The Voice of OECD Business

January 8, 2009

Mr. Jeffrey Owens
Director
OECD Centre for Tax Policy and Administration (CTPA)
2, rue André Pascal
75016 Paris
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Dear Mr. Owens:

Set forth below are the comments and recommendations of BIAC with regard to the July 7, 2008 document captioned "Discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention" (the "Discussion Draft").

We commend the OECD on the general quality of the Discussion Draft. It presents a far more internally consistent interpretation of Article 7, and application of the July 17, 2008 Report on the Attribution of Profits to Permanent Establishments (the "Final Report"), than does the partial implementation contained in the 2008 revision to the Model Treaty Commentary. We urge that, with the modifications suggested below, the revised Article 7 and Commentary be quickly adopted and that OECD member states make every effort quickly to incorporate the new understandings of Article 7 reflected in the Discussion Draft in bilateral treaties.

In providing comments on the Discussion Draft, BIAC has assumed that the Final Report is indeed now in final form. We have refrained from any comments suggesting changes to the principles contained in the Final Report even though we continue to disagree with certain elements of the Final Report as suggested in our previous comment letters dated 3 November 2005 and 8 August 2007. Accordingly, we limit ourselves herein to comments intended to assure that the Final Report is appropriately and clearly implemented in its entirety in Model Treaty language and in the associated Commentary and to assure that a foundation of appropriate procedural principles for dispute resolution is established. To be specific, BIAC believes that the optimal way to resolve disputes in transfer pricing is through the inclusion in tax treaties of workable concepts relative to avoiding double taxation that can be effectively applied in arbitration in addition to the mutual agreement procedures. It is crucial to the achievement of this aim that all revisions in Model Treaty language facilitate the resolution of disputes through the mechanisms of mutual agreement and arbitration and we urge that this objective is implicit in any changes to Article 7.

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Specific recommendations for changes or additions to the proposed text of the Model Treaty or commentaries are highlighted below in **bold.**

1. The Language of Article 7, Paragraph 2—Recommendation for More Comprehensive Text

Article 7, paragraph 2, as revised in the Discussion Draft is the critical Model Treaty provision controlling determinations of the amount of profit that should be attributed to a permanent establishment. Under the Final Report, four critical principles are to be applied in attributing profits to a permanent establishment. These are: (i) the permanent establishment is to be treated as a "functionally separate entity" dealing independently with other parts of the enterprise and with third parties; (ii) a detailed functional analysis focusing on key people functions must provide the foundation for all profit attribution determinations; (iii) attribution of assets and risks to the permanent establishment should be premised on the functional analysis; and (iv) principles of arm's length dealing should be applied to allocate profits between the permanent establishment and other parts of the enterprise. We believe each of these four fundamental principles should be more fully reflected in the language of Article 7, paragraph 2.

Acknowledging the difficulty of synthesizing the details of the Final Report into concise Model Treaty provisions, we think that Article 7, paragraph 2 is incomplete. The proposed language reflects some of these principles, but it fails to reflect each of these Final Report principles comprehensively. **We therefore recommend that the language of Article 7, paragraph 2 be revised to provide as follows:**

> *For the purposes of this Article and Article [23A][23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits 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 on an arm's length basis with the enterprise of which it is a permanent establishment. The profits attributable in each Contracting State to the permanent establishment shall be determined taking into account the functions performed by the permanent establishment and other parts of the enterprise, and the assets deemed owned and the risks deemed assumed by the permanent establishment and by other parts of the enterprise on the basis of the functions performed.*

2. Emphasise that the Obligation of Contracting States to Relieve Double Taxation is not changed—Recommended Addition to Commentary

Revised Article 7, paragraph 2 contains an explicit reference to Article 23 relating to the methods for relieving double taxation. Such a reference to Article 23 does not exist under the current Model Treaty language. BIAC believes that this explicit reference to Article 23 is an appropriate clarification and confirmation and we therefore support the change in the language.

We interpret the explicit cross-reference to Article 23 as confirming that the home country has an obligation under the Model Treaty to relieve double taxation with respect to profits properly attributed to the permanent establishment by the host country. BIAC emphasizes that such an obligation exists under the existing Model Treaty language and so welcomes the explicit reference to that principle in the revised language.

While the addition of the reference to Article 23 is a useful clarifying change to the Model Treaty language, BIAC believes that it is important that the Commentary clearly state that the addition of the Article 23 reference is in no way intended to alter the already existing obligation of the home country to relieve double taxation with respect to profits properly attributed to a permanent establishment in the host country. The revised Commentary should make it clear that this explicit cross-reference in Model Treaty language should not be read by any Contracting State to suggest that the obligation to relieve double taxation under existing Model Treaty provisions is in any way more limited than will be the case under the revised language. **Accordingly, we recommend that the following sentences be added to paragraph 16 or 24 of the revised Commentary, or at some other appropriate place in the Commentary.**

> *Paragraph 2 as it existed prior to [2010] did not contain an explicit reference to Article 23. The addition in paragraph 2 of an explicit reference to Article 23 is intended only to clarify the existing obligation of the home country to relieve double taxation with respect to profits properly attributed to a permanent establishment under Article 7. That reference is not intended to alter in any way the scope of the already existing obligation of the home country to relieve double taxation with respect to profits properly attributable to a permanent establishment under Articles 7 and 23.*

3. The Language of Article 7, Paragraph 3—Recommended Deletion to Reinforce Obligation to Relieve Double Taxation in Context of Different 'Arm's Length' Amounts

The proposed language of Article 7, Paragraph 3(b) implicitly suggests that certain limits exist under the Model Treaty on the obligation of the contracting states to relieve double taxation. In particular, the phrase at the end of the indented language in Paragraph 3(b) suggests that under certain circumstances, "in the absence of [paragraph 3], Article 23 would not apply to eliminate the double taxation of … profits."

While not clearly articulated in either the draft language of the treaty or in the draft Commentary, the OECD's working premise seems to be that, absent Article 7, Paragraph 3, if the home country's domestic law or its application of transfer pricing principles leads to an "arm's length" result, it has no further obligation under the treaty to relieve double taxation even if the host country attributes a different "arm's length" amount of profits to the permanent establishment. Thus, the Discussion Draft implies the proposition that, consistent with their treaty obligations, the contracting states can attribute different amounts of profit to a permanent establishment, provided each amount can be said to be consistent with the arm's length principle.

BIAC disagrees fundamentally with this proposition. Our strong disagreement with this proposition underlies many of the comments in the following sections of this letter, and to reiterate our earlier comments, this proposition would undermine the effectiveness of arbitration in dispute resolution.

We believe that taxation consistent with the treaty occurs only when the home country and the host country impose tax based on the attribution to the permanent establishment of the same amount of profit in each country.[1] The language of Article 23 requires categorically that the home country shall take steps to relieve double taxation. It does not either explicitly or implicitly limit this obligation to relieve double taxation to situations where the home country concludes that its own domestic laws attribute a non-arm's length or improper amount of profit to the permanent establishment. Double taxation based on two different "arm's length" amounts is not taxation "in accordance with the terms of the convention."

For the foregoing reasons, we strongly recommend that the words "and, in the absence of this paragraph, Article 23 would not apply to eliminate the double taxation of these profits" be removed from Paragraph 3(b) of Article 7.

The practical application of the frame of reference being advocated by BIAC is in connection with procedures for initiating and addressing disputes. Disagreements can and do arise with regard to the question of the amount of profits or expense properly attributable to a permanent establishment. In this context, we recognize that the home country is not obliged by the treaty to relieve double taxation of amounts it does not agree are "properly" allocated to the permanent establishment, subject to a best efforts obligation to resolve disputes. Disagreements between contracting states as to the amount of profits to be properly attributed to a permanent establishment are appropriately resolved through the Mutual Agreement Process under Article 25, as enhanced by arbitration procedures. Access to the Article 25 process is not and should not be in any way limited to situations where one of the contracting states concludes that its position is non-arm's length. Rather, such access must be available whenever double taxation arises by virtue of the contracting states attributing differing amounts to the permanent establishment for whatever reason.

4. The 'Arm's Length Range'—Recommendations to Correct Improper use of the Concept

The draft Commentary on paragraph 3 carries over the same theme as described in section 3 above, erroneously implying that, under at least some circumstances, contracting states can fulfill their treaty obligation to relieve double taxation by adopting a position within an arm's length range, even if the positions of the two contracting states are at different points within that range. While the language in the draft Commentary is hazy, it seems to suggest in this regard that it makes a difference (i) whether the differing positions are arrived at through adjustments or through initial

[1] We understand, as explained in paragraphs 27 and 48 of the Discussion Draft Commentary, that differences in local country treatment of certain items of profit can give rise to double taxation that the treaty does not relieve. Be that as it may, the treaty does impose an obligation on the contracting parties to seek a meeting of the minds as to the amount of profit properly attributed to a permanent establishment in each instance.

filings; and (ii) whether the differing positions are mandated by local law as opposed to being consistent with general arm's length principles.

As stated above, we categorically reject the proposition that contracting states under the treaty can or should be able to satisfy their obligations to relieve double taxation without arriving at a consistent, agreed position as to the specific amount of income and expense to be properly allocated to a permanent establishment, whether by resolution through the mutual agreement procedure or ultimately by arbitration. Double taxation contrary to the treaty exists whenever two contracting states allocate different amounts of profit to the permanent establishment, whether or not one or both of those amounts lie within an arm's length range, and whether or not those amounts are arrived at through initial filings in accordance with local law, or by reason of adjustments in one or both countries. **The suggestion in the last sentence of paragraph 58 that countries taxing at different points within an agreed 'arm's length range' may each be taxing in a manner consistent with the treaty is fundamentally incorrect and must be deleted.**

The concept of an 'arm's length range' contained in the Transfer Pricing Guidelines exists for one limited purpose. It recognizes that profit allocation and transfer pricing issues are not precise, and that therefore, if a <u>taxpayer</u> takes a position that is consistent with the range of dealings observed among unrelated parties, its profit allocation determinations should not be set aside by taxing authorities.

The arm's length range concept does not limit the availability of double tax relief under the Treaty. It does not relieve contracting states from their obligation to reach agreement with regard to profit allocation questions. It does not give countries latitude to take differing positions that both happen to fall within an arm's length range. And it certainly does not limit the principle that double taxation within the meaning of the treaty exists in every case where the countries in question fail to agree on the amount of profit and expense attributable to a permanent establishment.

To the extent the draft Commentary suggests or implies that countries are not obliged, either under the existing Model Treaty language, or under the proposed revision of the Model Treaty and Commentary language in the Discussion Draft, to reach full agreement on the amount of income and expense attributable to a permanent establishment, that language should be modified or deleted, as described more fully in sections 6 and 7 of this letter, below.

5. Deference to Host Country Determinations—Recommendation to Reconsider Expanded use of the Methodology

BIAC has previously expressed its concern regarding the expansion of the procedure that in practice would give deference to host country determinations ("rule of deference") included in previous iterations of the OECD's work on Article 7. We are concerned that this rule, now reflected in Article 7, Paragraph 3 and in the optional language described at paragraphs 53 and 67, may prove to be simultaneously futile and counterproductive.

Our principal reasons for these previously articulated concerns are as follows:

(i) We believe that if such a rule were to be expanded into a rule of general treaty interpretation, it would inappropriately endorse the practice of some traditional source countries of taking aggressive positions in transfer pricing / profit allocations and then relying on the deference rule to tilt the dynamics of dispute resolution in their direction. Our concern in this regard would grow exponentially if the rule of deference were to be extended into an Article 9 context.2 In these contexts, BIAC believes that the expansion of the rule of deference reflected in Article 7, Paragraph 3 and in the optional additional paragraphs contained in the Discussion Draft may ultimately inhibit rather than ease the resolution of profit allocation controversies through the mutual agreement process, as some countries will inevitably take aggressive positions and insist on unwarranted deference for those positions from their treaty partners. Indeed, we can foresee that such posturing may, over time, have the effect of undermining even that level of consensus on transfer pricing / profit allocation matters that currently exists among OECD countries.

(ii) The application of the rule of deference is premised on the agreement by the home country that the result yielded by application of the host or source country's approach is consistent with arm's length dealing. Because such an agreement is a precondition for application of the rule of deference, and because it is a relatively simple matter for any country to contend that any particular result is inconsistent with arm's length dealing in a particular case, we believe that the rule of deference will have little meaningful practical application.

The risk that these provisions will prove irrelevant in the context of real tax disputes is particularly high with regard to the optional provisions contained in the Discussion Draft. Those provisions appear to be intended to create, in common cases, mutual obligations on the part of each of the contracting states to defer to the position of the other. (See paragraph 54 of the draft Commentary) The creation of theoretical mutually offsetting obligations to defer to the position of the other party will provide no practical assistance to competent authorities seeking to resolve real tax disputes.

Our concern that the rule of deference will prove simultaneously futile and counterproductive is, if anything, exacerbated by the inclusion of paragraph 3 in the Model Treaty and the inclusion in the Commentary of 30 paragraphs elaborating on the mechanics of double tax relief under the rule of deference. The expansion of this discussion beyond problems related to the allocation of free capital, particularly in the form of optional Model Treaty language containing varied approaches, enhances our concern that the Commentary will tilt the playing field to the advantage of aggressive source jurisdictions. **We once again urge the OECD to reconsider the wisdom of significantly expanding the application of a rule requiring deference to host country determinations in resolving disputes regarding profit attribution matters**.

[2] It is particularly troubling in this regard that several paragraphs of the Commentary discussing the elaboration of the rule of deference draw parallels to the provisions of Article 9. See, e.g. proposed paragraphs 61, 63 and 64. Any implication that the rule of deference extends to Article 9 cases should be avoided.

6. Recommendations for Additions and Changes to the Commentary Related to Paragraph 3

Through our discussions with the OECD participants, we believe that the OECD member countries fully intend that the provisions of revised Article 7 and Article 23 should lead to full relief from double taxation in virtually all cases. If the OECD member countries insist on pursuing the highly detailed elaboration and expansion of the rule of deference set out in the Discussion Draft version of the Article 7 Commentary, we therefore strongly recommend that the Commentary on Paragraph 3 be prefaced with a straightforward statement of their intent in the Model Treaty regarding relief from double taxation. Such a statement could be included after paragraph 40 and should, in our view, state in a straightforward fashion the following four principles.

(i) When profit is properly attributed to a permanent establishment situated in the host country, the home country has an obligation under the treaty to take all steps necessary to relieve double taxation.

(ii) Double taxation is only relieved, and taxation consistent with the treaty achieved, when the amount of profit attributed to the permanent establishment by the host country is the same as the amount of profit attributed to the permanent establishment by the home country for purposes of applying its rules on double tax relief.

(iii) In every situation where the host country and home country take positions under their domestic law or otherwise that attribute differing amounts of income and / or expense to the permanent establishment, taxation contrary to the treaty occurs and the taxpayer has the right to seek relief from double taxation under the treaty mutual agreement procedures of Article 25(1).

(iv) In any case where the competent authorities are unable to resolve the question of the amount of income and expense to be properly attributed to a permanent establishment, the taxpayer has the right to seek full relief from double taxation under the arbitration provisions of Article 25(5).

To implement these general principles through the new Commentary, **we recommend the following changes be made to the Discussion Draft version of the Commentary on Paragraph 3.**

- **The words "in most cases" should be deleted from paragraph 40**

- **The following language should be inserted in new paragraphs to be inserted following paragraph 40.**

  40a. The provisions of Article 7 and Article 23 are intended to work together to relieve double taxation in situations where a permanent establishment exists. When profit is properly attributed to a permanent establishment by the host country, the home country is obliged under Article 23 to take the steps necessary to relieve the resulting double taxation. Double taxation is only relieved, and taxation consistent with the treaty achieved, when the amount of profit attributed

to the permanent establishment in the host country is the same as the amount of profit attributed to the home country for purposes of applying its rules on double tax relief. In every situation where the host country and home country take positions under their domestic law or otherwise that attribute differing amounts of profit to the permanent establishment, taxation contrary to the treaty occurs and the taxpayer has the right to seek relief from double taxation under the mutual agreement procedures of Article 25(1). In any case where the competent authorities are unable to resolve the question of the amount of profit and expense to be properly attributed to a permanent establishment, the taxpayer has the right to seek full relief from double taxation under the arbitration provisions of Article 25(5).

40b. Article 7, Paragraph 3 is intended to provide mechanical rules to assist competent authorities in agreeing as to the amount of profit properly attributable to a permanent establishment in the special case involving the attribution of free capital to a permanent establishment. It does not add to the general obligation to relieve double taxation, but provides a mechanical methodology to assist in resolving disagreements. The optional provisions described below, if they are included in a treaty, are also intended to serve this same function in situations other than those related to the allocation of free capital.

- **The first sentence of paragraph 43 contravenes the principles described above regarding treaty relief from double taxation and should be deleted.**
- **The last two sentences of paragraph 50 contravene the principles described above and should be deleted.**
- **The last sentence of paragraph 52 contravenes the principles described above and should be deleted.**

We believe that the foregoing changes would put the rule of deference in a more workable procedural context and would help avoid the unfortunate and erroneous assertion that the obligation to relieve double taxation is limited to situations where one country or the other takes a position that is inconsistent with the arm's length standard. A clear statement of these fundamental principles would properly clarify that the provisions of paragraph 3, and the optional alternatives thereto described in the draft Commentary, are intended merely as mechanical and procedural aids to the resolution of double taxation matters under the normal Mutual Agreement measures of the treaty.

Consistent with this, we recommend that the Commentary should be amended to state very clearly that paragraph 3 and the optional treaty language set out at paragraphs 53 and 67 do not alter in any way the fundamental obligation of the contracting states to relieve double taxation already existing in the Model Treaty.

7. Recommendations Regarding the Optional Language in Paragraphs 53 and 67 of the Commentary

For the reasons set forth above, we disagree with the language in the last sentence of paragraph 68, which states that the optional language of paragraph 63 creates a more robust obligation to relieve double taxation than does the existing language of Articles 7, 23 and 25. The existing language of Article 23 states without equivocation that the home country shall relieve double taxation with respect to profit properly taxed in the host state under the provisions of the Treaty, including Article 7. We do not believe that additional language is required to strengthen the obligation to relieve double taxation or that any suggestion should be made in the revised Commentary that would tend to suggest that the obligation under either the existing Model Treaty, or the Discussion Draft version of Article 7 adopted without the optional language, is in some way limited or equivocal.

We recommend that additional language should be inserted into the draft Commentary on paragraph 3 to state clearly that a decision by contracting states not to adopt either of the optional provisions set out in paragraphs 53 and 67 of the draft Commentary shall not be interpreted as limiting in any way the fundamental obligations of the Contracting States to fully relieve double taxation under the treaty.

Also, to the extent any language in paragraphs 40 to 69 of the draft Commentary is inconsistent in any way with the basic principle articulated above, it should be revised. Thus, for example, the fourth sentence of paragraph 53 might be read as suggesting that, in the absence of the optional language, a country's domestic law rules could override the treaty and preclude the country from meeting its obligation to relieve double taxation under the treaty. We disagree with any such suggestion and reiterate that the Commentary should be clarified to make it clear that the treaty requires countries to use their best efforts to relieve double taxation through the MAP process, enhanced by available arbitration provisions, in any case where double taxation arises as a result of inconsistent profit allocations in the home and host countries.

Finally, and most importantly, if notwithstanding the analysis above, somehow the OECD continues to regard paragraphs 53 and 67 as essential to establishing the obligation to relieve double taxation, then to be consistent it is imperative that the language therein not be optional. If the OECD believes that the optional language is necessary to create an obligation on the part of the contracting states to relieve double taxation in every case by agreeing on the amount of profit and expense attributable to a permanent establishment, then making that language "optional" is highly inappropriate. The primary purpose of the treaty is to relieve double taxation. Optional language should be limited to the instances where there is genuine discretion in treaty development. The duty to relieve double taxation is not one of those instances. If the OECD believes that the optional language is needed to assure such duty is clear in every case involving the attribution of profits to permanent establishments under Article 7, then the broadest possible version of the optional language should be included in the text of the Model Treaty itself in order to insure that double taxation will be relieved. The relief of double taxation is the essence of the treaty. It is not acceptable for the OECD to propound a Model Treaty and associated Commentary which the organization does not believe to be effective in relieving double taxation.

8. Recommendations Regarding Review of Excessive and Unfocused Documentation References

The Discussion Draft emphasizes at various points the importance of taxpayer documentation of dealings and allocations of risk and assets between the permanent establishment and other parts of the enterprise.[3] **BIAC has three fundamental concerns regarding the references to documentation in the Discussion Draft. To rectify these concerns we recommend that Commentary be reviewed for all references to documentation and include only those that serve a substantial purpose in applying the Model Treaty.**

First, we note that the references to documentation of various types in OECD publications relating to transfer pricing are multiplying at an alarming rate. The emphasis on taxpayer prepared documentation in this Discussion Draft, in the OECD paper on business restructurings, the discussion drafts on comparability and profits methods, and in the Article 7 Final Report, to name but a few, is quite remarkable. The business community is very concerned that the escalating burdens of transfer pricing compliance are progressing both beyond a level that is reasonable and sustainable, and beyond a level where governments are able to make practical use of the documentation being demanded. We believe that the time has come to begin moderating the ever increasing demand for additional transfer pricing documentation. Documentation by taxpayers is not a cure-all for every vacuum in tax administration and ought not to be used in this way.

In this regard we note with particular concern the suggestion that separate books and records, including a separate balance sheet, reflecting the assets deemed attributable to the permanent establishment under the application of the approved OECD approach to the attribution of profits to permanent establishments. Taxpayers are already required to maintain both financial accounting records and tax accounting records relating to the operation of branches, reflecting the assets actually held in the branch. To now require as a condition of doing business in branch form, the creation of a separate deemed asset balance sheet based on fuzzy notions of "economic" ownership far exceeds the bounds of reasonable compliance burdens.

Second, we note that the discussions of documentation in the Discussion Draft are confusing because of the use of the same term, documentation, to describe two essentially different undertakings. The term is used in one sense to describe business records reflecting in branch books and internal memoranda the actual undertakings of the enterprise. It is used in a second sense to refer to after the fact analyses of whether the results of dealings are consistent with the arm's length principle. The clarity of the Discussion Draft would be enhanced if different terms were utilized to refer to these very different kinds of documents.

Third, BIAC understands that taxpayers should reflect contemporaneously in branch books and other internal documents the actual dealings between a real permanent

[3] See particularly the discussion in paragraph 23.

establishment and its home office. BIAC also understands that where a material profits allocation or transfer pricing issue arises from inter-branch dealings, local laws in some countries may require preparation of after the fact "documentation" supporting the arm's length nature of those dealings.

We note, however, that because of the discussions of dependent agent permanent establishments in the period leading up to the publication of the Final Report, businesses are experiencing a greatly increased number of situations where countries are asserting the existence of dependent agent permanent establishments in situations where the existence of a permanent establishment under traditional Article 5 principles is highly questionable. In situations where a taxpayer does not believe a permanent establishment exists in a particular country, the Commentary should make it clear that the taxpayer is not expected to record non-existent transactions in non-existent branch books, or to undertake transfer pricing studies with respect to dealings of a purely hypothetical permanent establishment. There should be no penalty for failure to provide either type of documentation in such situations.

We appreciate your consideration of the foregoing comments and look forward to further discussions on these matters and on revisions to the Discussion Draft.

Respectfully submitted,

Patrick J. Ellingsworth
Chairman, BIAC Committee on Taxation and Fiscal Affairs