EBITDA of the PE	70
Routine profit (to be determined at arm's length)	5
Cost for the use of intangibles =	65 (70 - 5)
Before tax profit of the PE	5

As shown in the table above, the correct application of the guidelines under Action 8-10 lead to an effective reduction of the profits attributable to the PE in the income-source country because of the cost for the use of intangibles.

As a matter of fact, the example above does not appear to be far from capturing the economic substance of the digital economy's main operators.

In conclusion, we find it necessary to provide further guidance on attribution of profit to permanent establishment (of the digital sector) because the application of the guidance provided in the discussion

draft ex se could lead to some misinterpretation when determining the fair market profit share of the PE-hosting country.

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If you have questions or you would like further clarification, regarding any of the points discussed above, please contact [milano@virtax.it](mailto:milano@virtax.it).

Respectfully submitted,

Yours sincerely,

Tremonti Romagnoli Piccardi e Associati

**COMMENTS ON THE SECOND  
PUBLIC DISCUSSION DRAFT  
ISSUED ON JUNE 22<sup>nd</sup>, 2017**

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

September 7<sup>th</sup>, 2017

Yoshiaki Nishimura

Representative Director

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September 7<sup>th</sup>, 2017

Dear Mr. VanderWolk,

We at United Partners would like to thank you for the opportunity to comment on the Second Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments (hereinafter referred to as “the 2017 Discussion Draft”) as issued on June 22<sup>nd</sup>, 2017.

While we were unable to comment on the First Discussion Draft issued on July 4<sup>th</sup>, 2016 (hereinafter, referred to as “the 2016 Discussion Draft”) we closely monitored the discussion. However, as essential theoretical analysis to our proposals outlined in our comments on the 2017 Discussion Draft, please find attached our analysis of extracted P&Ls from the 2016 Discussion Draft.

We would be delighted to discuss any questions you may have related to our comments. We would also welcome the opportunity to contribute to the discussion as part of the public consultation meeting in November.

With Best Regards,

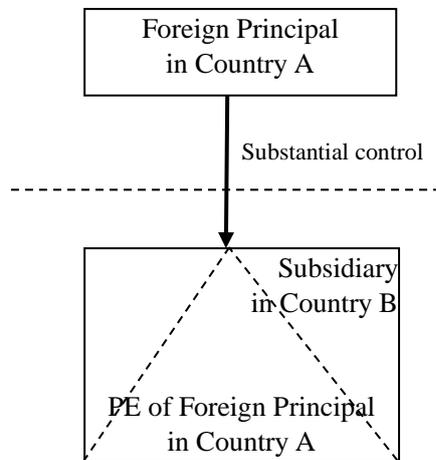
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## 1 General Comments on the Discussion Draft

### 1.1 Uniqueness of the transactions in question



- The Double Taxpayer Approach is outlined in Paragraphs 10 and 11:

Examples 1-4 represent cases where a *Dependent Agent Enterprise (the subsidiary in Country B)* and a *non-resident enterprise in a source country (the Foreign Principal in Country A)* are related enterprises. Under Article 5 of the OECD Model Tax Convention (2017 revised draft), *the PE of the Foreign Principal (the parent company in Country A) exists in the Dependent Agent Enterprise (the subsidiary in Country B) as a result of the activities of the Dependent Agent Enterprise*. According to Paragraphs 10 and 11, *the PE of the Country A Foreign Principal (in Country B) and the Dependent Agent Enterprise (the Country B subsidiary) share the tax burden in the source country (the Double Taxpayer Approach)*.

- 1) *PE (in Country B) of the Foreign Principal in Country A* (liable for PE taxation based on the attribution of profits to PE)
- 2) *Subsidiary in Country B* (liable for corporate tax on profits other than PE taxation on the Foreign Principal)

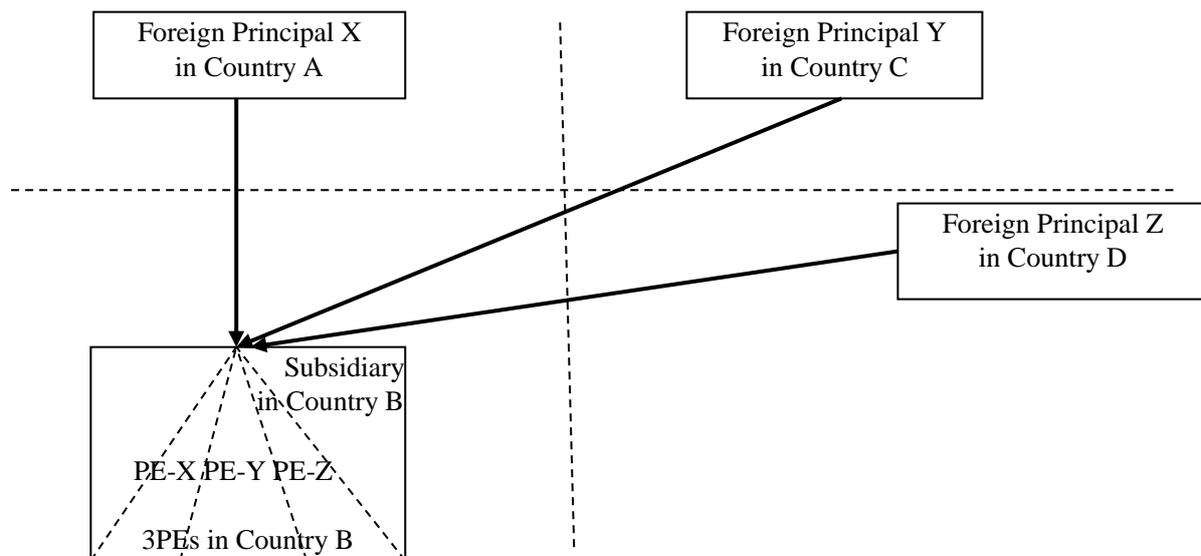
- The Single Taxpayer Approach is outlined in Paragraphs 20 and 21:

The 2010 Attribution of Profits Report and the Discussion Draft seek to simplify the tax burdens in the source country. While both *the PE of the Foreign Principal (the parent company in Country A)* and *the Dependent Agent Enterprise (the subsidiary in Country B) in the source country* determine the tax payable, only *the Dependent Agent Enterprise (the subsidiary in Country B)* will bear the tax burden in the source country (the Single Taxpayer Approach).

- 1) *PE (in Country B) of the Foreign Principal in Country A* (liable for PE taxation based on the attribution of profits to PE)
- 2) *Subsidiary in Country B* (liable for consolidated corporate tax on the Country B subsidiary's total profits as well as PE taxation on the Foreign Principal)

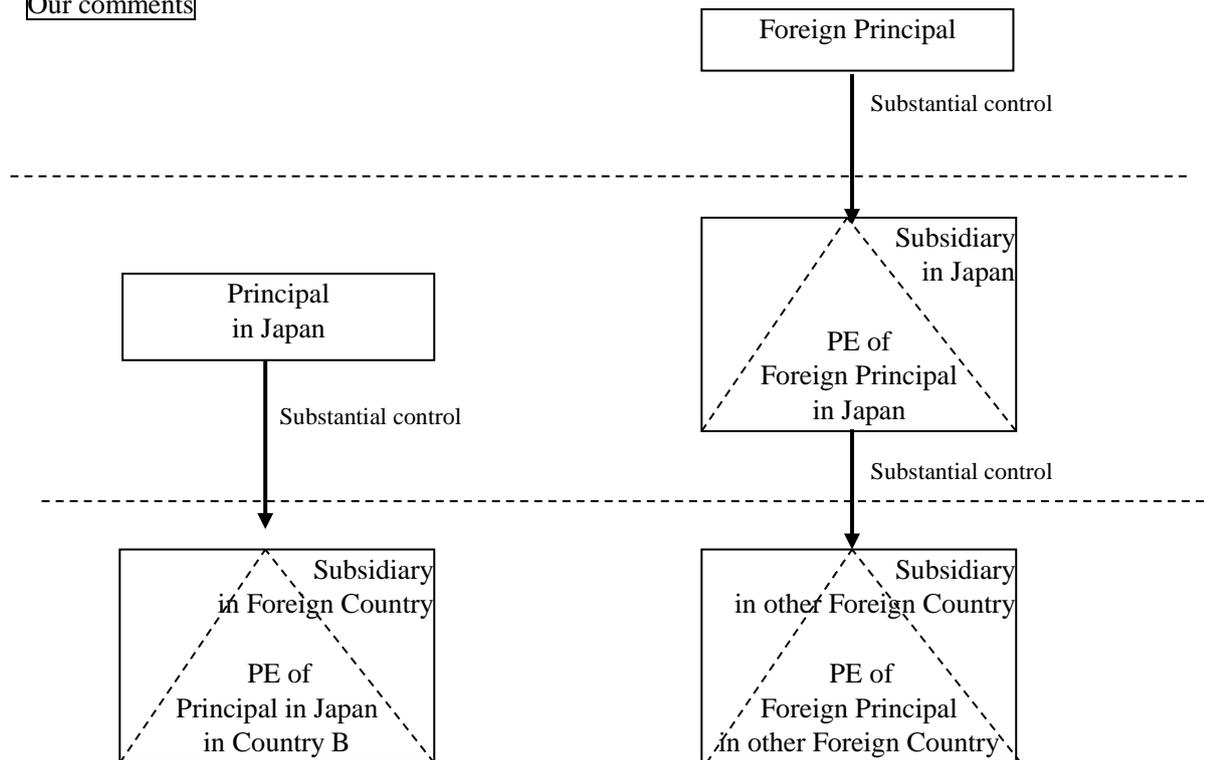
**Our comments**

- ✓ Whether we adopt the Single Taxpayer Approach or Double Taxpayer Approach depends on *the PE structure in Country B of the Foreign Principal (the parent company in Country A)*. That is, the likelihood of PE can be determined through the Independent PE Test as follows:
  1. If *the Agent (the subsidiary in Country B)* in question is independent in both a legal and an economic sense, then *the Agent (the subsidiary in Country B)* will be considered independent from *the Foreign Principal* under OECD principles and be considered a “Single Taxpayer”.
  2. In viewing the Legal Independence, the question is whether, in carrying out its activities on behalf of *the Foreign Principal (the parent company in Country A)*, *the Agent (the subsidiary in Country B)* was subject to detailed instructions of or comprehensive control by *the Principal (the parent company in Country A)*. If so, *Agent (the subsidiary in Country B)* Independence will likely be denied.
  3. If, however, *the Agent (the subsidiary in Country B)* is carrying on its business for its own account, its independence will likely be respected. In assessing the Economic Independence, the focus is on the entrepreneurial risk taken by *the Agent (the subsidiary in Country B)*. *An Agent (the subsidiary in Country B)* with no entrepreneurial risk would be unlikely to be considered independent. *An Agent (the subsidiary in Country B)* that works exclusively for *one Principal (the parent company in Country A)* is less likely to assert Economic Independence from *the Principal (the parent company in Country A)* than *one who works with multiple Principals (e.g., a related company in Countries C and D)*.



4. In terms of whether *the Agent* is acting in the ordinary course of their business and *the Agent (the subsidiary in Country B)* can prove its Independence but, nevertheless, in its conduct with *the Principal in question (the parent company in Country A)* acts outside of its normal business activities, then the Independent Agent Exception will not apply to *that Agent*.
- ✓ If *the Agent (the subsidiary in Country B)* is determined as Independent PE, then in theory only the Single Taxpayer Approach can be applied as *the Agent PE* will be disregarded. On the contrary, if *the Agent (the subsidiary in Country B)* is determined as *Agent PE*, then, theoretically, the Double Taxpayer Approach can be applied. Contrary to the Discussion Draft, it would appear that the Taxpayer has no discretion in selecting either a Single or Double Taxpayer Approach.

**Our comments**



- ✓ In determining the tax amount for PE, in the case of a *Resident Enterprise of a country* which employs a Worldwide Taxation approach (such as Japan), the attribution of profits to *PE in the source country* is aggregated with the taxable profits of *the Resident Enterprise*. It is reasonable that *the PE in the source country* pays tax in the source country (i.e. adopting the Double Taxpayer Approach and adjusting for double taxation through foreign tax credits). In the case of a *Resident Enterprise of a country* which employs a Territorial Taxation approach, while there is no possibility for Double Taxation in the source country and *the resident country*, some compliance operations such as foreign tax credit certification can occur if Single Taxpayer and Worldwide Taxation approaches are adopted.

## 1.2 Article 7 (Attribution of profits to PE) and Article 9 (Transfer Pricing taxation)

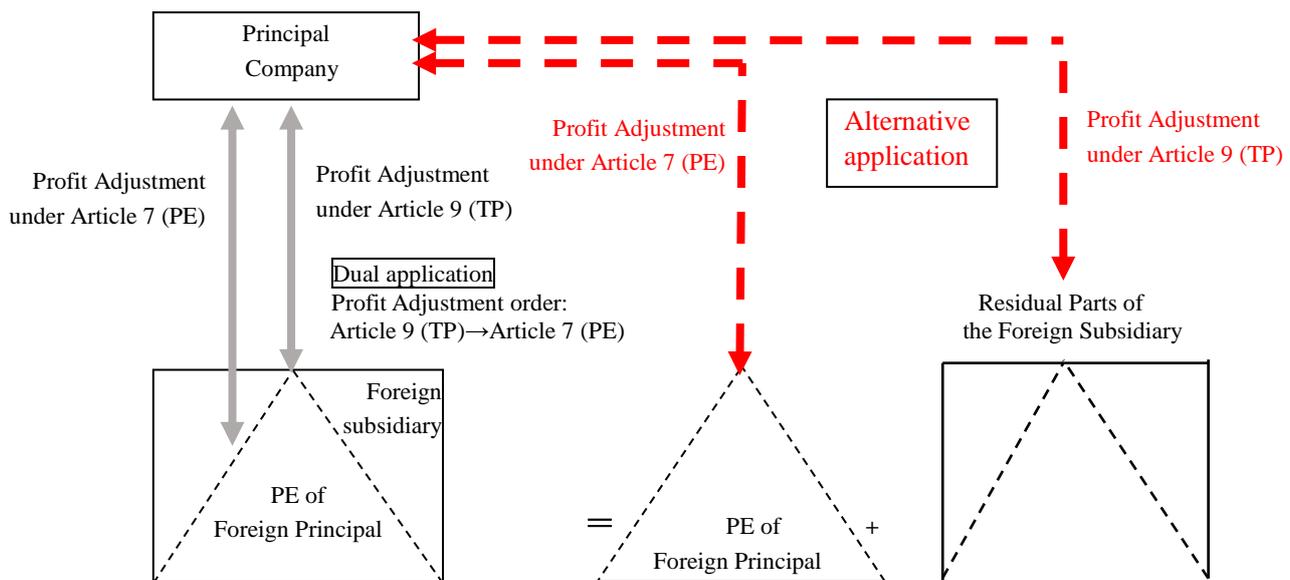
### 1.2.1 Dual application of Article 7 and Article 9 and the order of their application

- The dual application of Article 7 and Article 9 and the order of their application is outlined in Paragraph 12:

In the example where a *Dependent Agent Enterprise (a subsidiary in Country B)* and a *non-resident Foreign Principal (a parent company in Country A) in the source country* are related enterprises, the dual application of Article 7 (the attribution of profits to PE) and Article 9 (Transfer Pricing taxation, “TP”) is assumed. With respect to the order of the application, the Discussion Draft states that Article 9 should be applied first, followed by Article 7.

**Our comments**

- ✓ The Discussion Draft states that Article 9 (TP) and Article 7 (the attribution of profits to PE) shall both be applied and that Article 9 shall be prioritized over Article 7. However, the Discussion Draft does not provide any interpretation of the results derived from examples 1-5 in the Discussion Draft.



- ✓ We propose that a *Dependent Agent Enterprise* should be divided into the *PE of the Foreign Principal (the parent company in Country A)* and the *Residual parts of the Foreign Subsidiary*. In the case where the *PE of the Foreign Principal (the parent company in Country A)* exists, the attribution of profits to PE shall be applicable to those internal transactions between the *Foreign Principal* and the *PE of the Foreign Principal*. In the case where the *PE of the Foreign Principal (the parent company in Country A)* does not exist and only a *Dependent Agent Enterprise* exists, only Transfer Pricing taxation is applicable to those transactions between the related parties.
- ✓ In the case where there is the possibility for a *Foreign (agent) PE of a domestic company* to exist in a *Dependent Agent Enterprise (the subsidiary in Country B)*, if independent Significant People functions are recognized in the residual parts of the *Dependent Agent Enterprise (the subsidiary in Country B)*, the entire *Dependent Agent Enterprise* will be an Independent Agent.
- ✓ As a result of the revision of Article 5 of the OECD model convention, there is an increasing likelihood of a PE judgement. However, in most cases, as long as the Taxpayer is an Independent Agent as well as a rational Taxpayer, there may not be so many PE judgements since the Taxpayer is motivated to be recognized as an Independent Agent and avoid Double Taxation in their relevant resident country and source country.
- ✓ In the case where the *Foreign PE of a domestic company* exists in a *Dependent Agent Enterprise (a subsidiary in Country B)* only Article 7 applies. If PE does not exist or a *Dependent Agent enterprise (a subsidiary in Country B)* is an Independent Agent, only Article 9 (TP) is applicable. Both applications cannot be applied simultaneously. Applying either TP or attribution of profits to PE alternatively will provide a simplified, consistent method of analysis and the calculation can be explained in terms of AOA principles.

### 1.2.2 Significant People Functions of risks in Article 7 and Attribution of Risks in Article 9

- The following assumption is outlined in Paragraph 12:  
There are Significant People functions in AOA including the attribution of risks and the function for risk control in Article 9. It is not possible to interpret whether these concepts are similar or can be convertible between Article 7 and Article 9.

**Our comments**

- ✓ The issue in Article 7 (the attribution of profits to PE) is the cost of cross-border trade among *a Foreign Principal, a subsidiary and a PE*. In Article 9 (Transfer Pricing taxation), the issue is the cost of cross-border trade between *a Foreign Principal and its foreign-related parties*. In Article 7, there is a common objective that an Arm's Length Price ("ALP") shall be pursued through the application of Transfer Pricing Methods ("TPM") in the transfer of assets or provision of services between cross-border entities existing under the control of one company.
- ✓ Article 7 (the attribution of profits to PE) and Article 9 (Transfer Pricing taxation) seem to differ in terms of non-tangible assets, internal transactions, Significant People Functions and assets. However, rather than seeking to rationalize these different systems, we think it is simpler to focus on the common intentions of Article 7 and Article 9 through assuming that internal transactions, Significant People Functions, the assets in Article 7 and the intangible assets in Article 9 are similar or are convertible.

<Article 9>

External TP – ALP = f (functions, risks, **intangible assets**\*, external contracts)

\*Intangible assets = f (Development, Enhancement, Maintenance, Protection, Exploitation)

- ① Analyze the functions performed by foreign related parties in external transactions, risks assumed by foreign-related parties, and intangible assets such as Development, Enhancement, Maintenance, Protection, Exploitation DEMPE analysis (Function and Fact analysis);
- ② Analyze the comparability between related-party transactions and non-related party transactions;
- ③ Determine the ALP by applying TPM to foreign-related party transactions between *a Company in question and a foreign related party*.

<Article 7>

Internal TP – ALP = f (functions, risks, **assets, SFP**, external contracts, **internal transactions**)

\*\*The combination of assets, SFP and internal transactions is the source of excess profits for multinational enterprises. That is, the activities of research and development, design, procurement, market development, sales and marketing indicate a place where positive decision-making occurs and can be rationally considered as having the same meaning as intangible assets in the Article 9 analysis.

- ① Assuming that *the PE* is an entity doing business independently from *the company*, evaluating functions that *the PE* performs, assets that *the PE* uses, internal transactions between *the PE* and *the principal company*, and other situations such as risks assumed by *the PE*, external transactions, etc. (Function and Fact analysis);
  - ② Analyzing comparability between internal transactions and non-related party transactions or non-related party internal transactions;
  - ③ Determining ALP by applying TPM to internal transactions between *the PE* and *HQ etc.*
- ✓ In determining that Article 7 (the attribution of profits to PE) and Article 9 (Transfer Pricing taxation) are similar or can be convertible, in the case where *a Dependent Agent Enterprise (a subsidiary in Country B)* and *a non-resident enterprise (the Foreign Principal in Country A)* are related parties in Country B, the following conclusion is logically reasonable: If *the PE of a non-resident enterprise (the Foreign Principal in Country A)* exists, Article 7 applies. If not, then Article 9 applies.

### 1.3 Issues of attribution of financial assets and liabilities between HQ and a PE under Article 7 (the attribution of profits to PE)

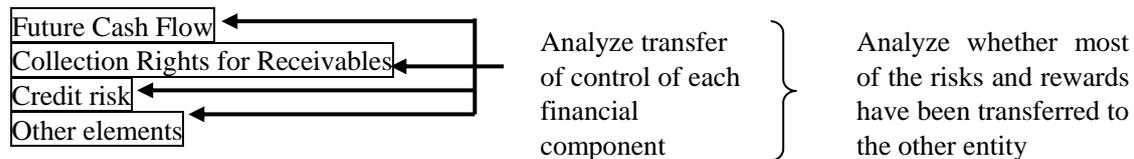
#### Our comments

- ✓ In Article 7, a *company* is required to proactively define the assets it employs and internal transactions between *the company* and *its PE*. Through these definitions, internal TP is considered to have been determined at a level of ALP for transactions such as asset transfers or provision of services among cross-border entities. An evaluation is necessary with regard to how the assets are transferred between cross-border related entities.
- ✓ Various scenarios can be assumed when assets are transferred between cross-border related entities:
  - A) Purchase/Sale of assets;
  - B) Rental/Lending of assets;
  - C) Deposit/Storage of assets; and
  - D) Granting usage rights/Receiving usage rights for assets.
- ✓ The analysis of the example which was intended to provide a clear explanation of “assets used at *the PE*, internal transactions between *the PE* and *the company*” in Article 7, is insufficient in terms of its assumptions since the analysis indicates the reason for the asset transfer between cross-border entities as being a simple Purchase/Sale of assets. If we assume an Independent entity, the reason for the asset transfer needs to be carefully analyzed. As court judgments illustrate, we need to examine transactions from the view point of whether they are Purchases/Sales of assets or service provision transactions without any transfer of assets.
- ✓ When a Taxpayer seeks legal stability, transferring internal transactions into external contracts is considered to be a conservative method of achieving this. In terms of the accounting principles for financial instruments with respect to Derecognition Criteria for Financial assets and Financial liabilities (the Financial Component Approach, the Risk/Reward Approach), Article 7 needs to strictly define the Derecognition / Recognition of asset transfer as well as the liabilities and risks attached to them so that *the beneficial owner of those assets, liabilities and risks* can be clearly identified.

Financial Components for  
Financial Instruments

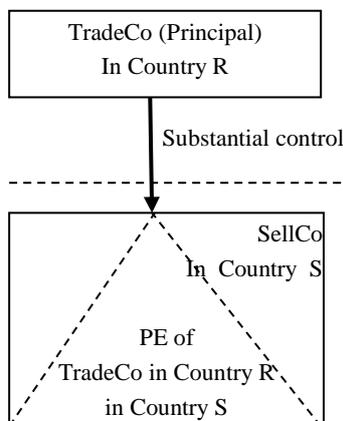
Financial Component  
Approach

Risk/Reward  
Approach



## 2 Comments on each example

### 2.1 Example 1 (Commissionaire Arrangement)



TradeCo... Retailer of widgets

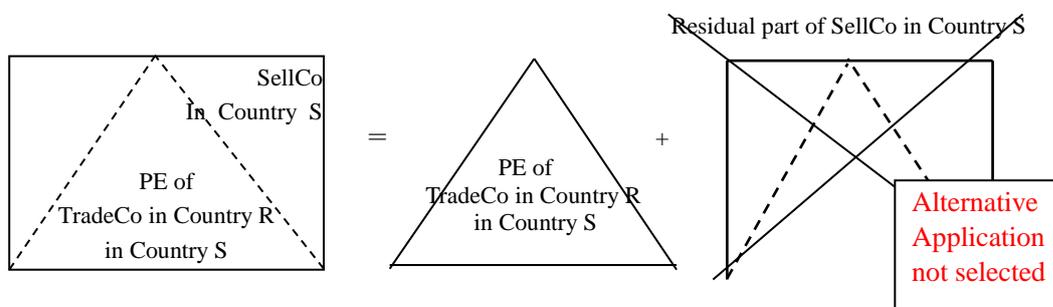
(Note) TradeCo performs its business in Country S only through SellCo.

SellCo... As the sole agent of TradeCo, SellCo conducts marketing and sales activities in Country S and sells widgets in its own name on behalf of TradeCo to buyers in Country S. SellCo receives a commission equal to X % of the sales revenue received by TradeCo.

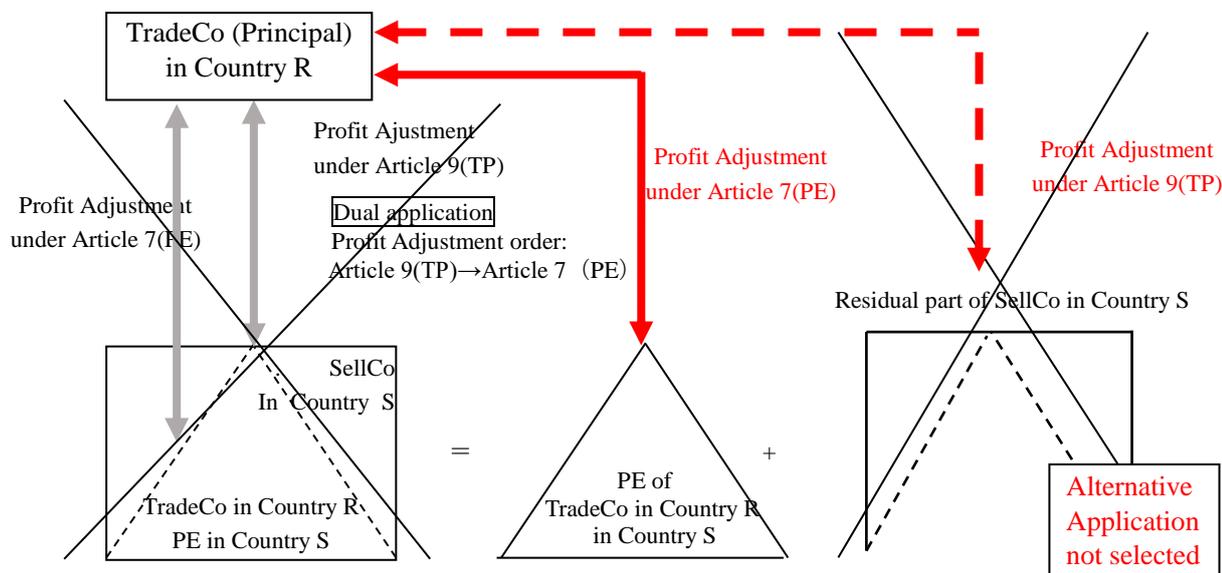
(Note) SellCo does not own widgets at any point nor does it have any rights to the amounts paid by the buyers for the widgets.

SellCo's business consists solely of its activities for TradeCo.

#### 2.1.1 Entity Analysis of the Dependent Agent Enterprise in a source country (SellCo in Country S)



#### 2.1.2 Application of Article 7 (the Attribution of Profits to PE) alone



- ✓ As the PE of TradeCo in Country R exists in SellCo in Country S, only Article 7 (the attribution of profits to PE) applies to this Example 1.

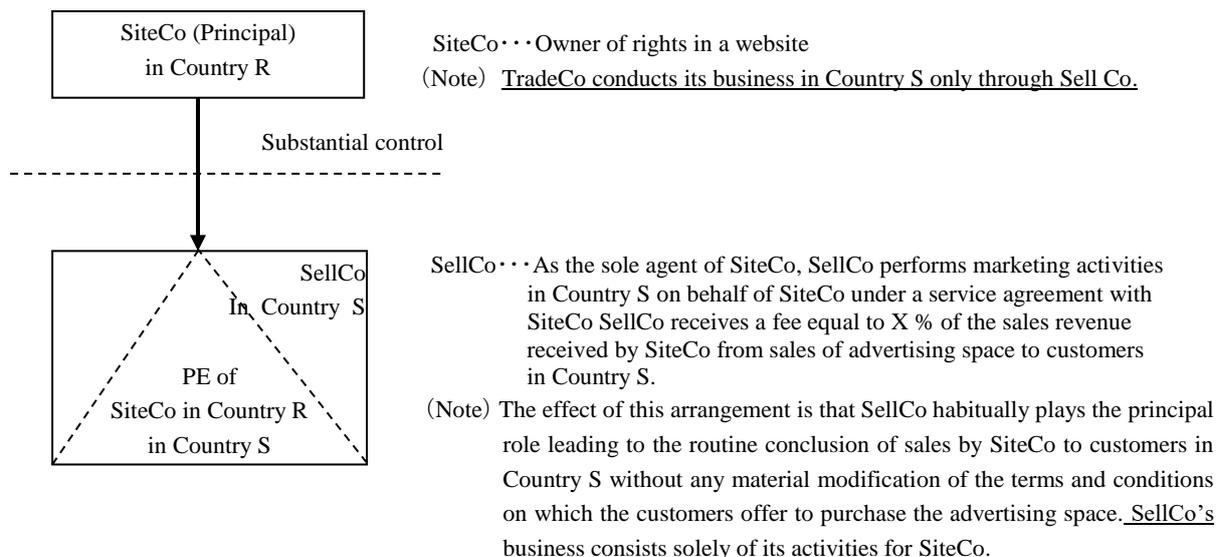
✓ The attribution of profits to PE for the PE of TradeCo is as follows:

TradeCo in Country R (Legal Owner)		SellCo in Country S (Legal Owner)	
TradeCo (Beneficial Owner)		SellCo (Beneficial Owner)	
HQ in Country R	PE in Country S	Residual other than PE attribution in Country S	
Sales revenue	***		
Costs of goods sold	***		
Service provision fee provided by PE to HQ	***	Sales revenue for services Paid by HQ to PE	***
Advertising costs	***	Advertising costs	***
Sales promotion costs	***	Sales promotion costs	***
Operating profit	***	Operating profit	***

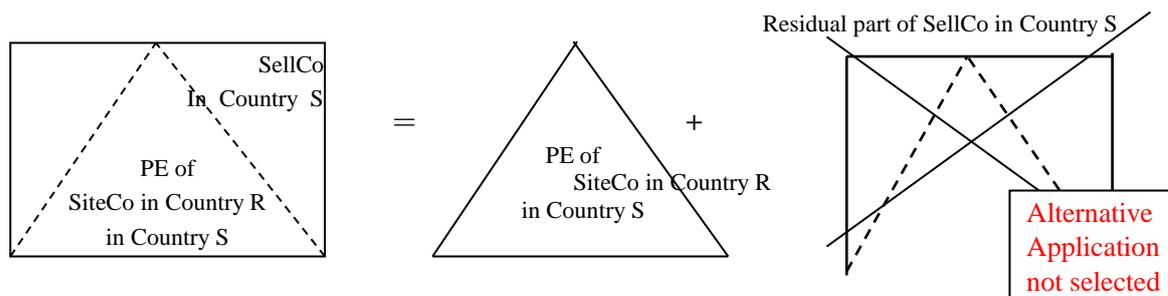
Alternative Application not selected

(Note) It is assumed that TradeCo has no operations of its own in Country S and makes no sales to customers in Country S other than those made by SellCo.  
SellCo's business consists solely of its activities for TradeCo.

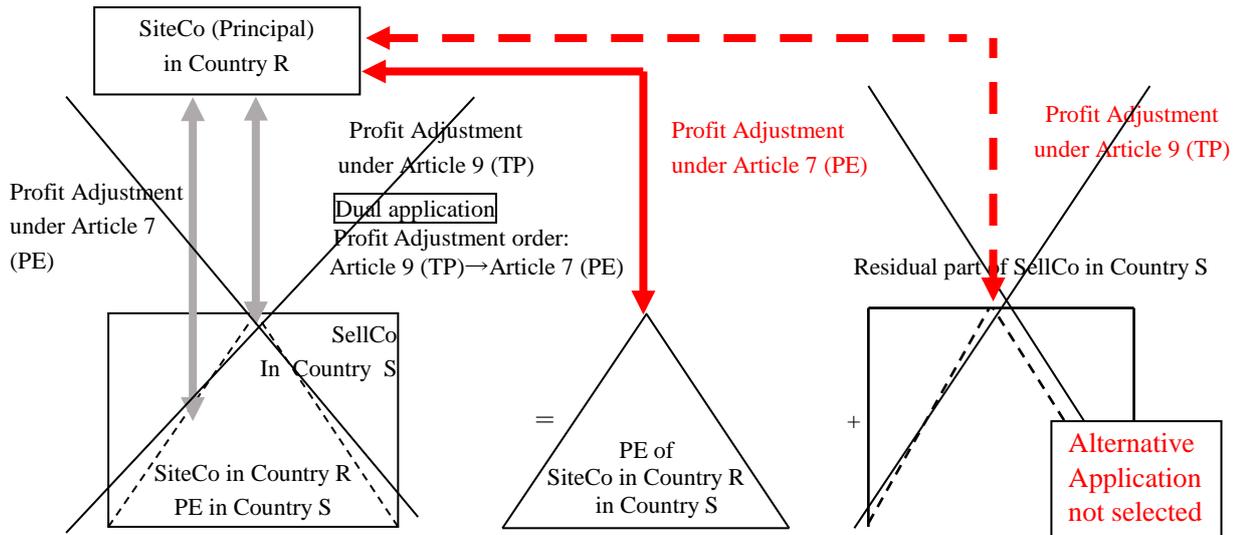
## 2.2 Example 2 (Website Advertising Arrangement)



### 2.2.1 Entity analysis of a Dependent Agent Enterprise in a source country (SellCo in Country S)



## 2.2.2 Application of Article 7 (the Attribution of Profits to PE) alone



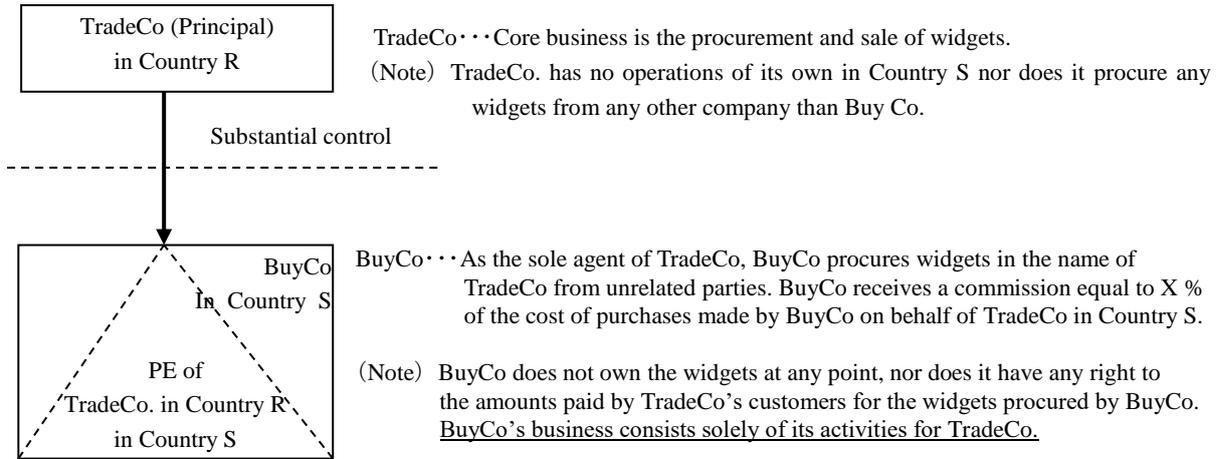
- ✓ As the PE of SiteCo in Country R exists in Sell Co in Country S, only Article 7 (the Attribution of Profits to PE) applies to this Example 2.
- ✓ The determination of the Attribution of Profits to PE for the PE of SiteCo is expected as below:

SiteCo in Country R (Legal Owner)	SellCo in Country S (Legal Owner)	
	SiteCo (Beneficial Owner)	SellCo (Beneficial Owner)
HQ in Country R	PE in Country S	Residual other than PE attribution in Country S
Sales revenue	***	
Costs of goods sold	***	
Service provision fee provided by PE to HQ	***	Sales revenue for services Paid by HQ to PE ***
Advertising costs	***	Advertising costs ***
Sales promotion costs	***	Sales promotion costs ***
Operating profit	***	Operating profit ***

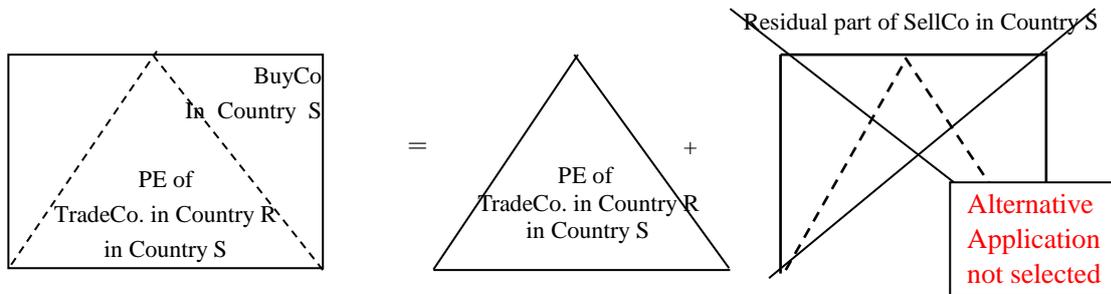
Alternative Application not selected

(Note) It is assumed that SiteCo has no operations of its own in Country S and makes no sales to customers in Country S other than those made by SellCo. SellCo's business consists solely of its activities for SiteCo.

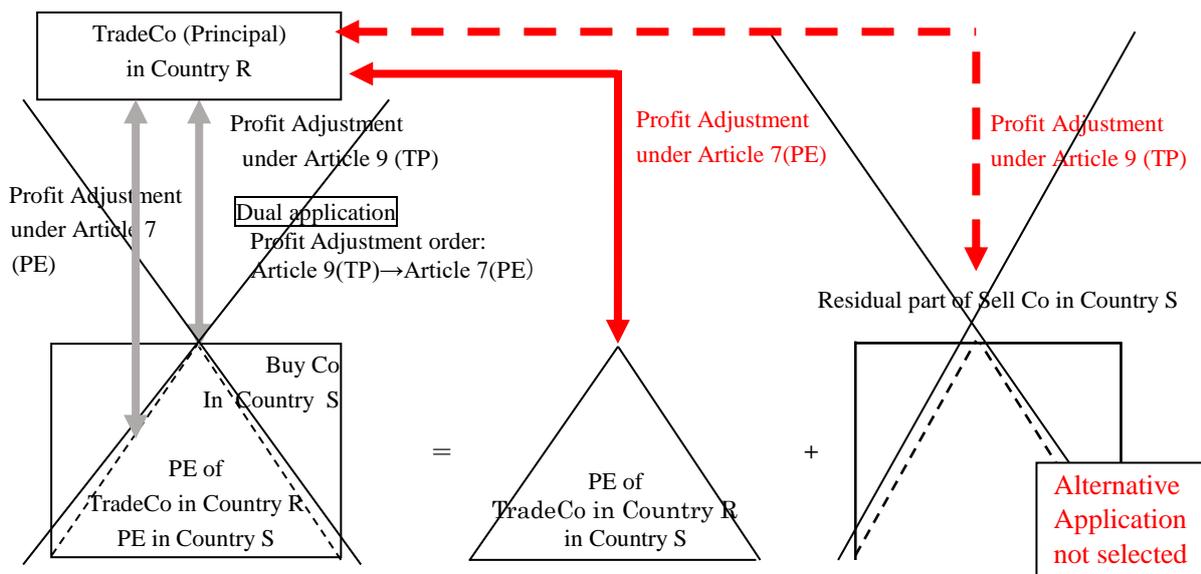
### 2.3 Example 3 (Procurement Arrangement)



#### 2.3.1 Entity analysis of a Dependent Agent Enterprise in a source country (BuyCo in Country S)



#### 2.3.2 Application of Article 7 (the Attribution of Profits to PE) alone



- ✓ As the PE of TradeCo in Country R exists in BuyCo in Country S, only Article 7 (the Attribution of Profits to PE) applies to this Example 3.

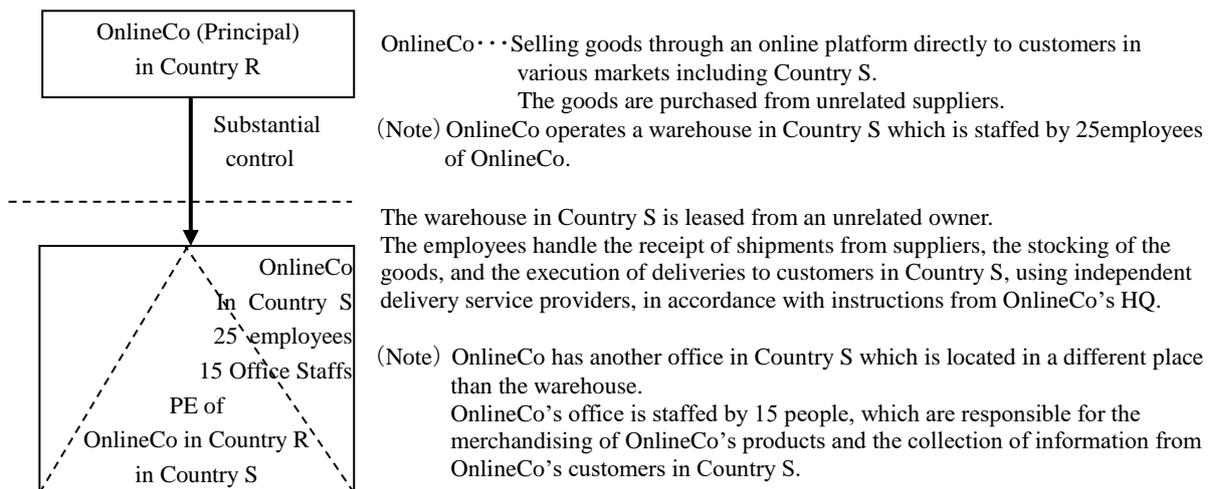
✓ The Attribution of Profits to PE for the PE of TradeCo is as follows:

TradeCo in Country R (Legal Owner)		BuyCo in Country S (Legal Owner)	
TradeCo (Beneficial Owner)		BuyCo (Beneficial Owner)	
HQ in Country R	PE in Country S	Residual part other than PE attribution in Country S	
Procurement of widgets	***		
Service provision fee provided by PE to HQ	***	Sales revenue for services paid by HQ to PE	***
Advertising costs	***	Advertising costs	***
Sales promotion costs	***	Sales promotion costs	***
Operating profit	***	Operating profit	***

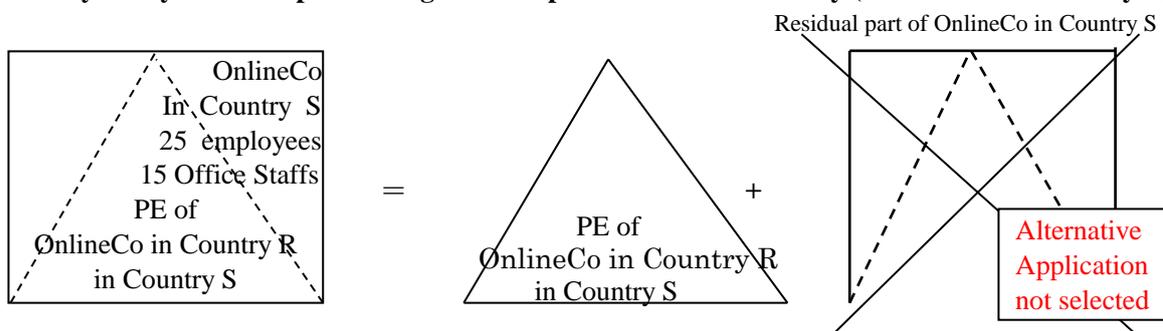
Alternative Application not selected

(Note) It is assumed that TradeCo has no operations of its own in Country S and makes no procurement from any entities other than BuyCo.  
BuyCo's business consists solely of its activities for TradeCo.

## 2.4 Example 4 (Warehousing, Delivery, Merchandising and Information Collection Arrangement)

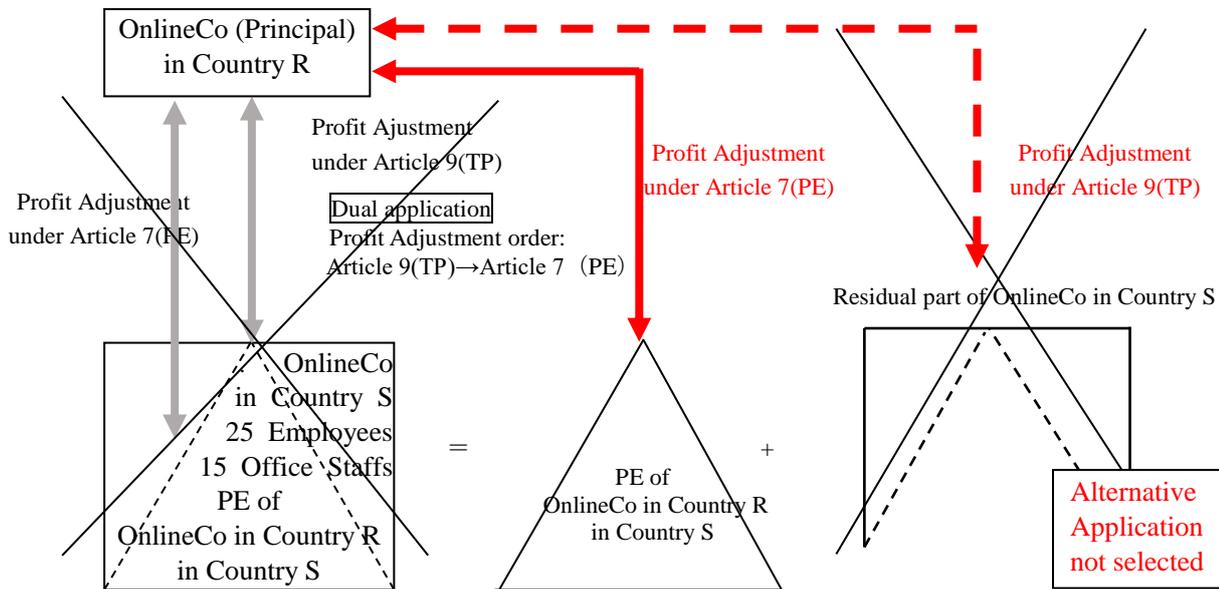


### 2.4.1 Entity Analysis of a Dependent Agent Enterprise in a source country (Warehouse in Country S)



✓ Provided that the business activities carried out by OnlineCo at the warehouse and at the office constitute complementary functions that are part of a cohesive business operation, the warehouse and the office constitute two PEs in Country S since each of these locations is a fixed place of business through which the business of OnlineCo is partly carried out, and the overall activity resulting from the combination of the activities carried out in Country S is not of a preparatory or auxiliary character.

## 2.4.2 Application of Article 7 (the attribution of profits to PE) alone



- ✓ As the PE of OnlineCo in Country R exists at the warehouse in Country S, only Article 7 (the attribution of profits to PE) applies to this Example 4.
- ✓ The determination of the attribution of profits to PE for the PE of OnlineCo is as follows:

OnlineCo in Country R (Legal Owner)	SellCo in Country S (Legal Owner)	
OnlineCo (Beneficial Owner)	PE (Beneficial Owner)	SellCo (Beneficial Owner)
HQ in Country R	PE in Country S	Residual part other than PE attribution in Country S
Online Sales revenue	***	
Costs of goods sold	***	
Service provision fee provided by PE to HQ	***	Sales revenue for services Paid by HQ to PE ***
Personnel costs at the warehouse in Country S (25 employees)	***	Personnel costs at the warehouse in Country S (25 employees) ***
Lease costs for the warehouse in Country S	***	Lease costs for the warehouse in Country S ***
Delivery costs in Country S	***	Delivery costs in Country S ***
Personnel costs at the office in Country S (15 employees)	***	Personnel costs at the office in Country S (15 employees) ***
Lease costs for the office in Country S	***	Lease costs for the office in Country S ***
Operating profit	***	Operating profit ***

Alternative Application not selected

END



September 14, 2017

**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 (“revised Discussion Draft” or “Discussion Draft”). USCIB would be pleased to present comments at the public consultation.

**General Comments**

In our prior comment letter (attached) on the 2016 Profit Attribution Discussion Draft, USCIB noted that the mandate under the Action 7 Final Report 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. The introduction to the Discussion Draft states that “the new Discussion Draft sets out high-level principles outlined in paragraph 1-21 and 36-42 for the attribution of profits to permanent establishments in the circumstances addressed by the Report on BEPS Action 7. Importantly, countries agree that these principles are relevant in attributing profits to permanent establishments.”

In our view, the OECD has taken a significant step back from the AOA. The AOA is intended to apply the arm’s length standard in the context of a head office and a permanent establishment. The high-level principles articulated in the Discussion Draft conflict with the AOA and therefore violate the mandate to provide additional guidance on the how the AOA applies to new forms

of permanent establishment without making substantive modifications to those rules. Significantly, the consensus does not extend to the examples in the Discussion Draft, which illustrates the fundamental lack of agreement on how the high-level principles would apply in practice. The lack of clarity around how these rules apply will likely increase the risk of double taxation and increase complexity since countries may take very different approaches to determining how profit ought to be attributed to the PE.

USCIB believes that the Discussion Draft, having backed away from the primacy of the AOA, does not provide enough guidance to achieve the goal of maximum certainty, an objective identified as a goal in the new version of the Model, the Commentary and the AOA report.<sup>1</sup> The OECD Commentary on Article 7 acknowledges the considerable variation in interpretations of Article 7.<sup>2</sup> Most of our comments on the 2016 Discussion Draft asked for more clarity on how profits would be attributed to a permanent establishment. This Discussion Draft moves in the direction of providing less guidance and less certainty. Consensus on high-level principles without guidance on their detailed application will lead to inconsistent, and potentially overbroad, application of those high-level principles, which will produce more disputes and, in turn, discourage foreign direct investment. Guidance should therefore be precise in its scope—here, confined to the attribution of profits to permanent establishments arising from the BEPS modifications to Article 5(5)—and in the particulars of its application. USCIB is concerned that the inability to reach consensus on anything other than high-level principles may be, at least in part, a function of the Inclusive Framework and the need to reach agreement among 100 countries. This may be an ongoing problem that will impair the effectiveness of the OECD. The goal of working in multilateral fora is to bring countries together to find mutually agreed solutions, and while the OECD should certainly strive for consensus, if consensus can only be achieved at the very high level of generality reflected in the Discussion Draft, the resulting guidance may prove more harmful than helpful, reducing certainty rather than enhancing it. This needs to be addressed before the operation of the Inclusive Framework is entrenched and there is no possibility of change. USCIB would be pleased to work with the OECD to address these concerns.

It is not clear to us what this guidance is. The mandate calls for additional guidance on the operation of the AOA to new forms of permanent establishments that does not make modifications to those rules. Thus, it would seem that the Discussion Draft could be an additional report that would supplement the existing guidance on the AOA. If that is the case that should be made clear. If that is the intention, then the OECD should amend the Commentary to reference this supplement. The OECD will also need to take the appropriate steps (Council Recommendation to adopt such supplemental guidance).

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<sup>1</sup> 2014 OECD Model Tax Convention, Article 7 Commentary, paragraph 7. This provision (and paragraphs 4 and 5 mentioned below) are unchanged in the draft 2017 Model Tax Convention.

<sup>2</sup> IBID, paragraphs 4 and 5.

USCIB is uncertain why the OECD has stepped away from the language of the AOA, particularly with respect to the examples which are explicitly governed by the 2010 version of the AOA; therefore, language appropriate to applying the AOA should be used. 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, 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 marketing service by a contract service provider, will influence the determination of the most appropriate method and the search for available comparables. The Discussion Draft seems to reject this approach, even when purportedly applying the 2010 version of the AOA – which is inconsistent with the mandate.

The Discussion Draft covers administrative approaches to enhance simplification<sup>3</sup>. Although the draft recognizes the burden associated with complying with tax and reporting obligations, the draft does not recommend simplification measures. USCIB believes that the final guidance should recommend that countries adopt simplification measures and supports the BIAC position set forth as an appendix to its comment letter. USCIB members are prepared to work with the OECD and member countries to develop appropriate measures.

### Detailed Comments

#### *Changes to Article 5(5) and 5(6) and the Commentary*

It is not clear that paragraphs 3 through 7 are necessary. These five paragraphs summarize the changes made to the OECD Model and Commentary as part of the BEPS process and reflected in the 45-page Action 7 Final Report. Like all summaries, it is incomplete and may be misleading. USCIB recommends that these paragraphs be deleted.

If these paragraphs are not deleted, then paragraph 7 of the Discussion Draft should be revised. Paragraph 7 provides that: “any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5(5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5(5).” USCIB is concerned with the “any approach” and “deemed to exist” language of this sentence. While we do not believe this interpretation is intended, this language could provide support for positions that countries have asserted that are not consistent with the OECD Model and its Commentary. Some tax authorities have taken aggressive positions with respect to attributing profits to PEs and those

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<sup>3</sup> Paragraphs 20 and 21.

positions should not be inadvertently buttressed. USCIB believes that paragraph 9 and paragraph 7 of the Discussion Draft are intended to express a similar idea; that is, a valid approach to attributing profits would be one that was permitted under a prior version of the Model Tax Convention and its Commentary. The drafting in paragraph 9 is much clearer. If paragraph 7 is retained, it should be redrafted along the lines of paragraph 9. Paragraph 7 (and paragraph 9) should also explicitly mention the arm's length standard.

Paragraph 8 is mainly taken from paragraph 101 of the 2017 Model (which is still in draft form, although not subject to comment). The first sentence of paragraph 8 provides: "one of the effects of paragraph 5 will typically be that the rights and obligations resulting from the contracts to which Article 5(5) refers will be properly allocated to the permanent establishment." USCIB is very concerned that this language will result in short-circuiting of the functional analysis that is necessary before Article 7 can be properly applied. As we pointed out in our prior letter, 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. The analysis should not be short-circuited; the results should not be based on what is "typical", but rather on the fact and circumstances of each case. The second sentence of paragraph 8 contains limiting language, but that language does not extend to determining whether the rights and obligations are properly allocated to the PE. This should be made clear. The rights and obligations will not be allocated to the PE in every case and a proper factual analysis is required to determine whether that allocation is correct.

USCIB strongly believes that the appropriate approach to the interaction of Article 9 and Article 7 is that Article 9 should be applied first. Paragraphs 11 and 12 of the Discussion Draft set forth the issue and waffle on whether Article 9 or Article 7 ought to be applied first. It is important to have a framework that countries apply consistently. USCIB believes this framework ought to require the application of Article 9 first.

To apply Article 7, one must know the amount of profit to be allocated between the head office and the permanent establishment of the non-resident enterprise, which in principle cannot be determined until one has established the arm's length prices for transactions between the non-resident enterprise and the local associated enterprise, or "intermediary" in the language of the Discussion Draft. Relatedly, the risks borne by the non-resident enterprise as a whole (head office and DAPE) must be determined before they can be attributed between the head office and the DAPE. In the Article 9 analysis, one evaluates which party, as between the non-resident enterprise and the intermediary, bears the various risks relevant to the related party transaction. This analysis thus provides the factual predicate for risk attribution in the PE context. Conducting the Article 9 analysis first reduces the likelihood of double remuneration to risk-bearing, a problem that arose in the examples in the prior discussion draft.

As a practical matter, applying Article 9 first reduces the likelihood that a tax authority will inappropriately attribute income to a DAPE. As the prior discussion draft acknowledged, and as this Discussion Draft implies, a DAPE can exist but have no attributable income, because the intermediary receives arm's length compensation for all of its functions, assets, and risks, including those related to the DAPE activity. But if a tax authority goes through the analysis to find a DAPE, it may be difficult to resist the urge to attribute additional profit to the DAPE if it has not already been determined that local functions, assets and risks are fully remunerated through the intermediary.

Starting with Article 7 may also discourage the use of simplified methods, since the approach of many simplified methods would be to permit the intermediary to pay tax on the combined income of the intermediary and the DAPE.

USCIB strongly supports the statements in paragraph 12 that countries "must ensure that there is no double taxation in the source country" of the same profits in the hands of the DAPE and the hands of the intermediary.

The following paragraphs (13 through 19) attempt to elaborate on the relationship between Article 7 and Article 9 in the context of risk and which party is entitled to the return from risk. These paragraphs seem to say that Article 7 and Article 9 need not be aligned with respect to risk so long as the source country does not tax the same profits twice. A problem with this framework is that it does not deal with double taxation between the source and residence countries. If the source and residence countries agree that under Article 9 the risk is allocable to the residence country, then under Article 9 that income (or loss) from the realization of those risks will be taxable in the residence country. If the source country can argue under Article 7 that risk is assumed by the PE, then that profit would be shifted to the source country. Unless the residence country agrees to forego the tax due under Article 9, the income will be subject to tax in both countries (and losses could be duplicated). Conversely, if the source country allocates the risk to the intermediary under Article 9 and the residence country allocates some part of the same risk to the head office under Article 7, then both the residence and the source country will tax the same income (or allow the same losses), albeit under different articles and different theories. Since a main objective of tax treaties is the avoidance of double taxation by the two parties to the convention, not resolving this issue undercuts that objective.

USCIB believes that the failure to align Article 7 and Article 9 is linked to the failure to identify which Article should be applied first. USCIB is concerned that countries that apply Article 7 first will take the position that the priority of application confers a priority of taxing right and expect the country of the head office to defer to its right to tax. As discussed above, USCIB believes that applying Article 9 first is the better answer. However, given the possibility that the order of application and non-alignment of Article 7 and Article 9 might create a significant risk of double taxation, countries should resolve the issue in their bi-lateral agreements, so that taxpayers are not caught in the middle. Because resolving these issues in bi-lateral agreements

(or additional changes to the MLI) requires an agreed upon approach, the OECD should express a view as to the proper interpretation of the interaction of Article 7 and Article 9.

USCIB strongly supports the statements in paragraph 19 that indicate that in certain cases the “profits attributable to the PE could be minimal or even zero.”

*Examples Illustrating the Attribution of Profits to Deemed PEs under Article 5(5)*

USCIB finds that the examples are generally unhelpful and quite opaque. The statements of fact use conclusory terms that presuppose the answer, rather than attempting to analyze facts and reach conclusions based on the application of law to facts.

Examples that posit realistic facts and apply the law to the facts are more difficult to construct, but are much more useful to both tax administrators and taxpayers. Deleting numbers from the examples makes the examples less helpful and more difficult to follow.

In examples one and two it seems the better reading of the examples is that there is a deemed transaction between Tradeco and the PE and Siteco and the PE.<sup>4</sup> In both cases, the dealing seems to be a deemed sale from the head office to the PE. In the case of Tradeco, the sale is of goods. In the case of Siteco, the sale is of advertising space. USCIB understands that the goal of this Discussion Draft is to provide guidance that is relevant to all countries, regardless of their approach to attributing profits to PEs. Nevertheless, these examples are explicitly applying the principles of the AOA (creating a dealing between the head office and the PE) but obfuscate that fact. If the examples are, in fact, deeming a transaction that corresponds to a dealing, then that should be clear, for both taxpayers and tax authorities. Lack of clarity will only lead to misunderstandings and disputes. As stated in our general comments, since these examples are based on the 2010 AOA, they should use the language and the framework of the 2010 AOA. It would be much more helpful if the examples identified the hypothetical separate entity, characterized the dealings, and looked for comparables based on the FAR analysis.

Example 3 ought to be deleted. There are some questionable factual assumptions that would likely mean that the example would apply only in extremely unusual circumstances. The example assumes that “procurement and sale of widgets” is the core business of Tradeco. This assumption is key to the example, since procurement is frequently not a core business activity, as paragraph (4) of Article 5 has recognized and continues to recognize.<sup>5</sup> Further, the widgets are purchased “on behalf of Tradeco and in the name of Tradeco”. Although Article 5(5) has been expanded to cover sales and services to be supplied by a nonresident through a dependent agent PE, it has not been expanded to cover purchases. So, Article 5(5) only applies to this example because Buyco purchases in the name of Tradeco. It seems unlikely that any taxpayer would structure its purchases in this fashion if the result is to create an Article 5(5) PE for Tradeco.

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<sup>4</sup> These would be the dealings, if the examples were applying the AOA.

<sup>5</sup> Even under the draft 2017 Model purchase may be a preliminary or auxiliary activity and not constitute a PE.

The proper analysis of this example ought to be under Article 5(4), but Tradeco is not doing the purchasing, so Tradeco could not have a PE under Article 5(4). It seems as though the OECD may be trying to expand Article 5(5) to cover a case that is not covered by the new language of Article 5(5) or 5(4). The proper way to achieve any such expansion would be through a change to the relevant treaty language. This example, therefore, ought to be deleted.

*Attribution of Profits to Permanent Establishments Resulting from Changes to Article 5(4) and the Commentary*

USCIB agrees with the discussion of profit attribution under this section. In particular, we strongly support the statement in paragraph 39 – “the profits to be attributed to a PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that cause it to be a PE.” This statement is very important, given that the activities identified in Article 5(4) are likely to be low-value adding activities and performing low-value activities in a PE should not cause other profit to be allocated to that PE.

The OECD should, therefore, make clear in example 4 that the only profits that are attributable to the PE are those attributable to functions, assets and risks actually performed or assumed in the country where the warehouse is located, that is the warehousing activities. The profit attributable to the PE should only be that which arises from a deemed dealing between the PE and the head office that relates to the distribution function. The profit attributable to the warehousing function ought to be readily determinable from available comparables. The profit attributable to warehousing and delivery should not include the profit from the sale of the delivered goods. The entity that earns the profit from the sale should be the entity that sells the product, not the entity performing the warehouse and the delivery function.

USCIB believes that this could be made clearer by modifying example 4 to explicitly state that under the facts of this example, the profit from the sales of the products stored at and delivered from the warehouse are not attributable to the PE.

Sincerely,

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Vienna, September 9, 2017

**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 of all, we would like to congratulate the OECD for the additional work done 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 22 June 2017. We are grateful for the opportunity to provide comments and we hope that our comments and suggestions might provide valuable inputs for future developments and improvements to the final OECD guidance.

## **1. Introduction**

The Public Discussion Draft on BEPS Action 7 "Additional Guidance on the Attribution of Profits to Permanent Establishments" (hereinafter the "Discussion Draft") is intended to provide further guidance on the issue of profit attribution to permanent establishments (hereinafter "PEs"), using a different approach than the one adopted in the 2016 "Discussion Draft", i.e. not proposing additional amendments to the previous work on attribution of profits to PEs. In order to provide further clarifications on the topic, the Discussion Draft highlights specific types of PEs and provides a high-level application of the principles of profits attribution to those types of PEs. The following topics are addressed by the Discussion Draft:

- a) Permanent establishments resulting from changes to article 5(5) and 5(6) and the commentary; and
- b) Permanent establishments resulting from changes to article 5(4) and the commentary.

We would like to take this opportunity to provide our comments on the Discussion Draft, with specific reference to:

- the general issues of profits attribution to PEs (see section 2, below),
- the proposed application of the principles of profit attribution to PEs resulting from changes to article 5(5) and 5(6) and the commentary (see section 3, below) and
- the proposed application of the principles of profit attribution to PEs resulting from changes to article 5(4) and the commentary (see section 4, below).

## 2. General comments on profit attribution to permanent establishments

### 2.1. The functioning of Art 7 AOA and Art 9 OECD Model

First, it has to be pointed out that the Discussion Draft correctly differentiates between the level of “applicability” and the level of “application” of profit attribution to PEs. In this respect, the work of the OECD under BEPS Action 7 (“*Preventing the Artificial Avoidance of Permanent Establishment Status*”) preliminarily dealt with the “applicability” of PE profits attribution (i.e., Art 5 OECD Model was revised), but did not focus on the “application” of PE profit attribution. However, to a certain extent BEPS Action 7 also pointed out that the level of “application” of profit attribution to PEs (thus being subject to Art 7 OECD Model) will be dealt with by providing additional guidance (see also paragraph 2 of the Discussion Draft). This differentiation is mainly caused by the fact that the principles of the AOA already introduced a functional-based arm’s length understanding in 2010.<sup>1</sup> Accordingly, there appears no need to revise the respective guidance (i.e., PE profit attribution was already “aligned with value creation”). Therefore, the current Discussion Draft has a limited scope by only highlighting two main issues, namely the level of “applicability” which is then interlinked with the level of “application” in a broad sense. From our point of view, the two-fold understanding of “applicability” and “application” of the principles of profit attribution to PEs is well suited in setting-up this Discussion Draft.

In comparison, the work on BEPS Actions 8-10 (“*Aligning Transfer Pricing Outcomes with Value Creation*”) primarily focused on the level of “application” of transfer pricing rules with special focus on Art 9 OECD Model (the level of “applicability” of transfer pricing rules is interrelated with the understanding of the term “associated enterprise”, which was not dealt with during the OECD BEPS project).<sup>2</sup> However, given the understanding of profit attribution to PEs in light of the AOA, which follows a two-step approach, the work under BEPS Actions 8-10 could eventually (at least indirectly) influence the understanding on profit attribution to PEs. In this respect it is worth to recall the two-step approach laid down in the AOA:<sup>3</sup>

- The first step aims at hypothesising a PE as a separate and independent enterprise. Significant people functions (hereinafter “SPFs”) form the starting point. The SPFs

<sup>1</sup> See OECD (2010), Report on the Attribution of Profits to Permanent Establishments, OECD Publishing, www.oecd.org, pages 16 et seq; cf Petruzzi/Holzinger, Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era, World Tax Journal 2017, 263 (267 et seq).

<sup>2</sup> Cf OECD (2015), Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – Final Reports, OECD Publishing, www.oecd.org, pages 13 et seq.

<sup>3</sup> See OECD (2010), Report on the Attribution of Profits to Permanent Establishments, OECD Publishing, www.oecd.org, pages 14 et seq.

performed by the PE are the basis for the attribution of assets, risks and capital. Given these steps, the PE is hypothesised being a separate and independent enterprise.

- Once the PE is hypothesised as a separate and independent enterprise, the second step of the AOA (i.e., the application of the OECD Transfer Pricing Guidelines in analogy) mostly concerns the application of the most appropriate transfer pricing method.

From our point of view, the second step of the AOA cannot lead to any differences in the outcome of arm's length remunerations under Art 7 AOA and Art 9 OECD Model. Accordingly, the first step of the AOA has to be analysed in order to find out potential differences. In this respect, the functional and factual analysis under Art 7 AOA is meant to establish the basis for the profit attribution in light of a functional understanding (seeking for the actual conduct of the parties). With regard to Art 9 OECD Model, already in a "pre-BEPS era", there was only one major potential difference left between the functional and factual analysis under Art 7 and the functional and risk analysis under Art 9, namely the absence of contractual arrangements in case of a PE (since dealings are the intra-company equivalent of contracts, but do not have the same legal character).<sup>4</sup>

However, already pre-BEPS this difference was only a legal one, since an enterprise simply cannot legally enter into contracts with itself. Moreover, already the OECD Transfer Pricing Guidelines 2010 made specific references to an analysis of contractual arrangements in light of the actual conduct of the parties. However, *prima vista* it can be argued, that the functional-based understanding of dealings under Art 7 AOA and the formalistic understanding of contractual arrangements under Art 9 OECD Model (pre-BEPS) could have caused different results under the two articles.<sup>5</sup> From our point of view, it was however already questionable at that time 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 Art 7 AOA and Art 9 OECD Model (pre-BEPS).

Post-BEPS, the formalistic understanding of the relevance of contractual arrangements under Art 9 was replaced by a more functional-based understanding, according to which the actual conduct of the parties (i.e., the substance or the functions behind the contractual arrangement) is key, thus further narrowing the arm's length interpretation of Art 7 and Art 9. According to our understanding, the work under BEPS Actions 8-10 has not directly influenced the profit attribution to PEs (i.e., no additional guidance on how to derive arm's length PE profits has been provided), but rather has closed the potential gap between Art 7 AOA and Art 9 OECD Model, by bringing the arm's length understanding of Art 9 closer to the understanding of Art 7 AOA.<sup>6</sup> Accordingly, Art 7 AOA already fundamentally incorporated a functional-based arm's length understanding, which is – in light of the changes due

<sup>4</sup> Cf *Petruzzi/Holzinger*, Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era, *World Tax Journal* 2017, 263 (278 et seq).

<sup>5</sup> See OECD (2010), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing, [www.oecd.org](http://www.oecd.org), paragraph 1.53.

<sup>6</sup> Cf OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 – Final Reports*, OECD Publishing, [www.oecd.org](http://www.oecd.org), pages 13 et seq; See OECD (2017), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD Publishing, [www.oecd.org](http://www.oecd.org), paragraphs 1.42 et seq; see also *Petruzzi/Holzinger*, Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era, *World Tax Journal* 2017, 263 (288).

to BEPS Actions 8-10 – now also the key element for the compliance with the arm's length principle under Art 9 OECD Model.

Given the interpretation which can be derived from an analysis of the AOA (applying proper legal interpretation methods) and the outcomes of the OECD BEPS project, one of the key issues with regard to profit attribution to PEs under Art 7 AOA in comparison with Art 9 OECD Model appears to be the need to rethink the Discussion Draft's preference for the dual taxpayer approach.

The dual taxpayer approach is applicable in situation when an intermediary (or a dependent agent enterprise, hereinafter "DAE") carries out activities in a host Country for a foreign principal, which give rise to a PE (or a dependent agent PE, hereinafter "DAPE") under Art 5(5) OECD Model. According to the general understanding of the dual taxpayer approach, such a situation would lead to two different taxable persons in the host Country. Consequently, the intermediary/DAE would be taxed for the activities performed in its own name/account, while the DAPE would be taxed for the activities performed in the name/account of its principal.<sup>7</sup>

However, from our point of view, the dual taxpayer approach might appear no longer justified. In cases in which the relation between associated enterprises (i.e., the relation between principal and intermediary/DAE) is properly remunerated under the arm's length principle laid down in Art 9 OECD Model – and includes both the activities the intermediary/DAE performs in its own name/account as well as the activities performed in the name/account of its principal –, no additional profits can be attributed to a PE under Art 7 AOA (based on the so-called "single taxpayer approach"). Even in situations when the intermediary/DAE is not properly remunerated, Art 9 OECD Model provides sufficient possibilities to carry out transfer pricing adjustments to reach a proper remuneration by means of the application of the arm's length principle. Assuming there would be an intermediary/DAE and a DAPE in the host Country, under the single taxpayer approach the compliance burden would be essentially reduced since only the intermediary/DAE would be considered a taxable person in the host Country. In both cases, i.e., the intermediary/DAE is properly remunerated either at the outset or only after adjustments, the intermediary/DAE will eventually be taxed on the basis of all the arm's length taxable profits, i.e. the ones generated by the profits realized in its own name/behalf and the ones realized in the name/behalf of its principal.

If one considers the aspects of tax filing and assessment, it is very questionable why tax administrations should rather attempt to tax an intermediary/DAE and a DAPE, instead of simply taxing one taxable person (i.e., the intermediary/DAE) at arm's length. In our view, no decisive arguments can be brought forward which would support a further focus on the dual taxpayer approach, since its application only leads to higher administrative cost and, therefore, to negative consequences for both, tax administrations and taxpayer (e.g., increased workload and costs of tax administration, leading to a reduction of tax base in the host Country due to additional and unnecessary compliance costs, increased workload for taxpayer in order to ensure compliance, increased legal uncertainty for taxpayer and tax administration). Moreover, the adoption of the dual taxpayer approach might lead, in cases of "zero-profit" DAPEs (i.e. DAPEs with no additional profit that could be assessed, based on

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<sup>7</sup> See OECD (2010), Report on the Attribution of Profits to Permanent Establishments, OECD Publishing, www.oecd.org, pages 165 et seq.

the fact that all profits have already been taxed in the hands of the intermediary/DAE), tax administrations might be tempted to still tax "some" extra-profits in the hands of the DAPE, due to the assumption that in the presence of a PE there should always be entitlement to extra-profits.

Therefore, from our point of view – and as already pointed out during the course of our comments to the 2016 Discussion Draft<sup>8</sup> – the Discussion Draft should consider, going forward, focusing on the single taxpayer approach.

To a certain extent we are of the opinion that some of the arguments against the preference for the dual taxpayer approach were already considered when setting-up this Discussion Draft. However, in conclusion, a very clear statement can be found in the Discussion Draft according to which the dual taxpayer approach is still the preferred option (nevertheless, as we believe, most probably not a consensus position among all OECD member states).

## 2.2. Specific remarks on the general statements in the preface of the examples

### 2.2.1. Two taxpayers in the host Country?

As already indicated above, the dual taxpayer approach has various negative consequences. Nonetheless – as stated in the Discussion Draft<sup>9</sup> – when "a PE is deemed to exist under Art 5(5) due to the activities of an intermediary, those activities are relevant to **two taxpayers in the host Country: the intermediary (which may be a resident of the host Country) and the PE (which is a PE of a non-resident enterprise).**" Therefore, the Discussion Draft clearly confirms its intent not to deviate from the dual taxpayer approach in general.

However, if one analyses the preface of the examples in the Discussion Draft and some conclusions in the examples, it appears that this general preference for the dual taxpayer approach seems to be restricted to a certain extent. In this respect it is pointed out that a "**number of countries actually collect tax only from the intermediary even though the amount of tax is calculated by reference to activities of both the intermediary and the Art 5(5) PE. It is also important to note that the potential burden on a non-resident enterprise of having to comply with host Country tax and reporting obligations in the event it is determined to have an Art 5(5) PE cannot be dismissed as inconsequential, and nothing in this guidance should be interpreted as preventing host countries from continuing or adopting the kind of administratively convenient procedure mentioned above.**"<sup>10</sup> From our point of view, especially the first sentence of the cited reference clearly indicates that a larger group of OECD member states applies the single taxpayer approach, meaning that already now the dual taxpayer approach does not seem to be a consensus position anymore. In addition, also the second part of the cited reference (highlighted in bold), indicates that the Discussion Draft provides its member states with a "card blanche" in order to

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<sup>8</sup> See Comments Received on Public Discussion Draft – BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments – Part II, page 403 et seq.

<sup>9</sup> See Public Discussion Draft on BEPS Action 7 "Additional Guidance on the Attribution of Profits to Permanent Establishments" (2017), paragraph 10.

<sup>10</sup> See Public Discussion Draft on BEPS Action 7 "Additional Guidance on the Attribution of Profits to Permanent Establishments" (2017), paragraph 21.

deviate from the dual taxpayer approach and apply more convenient solutions for non-resident enterprises in the host Country. If one reads both sentences in conjunction the provided “card blanche” in our view is meant to permit the application of the single taxpayer approach at least as an alternative to the dual taxpayer approach.

Even though one could argue that the “card blanche” approach is a step into the right direction (i.e., a broader application of the single taxpayer approach), this has two disadvantages, namely (i) legal uncertainty and (ii) inconsistency on an international level. The problem of legal uncertainty could possibly be solved by publicly communicating that certain countries apply the single taxpayer approach; such a transparent communication mechanism is also suggested in the Discussion Draft with respect to the countries’ preferred order of application of Art 7 and Art 9,<sup>11</sup> thus being a viable solution. With respect to inconsistency on an international level, the only solution is to come to a common consensus between the OECD member states (as a future target). However, even when both problems cannot be properly solved, we are still of the opinion that the positive effects of the single taxpayer approach outweighs those disadvantages.

### **2.2.2. Same taxable profits under Art 7 and Art 9?**

The next issue addressed by the Discussion Draft, is the question of whether or not the application of Art 7 AOA and Art 9 OECD Model leads to the same arm’s length profits. In this respect the Discussion Draft starts analysing this issue by elaborating on the newly introduced guidance on risk assumption under BEPS Actions 8-10. When the Discussion Draft interlinks the issue of risk assumption with the relevance of contractual arrangements in a “post-BEPS era”, this is – from our point of view – the most suitable criterion to draw conclusions on the comparability of Art 7 AOA and Art 9 OECD Model.

The Discussion Draft points out in that the *“guidance produced under BEPS Actions 8-10 (...) clarified that contractual allocations of risk assumption are respected only when they are supported by the actual control over risks and the financial capacity to assume the risk. The guidance (...) established, among other things, that where the party contractually assuming the risk does not control the risk or does not have the financial capacity to assume the risk, that risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.”*<sup>12</sup> In addition, it is acknowledged by the Discussion Draft that the *“allocation of risks for transfer pricing purposes does not change the facts on which the application of Art 5(5) is predicated (...)”*<sup>13</sup> To this end we are fully aligned with the conclusions drawn by the Discussion Draft.

However, given this understanding, the Discussion Draft shifts its focus to the PE context in order to draw further conclusions of the new guidance on risk assumption on profit attribution to PEs. In this respect, *“the legal and factual position [in the PE context] is that there is no single part of an enterprise which legally owns the assets, assumes the risks, possesses*

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<sup>11</sup> See Public Discussion Draft on BEPS Action 7 “Additional Guidance on the Attribution of Profits to Permanent Establishments” (2017), paragraph 12.

<sup>12</sup> See Public Discussion Draft on BEPS Action 7 “Additional Guidance on the Attribution of Profits to Permanent Establishments” (2017), paragraph 13.

<sup>13</sup> See Public Discussion Draft on BEPS Action 7 “Additional Guidance on the Attribution of Profits to Permanent Establishments” (2017), paragraph 14.

*the capital or contracts with separate enterprises. The mechanism to determine the attribution of risk assumption to a PE will depend on the applicable tax treaty in a given case.*"<sup>14</sup> According to the Discussion Draft – in light of tax treaties, which incorporate the AOA – *"the notion of 'significant people functions' [is used] for attributing risk assumption and economic ownership of assets to a PE."* From our point of view, it has to be considered that SPFs are not used for *"attributing risk assumption"*, but rather to attribute *"risks assumed"*.<sup>15</sup> Unlike the functional and risk analysis under Art 9 OECD Model (including the newly introduced guidance on risk assumption), the functional and factual analysis in light of the AOA does not analyse the risks, which are assumed by a PE in the same way. Under the AOA one identifies the dealings between headquarter and PE, which are subject to SPFs. Based on these SPFs the risks are attributed to the PE. Accordingly, if the analysis of the dealings leads to the conclusion that a PE carries out the SPFs of a Limited Risk Distributor (hereinafter "LRD"), then only limited risks will be attributed to the PE. However, if the analysis of the dealings leads to the conclusion that the PE carries out SPFs of a fully-fledged distributor, there are consequently more risks to be attributed to the PE (since assets and risks follow functions).

At this point the question concerning the interrelation with risk assessment under Art 9 OECD Model arises. In this context, the risk assessment alone might not appear as a proper mean to compare Art 7 AOA and Art 9 OECD Model. However, in combination with the effects of risk assessment on the relevance of contractual arrangements, it is. In this respect, a mere contractual assumption of risks is not enough under Art 9 OECD Model, if the contractual arrangement is not supported by the (i) actual control over risks **and** the (ii) financial capacity to bear the risks. Under Art 7 AOA capital (i.e., financial capacity) to bear the risks is attributed to the PE on the basis of functions carried out, assets used and risks assumed (since capital follows functions, assets and risks). However, with respect to control over risk, the Discussion Draft states that, *"[w]hile there may be functions that would be considered both significant people functions for the attribution of risk for the purposes of the AOA and risk control functions for the purposes of Art 9, the conclusion cannot be drawn that these two concepts are aligned or can be used interchangeably for purposes of Art 7 and Art 9."*<sup>16</sup> From our point of view, this conclusion in the Discussion Draft is doubtful, since risk control functions are typically functions, which are carried out by people. In fact, it is not necessary the case that the functions – under Art 9 OECD Model – are carried out by staff of the enterprise itself (e.g., outsourced risk control) as long as the important control functions are in the hands of the enterprise. The risk attribution based on the notion of SPFs under Art 7 AOA should exactly follow the same understanding. If the SPFs actively controlling the risks are carried out by the PE, then the risks are attributable to the PE. If the PE conducts important "risk controlling functions", control of which is actively carried out by anyone else, then the important "risk controlling function" is in the hands of the PE's SPF, which forms the basis for the attribution of the risks to the PE. Therefore, we are of the opinion that the statement of the Discussion Draft according to which *"the conclusion cannot be drawn that these two concepts are aligned or can be used interchangeably for purposes*

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<sup>14</sup> See Public Discussion Draft on BEPS Action 7 "Additional Guidance on the Attribution of Profits to Permanent Establishments" (2017), paragraph 15 et seq.

<sup>15</sup> See OECD (2010), Report on the Attribution of Profits to Permanent Establishments, OECD Publishing, www.oecd.org, pages 16 et seq.

<sup>16</sup> See Public Discussion Draft on BEPS Action 7 "Additional Guidance on the Attribution of Profits to Permanent Establishments" (2017), paragraph 17.

of Art 7 and Art 9”<sup>17</sup> appears not reflecting a proper understanding of Art 7 AOA and Art 9 OECD Model, or if so, both understandings have to be aligned.

However, even though we do criticize the above mentioned opinion laid down in the Discussion Draft, we think that the further conclusions<sup>18</sup> are in line with the guidance provided under Art 7 AOA and Art 9 OECD Model. In this respect, especially the following statement in the Discussion Draft is of major importance and perfectly in line with a proper interpretation of the arm`s length principle from our point of view: *“Accordingly, where a risk is found to be assumed by the intermediary under the guidance (...) [on Art 9 OECD Model], such risk cannot be considered to be assumed by the non-resident enterprise or the PE for the purposes of Art 7. Otherwise, double taxation could occur in the source Country through taxation of the profits related to the assumption of that risk twice, i.e. in the hands of both the PE and the intermediary.”*

### **2.2.3. Order of application of Art 7 and Art 9?**

The Discussion Draft correctly points out that the OECD Model and the OECD Commentary do not explicitly state *“whether a profit adjustment under Art 9 should precede the attribution of profits under Art 7 [or vice versa].”* In the end, we agree with the Discussion Draft that the order of application of the two articles should not have any impact on the profits that should be eventually taxable in the host Country, since both articles are based on the same arm`s length understanding. This is true especially in light of the work under BEPS Actions 8-10, when the last remaining “systematic gap” between Art 7 AOA and Art 9 OECD Model (i.e., the relevance of contractual arrangements) was aligned.

The Discussion Draft points out that *“many jurisdictions find it logical and efficient first to accurately delineate the actual transaction between the non-resident enterprise and the intermediary and to determine the resulting arm`s length profits while others may decide to undertake an Art 7 analysis first and then to apply Art 9 to adjust the profits of the associated enterprises (i.e. the non-resident enterprise and the intermediary). In any case, the order in which Art 7 and Art 9 are applied should not impact the amount of profits over which the source Country has taxing rights as a result of the activities of the intermediary on behalf of its associated non-resident enterprise in the source Country.”*<sup>19</sup> While we are in favour of applying Article 9 OECD Model first, in light of the different order of application used by countries, we welcome the Discussion Draft`s recommendation according to which the *“approach adopted by a jurisdiction should be applied consistently and could be made public for purposes of transparency and certainty for taxpayers.”*<sup>20</sup>

### **3. Attribution of profits to permanent establishments resulting from changes to article 5(5) and 5(6) and the commentary**

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<sup>17</sup> See Public Discussion Draft on BEPS Action 7 “Additional Guidance on the Attribution of Profits to Permanent Establishments” (2017), paragraph 17.

<sup>18</sup> See Public Discussion Draft on BEPS Action 7 “Additional Guidance on the Attribution of Profits to Permanent Establishments” (2017), paragraph 18.

<sup>19</sup> See Public Discussion Draft on BEPS Action 7 “Additional Guidance on the Attribution of Profits to Permanent Establishments” (2017), paragraph 12.

<sup>20</sup> See Public Discussion Draft on BEPS Action 7 “Additional Guidance on the Attribution of Profits to Permanent Establishments” (2017), paragraph 12.

This section deals with the specific questions raised in the Discussion Draft with regard to the “attribution of profits to permanent establishments resulting from changes to article 5(5) and 5(6) and the commentary”, whereby the Discussion Draft’s chosen order of examples will be followed.

### **3.1. Example 1: Commissionaire structure (related intermediary)**

#### **3.1.1. Facts of the case**

In example 1 TradeCo is resident of Country R. SellCo is a commonly owned company resident in Country S (i.e., related intermediary). TradeCo buys and sells certain products and SellCo carries out marketing and sales activities on behalf of TradeCo as a commissionaire. In this respect, SellCo sells the products of TradeCo in its own name but on the account of TradeCo. SellCo does not own the sold products, nor is it entitled to the amounts paid by the buyers of the products (i.e., on the account of TradeCo). SellCo is remunerated for the performance of the marketing and sales activities by a commission fee equal to a certain arm’s length percentage of the sales revenue received by TradeCo from the sales by SellCo on behalf of TradeCo (i.e., arm’s length remuneration under Art 9 OECD Model). SellCo is only engaged for TradeCo and does not carry out activities for others. TradeCo does not carry out any operations in Country S nor does it sell products to customers in Country S besides those sales made by SellCo on its behalf.

There is a double tax treaty (hereinafter “DTT”) in place between Country R and Country S, which incorporates the changes due to the BEPS Project.

#### **3.1.2. Conclusions drawn by the Discussion Draft**

Due to the fact that SellCo “*habitually concludes contracts*” for the sale of goods on behalf of TradeCo in Country S, TradeCo has a PE in Country S according to Art 5(5) OECD Model. The exemption for independent agents according to Art 5(6) OECD Model is not applicable in the underlying case, since SellCo acts “*exclusively (...) on behalf of one (...) enterprise(...) to which it is closely related*”.

Since there is a PE in Country S, the Discussion Draft consequently concludes that Art 7 AOA is applicable, thus meaning that those profits are attributable to the PE, which it would have derived if it were a separate and independent enterprise under the same conditions. According to the Discussion Draft the profits attributable to the PE have to be derived as follows:

- Starting point are the **revenues**, which TradeCo received from sales of goods to customers in Country S;
- This amount is reduced by the amount, which TradeCo would have received if it would have sold the products to an unrelated party, which performs same or similar activities that SellCo under the same or similar conditions;
- This amount is further reduced by other expenses for purposes of the PE;
- Finally also the arm’s length **remuneration** of SellCo under Art 9 OECD Model is deducted.

We understand that this calculation aims to capture the “retained” sales profit (considering the related expenses) in comparison with a sale using a third party. The concept appears from the outset similar to using the Resale Price Method or a Transactional Net Margin Method.

In a next step the Discussion Draft concludes that – for reasons of administrative convenience – *“the tax administration in Country S may choose to collect tax only from SellCo even though the amount of tax is separately calculated by reference to the tax liability of SellCo and the PE.”*

Finally, the Discussion Draft highlights that the provided conclusions would be the same if SellCo would not act under a commissionaire arrangement, but rather under a services agreement, according to which TradeCo remunerates SellCo based on a fee payable that equals to a certain (arm’s length) percentage of the sales revenue received by TradeCo from sales to customers in Country S. Also here, the service agreement would give rise to a PE of TradeCo under Art 5(5) OECD Model in Country S if SellCo *“habitually plays the principal role leading to the conclusion of contracts”*.

### **3.1.3. Comments on Example 1**

In general, the conclusions drawn by the Discussion Draft are in line with the current guidance on Art 7 AOA and Art 9 OECD Model. However, the following issues have to be addressed.

Concerning the level of “applicability” of the principles of profit attribution, the Discussion Draft correctly concludes that the activities performed by SellCo in the host Country give rise to a PE of TradeCo on the basis of the new Art 5(5) OECD Model. Moreover, it is correct that the independent agent exemption of Art 5(6) OECD Model is not applicable in the underlying case. The variation of the example according to which it is elaborated that a service agreement between TradeCo and SellCo would also give rise to a PE of TradeCo in the sense of Art 5(5) OECD Model, since SellCo would then *“habitually play(...) the principal role leading to the conclusion of contracts”* for TradeCo is also understandable. From our point of view, the proposed interpretation is within the interpretational boundaries of the new Art 5(5) OECD Model.

However, as indicated in section 2.2.1, we are of the opinion that the dual taxpayer approach is not the most appropriate approach to ensure taxing rights of the host Country. If one would apply the single taxpayer approach in the underlying case, one would not carry out an in-depth analysis of the potential profits attributable to the PE of TradeCo, but rather focus on the analysis of taxing SellCo’s taxable profits in the host Country, on the basis of a proper arm’s length remuneration (paid by TradeCo). Given the fact pattern or the transactions, which are carried out by SellCo on behalf of TradeCo, this conclusion is perfectly in line with the value creation in the host Country; all major risks are borne by the principal.

The application of the dual taxpayer approach does not lead to any kind of additional taxable revenue for the tax administration; however, it does increase the compliance burdens for both tax administration and taxpayer. Following the dual taxpayer approach, the starting point of the evaluation of profits attributable to the PE are the arm’s length taxable profit of SellCo. These arm’s length taxable profits of SellCo are then recalculated by exactly the

same principles, resulting in zero additional taxable profits of the PE in the host Country (i.e., “zero-sum game”). Given the proposed calculation scheme in the Discussion Draft,<sup>21</sup> the result will in our view eventually be the same.

From our point of view, the “*other expenses, wherever incurred, for the purposes of the PE*”, which are addressed in the calculation scheme in the Discussion Draft,<sup>22</sup> have to be further analysed. In footnote 7, the Discussion Draft explains what is meant with those “*other expenses, wherever incurred, for the purposes of the PE*” as follows: “*For activities undertaken by TradeCo (as home office) on behalf of the PE, this would include an arm’s length allocation of expenses associated with these activities, or, under the AOA, a ‘dealing’ between the PE and TradeCo (as home office) associated with TradeCo’s activity on behalf of the PE.*” These expenses fit in the system only if the starting point are the “retained” sales profit (see our comments to a comparison with a LRD in section 3.1.2.).

Looking at the higher administrative costs of compliance with the dual taxpayer approach, the question arises in which Country those compliance costs should be deductible. Since they are attributable to the PE, they – at least in a first step – reduce the taxable result in the host Country. If one considers that the residence Country of the principal applies the single taxpayer approach (see again section 2.2.1. above), whereas the host Country applies the dual taxpayer approach (resulting in those additional compliance costs), the principal is eventually confronted with legal uncertainty on whether or not the costs resulting from compliance burden in the host Country will be deductible also in the residence state. As a consequences of legal uncertainty, this issue will lead to further costs for taxpayers and tax administrations (e.g., court proceedings, etc.), thus increasing the negative effects of the (inconsistent) application of the dual taxpayer approach.

Summing up, it appears that little (if none) sound arguments can be brought forward in favour of the dual taxpayer approach in example 1. Accordingly, the Discussion Draft should consider, going forward, focusing on the single taxpayer approach.

## **3.2. Example 2: Sale of advertising on a website (related intermediary)**

### **3.2.1. Facts of the case**

In example 2 SiteCo, a company resident in Country R, owns the rights in a website. Again, SellCo, which is an associated company resident in Country S, performs different marketing activities on behalf of SiteCo in Country S under a services agreement with SiteCo. SellCo is remunerated by SiteCo on the basis of a certain percentage of the sales revenue received by SiteCo from sales of advertising space to customers in Country S, which is considered being arm’s length. SellCo habitually plays the principal role leading to the routine conclusion of sales by SiteCo in Country R to customers in Country S without material modification of the terms and conditions. Moreover SellCo is exclusively engaged for SiteCo. There is no further business activity of SiteCo in Country S.

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<sup>21</sup> See Public Discussion Draft on BEPS Action 7 “Additional Guidance on the Attribution of Profits to Permanent Establishments” (2017), paragraph 25.

<sup>22</sup> See Public Discussion Draft on BEPS Action 7 “Additional Guidance on the Attribution of Profits to Permanent Establishments” (2017), paragraph 25.

Again, there is a DTT in place between Country R and Country S, which incorporates the changes due to the BEPS Project.

### **3.2.2. Conclusions drawn by the Discussion Draft**

Due to the fact that SellCo habitually plays the principal role leading to a routinely conclusion of sales by SiteCo in Country R to customers in Country S without material modification of the terms and conditions, the Discussion Draft concludes that SiteCo has a PE in Country S.

Again with regard to profit attribution to the PE, the Discussion Draft proposes the following calculation scheme, which is directly or by analogy based on the principles of Art 9 OECD Model:

- Starting point are the revenues, which SiteCo received from sales of goods to customers in Country S;
- This amount is reduced by the amount, which SiteCo would have received if it would have sold the rights to the advertising space to an unrelated party, which performs same or similar activities that SellCo under the same or similar conditions;
- This amount is further reduced by other expenses for purposes of the PE;
- Finally also the arm's length remuneration of SellCo under Art 9 OECD Model is deducted.

We understand hereby that this calculation again aims to capture the "retained" sales profit (considering the related expenses) in comparison with a sale using a third party (see comments in section 3.1.2. above).

Moreover, the Discussion Draft points out again, that – for reasons of administrative convenience – the tax administration in Country S may choose to collect tax only from SellCo.

### **3.2.3. Comments on Example 2**

With regard to the level of "applicability" of the principles of profit attribution, the conclusions derived by the Discussion Draft are in line with the changes introduced on the basis of BEPS Action 7.

The conclusions drawn by the Discussion Draft in example 2 are again in line with the existing guidance on Art 7 AOA and Art 9 OECD Model. Given the comparable fact pattern of example 2, the comments on example 1 (see section 3.1.3. above) are equally relevant for this example.

Again it appears that little (if none) sound arguments can be brought forward to apply the dual taxpayer approach in the underlying situation. Accordingly, the Discussion Draft should consider focusing on the single taxpayer approach.

### **3.3. Example 3: Procurement of goods (related intermediary)**

### 3.3.1. Facts of the case

In example 3 TradeCo – a resident in Country R – purchases and sells a certain trade product. BuyCo, a commonly owned company resident in Country S, procures those trade products on behalf of TradeCo in Country S, thus acting as a purchasing agent of TradeCo. BuyCo purchases the trade product in the name of TradeCo from different unrelated suppliers in Country S. Throughout the whole process BuyCo does not own the trade products at any point, nor is it entitled to TradeCo's revenues resulting from the sale of these trade products to customers. BuyCo is remunerated by TradeCo for its activities as purchasing agent via a certain commissionaire's fee, which is considered being arm's length. Again BuyCo's business consists solely of its activities for TradeCo and TradeCo does not carry out other business operations in Country S.

Again, there is a double tax treaty (hereinafter "DTT") in place between Country R and Country S, which incorporates the changes due to the BEPS Project.

### 3.3.2. Conclusions drawn by the Discussion Draft

First, the Discussion Draft concludes that the given activities of BuyCo in the Country S give rise to a PE of TradeCo in Country S under Art 5(5). This is again caused by the fact that BuyCo habitually concludes contracts in Country S on behalf of TradeCo and BuyCo can further be not qualified as independent agent, meaning that the exemption of Art 5(6) OECD Model does not apply. Moreover, the procurement of the trade products by BuyCo, which are intended to be resold by TradeCo, cannot be seen as an activity of a preparatory or auxiliary character in relation to TradeCo's business.

Concerning profit attribution to the PE in Country S, the Discussion Draft again proposes the following calculation scheme, which is directly or by analogy based on the principles of Art 9 OECD Model:

- Starting point are the revenues, which TradeCo would have had to pay if it had purchased the trade products from an unrelated supplier performing the same or similar activities the BuyCo performed on behalf of TradeCo;
- This amount is reduced by the amount, which TradeCo paid to unrelated suppliers in Country S;
- This amount is further reduced by other expenses for purposes of the PE;
- Finally also the arm's length remuneration of BuyCo under Art 9 OECD Model is deducted.

Moreover, the Discussion Draft points out again, that – for reasons of administrative convenience – the tax administration in Country S may choose to collect tax only from BuyCo.

### 3.3.3. Comments on Example 3

Concerning the level of "applicability" of the principles of profit attribution, the Discussion Draft highlights a crucial aspect in terms of PE existence, which can be seen as a "change of paradigm" in international tax law, as so far as – due to various reasons – purchasing activities did not give rise to PEs.

However, in light of the newly introduced changes based on the word of BEPS Action 7, also such activities can give rise to a PE of the principal in the host Country, especially in situations where those activities do not constitute mere activities of preparatory or auxiliary character. Since this is not the case in example 3, the conclusions in the Discussion draft concerning the existence of the PE in Country S are correct.

With regard to the level of “application” of the principles of profit attribution, we may again reference to the comments on example 1 (see section 3.1.3. above) since they equally apply for this example.

Accordingly, also in example 3 it appears that little (if none) sound arguments can be brought forward to apply the dual taxpayer approach. Also in such situation, the application of the single taxpayer approach only leads to advantages.

#### **4. Attribution of profits to permanent establishments resulting from changes to article 5(4) and the commentary**

This section in the Discussion Draft deals with a specific example with regard to the “attribution of profits to permanent establishments resulting from changes to article 5(4) and the commentary”.

##### **4.1. Example 4: Warehousing, delivery, merchandising and information collection activities**

###### **4.1.1. Facts of the case**

In example 4, the Discussion Draft deals with topics of Art 5(4) PEs. In this respect, OnlineCo, a company resident in Country R, sells products via an online platform directly to customers in various markets including Country S. OnlineCo purchases the products from unrelated suppliers and operates a warehouse in Country S. To run the warehouse OnlineCo has 25 employees. The warehouse does not belong to OnlineCo but is leased from an unrelated party. At the warehouse the following functions are applied:

- Handling of the receipt of shipments from suppliers,
- Stocking of products,
- Execution of deliveries to customers in Country S, via third party logistic providers.

Besides the warehouse, OnlineCo also has an office in Country S. The office is located in a different place than the warehouse. To run the office OnlineCo has 15 employees. These employees carry out the following functions:

- Merchandising of OnlineCo’s products
- Collection of information from OnlineCo’s customers in Country S.

Again, there is a DTT in place between Country R and Country S, which incorporates the changes due to the BEPS Project, especially including the addition of Art 5(4.1) OECD Model.

#### **4.1.2. Conclusions drawn by the Discussion Draft**

Based on the fact pattern, the Discussion Draft assumes that the business activities carried out by OnlineCo both at the warehouse and at the office are to be understood as complementary functions, being part of a cohesive business operations, thus constituting two fixed place PEs in Country S according to Art 5(1) OECD Model, since the performed activities do not – from a holistic perspective – form mere activities of preparatory or auxiliary character.

Due to the fact that PEs exist in Country S, Art 7 AOA is again applicable. In this respect, the Discussion Draft suggests the following calculations scheme for each of the two PEs (note: the calculations scheme is shown in a simplified way)), which is again directly or by analogy based on the principles of Art 9 OECD Model:

- Starting point is the amount which OnlineCo would have paid to an independent provider of the warehouse and the office and the performance of the associated functions, under the same conditions or similar conditions;
- expenses wherever incurred, for the purpose of the PE (e.g. employees remunerations, rents,)

#### **4.1.3. Comments on Example 4**

Starting again with the level of “applicability” of the principles of profit attribution to PEs, the newly introduced changes in Art 5(4.1) OECD Model cause that the underlying warehouse and office structure does not qualify for the “preparatory or auxiliary” exemption. Given the intent of BEPS Action 7, the Discussion Draft correctly concluded that such a setting gives rise to two different PEs in Country S.

With respect to the “application” of the principles of profit attribution to PEs, the proposed solution of the Discussion Draft is also in line with the existing guidance laid down in the AOA. However, from a general perspective we want to emphasise that those situations, which were preparatory and auxiliary before the BEPS Project (at least in the majority of cases) and which are no longer exempted now, require an in-depth analysis of the functional and factual situation.

We share the view that the profit attribution does not necessarily have to be based on simple cost-plus remunerations, but could also require the application of other methods depending on the type and combination of “preparatory and auxiliary” activities in line with general transfer pricing guidance.

### **5. Conclusions**

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. Legal aspects (e.g., non-existence of ratings of PEs) must not be overestimated under a holistic perspective. To a certain extent the wordings of the guidance on Art 7 AOA and Art 9 OECD Model appear not to be consistent. However, proper legal interpretations support the view that most of the “wording differences” are in fact neglectable. Given this understanding, we would suggest to align the wording of the guidance on the two articles and, in the longer run, possibly merge the two articles into a single one.

In addition, we would recommend the following:

- Implementation of more explicit statements in the guidance on Art 7 and Art 9 according to which the separate legal entity approach – without any deviation – is the core principle in transfer pricing and profit attribution to PEs, which has to be followed in order to comply with the arm's length principle.
- Moreover, we emphasise that the current Discussion Draft has correctly highlighted that contractual arrangements are just the starting point of a proper functional and risks analysis under Art 9 OECD Model. As far as fact oriented arguments lead to the conclusion that the contracts are not in line with the actual conduct of the parties, those other arguments prevail. However, due to the high importance of this issue (not just for the execution of a transfer pricing analysis under Art 9 OECD Model, but also from a systematic point of view, since it would close the last relevant "gap" between Art 7 AOA and Art 9 OECD Model) it should further be highlighted that the work under BEPS Actions 8-10 caused a functional-based understanding of the arm's length principle under Art 9 OECD Model, which corresponds to the understanding of Art 7 AOA. Given this understanding, dealings are to be understood as the intra-group equivalent of contracts.
- The dual taxpayer approach should explicitly be abandoned or at least considered as an alternative option, since it does not provide the source Country with any additional tax revenues and leads to administrative disadvantages for both tax administration and taxpayer. If one bears in mind that both, Art 7 and Art 9 should be based on the same understanding of the arm's length principle, the single taxpayer approach is in our view the most appropriate solution. Accordingly, we think that this should be the preferred approach by the OECD going forward.

Faithfully yours,

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