UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL
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Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 7 – Additional Guidance on the Attribution of Profits to Permanent Establishments ("Discussion Draft")

Dear Mr. VanderWolk,

USCIB is pleased to provide comments on the OECD's Discussion Draft on BEPS Action 7 – Additional Guidance on the Attribution of Profits to Permanent Establishments ("revised Discussion Draft" or "Discussion Draft"). USCIB would be pleased to present comments at the public consultation.

General Comments

In our prior comment letter (attached) on the 2016 Profit Attribution Discussion Draft, USCIB noted that the mandate under the Action 7 Final Report is to provide additional guidance on how the rules of the Authorized OECD Approach (AOA) apply to the new forms of permanent establishment (PE) created by the BEPS changes to Article 5 without making substantive modifications to those rules. The introduction to the Discussion Draft states that "the new Discussion Draft sets out high-level principles outlined in paragraph 1-21 and 36-42 for the attribution of profits to permanent establishments in the circumstances addressed by the Report on BEPS Action 7. Importantly, countries agree that these principles are relevant in attributing profits to permanent establishments."

In our view, the OECD has taken a significant step back from the AOA. The AOA is intended to apply the arm's length standard in the context of a head office and a permanent establishment. The high-level principles articulated in the Discussion Draft conflict with the AOA and therefore violate the mandate to provide additional guidance on the how the AOA applies to new forms of permanent establishment without making substantive modifications to those rules. Significantly, the consensus does not extend to the examples in the Discussion Draft, which illustrates the fundamental lack of agreement on how the high-level principles would apply in practice. The lack of clarity around how these rules apply will likely increase the risk of double taxation and increase complexity since countries may take very different approaches to determining how profit ought to be attributed to the PE.

USCIB believes that the Discussion Draft, having backed away from the primacy of the AOA, does not provide enough guidance to achieve the goal of maximum certainty, an objective identified as a goal in the new version of the Model, the Commentary and the AOA report.[1] The OECD Commentary on Article 7 acknowledges the considerable variation in interpretations of Article 7.[2] Most of our comments on the 2016 Discussion Draft asked for more clarity on how profits would be attributed to a permanent establishment. This Discussion Draft moves in the direction of providing less guidance and less certainty. Consensus on high-level principles without guidance on their detailed application will lead to inconsistent, and potentially overbroad, application of those high-level principles, which will produce more disputes and, in turn, discourage foreign direct investment. Guidance should therefore be precise in its scope—here, confined to the attribution of profits to permanent establishments arising from the BEPS modifications to Article 5(5)—and in the particulars of its application. USCIB is concerned that the inability to reach consensus on anything other than high-level principles may be, at least in part, a function of the Inclusive Framework and the need to reach agreement among 100 countries. This may be an ongoing problem that will impair the effectiveness of the OECD. The goal of working in multilateral fora is to bring countries together to find mutually agreed solutions, and while the OECD should certainly strive for consensus, if consensus can only be achieved at the very high level of generality reflected in the Discussion Draft, the resulting guidance may prove more harmful than helpful, reducing certainty rather than enhancing it. This needs to be addressed before the operation of the Inclusive Framework is entrenched and there is no possibility of change. USCIB would be pleased to work with the OECD to address these concerns.

It is not clear to us what this guidance is. The mandate calls for additional guidance on the operation of the AOA to new forms of permanent establishments that does not make modifications to those rules. Thus, it would seem that the Discussion Draft could be an additional report that would supplement the existing guidance on the AOA. If that is the case that should be made clear. If that is the intention, then the OECD should amend the Commentary to reference this supplement. The OECD will also need to take the appropriate steps (Council Recommendation to adopt such supplemental guidance).

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[1] 2014 OECD Model Tax Convention, Article 7 Commentary, paragraph 7. This provision (and paragraphs 4 and 5 mentioned below) are unchanged in the draft 2017 Model Tax Convention.
[2] IBID, paragraphs 4 and 5.

USCIB is uncertain why the OECD has stepped away from the language of the AOA, particularly with respect to the examples which are explicitly governed by the 2010 version of the AOA; therefore, language appropriate to applying the AOA should be used. The first step in applying both the 2008 and 2010 versions of the AOA is hypothesizing the PE and identifying the "dealings" between the PE and the rest of the enterprise. This requires a disciplined analysis of the functions, assets and risks that are treated as part of the PE. It is important to determine where the relevant significant people functions really take place. Once that functional analysis has been done, the dealings between the head office and the PE need to be constructed. The dealings are critical to the application of the AOA because the dealings form the basis for step two, determining which transfer pricing method is the most appropriate method. The most appropriate method will depend on the type of dealing that is constructed. That is, for example, whether the dealing is a sale to a distributor or the provision of a marketing service by a contract service provider, will influence the determination of the most appropriate method and the search for available comparables. The Discussion Draft seems to reject this approach, even when purportedly applying the 2010 version of the AOA – which is inconsistent with the mandate.

The Discussion Draft covers administrative approaches to enhance simplification[3]. Although the draft recognizes the burden associated with complying with tax and reporting obligations, the draft does not recommend simplification measures. USCIB believes that the final guidance should recommend that countries adopt simplification measures and supports the BIAC position set forth as an appendix to its comment letter. USCIB members are prepared to work with the OECD and member countries to develop appropriate measures.

<u>Detailed Comments</u>

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

It is not clear that paragraphs 3 through 7 are necessary. These five paragraphs summarize the changes made to the OECD Model and Commentary as part of the BEPS process and reflected in the 45-page Action 7 Final Report. Like all summaries, it is incomplete and may be misleading. USCIB recommends that these paragraphs be deleted.

If these paragraphs are not deleted, then paragraph 7 of the Discussion Draft should be revised. Paragraph 7 provides that: "any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5(5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5(5)." USCIB is concerned with the "any approach" and "deemed to exist" language of this sentence. While we do not believe this interpretation is intended, this language could provide support for positions that countries have asserted that are not consistent with the OECD Model and its Commentary. Some tax authorities have taken aggressive positions with respect to attributing profits to PEs and those

[3] Paragraphs 20 and 21.

positions should not be inadvertently buttressed. USCIB believes that paragraph 9 and paragraph 7 of the Discussion Draft are intended to express a similar idea; that is, a valid approach to attributing profits would be one that was permitted under a prior version of the Model Tax Convention and its Commentary. The drafting in paragraph 9 is much clearer. If paragraph 7 is retained, it should be redrafted along the lines of paragraph 9. Paragraph 7 (and paragraph 9) should also explicitly mention the arm's length standard.

Paragraph 8 is mainly taken from paragraph 101 of the 2017 Model (which is still in draft form, although not subject to comment). The first sentence of paragraph 8 provides: "one of the effects of paragraph 5 will typically be that the rights and obligations resulting from the contracts to which Article 5(5) refers will be properly allocated to the permanent establishment." USCIB is very concerned that this language will result in short-circuiting of the functional analysis that is necessary before Article 7 can be properly applied. As we pointed out in our prior letter, in some cases, the most appropriate characterization of the dealing between the head office and the DAPE may be a sale to a limited risk distributor. In other cases, the most appropriate characterization of the dealing between the head office and the DAPE would be the provision of a service and the payment of a commission to a service provider. The analysis should not be short-circuited; the results should not be based on what is "typical", but rather on the fact and circumstances of each case. The second sentence of paragraph 8 contains limiting language, but that language does not extend to determining whether the rights and obligations are properly allocated to the PE. This should be made clear. The rights and obligations will not be allocated to the PE in every case and a proper factual analysis is required to determine whether that allocation is correct.

USCIB strongly believes that the appropriate approach to the interaction of Article 9 and Article 7 is that Article 9 should be applied first. Paragraphs 11 and 12 of the Discussion Draft set forth the issue and waffle on whether Article 9 or Article 7 ought to be applied first. It is important to have a framework that countries apply consistently. USCIB believes this framework ought to require the application of Article 9 first.

To apply Article 7, one must know the amount of profit to be allocated between the head office and the permanent establishment of the non-resident enterprise, which in principle cannot be determined until one has established the arm's length prices for transactions between the non-resident enterprise and the local associated enterprise, or "intermediary" in the language of the Discussion Draft. Relatedly, the risks borne by the non-resident enterprise as a whole (head office and DAPE) must be determined before they can be attributed between the head office and the DAPE. In the Article 9 analysis, one evaluates which party, as between the non-resident enterprise and the intermediary, bears the various risks relevant to the related party transaction. This analysis thus provides the factual predicate for risk attribution in the PE context. Conducting the Article 9 analysis first reduces the likelihood of double remuneration to risk-bearing, a problem that arose in the examples in the prior discussion draft.

As a practical matter, applying Article 9 first reduces the likelihood that a tax authority will inappropriately attribute income to a DAPE. As the prior discussion draft acknowledged, and as this Discussion Draft implies, a DAPE can exist but have no attributable income, because the intermediary receives arm's length compensation for all of its functions, assets, and risks, including those related to the DAPE activity. But if a tax authority goes through the analysis to find a DAPE, it may be difficult to resist the urge to attribute additional profit to the DAPE if it has not already been determined that local functions, assets and risks are fully remunerated through the intermediary.

Starting with Article 7 may also discourage the use of simplified methods, since the approach of many simplified methods would be to permit the intermediary to pay tax on the combined income of the intermediary and the DAPE.

USCIB strongly supports the statements in paragraph 12 that countries "must ensure that there is no double taxation in the source country" of the same profits in the hands of the DAPE and the hands of the intermediary.

The following paragraphs (13 through 19) attempt to elaborate on the relationship between Article 7 and Article 9 in the context of risk and which party is entitled to the return from risk. These paragraphs seem to say that Article 7 and Article 9 need not be aligned with respect to risk so long as the source country does not tax the same profits twice. A problem with this framework is that it does not deal with double taxation between the source and residence countries. If the source and residence countries agree that under Article 9 the risk is allocable to the residence country, then under Article 9 that income (or loss) from the realization of those risks will be taxable in the residence country. If the source country can argue under Article 7 that risk is assumed by the PE, then that profit would be shifted to the source country. Unless the residence country agrees to forego the tax due under Article 9, the income will be subject to tax in both countries (and losses could be duplicated). Conversely, if the source country allocates the risk to the intermediary under Article 9 and the residence country allocates some part of the same risk to the head office under Article 7, then both the residence and the source country will tax the same income (or allow the same losses), albeit under different articles and different theories. Since a main objective of tax treaties is the avoidance of double taxation by the two parties to the convention, not resolving this issue undercuts that objective.

USCIB believes that the failure to align Article 7 and Article 9 is linked to the failure to identify which Article should be applied first. USCIB is concerned that countries that apply Article 7 first will take the position that the priority of application confers a priority of taxing right and expect the country of the head office to defer to its right to tax. As discussed above, USCIB believes that applying Article 9 first is the better answer. However, given the possibility that the order of application and non-alignment of Article 7 and Article 9 might create a significant risk of double taxation, countries should resolve the issue in their bi-lateral agreements, so that taxpayers are not caught in the middle. Because resolving these issues in bi-lateral agreements (or additional changes to the MLI) requires an agreed upon approach, the OECD should express a view as to the proper interpretation of the interaction of Article 7 and Article 9.

USCIB strongly supports the statements in paragraph 19 that indicate that in certain cases the "profits attributable to the PE could be minimal or even zero."

Examples Illustrating the Attribution of Profits to Deemed PEs under Article 5(5)

USCIB finds that the examples are generally unhelpful and quite opaque. The statements of fact use conclusory terms that presuppose the answer, rather than attempting to analyze facts and reach conclusions based on the application of law to facts.

Examples that posit realistic facts and apply the law to the facts are more difficult to construct, but are much more useful to both tax administrators and taxpayers. Deleting numbers from the examples makes the examples less helpful and more difficult to follow.

In examples one and two it seems the better reading of the examples is that there is a deemed transaction between Tradeco and the PE and Siteco and the PE.[4] In both cases, the dealing seems to be a deemed sale from the head office to the PE. In the case of Tradeco, the sale is of goods. In the case of Siteco, the sale is of advertising space. USCIB understands that the goal of this Discussion Draft is to provide guidance that is relevant to all countries, regardless of their approach to attributing profits to PEs. Nevertheless, these examples are explicitly applying the principles of the AOA (creating a dealing between the head office and the PE) but obfuscate that fact. If the examples are, in fact, deeming a transaction that corresponds to a dealing, then that should be clear, for both taxpayers and tax authorities. Lack of clarity will only lead to misunderstandings and disputes. As stated in our general comments, since these examples are based on the 2010 AOA, they should use the language and the framework of the 2010 AOA. It would be much more helpful if the examples identified the hypothetical separate entity, characterized the dealings, and looked for comparables based on the FAR analysis.

Example 3 ought to be deleted. There are some questionable factual assumptions that would likely mean that the example would apply only in extremely unusual circumstances. The example assumes that "procurement and sale of widgets" is the core business of Tradeco. This assumption is key to the example, since procurement is frequently not a core business activity, as paragraph (4) of Article 5 has recognized and continues to recognize.[5] Further, the widgets are purchased "on behalf of Tradeco and in the name of Tradeco". Although Article 5(5) has been expanded to cover sales and services to be supplied by a nonresident through a dependent agent PE, it has not been expanded to cover purchases. So, Article 5(5) only applies to this example because Buyco purchases in the name of Tradeco. It seems unlikely that any taxpayer would structure its purchases in this fashion if the result is to create an Article 5(5) PE for Tradeco.

[4] These would be the dealings, if the examples were applying the AOA.

[5] Even under the draft 2017 Model purchase may be a preliminary or auxiliary activity and not constitute a PE.

The proper analysis of this example ought to be under Article 5(4), but Tradeco is not doing the purchasing, so Tradeco could not have a PE under Article 5(4). It seems as though the OECD may be trying to expand Article 5(5) to cover a case that is not covered by the new language of Article 5(5) or 5(4). The proper way to achieve any such expansion would be through a change to the relevant treaty language. This example, therefore, ought to be deleted.

Attribution of Profits to Permanent Establishments Resulting from Changes to Article 5(4) and the Commentary

USCIB agrees with the discussion of profit attribution under this section. In particular, we strongly support the statement in paragraph 39 – "the profits to be attributed to a PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that cause it to be a PE." This statement is very important, given that the activities identified in Article 5(4) are likely to be low-value adding activities and performing low-value activities in a PE should not cause other profit to be allocated to that PE.

The OECD should, therefore, make clear in example 4 that the only profits that are attributable to the PE are those attributable to functions, assets and risks actually performed or assumed in the country where the warehouse is located, that is the warehousing activities. The profit attributable to the PE should only be that which arises from a deemed dealing between the PE and the head office that relates to the distribution function. The profit attributable to the warehousing function ought to be readily determinable from available comparables. The profit attributable to warehousing and delivery should not include the profit from the sale of the delivered goods. The entity that earns the profit from the sale should be the entity that sells the product, not the entity performing the warehouse and the delivery function.

USCIB believes that this could be made clearer by modifying example 4 to explicitly state that under the facts of this example, the profit from the sales of the products stored at and delivered from the warehouse are not attributable to the PE.

Sincerely,

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