USCIB UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL
Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
2 rue Andre-Pascal
75775, Paris
Cedex 16
France
(taxtreaties@oecd.org)

Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 7: Prevent the Artificial Avoidance of PE Status

Dear Ms. de Ruiter,

USCIB[1] is pleased to have this opportunity to provide comments on OECD's discussion draft on BEPS Action 7. USCIB would like the opportunity to present comments at the public consultation.

General Comments

USCIB generally supports the comments submitted by BIAC. We write separately in order to emphasize certain points and highlight our member's perspective on the discussion draft.

Countries have a jurisdictional basis for taxing any business profits that are earned within their jurisdiction. Treaties have historically included a permanent establishment ("PE") threshold, which limits this right to tax, because of the potential negative impact of assertions of taxing jurisdiction on cross-border trade. If the costs of engaging in cross-border trade exceed the profits, particularly if the activities driving the costs are minor, then business will actively seek ways to avoid engaging in those activities. Therefore, there is and should be a relationship between the expected profit from an activity and whether that activity should be considered to create a PE. USCIB is concerned that the proposals contained in the Discussion Draft, rather

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

than being limited to addressing abuse cases, as Action 7 requires, would merely lower the PE threshold for all activities. We believe this approach is flawed since simply lowering the threshold will have an impact on non-abusive cases, discourage cross-border trade, and result in a rebalancing of the split between "source" and residence taxation.

Both PE and transfer pricing rules are concerned with the proper allocation of taxing jurisdiction between countries. They serve different functions, however, and it is not appropriate to try to fix the perceived flaws in one (the transfer pricing rules) by expanding the other (the PE rules). When the transfer pricing rules are working correctly, the income earned by the local agent will properly reflect the activities performed in the local jurisdiction. Creating a PE based on those activities will create many PEs with little if any additional income and will result in complexity, disputes as to both the existence of the PE and the profit attributable to it, and the possibility of retroactive indirect tax adjustments.

The recently published discussion draft on BEPS Action 14: Making Dispute Resolution More Effective, is a disappointment to USCIB members. In the absence of a commitment to mandatory binding arbitration, there is no guarantee that disputes will be resolved. It is essential, therefore, that the operation of the PE rules be clear and unambiguous. As pointed out repeatedly below, unresolved disputes between countries as to the existence of a PE are likely to result in unresolved double taxation since both countries may assert alternative bases for taxing the same income.

The proposed rules would significantly lower the threshold at which an enterprise of the state of residence would be considered to have a PE in the other ("source") state. The exact scope and intent of the rules is unclear, but USCIB expects that adoption of the proposed rules would result in the proliferation of PE assertions. The burdens of complying with a corporate income tax obligation, including the administrative and reporting burdens, are significant and companies consider these obligations in deciding whether to and how much of an investment to make in another country. The administrative costs are primarily those associated with the cost --- which can run into multiple millions of dollars -- of creating systems that generate the financial data specific to each PE.[2] These costs include not only costs associated with complying with income tax obligations, but also with other obligations that may arise as result of having created a PE. These costs may include complying with indirect tax obligations, local registration and reporting requirements, and other local annual filing requirements. The compliance costs for both taxpayers and tax authorities would be disproportionate to the amount of tax that would be raised. Businesses may decide that an investment is not worth the administrative and

[2] We working with BIAC to gather information relating to these costs and will provide such data as soon as soon as possible as part of the BIAC appendix to its comment letter. Some information is already included in that appendix. See also footnote 15.

tax cost and reduce or eliminate an investment to ensure that PEs are not created.[3] These decisions will reduce the global footprint of a business and local employment and investment. For each individual company, these decisions may not have a significant impact, but replicated globally, such decisions in the aggregate could have an important, negative impact on cross-border trade and investment. Thus the discussion draft's significant expansion of the PE concept will create a significant trade barrier.

The adoption of these rules would create PEs from little, if any, activity by the nonresident enterprise within the "source" jurisdiction. If the foreign enterprise performs no functions and assumes no risks itself in the local jurisdiction, then the only activities to look to are those performed by other parties, whether a local affiliate, independent agent or dependent agent. Creating a PE from these activities and attributing profit to it would result in double taxation. This double taxation would be especially pernicious because it would be a case of the same country taxing the same income twice. This proliferation of PEs would have a significant negative impact on companies, and USCIB expects companies would respond by making fundamental changes in their business models. A number of examples of these types of changes are set out in the BIAC comment letter.[4] USCIB members agree that companies might adopt these and other new business models in response to the proposed rules. Additional examples would likely be identified with more time to consider the impact of these proposed changes.

The rules proposed in the discussion draft would create significant uncertainty. Recently, particularly in Western Europe, authorities have been asserting criminal liability (including at the individual non-resident director level) for failure to file tax returns when the tax authorities asserted a PE existed. Individuals should not be at risk of criminal penalties when the rules are subjective and/or uncertain.

The discussion draft dismisses[5] as insubstantial the issues relating to attributing profits to these new PEs. To the contrary, we believe profit attribution is the most significant issue in a PE controversy. Countries want to create more PEs because they want to attribute profits to them to raise tax revenue. To the extent that a PE is "virtual" or essentially "virtual" because functions, assets and risks of that PE are minimal, no significant profits should be attributed to that PE. Countries may, however, attempt to use these marginal PEs to attribute significant

[3] USCIB strongly opposes the UK's recent diverted profits tax proposal. Taxpayers should be able to take tax laws into account when adopting their structures and should not be penalized for taking steps to avoid PE status.
[4] USCIB believes that the response of business to these proposed changes is a prime example of why the corporate income tax is inefficient.
[5] Whilst the preliminary work has identified a few areas were (sic) additions/clarifications would be useful, it has not identified substantial changes that would need to be made to the existing rules and guidance concerning the attribution of profits to a permanent establishment if the proposals included in this note were adopted. Paragraph 45 of the discussion draft.

profits based on the value of the market or other attribution theory. The discussion draft notes that "these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income."[6] Broad PE rules, combined with a lack of clear guidance on profit attribution, may encourage some countries to assert that the international standards have been fundamentally changed. Other countries may not share this view and the lack of clarity may cause companies to be caught in the middle with profits attributed to both jurisdictions resulting in double taxation. The final guidance should clearly state that this is not intended to be the case.

There are many function-specific profit attribution questions. For example, some assert that warehouses generate significant profits, even though warehousing and delivery functions are routinely outsourced and third party comparables demonstrating low profit margins may be readily available. It is not difficult to imagine disputes on the value of this function. USCIB expects that the value of raw data to be controversial. We elaborate on this below.

The discussion draft does not address the potential interaction of these rules with the limited force of attraction principle that is part of the UN Model. These proposed rules are intended to only affect the OECD Model. However, if these changes are implemented through the adoption of a multilateral instrument that would amend bilateral treaties that contain both OECD-based business profits articles and UN-based business profits articles, then it is necessary to consider the impact of the force of attraction principles on profit attribution. Significantly expanding the PE rules has the potential to significantly expand the application of the force of attraction rules.

The PE proposals also fail to recognize the bilateral nature of tax treaties. PE rules that restrict the ability of a "source" country to impose tax are particularly appropriate in the context of trade relationships in which the flow of foreign direct investment runs both ways. Each country will be both benefitted and burdened by rules restricting the creation of PEs. The proposed rules would create significant burdens with no significant net tax impact between the treaty partners. The proposals are, therefore, particularly inappropriate in the context of economies where FDI is reciprocal. After five years of rapid growth, Chinese annual FDI in the US now exceeds FDI by US companies into China by most measures — including China's own official statistics.[7] Countries may be willing to agree to a PE provision that permits more "source" country taxation in the context of a relationship where the FDI is more one way, or in exchange for other concessions by the "source" country in the bilateral relationship, but that should not

[6] Discussion draft, paragraph 3, page 10.

[7] **New Realities in the US-China Investment Relationship** by Daniel H. Rosen and Thilo Hanemann | April 29, 2014. http://rhg.com/notes/new-realities-in-the-us-china-investment-relationship. See also, U.S. - India Economic and Trade Relationship: Indian Investment in the U.S. http://www.whitehouse.gov/sites/default/files/rss_viewer/fact_sheet_indian_investment_us.pdf.

become the model.[8] Lowering the PE threshold will inevitably give rise to additional disputes both as to the existence of a PE and the profits attributable to it. Taxpayers, therefore, must have access to effective dispute resolution procedures. USCIB continues to believe that mandatory binding arbitration is necessary to improve currently ineffective dispute resolution. If dispute resolution continues to be ineffective, maintaining a higher PE threshold is essential because ineffective dispute resolution will lead to increased unresolved double taxation. In determining the costs of these proposals, the OECD should consider the impact of disputes and dispute resolution. These costs may be significant and business will seek to avoid them. These high costs will all have a negative impact on cross-border trade.

A. Artificial avoidance of PE status through *commissionnaire* arrangements and similar strategies

The current text of Article 5(5) of the OECD Model has led to many controversies regarding the proper interpretation of the clause "has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise".

In recent years, litigation over application of this clause to enterprises operating under a *commissionnaire* commercial relationship has reached the highest courts of France, Italy and Norway.[9] Each of the three cases involved an Article 5(5) that was essentially the same as Article 5(5) of the OECD Model.[10] In all three cases, the highest court of the jurisdiction concluded that no deemed PE could exist since as a matter of law the *commissionnaire* does not enter into contracts in the name of its principal.[11]

USCIB understands that the purpose of the changes proposed in the Action 7 discussion draft is, in contrast to these decisions, generally to treat *commissionnaire* and similar arrangements as

[8] To the extent that countries might agree to a more expansive PE rule in a bilateral agreement based on the one-way nature of FDI or in exchange for other concessions such as reduced rates of withholding, addressing the PE rules in the MLI will be extremely difficult because taking these bilateral aspects into account will be difficult and countries may be unwilling to make multilateral concessions that would take away their ability to bargain on other issues such as withholding taxes.

[9] CE 31 mars 2010 n°304715 et 308525, 10° et 9° s.-s., Sté Zimmer Ltd.; *Boston Scientific*, Italian Supreme Court, Tax Section, n. 3769 of Mar. 9, 2012; Borgarting Lagmannsrett, dated 2 March 2011, *Dell Products vs. Skatt Øst*, ref 10-032855ASD-BORG/03.

[10] As relevant to *Boston Scientific*, the Italy-Netherlands Tax Treaty contains the dependent agent PE test in Article 5(4). It states, "A person acting in one of the States on behalf of an enterprise of the other State--other than an agent of an independent status to whom paragraph 5 applies--is deemed to be a 'permanent establishment' in the first State if it has in this State, and habitually exercises, an authority to conclude contracts in the name of the enterprise, unless the activity of said person is limited to the purchase of goods and merchandise for the enterprise."

[11] In *Boston Scientific*, the Regional Tax Court (lower court) concluded that the commissionnaire entered into contracts in its own name and therefore did not exercise "an authority to conclude contracts in the name of [the principal]". The Supreme Court did not decide the case on the merits, but instead, rejected the tax authorities' appeal on procedural grounds.

creating a taxable nexus for the nonresident enterprise in the jurisdiction in which the commissionnaire performs its activities.

1. Need to clarify policy grounds for the proposed changes

As a threshold matter, USCIB believes that the Focus Group should clearly state the policy goals the proposals are intended to achieve. A clear statement of the policy goals is a necessary prerequisite to evaluating the policy and assessing whether any particular proposal will serve that goal.

a. Policy to prevent artificial avoidance of PE status

The Action 7 text states that the policy goal of Action 7 is to prevent the "artificial" avoidance of PE status. If this indeed is the policy goal, then USCIB believes that the proposals should focus on structures which have no business substance or are abusive.

If combating abuse is the policy goal, we respectfully object to the assumption in the Discussion draftthat the decision by a corporate group to regulate the commercial activities of a sales solicitation and marketing entity through a *commissionnaire* contract constitutes an "artificial avoidance of PE status". A corporate group may choose among several commercial relationships to govern the activity of sales solicitation and/or marketing personnel located in a market jurisdiction, including reseller, agent with power of representation, agent without power of representation, and (in some countries) *commissionnaire*. [12] As long as the parties' actions are consistent with the commercial and legal relationships, simply making a choice of one commercial relationship over the other cannot be regarded as abusive.

b. Policy to prevent income shifting

USCIB believes that the main policy goal motivating the focus on *commissionnaire* commercial relationships is based on the assertion that such arrangements erode the taxable base of market jurisdictions. The Executive Summary states as follows: "[i]t is clear that in many cases *commissionnaire* structures and similar arrangements were put in place primarily in order to erode the taxable base of the State where sales took place." This is a transfer pricing matter, and should not be used to justify creating a PE based on a *commissionnaire* relationship. If the essential issue is a transfer pricing matter, then the focus of this portion of the Action 7 work

[12] For example, the German Civil Code and Commercial Code (Buergerliches Gesetzbuch, BGB, Handelsgesetzbuch, RGBl. 1897 S. 219) have differentiated between buy-sell distributors (Wiederverkaeufer), commissioned agents (Handelsvertreter), brokers (Handelsmakler) and commissionnaires (Kommissionaere) since these laws came into effect in the year 1900. Each of these forms of distribution relationship allocate risks, responsibilities and opportunities differently between the two parties (see, for example, www.wirtschaftslexikon24.com/d/kommission%C3%A4r/kommission%C3%A4r.htm**).**

should be on the transfer pricing aspects of business restructurings and the compensation of sales entities operating under *commissionnaire* contracts.

The mere choice by a group to use *commissionnaire* contracts to govern the activities of its sales solicitation and marketing entities does not constitute either an "artificial" avoidance of PE or a potential abuse of the transfer pricing rules. In the case of a newly established entity, for example, where there has been no business restructuring, the choice to use a *commissionnaire* contract cannot be considered an abusive transaction of any kind. Groups are entitled to decide the levels of investment in functions and infrastructure for any particular jurisdiction and the profit allocation should follow from those decisions.

2. <u>Clearly define commercial transactions to be addressed through a change in the PE rules</u>

In the event that the final report under Action 7 will include proposed changes to Art. 5(5), USCIB believes that it will be essential to provide a more precise statement of the commercial structures which the Focus Group believes should constitute a deemed PE under a revised Article 5(5). The Action Plan itself refers only to the use of "*commissionnaire* arrangements and the specific activity exemptions." The policy statement in the Executive Summary of the Discussion Draft, however, seems to describe sales solicitation activities of a considerably wider scope than merely those conducted by entities operating under *commissionnaire* arrangements. It states as follows:

"As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business."

If the policy goal is to cover only *commissionnaire* arrangements, then the final draft should state that clearly. If the policy goal is to cause sales solicitation activities of a wider scope than those conducted under *commissionnaire* arrangements to create deemed PEs of the nonresident supplier, USCIB suggests that greater precision as to what commercial arrangements are covered is necessary. USCIB believes that the expansion in the scope of the PE rules should be limited to abusive activities.

a. Distributorship/reseller arrangements to be excluded

USCIB understands that the Focus Group intended that in no case could a deemed PE be created by the activities of an enterprise acting as a distributor / reseller of goods or services in its own name, but not acting pursuant to a *commissionnaire* arrangement. This should be clarified, as the language in certain of the options is sufficiently ambiguous that absent clarification, tax administrations perhaps not aware of the intended scope of these new provisions could assert that such distribution arrangements are also covered by the new language.

Each of the options includes the clause that Article 5(5) applies to persons who act "on behalf of" an enterprise. Distributors / resellers act on their own behalf, and not on behalf of another. Accordingly, it should be made clear that distributors / resellers are outside the scope of any of the options.

The final report should be clear that distributor / reseller arrangements are excluded, even if the commercial terms between the supplier and the distributor / reseller allocate certain commercial risks to the supplier. Such arrangements exist between unrelated parties and do not create a taxable presence for the supplier in the jurisdiction of the distributor. The PE rules should not create unnecessary distinctions between the treatment of related and unrelated party transactions, such distinctions would violate the arm's length principle and will create perverse incentives to structure business using unrelated parties. An example would be inventory consignment arrangements, where the risk of damage to inventory or unsold inventory is retained by the supplier.

This confirmation is of paramount importance, as otherwise significant uncertainty (especially in light of the absence of effective dispute resolution mechanisms) will be introduced into the tax treatment of cross-border distribution arrangements which uncertainty does not exist today.

b. Definition of *commissionnaire* arrangements

If the Focus Group wishes to modify Article 5(5) of the MTC so as to cause a sales solicitation and/or marketing entity operating under a *commissionnaire* contract to create a deemed PE of its principal, USCIB suggests that a better means to achieve that goal is to use a much more precise definition of the targeted activity. The *commissionnaire* commercial relationship is a well-known element of the commercial law, so precise references to that relationship will be easily understood by taxpayers and tax administrators. Each of the four proposed options has the possibility of causing extensive unintended effects for distributor and reseller arrangements. If the policy goal is to describe only *commissionnaire* commercial relationships, we believe that such arrangements should be defined with precision. Since *commissionnaire* relationships exist only in certain countries, any proposed changes should address those specific arrangements only.

As a preliminary matter, it is useful to refer to the civil law basis of the commercial relationship of *commissionnaire*. Articles L132-1 to L132-9 of the French Code of Commerce are representative of the enabling statute defining the commercial nature of a *commissionnaire* contract. Article L 132-1 defines the *commissionnaire* relationship as follows: "A commissionnaire is a person who acts in its own name or under a corporate name on behalf of a principal" ("Le commissionnaire est celui qui agit en son propre nom ou sous un nom social pour le compte d'un commettant."). While the laws of various civil law jurisdictions show some variations in this expression, the general terms of the commercial mandate are the same in the civil codes of most countries which authorize this commercial relationship.

A *commissionnaire* commercial relationship exists only in the form as created and governed by the applicable commercial code. Therefore, the most precise approach to achieve the policy goal expressed in the Discussion draftis to define the arrangements subject to Article 5(5) by means of an explicit cross-reference to the applicable statutes. Since the terms of most *commissionnaire* statutes are fairly uniform and the *commissionnaire* commercial relationship is distinct under the law from distributorship, agency, trustee, or other commercial relationships, the operative language of an amended Article 5(5) could simply refer to persons which act on behalf of another under the authority of a "*commissionnaire*" statute. To remove any doubt as to what relationships are covered, the Commentary could include references to the applicable statutory provisions of those jurisdictions which authorize *commissionnaire* relationships and which agree that such relationship should create a deemed PE of the nonresident principal.

3. <u>Comparison of options</u>

If, instead, the Focus Group chooses to define a broader scope of activities as within the scope of Article 5(5), USCIB believes that substantial refinements to Options A - D are needed to avoid unintended consequences.

The four options have been created through the combination of two sets of alternative changes to the text of Article 5(5). The first set of alternatives describes the actions which, if taken by the dependent person, could give rise to a PE of the nonresident enterprise, as follows:

- "…habitually engages with specific persons in a way that results in the conclusion of contracts…"; or

- "…habitually concludes contracts, or negotiates the material elements of contracts…".

The second pair of alternatives describes the commercial attributes of the contracts which are concluded as a result of the dependent person's activities, as follows:

- "…contracts, that are *a*) in the name of the enterprise, or *b*) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or *c*) for the provision of services by that enterprise…"; or

- "contracts which, by virtue of the legal relationship between that person and the enterprise, are on the account and risk of the enterprise…"

Of the first pair, USCIB considers the expression "habitually engages with specific persons in a way that results in the conclusion of contracts" to be exceedingly ambiguous and overbroad which will increase uncertainty and disputes. Again, the absence of effective dispute resolution should mean that language this unclear should not be adopted.

One could argue that almost every activity a marketing entity performs is intended to help the principal sell products but these activities should not create a PE. The current rule that creates a PE upon the exercise of the authority to conclude a contract in the name of the nonresident enterprise is simple and, for the most part, clear in practice. Personnel in a market jurisdiction may perform a wide variety of activities towards a potential customer base in the jurisdiction, including any or all of the following: market development; demand generation; education; marketing; sales solicitation; negotiation; returns; training; service; repair; and support. The "habitual engagement" term provides no guidance as to which, if any, of these activities are meant to be covered. If this option were to be adopted, it would be essential to provide clarity to taxpayers and tax administrations as to the type of commercial activities that are intended to be covered. Because of the broad scope and ambiguity of this option, it should be rejected. If the OECD were to adopt this proposal, then it would be necessary to define and significantly narrow the covered activities.

Of the second pair, the first expression which refers to contracts for the transfer of ownership of / right to use property or the provision of services by the nonresident enterprise is more precise than the alternative. This option, however, could be read to cover any sale to a distributor because the local distributor has to buy from the principal before it can complete a sales transaction. If distributors are not intended to be covered (we believe they are not and should not be covered) then this provision needs to be clarified. There are many commercial relationships commonly entered into between suppliers and distribution intermediaries which either prescribe or allow for the allocation of commercial risks to the supplier. For example, an agency relationship normally would allocate to the supplier as a matter of law all inventory risks, as the agent does not take title to inventory. In contrast, in a distributor relationship, the parties generally would be free to allocate various commercial risks between them as they see fit, such as through price protection clauses, rights of return of unsold inventory, warranty claim indemnification, and the like, all of which serve to allocate by contract commercial risks arising in the distribution chain between the supplier and distribution intermediary. A rule which refers to the allocation of commercial risk between the supplier and the distribution intermediary is highly ambiguous. Substantial further clarification would be needed for this second alternative to provide useful guidance to taxpayers and tax administrations, particularly in light of the lack of effective dispute resolution.

Of the four proposals, Option B provides more clarity than the other three but needs significant further clarification to make it practical for business and tax administrators to apply.

4. Suggestions for clarification of scope of Option B

If Option B were implemented, Article 5(5) would read as follows:

Notwithstanding the provisions of paragraphs 1 and 2, *but subject to the provisions of paragraph 6,* where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting *in a Contracting State* on behalf of an enterprise and*, in doing so*, has, and habitually exercises, in a Contracting State an authority to conclude*s* contracts*, or negotiates the material elements of contracts, that are:*

a) in the name of the enterprise, *or*

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that enterprise,

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 provisions of that paragraph.

The proposed inclusion of the clause "or negotiates the material elements of contracts" means that this proposal extends considerably beyond the case of *commissionnaires*, and includes activities involving negotiation of terms which currently do not cause a deemed PE of the nonresident enterprise.[13] Accordingly, USCIB requests that the Focus Group clarify this clause by reference to actual business models. We provide the following suggestions:

- Material elements. Guidance will be necessary as to what elements of contracts are to be regarded as "material". Depending on the type of transaction, a business may

[13] Para. 33 of Article 5 Commentary states as follows: "The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise."

consider a wide variety of contractual provisions to be material, in other cases those same elements may not be considered material. This will make the test very subjective and tax administrations may assert that an element is a material element, when the business believes it is not. In some cases, different persons in an organization will be responsible for negotiating different material terms (for example the sales organization may have responsibility for pricing while the legal group would have responsibility for indemnities), so guidance will be necessary as to which set of negotiations is the determinative one for PE purposes.

- Marketing or sales solicitation. It should be clarified that all marketing, sales solicitation, demand generation, and other customer-facing activities that do not involve the actual negotiation of terms of sale are not described by this text.

- Rate cards. It is common for enterprises to authorize local representatives to communicate prices to potential customers through rate cards, which may include pre-agreed discount ranges. The local personnel normally will have no authority to deviate from the ranges prescribed on the rate card. This should not be regarded as "negotiation", due to the absence of authority of the local personnel to deviate from agreed terms. Business policies which require escalations for approval of deviations by management personnel located outside of the market jurisdiction should be sufficient to establish that no PE would arise in the market state if behavior is consistent with the policy.

- Standard contracts. Many enterprises sell their goods and services through standard contracts, including online contracts. Since the terms of those contracts are not negotiated, it should be confirmed that Option B cannot apply to any sales made pursuant to standard contracts.

5. <u>Confirmation that any new rules can be applied prospectively only</u>

Any of these Options would represent a clear and substantial expansion of the OECD Model grant of authority to market jurisdictions to impose tax on sales made by nonresident enterprises. USCIB suggests that if these proposals go forward, the final report should clearly state that the purpose of the amendment is to change the existing international standards on the allocation of taxing rights on cross-border income. This is important in order to ensure that tax administrations cannot argue that these proposed changes are merely clarifications of existing treaty provisions.

The final report should expressly state that the new rules apply only to taxable periods beginning after a grace period following the effective date of the treaty amendments which incorporate the new rules. This will allow groups to restructure the commercial relationships among group members as necessary to conform to the new standards. Since such restructuring will in many cases require significant time and cost to reconfigure financial systems and implement other associated changes to business processes, it will be essential to provide a transition period of sufficient duration to allow enterprises to implement the necessary changes.

6. <u>Strengthen the requirements of "independence"</u>

In all four Options, the following amendment is proposed for Article 5(6):

6. ***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 acting on behalf of various persons 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 enterprise or associated enterprises, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to these enterprises.*** An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

USCIB does not believe that exclusivity should create dependent agent status. The principle of exclusivity seems to be directed at the ability of one party to control the other party because of bargaining power of the parties. If the agent is willing to engage on the agreed upon terms, it is not clear why this should not be considered arm's length and if it is arm's length then creating a PE will create double taxation from the additional profit attribution to the PE.

USCIB also does not believe that the OECD Model should accord different direct tax consequences to an enterprise simply because the agent is related to its customer. This proposal is a major erosion of the long-standing standard of respecting the separateness of entities and is in tension with Article 5(7) of the OECD Model which states that the fact that parties are related does not in itself constitute one a PE of the other.

If the final draft nevertheless contains this proposal, USCIB recommends that this restriction be limited to related persons.[14] It is very common, especially for small and medium sized enterprises, to engage independent marketing representatives to promote the enterprise's goods in a jurisdiction. These arrangements are particularly common when a growing business is first seeking to expand sales into a new market.

Under those circumstances, there can be no BEPS concern, as the independent agent will always be compensated at arm's length. Since the agent has been fairly paid, using any of the

[14] Affiliation though 50+% direct or indirect stock ownership could be an appropriate test.

activities of the agent to attribute profit of the foreign enterprise to the local country creates double taxation of the income from those local activities. It may be difficult for the enterprise to know if its independent agent is acting "almost exclusively" for it. Since this business model is used especially by smaller enterprises, this would impose a compliance obligation where it is least appropriate.

7. Compliance and administrative costs

As mentioned above, the cost of implementing structures and annual compliance for each PE can be significant. The BIAC annex contains examples of the costs that will be incurred. If the real problem is transfer pricing, then creating more PEs does not solve that issue, it simply creates another transfer pricing issue for the PE. As pointed out in multiple points in this comment letter, creating PEs that have little or no functions, assets or risks will only create more difficulties with respect to transfer pricing, with little profit attribution to be gained under current OECD guidelines. That problem is most evident in the context of commissionnaires where the PE is created entirely by the activities of another entity. Thus, if the commissionnaire is properly compensated for its activities, it is difficult to see what additional profit ought to be attributed to the new PE.

B. Artificial avoidance of PE status through the specific activity exemptions

The purpose of the specific activities exemption is to provide relief from filing and tax payment obligations for activities that are generally preparatory or auxiliary and also do not contribute significantly to the profits of an enterprise. Filing and payment obligations can create significant costs for a non-resident enterprise and will discourage investment in smaller and emerging markets. In revising these exceptions the OECD and member countries should keep these fundamental principles and their consequences in mind.[15]

1. The exceptions are not restricted to preparatory or auxiliary activities

Option E would not delete any of the activities from the list, but would make all of the activities subject to the condition that the activity is preparatory or auxiliary in nature to the business of that enterprise. USCIB does not support this option because it would create uncertainty with respect to every item on the list, would lead to a proliferation of PEs and a proliferation of disputes concerning whether a PE exists. Certainty of outcome is an important principle for business and subjecting all the items on the list to a subjective test would increase uncertainty. If this approach were to be adopted it would be essential to articulate a standard for consistently determining whether an activity is preparatory or auxiliary and to include many

[15] If it costs 1 million dollars to set up the accounting systems to generate data specific to each PE and 250,000 dollars to comply annually, a company will not make that investment for an activity that is only expected to generate minimal profit. It will find another way to accomplish that function.

examples. There is no evidence in the discussion draftthat such a standard has been considered or could be developed within the time available for the BEPS project. It would be inappropriate to adopt this option without further guidance especially in light of the current ineffective dispute resolution procedures

As discussed in detail below, USCIB believes that delivery, purchasing and data collection can be preparatory or auxiliary. If, however, countries do not accept that outcome (e.g., they believe delivery can never be preparatory or auxiliary) then adopting this option will mislead taxpayers (and other countries). Examples would be particularly important in these cases, because considering the deletion of some items will raise greater concerns about the scope of the exceptions.

Adopting one (or more) of the other options would preserve clarity for those items that remain on the list and would still permit taxpayers to make a case under existing subparagraph 4) e) that, for example, delivery could be preparatory or auxiliary.

USCIB generally believes a more targeted approach is better than introducing subjectivity into all of the specific activity exemptions. We offer comments on the more targeted approaches below.

2. <u>The word "delivery" in subparagraphs a) and b) of paragraph 4</u>

Option F would delete delivery from subparagraphs a) and b) of paragraph 4 of Article 5.[16] This option would be more appropriate if countries believe either that maintaining a fixed place of business through which delivery activities are conducted cannot be preparatory or auxiliary or would in most cases constitute a PE[17]. If this option is adopted, then it is important to be clear about a number of points. First, a shipper of goods using an unrelated shipping company (e.g., a common carrier) to deliver goods would not create a PE on behalf of the shipper because the unrelated shipping company's warehouse would not be a place of business of the unrelated shipper.[18] Further, these unrelated parties have been appropriately compensated, and using their activities to attribute profit from the foreign enterprise to a PE in the local country would create double taxation of those activities.

[16] Since the current UN Model does not cover delivery, it would be useful to know whether those countries that follow the UN Model have seen much scope for the application of the "storage" or "display" parts of that exception. It would also be useful to know whether they have seen companies attempting to fragment "storage" or "display" from delivery.

[17] To the extent that there is scope for delivery to be considered preparatory or auxiliary under the provision relating to other activities of a preparatory or auxiliary character, the OECD should consider examples of when delivery could continue to be considered preparatory or auxiliary.

[18] This is another example where the proposed rules may create perverse incentives to restructure operations using unrelated parties to avoid PE status.

Second, on determining profit attributable to a warehouse that would be a PE under the proposed rules the OECD should make clear that the only profits that are attributable to the PE are those attributable to activities actually performed in the country where the warehouse is located, that is the warehousing activities.[19] 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. That is, 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 actually sells the product, not the entity performing the warehouse and the delivery function.

Third, countries should recognize that these new PEs ought to share in the expenses of the enterprise. For example, warehouses should bear a share of management costs and a share of interest expense among others.

Fourth, an enterprise that maintains a centralized warehouse in one country for delivery of goods to customers located in multiple countries will only have a PE in the country in which the warehouse in maintained. This reinforces the second point above, since the profit of that warehouse ought to include a service fee for the deliveries to other countries but certainly not the profit from sales within those countries.

USCIB is especially concerned that the focus of countries in examining the delivery exception has been on marketing to ultimate consumers and that not enough thought has been given to the exception in the context of business-to-business transactions where BEPS concerns would be significantly less. For example, it might continue to be the case that maintaining a warehouse for the ultimate delivery of heavy equipment should be preparatory or auxiliary to the manufacture and sale of such equipment. In the oil and gas industry storage and distribution raises special issues that are described in detail in BIAC's appendix. These issues ought to be explicitly considered before substantial changes are adopted. If, after such consideration, it is concluded that these business-to-business transactions do not raise BEPS concerns, the OECD should include examples in the Commentary that make it clear that the delivery exception remains available under Article 5 (4) (e) in these cases. Since the UN Model does not contain an explicit exception for delivery, the OECD ought to consider what impact the absence of this exception has had on those jurisdictions which have adopted the UN Model on this point and on the businesses doing business in those jurisdictions.

3. <u>The exception for purchasing goods or merchandise or collecting information</u>

[19] For transfer pricing purposes, the PE created by a warehouse should be able to be the tested party and profitability should be computed using available comparables.

Option G would eliminate the preparatory or auxiliary exception for purchasing goods. USCIB believes that the exception for purchasing should be retained. Narrower solutions are available for cases that are considered problematic. In most cases the mere purchase of goods is too attenuated from earning profit to justify the creation of a PE. The PE rules are attempting to find the amount of activity that strikes an appropriate balance between requiring an enterprise that is not resident in a contracting state to comply with the tax and reporting burdens imposed by that state, and the revenue implications for the taxing jurisdiction of foregoing that tax. No business can function without purchasing goods, whether for internal consumption or processing and ultimate resale. The issue is not whether a purchasing function does or does not contribute to profit or loss; it clearly will. The issue is whether that contribution is sufficient to justify the creation of a PE? USCIB believes it is not.

Generally the tax and compliance burdens to business from a purchasing PE arising from such modest business activity will outweigh the tax benefit to governments. As pointed out above, the costs of setting up the structure to collect data to implement PE reporting can be millions of dollars. The profit attributable to the purchasing of goods should be minimal, the cost of implementing the PE structure could eliminate all of this profit, resulting in no benefit for the taxing jurisdiction to justify the time and expense of finding a PE, attributing profit to the PE, and auditing the result. Business is concerned that some countries will use purchasing PEs to attempt to attribute a significant portion of the profits earned by the combined business to the country of purchase. Given that possibility, businesses will restructure their purchasing functions to minimize PE risk. Purchasing will become even more centralized than it already is; local purchasing offices will be closed. Countries should also consider this burden in light of the reciprocal nature of these rules. That is, if purchasing is ordinarily an activity that generates little profit, the balance between administrative burden on taxpayers and versus revenue concerns of the countries, should be resolved in favor of minimizing the burden on taxpayers. In cases of reciprocal trade, goods are purchased in all countries, so exempting purchases burdens all countries and will benefit cross border trade in all countries.

If countries wish to create PEs from purchasing then they also need to accept that purchasing can contribute to losses. Sometimes this contribution may be direct. One company overpays for its inputs and therefore cannot sell its products at competitive prices and suffers losses. Another company misjudges the demand for a particular product and purchases too much and realizes a loss on its excess or spoiled product. Are countries willing to accept at least some portion of these losses? If not, they should not demand an additional share of the profits in cases in which the global value chain is profitable.

Turning to the three examples, the first example seems to ignore the recent work on transfer pricing. The benefit of group synergies, particularly in case of bulk purchasing power should benefit enterprises that make the bulk purchasing possible. It is not clear from the example what happens to the purchased goods, but if enterprises in multiple countries use the goods in their business, then the profit from that bulk purchase would in the most part be attributed to those enterprises and the purchaser would only be left with a commission for its services. The enterprises using the purchased goods might be in country S, country T or elsewhere.

The examples also seem to ignore the fact that these examples are arising in the context of a bilateral treaty relationship. That is, the "source" country is giving up its right to tax based on negotiations that are allocating taxing jurisdiction to the other state. As part of the bilateral negotiations the countries should be determining whether the other state will impose tax.[20] Residence countries frequently condition exemptions for business profits on the existence of a PE in the source jurisdiction[21]. So, this sort of interaction between the "source" and residence country raises the issue of conflicts of qualification. Business does not object to rules that resolve the issue of conflicts of qualification by only applying the territorial or exemption system in cases in which the "source" state imposes tax. This would be a narrower and more appropriate solution to address any unintended double non-taxation arising in the first example.[22] Eliminating double non-taxation through the proper resolution of conflict of qualification would – consistent with the current norms – eliminate double non-taxation by ensuring that the country of residence imposes tax. This narrower solution is therefore consistent with the Action Plan and the discussion draftwhich state "these actions are not directly aimed at changing the international standards on allocation of taxing rights on cross-border income."[23]

In recent UN discussions, however, some delegates objected to rules implementing this result, despite the fact that a rule resolving conflicts of qualification would only limit unintended double non-taxation and would not limit the ability of a country to adopt tax incentive legislation. The only reason to object to the principles set forth on conflicts of qualification would be that such principles are inconsistent with more "source" taxation (even if it is not exercised). Because BEPS is not intended to rebalance "source" and residence taxation, that objection ought not to be given any weight in this debate. Another narrower solution to the problem posed by the first example would be to adopt appropriate CFC rules dealing with foreign base company sales transactions, of which this a classic example; again this would preserve the current allocation of taxing rights between "source" and residence states.

[20] This is one of the difficulties inherent in the MLI approach. Income tax treaties should reflect the bilateral relationship between the countries negotiating the agreement and the MLI will complicate this.
[21] This issue does not of course come up in those countries (including the US) which eliminate double taxation through a credit mechanism. Thus, this example is irrelevant for those treaties in which the US is the residence country.
[22] See the OECD commentary on Article 23 A and 23 B paragraphs 32.1 et seq.
[23] Action Plan page 11 and discussion draftpara. 3 page 10.

In the second example, it is not clear why SCO is not also considered to be selling in State S. A more appropriate solution might be to make clear that SCO is both purchasing and selling, that is the buyers are also conducting selling activity in State S, so that the PE is not merely purchasing goods but also considered by the authors to be substantially participating in the sale of those goods.

USCIB agrees with the conclusion of the third example.

We also note that the UN Model treaty includes a specific exemption for purchasing activities.

In most cases, purchasing will make only a minor contribution to the overall profitably of the enterprise. The amount of tax due on these minor contributions will not justify the cost of establishing the structure necessary to create the financial information necessary to comply with PE rules and the annual compliance costs, and may, therefore, cause companies to close purchasing offices. Any abuse cases have simpler solutions. Therefore the exception for purchasing should be retained.

Option H would delete subparagraph d) of paragraph 4 of Article 5. The proposal would delete both the exception for purchasing and the exception for collecting information. The only justification offered for deletion of the collecting information exception is that "concerns have been expressed, however, that some enterprises attempt to extend the scope of that exception, e.g. by disguising what is in reality the collection of information for other enterprises by repackaging the information collected into reports prepared for those enterprises."[24] This justification strikes USCIB as particularly weak. Before considering adopting changes that would have a significant impact on taxpayers, the OECD should at a minimum first confirm that the concerns are well-founded.

Valuing raw data will be both difficult and controversial. As USCIB pointed out in our comments on the discussion draft on the Digital Economy:

> The discussion draft provides that data gathered from various sources is a primary input into the process of value creation in the digital economy. (Para. 183) A key challenge is the attribution of value to this data and the extent of value relative to other sources of value – systems, software and people. It may be challenging to assign an objective value to raw data (Para. 183) and determine the ownership of that data. Personal data is generally considered to be owned by the individual to whom it relates, rather than by a company. (Para. 183)

[24] Discussion draftparagraph 28.

USCIB believes that raw data has little or no intrinsic value, especially generally available raw materials such as usage data. Value is created by the aggregation of data and the application of analytics, which is achieved through investment in people and technological resources.[25]

The amount of raw data is exploding, particularly in connection with the internet of things. If countries take significantly different views on value of data that is collected, then the likely outcome is increased disputes and double taxation.

The "repackaging" of information is the value-adding activity. Repackaging information can mean sifting through enormous quantities of data to identify the important, relevant data. As noted above, USCIB believes that raw data has little or no intrinsic value, especially generally available usage data. Value is created by the aggregation of data and the application of analytics, which is achieved through investment in people and technological resources. The profits created by these activities should be taxed in the jurisdiction in which these activities occur.

We also note that the UN Model includes an exemption for information collection activities.

USCIB believes that the exception for collecting information should be retained.

4. <u>Fragmentation of activities between related parties</u>

Options I and J would address fragmentation of activities among associated enterprises, rather than among separate parts of the same enterprise. Most of our objections to these rules apply to both options, since the objections relate to the basic application of the anti-fragmentation rule. Both options would significantly undercut the concept of separate entity reporting. They would also create vastly different results for enterprises dealing with related vs. unrelated parties, undercutting the arm's length standard, which the Action Plan continues to support. As discussed above in the general comments section of this letter, this would cause companies to reconfigure their operations in ways that might be inefficient and therefore harmful to global trade and investment.

The proposed rule seems to be limited to activities that would otherwise be within the scope of Article 5 paragraph 4 and does not seem to cover other activities that would not create a PE. If, for example, an MNE owns an affiliate that operates a contract manufacturing facility in country A and another affiliate maintains a stock of goods at that manufacturing facility solely for the purpose of processing by that the first affiliate, it would seem under the proposed rules that the second enterprise would now have a PE in country A. If, however, the two entities were

[25] USCIB comment letter on OECD's Discussion drafton the Digital Economy, page 24.

unrelated, no PE would exist. If the contract manufacturer is a low-value activity, this will discourage the MNE from maintaining ownership of that affiliate. The only activity that the second affiliate is engaging in is “maintaining a stock of goods for purposes of processing by another enterprise.” How much gross income should be attributable to that PE? What are the functions, assets and risks that will be analyzed in determining the amount of that profit?

Assuming that the purchasing exception is retained, if a State R enterprise purchases goods through a local purchasing office in State S on behalf of many of the associated enterprises in the affiliated group and any of the goods purchased by the State R enterprise were used by an affiliated enterprise with a PE in State S, State R would have a PE in State S. What profit would be attributed to that PE? Only profit attributable to the goods used in State S? Any profit of the State R enterprises on products purchased in State S? How would the UN force of attraction principle apply? USCIB believes that the proper answer to these questions is that no PE should be created because the tax gained by the local jurisdiction would not justify the burden created.

As another example, if an MNE purchases the output of a manufacturing affiliate, and does not maintain a stock of goods (the affiliate owns its own inventory), but the MNE sends an employee to the manufacturing facility to inspect and perform quality control functions, is the anti-fragmentation rule applicable? As we read the proposed rule, it should not apply because there is no fixed place of business that is maintained solely for the purpose of carrying on an activity of a preparatory or auxiliary character. That is, the MNE would not have a PE because it does not have a fixed place of business to begin with and therefore the exceptions of paragraph 4 cannot apply. If the proposed rule is intended to apply in such a case, then the rule would be unadministrable. Virtually any time an employee of one company visited the offices of another associated enterprise, it would at least create the possibility that a PE would be created.

Finally, USCIB would like to the OECD to consider the facts of the first example in the OECD’s recently released discussion draft on profit splits[26] in the context of PEs. According to the example, the three OEMS are highly-integrated with a complex web of transactions. If that “web of complex transactions” includes transactions that would violate the proposed anti-fragmentation rule would each of these companies also have a series of PEs in various jurisdictions with accompanying burdens? As we stated above in the general comments, the PE threshold should not be used to fix problems with the transfer pricing rules. If there is a transfer pricing problem in this case, then the appropriate place to fix that problem is under the transfer pricing rules, not by creating additional duplicative PEs that will result in administrative burdens and double taxation.

[26] Paragraph 11, page 4, OECD discussion drafton the use of profit-splits in the context of the global value chain.

C. Splitting-up of contracts

The discussion draft proposes two alternative approaches for dealing with the problem of splitting up of contracts to avoid the time thresholds of the "building site or construction or installation project" rule of Art. 5(3) and the alternative service PE provision included in paragraph 42.23 of the Art. 5 Commentary. Option K essentially adopts an "automatic" approach as suggested in paragraph 42.45 of the Art. 5 Commentary. Option L would address this issue through adding an Example in the Commentary to the principal purposes test as proposed in the report on Action 6.

Of the two, USCIB believes that the automatic approach in Option K is preferable, for several reasons.

As noted in USCIB's comments on Action 6, USCIB does not believe that the "one of the principal purposes" test is an appropriate approach to a limitation on benefits rule. Accordingly, USCIB believes that any approach based on the very subjective "one of the principal purposes" test is flawed. The principal purpose test is even more problematic given the weakness of the dispute resolution draft.

In contrast, the "automatic" approach of Option K is precise and administrable. It also reflects accepted OECD guidance, as shown by the fact that the proposal is based on existing paragraph 42.25 of the Art. 5 Commentary. We offer the following additional suggestions for clarification or enhancement of Option K.

The proposed text suggests that all enterprises whose personnel contribute to the aggregation of activities would be regarded as maintaining the building site or services PE. This will create unnecessary reporting complexities. The PE should be of only the main provider, not of all entities whose activities contribute to the aggregation of days of presence. An appropriate rule would be that the enterprise which has the greatest number of days of presence would be the enterprise which is regarded as maintaining the PE. There is no guidance on how this rule would operate in the context of services PEs. If any enterprise which “contributes” days to the total is deemed to have a PE, this rule would be unadministrable in the context of services. In order to implement such a rule, the enterprise which is the main contractor for the project would need to track not only its employees (which is of course reasonable), but also the employees of all associated enterprises (which is not).

The discussion draft acknowledges that in many cases, enterprises may send specialists to work on a project for only a few days, and that in many cases there is no BEPS motivation behind the commercial fact that a contract may require the participation of personnel employed by different related enterprises. For example, many groups organize their service operations through "centers of excellence", in which persons with certain areas of expertise are predominantly hired and trained by a single group enterprise. In the event that a project requires the deployment of one or more personnel from such an enterprise to support a contract principally being performed by another related enterprise, it is hard to see any circumstance where the use of such personnel could be regarded as having a BEPS purpose.

The two proposed exceptions are different in nature in that one operates mechanically, while the other operates with a subjective requirement. In this context, USCIB believes that it would be appropriate to include both in a revised Option K, on the basis that they address different circumstances.

We note that the subjective alternative includes the same reference to "one of the principal purposes" which we believe is inappropriate for the general limitation on benefits proposal under Article 6. In this case, however, the scope of undesirable uncertainty and capricious application is much more limited, as the subjective test will only come into play if the more objective thresholds of the main rule and the proposed 30 day exception have already been exceeded.

Finally, USCIB suggests that any further Action 7 draft clearly describe this rule as an anti-abuse rule which is a specific and limited departure from the foundational principle of the international tax law that the business activities of separate legal entities will be respected as such. This principle has been expressed in Art. 5(7) of the OECD Model for many years. The PE determination is an entity by entity determination. Under the OECD Model, an enterprise can have a PE based only on its own activities, or in certain precisely defined circumstances, those of its dependent agent. In no other area of the international tax law, as governed by the OECD Model, are activities of separate enterprises aggregated. One of the reasons for USCIB's preference for the "automatic" rule is that such a departure from basic international tax principles should be allowed only if expressly authorized by treaty language. We suggest that any Commentary to be issued under this provision reinforce this point.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)

Washington Office
1400 K Street, N.W., Suite 905
Washington, D.C. 20005
202.371.1316 tel
202.371.8249 fax
www.uscib.org

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