BIAC THE VOICE OF BUSINESS AT THE OECD

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Ref: DISCUSSION DRAFT: BEPS ACTION 7 – "ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS"

Dear Jefferson,

Thank you for the opportunity to comment on the Discussion Draft: BEPS Action 7 – *Additional Guidance on the Attribution of Profits to Permanent Establishments* issued on 4 July 2016 ("the discussion draft").

As we have made clear from the beginning of the BEPS process, we understand that many governments had concerns about the Permanent Establishment (PE) rules. Concerns over the contract conclusion test for dependent agent PEs (DAPE), the preparatory and auxiliary rules, the independent agent rules, and time-related thresholds, were combining to make governments both more sceptical about the benefits of tax treaties, and more aggressive in their interpretation of those treaty provisions. That, in turn, was leading to more disputes between countries. As a result, BIAC made clear that it understood, for example, that the contract conclusion test for DAPE was likely to change to a different, lower threshold. But we also made clear that the overwhelming benefit of the current test was the certainty that it gave taxpayers (and many countries). Therefore, we requested that any replacement threshold be as clearly defined, and that definition be as widely agreed to, as the current rule.

As anticipated, the Action 7 report released in October 2015 substantially lowers the PE threshold and, consequently, there will be a significant increase in the number of PEs in territories where taxpayers already have established legal entities. The guidance the OECD provides must be robust enough to provide certainty to taxpayers (and countries) as to its interpretation in the multitude of cases where it will now apply. Without sufficient guidance, we are at risk of creating a proliferation of disputes and a mountain of administrative work, to the detriment of cross-border trade, and without significant benefit to tax authorities.

The attribution of profits to PEs is a notoriously difficult area and we commend the OECD for providing this draft guidance, which is directionally very encouraging. However, the discussion draft does not seem to fully recognise the complexities of profit attribution in a post-BEPS environment, implying that although there will be an increase in the number of PEs, the principles behind the attribution of profits have not changed. We are not sure that this is entirely correct. Furthermore, it is important to note that many MNEs that will be impacted have not had the volume of experience in applying profit attribution guidance in practice. In fact, many MNEs have historically gone to great lengths (e.g. setting up local legally incorporated entities) to ensure that the complexities of the Profit Attribution guidance are not something that they have to face. The significant lowering of the PE threshold, alongside fundamentally more complex guidance on the application of Article 9, leaves taxpayers feeling that room for different interpretation – and tax uncertainty – has grown dramatically.

BIAC has four main recommendations that we believe would facilitate the successful implementation of this guidance alongside revised Article 5 of the Model Tax Convention (MTC):

1. Additional guidance is required in relation to the revised Article 5 threshold before it is possible to provide comprehensive comments on the correct approach for attribution.
2. A <u>prerequisite</u> of adopting the Article 5 changes must be commitment to the Authorised OECD Approach (AOA) under Article 7.
3. The interpretation of Article 9 should be restricted to the consensus agreement reached in October 2015 in relation to BEPS Actions 8-10.
4. Additional clarity is required in respect of the application of OECD's proposed approach under Article 7.

In this response, we have provided significant detail in relation to these points, together with appendices outlining business models that may be helpful in developing and finalising the profit attribution guidance. We have also, of course, provided more detailed responses to the specific questions posed in the discussion draft. We would welcome the opportunity to provide more detail wherever you may find it useful.

Again, we thank you for the opportunity to comment on this discussion draft.

Sincerely,

Will Morris

Will Morris, Chair
BIAC Tax Committee

Introductory comments

1. BIAC strongly endorses pro-growth tax systems which facilitate cross-border trade and investment, enhancing economic growth and efficiencies in the international market place. The guidance on the attribution of profit to PEs should support cross-border trade and investment by clarifying which jurisdiction has the right to tax income, thus ensuring that income is not subject to double taxation.
2. Under the pre-BEPS Article 5, businesses appreciated the certainty that activity exemptions and contract conclusion tests provided. If the new profit attribution guidance is not implemented in a clear and consistent way, cross border investment as a whole will become more administratively complex, more uncertain, and ultimately more costly.
3. As a result, businesses may seek to modify business models or limit cross border investment in order to have certainty over the taxes due (and to mitigate the risk of double taxation).
4. Many aspects of the discussion draft are encouraging. The interplay with actions 8-10 and allocation of risks to dependent agent entities (DAEs), i.e. undertaking an Article 9 analysis and subsequently undertaking an Article 7 analysis, is the most sensible approach in our view. It is also useful to have numerical examples with a P&L in order to demonstrate how the guidance is applied (albeit with simplified fact patterns).
5. While we accept that the OECD's final recommendations on threshold are not technically within the scope of this consultation, we have concerns that both tax authorities and businesses will struggle to deal with the majority of new PEs that stem from it. The interplay between the new Article 5 and the new Transfer Pricing Guidelines (and thus attribution of profits under Articles 7 and 9) remains complicated and untested.
6. During the BEPS consultation, BIAC (along with several other commentators) noted that a move away from the clear "contract conclusion" test in the pre-BEPS MTC Article 5, which limited the number of PEs that could theoretically be created where ultimately limited or no profits would ever be allocated. The threshold revisions could lead to an enormous compliance burden for all MNEs as an unintended consequence of addressing the attribution of profits in the limited number of business models that the OECD considered to be posing a BEPS risk.
7. The examples in the Discussion Draft appear to confirm BIAC's concerns, and it is imperative that clear guidance is provided (and practice developed) both within and beyond the PE profit attribution workstream to ensure that taxpayers and tax authorities have a clear understanding of where PEs exist, the profits subsequently attributable to them, and the compliance burden that will arise. Tax authorities should be encouraged to consider these three areas together in development of domestic rules and practices to ensure that an appropriate balance is struck.
8. Developing clear, pragmatic guidance that helps reduce this enormous burden is paramount, and we remain committed to assisting the OECD in any way required in order to ensure that the profit attribution element of the BEPS PE reforms are successful in delivering a reduction in

the complexity and compliance burden that the new threshold brings. We recommend that the discussion draft be developed further to:

a. Mitigate the potential for differences in interpretation (in relation to Article 5, Article 7, and Article 9), and
b. Be practical enough for businesses to comply with (noting that, in its current form, MNEs will not have the resource to perform the requisite analysis in the increased number of cases to comply with this profit attribution guidance).

9. Overall, BIAC believes the solution to the BEPS risks that Action 7 attempts to address, such as the artificial avoidance of PEs through commissionaire arrangements and similar strategies, ought to be much more precisely targeted. The recommendations offered in the discussion draft place a significant compliance burden on taxpayers and will greatly increase tax uncertainty for all businesses operating cross-border, to the detriment of international trade and investment[1].
10. With this in mind, we have four main areas of comment on PEs (the first of which relates generally to the issue of PEs, and the latter three of which relate specifically to the topic of attribution):
    a. Without a clearer agreement and understanding of when the threshold for a PE has been breached, it is very difficult to develop or comment on precisely how the attribution rules should be applied.
    b. Without a commitment from all participating countries to adopt the AOA, there are many cases where the work on the attribution of profits to PEs will not be useful, potentially creating further confusion.
    c. The interpretation of Article 9 in the discussion draft goes beyond the consensus agreed in October 2015 in relation to BEPS Actions 8-10.
    d. While we agree with the OECD's proposed approach to Article 7 in several areas, given the complexity of global value chains and modern business models, we believe that additional work is required to reduce the risk of double taxation, minimise compliance burdens and to develop practical approaches to circumstances where the recognition of a PE is not expected to generate additional tax for a territory.

[1] With respect to Commissionaire arrangements in particular, there are several non-tax reasons why businesses may want to retain the existing structure, rather than transitioning to (for example) a Limited Risk Distributor (LRD) model. For example, legal entities being required to manage receipts and payments carry reporting and other legal obligations. Whilst we understand the OECD's concerns with the pre-BEPS taxation of commissionaire structures, in reality, the functions, assets and risks of a commissionaire are not as extensive as an LRD, and accordingly we would recommend that the total margin in the commissionaire territory (under Article 7 or a combination of Articles 9 and 7) should never exceed that of an LRD.

These areas are elaborated below.

11. We also have several specific comments on the examples outlined in the discussion draft. These are also elaborated below.
12. Finally, we have several more generic comments on process and scope:
    a. While we understand why the scope was limited to addressing DAPE and warehousing scenarios, as set out in paras 5 to 13, we consider that additional guidance is essential on how the future commentary will address PE profits in light of other BEPS changes. This is acknowledged in paragraphs 10 and 11 but there is disappointingly little reference to the Transfer Pricing Guidelines (TPG) amendments in the examples.
    b. It would be helpful for the OECD to explain what the exact output of this consultation is expected to be, as no amendments to the commentary to the MTC have been proposed as part of this work to date. BIAC's view is that the guidance contained in the OECD paper should be inserted into the commentary on the MTC and the AOA to ensure its legal standing.
    c. It would also be useful to understand how this work will be coordinated with the multilateral instrument to amend existing treaties.
    d. The Article 9 analysis allocates returns for risks to the Agent (Sellco) in Example 2 and (partially) in Example 4. In doing so, it assumes that the Agent would be allowed to deduct bad debt and inventory losses. In reality, deductions by Sellco may be subject to local country rules, many of which prescribe deduction only by a legal owner of the debts/ inventory. The OECD should encourage participating jurisdictions to change local tax rules where they would otherwise result in effective double taxation.

Clear guidance on threshold (under revised Article 5)

13. The OECD's final recommendations on Action 7 released in October 2015 departed from the thresholds that had previously been included in discussion drafts during the BEPS Project. While this is particularly true in relation to the definition of DAPE, business would also welcome clarity over the meaning of terms that apply to the Article 5(5) exemptions. In particular, we believe there is ambiguity around the following concepts (which more detail is provided on below):
    a. "plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification";
    b. "artificial splitting up of contracts" ; and
    c. "preparatory and auxiliary activities".

14. We believe that it is not possible for stakeholders to provide comprehensive comments on the attribution of profits (or for participating countries to accept the resulting guidelines) until these thresholds are understood more clearly.
15. Additionally, businesses see these threshold issues as a far more fundamental concern in relation to the potential compliance burden and risk of double taxation than the attribution guidance.

"Principal Role"

16. The Action 7 Final Report provided limited guidance on the meaning of the term:

    > *"The phrase must be interpreted in the light of the object and purpose of paragraph 5, which is to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, i.e. where that person acts as the sales force of the enterprise. The principal role leading to the conclusion of the contract will therefore typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise"*

17. This guidance is helpful in a scenario where only one salesperson prepares all relevant offer/tender documents, decides about the content and convinces one representative of the customer to accept a contract. However, in real life scenarios the complexity of modern business models (including in particular the ease of global communications and travel) mean that deal teams (rather than a simple sales individual) are generally quite dispersed.
18. Appendix II outlines several business models provided by BIAC members which demonstrate this complexity. The key concerns identified are:
    a. Can the "principal role" be undertaken by a group of individuals, or is there only one individual that can play the "principal role" on any deal?
    b. If a group of individuals can play the "principal role", and they operate in different countries, does this mean that a PE is created in each country (and if so, how should profits be allocated between them)?
    c. If only a single individual can play the "principal role" on a deal, how should it be determined which individual this is?
    d. If only a single individual can play the "principal role" on a deal, is it the individual, or the employer who needs to be behaving "habitually" in any country in order to create a PE?
    e. In either the case of an individual or a group of individuals, if an individual travels between several countries to habitually meet customer(s), is a PE created in all of the

countries to which that individual travelled (and if not, in which country/countries are PEs created)?

f. In either the case of an individual or a group of individuals, if an individual habitually communicates from different countries, with customers from different countries (e.g. over a period of months via telepresence, telephone, email or letter), is a PE created in all of the countries in which they worked on the deal (and if not, in which country/countries are PEs created)? Additionally, is there a difference in application caused by different methods of communication?

g. Where there are several distinct legal "contracting parties" within a group (e.g. one selling an asset and the other providing ongoing services such as maintenance or financing), will this result in several PEs in the same country?

h. Finally, we think a clearer definition of the term "principal" would be helpful. We assume that for most sales activities, the "principal" role in leading to the conclusion of contracts would be the salesperson.

Splitting-Up of Contracts and Fragmentation

19. We believe that additional guidance is required in terms of the new fragmentation clause, notably its limitation to those activities which constitute complementary functions and are part of a cohesive business operation. Even though we believe that the attribution principles as laid out in example 5 would also apply here, we would welcome a clear statement that merely being part of a cohesive business operation does not necessarily equate to value being attributable to the new deemed PE. The profit attribution to complementary activities should rather be determined by an analysis of the relevant facts and circumstances (i.e. the activities of the Significant People Functions (SPFs)).
20. Additionally, the final report on BEPS Action 7 contains various ambiguities in respect of the splitting up of contracts. Without greater clarity (e.g., by providing a list of circumstances in which non-tax reasons would be assumed or accepted[2]), the guidance will create uncertainty in respect of non-abusive commercial arrangements.
21. We would also welcome detailed clarification of the consequences of an abusive structure being asserted. For example, it would be helpful if the example does concluded on which entity would actually be deemed to have a PE (and importantly which would not).
22. In addition, the proposed changes to paragraph 18 of the OECD Model Commentary on paragraph 3 of Article 5 leave many questions unanswered, on which clarification would be

[2] For example, where a customer has requested specific contractual terms, or where the scope of work must be split due to location of requisite expertise.

welcomed to provide context and a greater degree of certainty to the way in which profits should be allocated:

- The term “connected activities” (which determines whether different periods of time should be combined) requires clear illustrative examples since the guidance provided in the Final Report regarding the definition of which activities should be considered to be connected is vague and subjective.
- It is stipulated that connected activities which are carried on at the same building site or construction or installation project during different periods of time by one or more enterprises closely related to the first-mentioned enterprise should be added together. More guidance is required to understand whether also a closely related enterprise (which is tax resident of the country in which the building site or construction or installation project is being executed) shall be considered for these purposes even if the profits out of its activities are fully taxable in its country of residence (i.e. country of activity).
- Example A: Company A (resident in Country A) commissions the supply and installation of machinery Unit 1 of Customer C’s factory in Country S (duration of 2 months). The DTA between Country A and Country S is aligned with the MTC. Ten weeks after the installation, has been completed, Customer C orders the supply and installation of a second identical machine in Unit 2 of the same factory from Company S (a wholly-owned subsidiary of Company A) which is resident of Country S. Company S will execute the installation in Country S (duration 14 months) but subcontracts Company A for the equipment supply, only. According to the group structure and group’s sales policy Company S is responsible to serve the market in Country S.
- Based on our understanding, this scenario should not result in the combining of the commissioning activities provided by Company A with the installation activities provided by Company S as (i) the decision to conclude the contracts was taken independently and separately and (ii) the entire profits related to the activities provided by Company S are taxed in Country S (i.e., no loss of tax base in Country S).
- Example B: The same facts as in Example A, however as two supervisors (employees of Company S) are currently working in another project, Company S requests personnel from Company A based on an intra-group hiring out of personnel agreement for an arm’s length price.
- We are of the view that Example B should result in the same conclusion as Example A. The entire profits related to the commissioning and installation activities are taxed in Country S via Company S (i.e. no loss of tax base in Country S).
- The mere fact that personnel of Company A are performing services under the sole functional guidance/ instruction of Company S (intra-group employee secondment, i.e. hired out from Company A to Company S) should not lead to “connected activities” since the taxable profits of the installation and commissioning activities of Company S would not

change (the tax deductible personnel costs would be equal to the situation where Company S deploys its own personnel instead given they are at arm's length).

23. In the Discussion Draft it is noted that no further guidance will be required on the profit allocation since the respective regulatory framework already exists. However, considering that the AOA approach has not been adopted uniformly by all countries (see Appendix I), and given the numerous open questions on the interpretation of the newly introduced anti-avoidance rules in connection with the splitting-up of contracts, we believe that clear guidance and explanatory examples on which profits would then be attributable to such PEs are required.

Preparatory and auxiliary

24. Whilst it is not our intention to challenge the OECD's Action 7 recommendations made in October 2015, we believe that clarification of the recommendations is required as a result of the OECD's follow up work on profit attribution to PEs.
25. The changes to paragraph 4 of Article 5 of the MTC require the listed activities to be preparatory and auxiliary in nature. This will lead to an increase in the number of PEs in excess of those where there is a tax-avoidance motive (and in particular an increase in the number of PEs where there are no or very low profits attributable to them).
26. The listed activities which currently do not constitute a PE are well understood and, subject to the modifications proposed to paragraph 5 of Article 5 of the MTC, should still constitute valid exclusions from the PE requirement. However, clarifying the meaning of "preparatory and auxiliary" in the MTC Commentary in the context of the revised Article 5 would provide welcome confirmation of this. For example, a foreign entity which maintains a stock of merchandise for delivery, where there is no related party commissionaire arrangement in place, and where contracts were never negotiated in the host country, may now be caught as a result of this modification.
27. As is noted in paras 104 (and 105) of the Discussion Draft, circumstances can arise where there would *prima facie* be a DAPE by virtue of the Action 7 extensions, but where no profits are attributable to that PE- thus merely resulting in incremental compliance burdens rather than incremental tax. We would suggest that if the predictable/forecast outcome of such an attribution would be of nil or negligible DAPE profits then that should be taken as *prima facie* evidence that the activities conducted by the DAE on behalf of the DAPE should be viewed as preparatory or auxiliary functions so that PE recognition and filing is not required. This could for example be framed as indicative guidance that if the forecast Net Present Value of DAPE taxable profits are less than, say, 5% of the NPV of combined DAE and DAPE profits then the DAE activities should be viewed as Preparatory or Auxiliary under the general Article 5(4)(e) exclusion (as extended into Article 5(5)).
28. Further, it would be useful if the OECD provided further guidance on how to distinguish a separate aftermarket business line from a main business line. For example, a business selling

equipment may also have an additional service line selling spare parts, which is likely to have relatively limited value (e.g. less than a third of the value of the main business). It is unclear how this would be dealt with in the context of the new guidance and whether such a service line would be considered merely auxiliary.

Corporate tax administrative burden

29. There is no practical solution offered to ensure the administrative complexity involved in applying the arm's length principle to the large number of PEs that will be created as a result of the revised Article 5 definition (which, even putting aside the MLI, is, in practice, likely to be applied beyond those treaties where it has been formally adopted).
30. Without clear guidance on threshold (and consistency in interpretation of attribution) it will often be the case that taxpayers lack the budget and resource to reliably interpret and apply the standards and consequently will struggle to comply, which will be to the detriment of both themselves and tax administrations. The SME community will struggle in particular to navigate these new rules.
31. In addition, as is clear from the examples in the discussion draft (and the number of potential PEs highlighted in the examples in Appendix II), there will be a vast number of PEs under the new threshold to which no (or very little) profit is ultimately allocated. In such instances, governments should take a sensible approach to domestic legislation, balancing the potential compliance burden (to both taxpayers and tax authorities) with the expected tax to be collected, and the benefits of investment and cross border trade to their economies more generally.
32. For example, an MNE produces 10 distinct and independent product lines from 10 legal entities located in 10 different countries. The products are sold via a sales network of 5 legal entities, each located in the MNE's 5 leading markets. The sales services provided by the 5 sales entities are priced on arm's length terms in accordance with Article 9 of the MTC and no SPFs are performed that would give rise to an allocation of profits to a PE of the non-resident producer. In this scenario, each of the 5 sales entities would submit a tax return as normal but, a further (10 x 5) 50 tax returns may also need to be filed for the non-resident PEs that would be created under the increased threshold. This reality is in contrast to the examples in the discussion draft where the burden of filing a single additional tax return is multiplied many times over.
33. BIAC believes that the solution to these issues is twofold. Firstly, the OECD must offer clear and practical guidance which can be applied to complex scenarios (as part of the ongoing process of which this consultation forms part). Secondly, participating countries must be pragmatic in their domestic implementation.

34. We believe that the OECD must take the lead in providing participating countries with innovative, pragmatic, and consistent solutions regarding domestic implementation. The OECD is ideally suited to do this. We would welcome the opportunity to discuss this further, but an initial survey of our members suggested the following options:

    a. De minimis thresholds where sales to resident customers are low (or nil).

    b. Exemptions for SMEs.

    c. Article 7 safe harbours (such that no detailed TP analysis is required).

    d. The ability to discuss and agree with the tax authority (and obtain acceptance by the other State tax authority) the "overall" compensation that would be due under Article 9 and 7[3], leading to either (i) amendment of the contracts such that the DAE legally takes on the deemed risks and received the appropriate compensation of the DAPE, or (ii) a TP adjustment in the DAE to the same effect. In this case, in lieu of filing tax returns each year, the non-resident company could file an annual self-declaration to confirm if there is any change to its business model as well as its risk, function and assets arrangements. No administrative requirements should be applied before the completion of the PE profit attribution analysis.

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

    i. The transfer pricing policy sufficiently rewards the parties to the controlled transaction based on the functions performed, risks assumed and assets owned/utilised;
    ii. The controlled transaction is accurately delineated;
    iii. The transfer pricing outcome is aligned with the economic activity that produced the profits (including SPFs), rather than the contractual allocations; and
    iv. The transactions are sufficiently documented in accordance with Action 13.

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

36. Finally, the OECD should comment on how taxpayers and tax authorities will deal with the auditing of the potentially greatly increased number of PEs. The taxable basis of a PE is not easy to define and, in order for any PE to be properly audited, management accounts must be used. Although we note that the link between management accounts and local accounts is not always easy to demonstrate, it is important that the OECD makes clear tax administrations

[3] We have used the term "State" authority, but we note that where local group entities and PE governed by different tax authorities in the same country (e.g. province, federal, or different tax administration divisions), these bodies coordinate properly to ensure taxpayers do not face double taxation.

should not seek to audit the entire P&L of an entity when only a small part of that entity gives rise (or potentially gives rise) to a PE.

Administrative burden caused by PE changes in respect of Non-Income taxes

37. As previously mentioned in BIAC submissions on PE status, BIAC urges the OECD also to consider the likely indirect tax impacts which will result from lowering the PE threshold, in particular the potential consequences for VAT as well as for Personal Income Tax (PIT) obligations (PAYE, wage tax, etc).
38. The creation of new PEs will likely lead to additional required VAT registrations, especially in countries where corporate tax and VAT registrations are automatically linked. This will add significant cost and complexity for business and tax authorities in terms of compliance and tax collection, as well as increasing the risk of disputes and instances of double taxation. This is due to the lack of legal certainty in the context of conflicting establishment definitions, force of attraction/collection rules where all supplies to local customers become subject to local VAT charged by the supplier even where the local PE does not intervene in the transaction (i.e. customer reverse charge not applicable), and challenges from tax administrations where there are apparent but totally legitimate mismatches between the PE's corporate tax return and VAT return. Lowering the PE threshold has similar consequences for PIT registrations: the Head office becomes liable to PAYE and wage taxes for the employees from the first day the PE has been constituted.
39. The consistent implementation of the OECD's International VAT/GST Guidelines should help mitigate such issues but we would also encourage the OECD to include explicit language in its proposals to highlight the fact that the term "permanent establishment" as used in the OECD Model Income Tax Treaty is a distinct concept from the "VAT establishment" term used in the International VAT/GST guidelines, such that the existence of one should not automatically result in the other. Such language already exists in the OECD International VAT/GST guidelines (footnote 24) and in the OECD BEPS Action 1 2015 Final Report (paragraph 337), however, there is a case for further strengthening this key point.

Commitment to the Authorised OECD Approach (AOA)

Adoption of the AOA

40. While comments are invited regarding its application to situations where the AOA is not followed, the discussion draft itself only provides guidance on situations where the relevant jurisdiction has adopted the approach taken in the 2010 Report on the Attribution of Profit to Permanent Establishments (i.e. attribution of profit under the AOA).

41. The changes to the MTC and Report on the Attribution of Profits to Permanent Establishments (the Report) in 2010 sought to introduce the AOA into all future treaties based on the MTC. However, for treaties entered into before this date (and in the application by non-OECD members) there remains significant divergence in how and when the AOA is applied. These changes were the culmination of a significant amount of work and were agreed upon by the vast majority of OECD countries; there is still some way to go to ensure they are widely applied.
42. The evidence suggests that the non-AOA approach results in tax authorities (and courts) applying a number of different methodologies (including, particularly, global formulary apportionment), which are incompatible with the arm's length principle.
43. Appendix I outlines a number of countries/cases where BIAC members have observed that tax authorities do not adopt the AOA in their calculations of attribution of profit to PEs. In *Rolls Royce India*, for example, the Indian Revenue attributed 75%-100% of the profit from the Indian contracts to the Dependent Agent PE (DAPE) in India. The Tax Tribunal and High Court attributed 50% of the global profit to manufacturing, 15% to R&D and the remaining 35% to sales/marketing. The entire 35% of the sales/marketing profit was attributed to the DAPE in India.
44. While we appreciate the reservations that some countries had made in to the application of the AOA to the pre-2010 Articles 5 and 7, business is anxious for the approach to be as consistent as possible going forward. The BEPS revisions to Article 5 of the MTC and the corresponding changes to the guidance on the allocation of profits to PEs provide an opportunity to address this existing inconsistency.
45. We note that while not all elements of the "BEPS Package" were minimum standards, the transfer pricing and PE threshold changes were a *package* of measures that are only coherent when taken together. This is critical when considering the interaction between the revised Chapter 1 of the OECD Transfer Pricing Guidelines (i.e. "the Article 9 analysis" for the purposes of this workstream), the revised definition of PE as per the 2016 MTC as recommended by the OECD BEPS Action 7 Final Report, and the output of the current work on the attribution of profits to these new PEs (i.e. "the Article 7 analysis") alongside the Article 9 analysis.
46. Consequently, we believe that if countries wish to adopt the revised threshold as outlined in the BEPS Action 7 Final Report, either under domestic law or treaty interpretation (which that tax authorities may feel compelled to do whether or not the wording of the relevant law/treaty Article 5 has been updated), then these countries should also be required formally to adopt the AOA.
47. Inasmuch as the existing guidance on the AOA (i.e., the 2008 Report relevant to the pre-2010 Article 7 and the 2010 Report relevant to the 2010 Article 7) is the subject of an OECD Council Recommendation (i.e., Council Recommendation C(2008)106), BIAC hopes that the new guidance on the application of the AOA to PEs will effectively become a supplement to the

existing guidance and that the Council Recommendation will be updated to reflect the incorporation of the new guidance into the existing guidance.

48. While OECD Council Recommendations are not legally binding, the OECD indicates that "practice accords them great moral force as representing the political will of Member countries and there is an expectation that Member countries will do their utmost to fully implement a Recommendation." Such an approach would provide desired certainty to taxpayers, at least in respect of OECD Member country tax administrations, regarding the manner in which the AOA will be applied to the new PEs, thereby minimising risks of double taxation. BIAC would also greatly welcome a similar expression of political commitment on the part of non-OECD countries to the agreed application of the AOA to the new PEs.

49. We consider that changes to Article 7 (including a commitment to the AOA) should be included as a minimum standard in the Multilateral Instrument (MLI), although we appreciate that this may be difficult for the OECD to mandate at this stage in the process. However, we would expect that no country should be able to adopt changes to Article 5 through the MLI without also committing to the AOA under Article 7.

Additional guidance on application of AOA

50. More specifically relating to the discussion draft, the analysis under the AOA within the Article 7 sections of the examples lacks some necessary detail. The complexity of step 1 of the AOA, and the pricing analyses required under step 2 seem not to be fully appreciated.

51. Under the AOA, step 1 requires hypothesising the PE and identifying its dealings with the rest of the enterprise. This entails a disciplined functional analysis to determine where the relevant SPFs take place. Once the functional analysis has been done, the "dealings" between the head office entity and the PE need to be constructed. Step 2 of the AOA is determining the most appropriate transfer pricing method, and is based on the analysis under step 1. In the discussion draft both steps appear to have been assumed. In reality, identifying the appropriate functions, assets, risks, and SPFs (and then pricing them) is an enormously complicated exercise, and should be given due consideration in the examples.

52. In the discussion draft, the functional analysis is essentially replaced by factual assumptions, which is necessary given that these are examples. However, the next step – construction of the dealings – is also omitted. In performing the analysis under Article 7, the dependent agent permanent establishment (DAPE) examples all start with 100% of the sales income in the DAPE without any analysis of why that approach is correct. This may be a holdover from the "old" DAPE definition under which the DAPE had to conclude contracts on behalf of the non-resident. In that case it might make sense to conclude that the "dealing" was a sale by the head office entity to the DAPE followed by a sale by the DAPE to the third party customer. If that was appropriate under the prior definition of a DAPE, it is no longer necessarily

appropriate under the new definition. The dealing needs to be defined based on the functional analysis and the dealing will not always a sale by the head office entity to the DAPE, followed by a sale by the DAPE to third parties. In some cases, the most appropriate characterisation of the dealing between the head office entity and the DAPE may be a sale to a limited risk distributor. In other cases, we believe that the most appropriate characterisation of the dealing between the head office entity and the DAPE would be the provision of a service and the payment of a commission to a service provider.

The discussion draft similarly does not cover the choice of the most appropriate transfer pricing method. Even if this is to be assumed, it is important for the choice of method to be articulated as it is a fundamental part of the analysis.

Interpretation of Article 9

53. While it is not intended to focus primarily on Article 9, the discussion draft is the first example of how the new TPG (as approved by the OECD Council in June 2016, plus further conforming amendments expected to be approved later in 2016) will work in practice. Although the discussion draft does not represent a consensus position of OECD/G20 countries, it could be seen as compelling evidence in the more general application of the revised TPG, even where PEs are not in point.
54. The examples (and in particular example 2) suggest that the Article 9 analysis requires an allocation of both the income and costs associated with bad debt, inventory management and warehousing.
55. We do not believe that this is in line with the output of BEPS Actions 8-10. Instead, we consider that in such examples the entity's headline compensation should be adjusted to reflect the functions, assets and risks undertaken by the tested party. It would also be helpful in example 2 if the first entry in the Sellco table labelled “Income from sales commissions” be renamed to include three lines (e.g. sales commission 10, inventory management 10, credit analysis 10)
56. Whilst we understand that an Article 9 approach should seek to identify an appropriate remuneration for an entity by “delineating the actual transaction”, we do not believe it necessarily follows that this should require an analysis of the profit and loss account, based on the “combined” profits. This is a more appropriate methodology when undertaking an Article 7 analysis but should not be relevant for calculating the arm’s length remuneration for a tested party based on its functions, assets, and risks. In particular, paragraph 45 of the Discussion Draft includes an explanation of total profits, which lends itself to the implication that a profit split is an appropriate methodology. If this approach is followed, it should be made explicit that this is not the intended implication.
57. We believe the language and analysis of Example 2 should accordingly be reconsidered as it pertains to Article 9. To recall that Example, it involves a company, Prima, that manufactures

products and sells the products through a network of sales agents (paragraph 21). With respect to one of its sales channels, Prima decides to delegate responsibility for inventory management and customer credit decisions to its sales agent, Sellco.

58. However, Example 3 makes clear that these activities could just as easily have been performed by Prima using a single employee. That Prima employee, by performing those functions, would not be taking on the inventory obsolescence or customer credit default risks personally, of course. The same conclusion would apply if Prima outsourced the same functions to an independent person, e.g., a former employee. In either case, the only risk the employee or independent party would be taking is the risk of being fired for not performing his or her job well. (This is the same risk that paragraph 28 recognises Sellco is taking with respect to the performance of its basic sales function).

59. We believe the Article 9 result for Prima should be the same whether it delegates the performance of the functions to an independent party (e.g., to a former employee) or to Sellco as a sales agent. Example 2 should be modified, accordingly, to explain why the Article 9 analysis as applied to Sellco in Example 2 reaches a result that is seemingly at odds with the result that would apply if the employee in Example 3 were to continue to perform his or her functions but as an independent enterprise.

60. We believe the conclusion in Example 2 would be more supportable if the Example were changed to assume that Prima delegated to Sellco decision-making authority with respect to inventory and credit management and allocated *to a second affiliate* the economic risk of inventory obsolescence and customer credit default – an affiliate not in a position to perform the oversight functions itself (as Prima does in Examples 1 and 3), i.e. if Prima had contractually transferred the risk to a second company; so the control functions in Sellco would transfer it back to Sellco.

61. At a minimum, the assumptions in Example 2 should be supplemented to include a statement that the agreement between Prima and Sellco is not consistent with arm's length or marketplace practice. The Article 9 Guidelines have no authority to upset conditions that would be agreed between independent enterprises; Example 2 should make plain that it is not seeking to do so here.

62. The terminology in paragraphs 20 and 42 pertaining to Example 2 should be changed. Both paragraphs refer to inventory and customer credit risk as being "contractually allocated to" Prima, implying that the contract is the event that gives rise to Prima's risk in these areas. This misrepresents the facts. Prima is a manufacturer that sells its goods through a network of sales agents. Since the goods originate with Prima, inventory and customer credit risks are with Prima from the outset. They may be contractually allocated *away* to the sales agents but the contract does not allocate those risks *to* Prima in any meaningful sense. The text in paragraphs

20 and 42 should recognize that the risks are borne by Prima by virtue of its role as the originator of the goods and not attribute that fact to Prima's contract with Sellco.

63. Regarding Example 4, we consider it would be helpful if the language in paragraph 72 be amended to make clear that the compensation arrangement described there does not reflect any sort of normative view that this is the compensation structure one would expect. Currently the paragraph says the applicable guidance makes clear that Sellco's compensation "may" have an element of profit or loss participation. We believe that the intent of this language is to convey that such an arrangement is permissive, not presumptive or prescriptive, and ask only that this be made clear to avoid any implication to the contrary. We highlight this point because we believe the compensation arrangement described in the example would be unusual in the marketplace. Sellco's role described in paragraph 69 is modest and while performance of its functions may indeed have an "effective influence" (see footnote 12) on Prima's realisation of bad debt risk (just as many things may influence that risk), it should not be assumed that a party performing Sellco's role would take on the risk embodied in the compensation arrangement described.
64. For avoidance of confusion, we suggest the text in the third bullet point of paragraph 73 be amended to make clear (as Example 4, Scenario B later does) that there may be situations under the arrangement described in which Sellco's compensation is reduced to reflect losses. Accordingly, we would strike the phrase "such that Sellco receives a fee equal to 40% of the difference" and substitute in its place "such that Sellco receives a fee (or suffers an expense, as the case may be) equal to 40% of the difference …."

Attribution under Article 7

Welcome developments

65. We support the use of Distributor Return as a proxy for allocation of returns for sales, contract conclusion and inventory related functions/risks in Example 3. In addition to Example 3, we consider that the Distributor return proxy be explicitly specified in Examples 2 and 4.
66. The discussion draft implies that generic sales channels do not lead to the creation of local marketing intangibles, which BIAC agrees is correct. However, the draft should be worded more clearly to ensure that in the case sales channels are not generic that there still will not be local marketing intangibles in every case, only when an analysis of the relevant facts and activities suggests that they have been created.

Complexity of different businesses (general)

67. For some sectors (for instance banking and insurance), it has long been recognised that applying the profit attribution guidance in a consistent way is incredibly complicated, with

enormous potential to arrive at different conclusions based on the same facts. Consequently, additional specific guidance has been provided by the OECD for these industries.

68. For other industries, however, there is currently not a solution for managing this complexity in a post-BEPS environment. We are concerned that in reality, different (non-FS) industries carry on significantly different business models and have significantly different capital structures. We do not believe that this point has been sufficiently recognised by the OECD or tax authorities to date. Indeed, the discussion draft seems to suggest that although there will be an increase in the number of PEs, the principles behind the attribution of profits has not changed, and therefore, significant additional guidance is not necessary.
69. Although this may well be correct from a theoretical perspective, as a practical matter once a PE is established, tax authorities often seek to attribute (excess) profit to it. Furthermore, it is important to note that many MNEs outside of the FS sectors mentioned above (or tax authorities) have not had the same volume of experience in applying profit attribution guidance in practice to non-FS MNEs. The significant lowering of the PE threshold, alongside fundamentally more complex guidance on the application of Article 9 could dramatically increase disputes and tax uncertainty.
70. A common concern for a warehouse operation PE is that the tax authority may erroneously use the anti-fragmentation concept when determining the profit attribution to the PE, especially those operating under complex business models. According to Action 7 and the additional guidelines, the anti-fragmentation rules should be used to determine the existence of PE only. If the PE has been recognised, the approaches quoted in the additional guidelines should be followed and no anti-fragmentation rules should be further applied. The discussion paper addresses this indirectly by stating that "although there will be an increase in the number of PEs, the principles behind the attribution of profits have not changed" but we believe it would be worthwhile to specifically clarify this point. The expected proliferation in the number of PEs that will arise under the new Article 5 definition increases the importance of this guidance, as it will now be used by a much larger number of businesses.
71. While we appreciate the resource constraints, and, indeed, the time pressures that the OECD is required to work to, we consider that in order to be most useful, the OECD should consider the development of more industry-specific guidance to alleviate the subjectivity and uncertainty that non-FS businesses face. BIAC is, of course, ready to help with this in any way that it can.

Simplicity of examples vs complexity of modern global trade

72. Appendix II outlines some business structures provided by BIAC members, and demonstrates the significant complexity of global business models and the corresponding variation in the locations (and number of locations) in which various functions will be undertaken by various individuals (many of whom will cross borders as they undertake these functions).

73. While we appreciate that this is the first discussion draft in this area (and that of course it will develop over time), and while we recognise the importance of guidance that covers simple scenarios that can be built upon, we are concerned that it overlooks the enormous difficulties that tax authorities and businesses will face in applying to subjective standards (Article 9 and Article 7) to highly-complicated transactions.
74. In particular, the guidance must include further detail on how split SPFs should be addressed. Our preference is that this be dealt with in a pragmatic manner, with clear thresholds that minimise the need to undertake analyses that cover many countries, and to then file returns with very low (or nil) profits in each country.
75. Additionally, while the discussion draft offers guidance on how the profits/losses arising from credit risk could be attributed, we note there is no indication of how to deal with entities that may take on pricing risk, or have developed local marketing intangibles.
76. Example 3 of Appendix II considers the factors involved in the valuation/allocation of pricing risk. We would welcome a more detailed example from the OECD to explain how pricing risk assumed by a Dependent Agent PE should be dealt with under the AOA.
77. Example 2 in Appendix II considers the example where there will be a multiplicity of PEs in one country in respect of a single transaction. This is another area of complexity where further explanation in the draft guidance would be very welcome.
78. We further suggest the OECD includes additional examples to address commonly used complex business models such as warehousing operation PE under a toll-manufacturing arrangement. The more comprehensive the examples available, the less likely it is that disputes will arise in respect of real world complex business models.

Assumption that PE exists

79. While the business models identified and outlined in the examples used in the discussion draft are simplified, they will still be relevant for some existing business models, and, to the extent that they identify the level of activity that can be undertaken with minimal attribution of profits, this provides some comfort to taxpayers wishing to structure the location of their people and functions such that they do not cross lines that would result in significant attribution of profits to PEs and the corresponding administrative burden that would apply.
80. However, we are concerned that in every example (however simplified) it is assumed that a PE exists and a profit attribution calculation must be performed. We believe this is a fundamental departure from the previously held practice that companies could opt to incorporate local subsidiaries and undertake robust transfer pricing analyses to limit the risk of PE challenge when operating overseas. It would be helpful to have a threshold example or, at least, an example showing exactly where a PE would not exist for the purposes of this guidance.

81. We do not believe that creating PEs wherever a subsidiary exists was the intention of the revised wording for Article 5 of the MTC, and would welcome additional examples of where a related enterprise does *not* create a PE in order to remove uncertainty in this respect. This is important given that Article 5.7 establishes that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company (par. 40 Commentaries on Art. 5.7).
82. Further, it is noted in the commentary that, "however, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude contracts in the name of the parent (see paragraphs 32, 33 and 34 above), unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article applies" (par. 41 Commentaries on Art. 5.7). We note that this paragraph has not been proposed to be amended by BEPS Action 7, potentially creating inconsistencies with the proposed new attribution of profits to PE guidance.

Additional comments on draft examples provided

General comments

83. The basic functional and factual analyses and application of step 1 of the AOA are critical to the usefulness of examples, particularly where the examples represent relatively simplified business models, but then must be applied to more complex business models in practice. We request that the functional and factual analyses for each example are, therefore, given more focus.
84. In particular, we propose that the tables for Examples 1 and 2 are integrated into the discussion of each example rather than relegated to Annexes, and a table on a consistent basis is inserted in relation to Example 4.
85. Additional guidance would be helpful with respect to the two key concepts "SPFs" and "Free Capital" in order to ensure that there is no ambiguity in understanding them.
86. The OECD make a number of assumptions in the paper which are applied to the practical examples presented. They concern:

    i. Assumptions regarding the facts that give rise to the creation of a PE, specifically in Example 1, (and taking into account the wording in the MTC Commentary on Art. 5(7)-40), providing that no additional functions, assets and risks were attributed to DAPE;

    ii. Assumptions regarding Remuneration of the Related Parties / Head Office/ PE (e.g. incentive fee); and

iii. Assumptions regarding Proportion of Attribution of risk to Head office and PE (e.g. 75%, 25%).

87. Whilst we appreciate that it is necessary to make certain assumptions for the purposes of providing examples, as there is no detail on how these assumptions were reached, we believe there is a risk that they could be misinterpreted as rules / official OECD positions. The OECD should be clear that these assumptions are not indicative of the most appropriate way to identify functions, assets and risks, nor to apportion profits to PEs, but are specific to the facts of these examples.

88. BIAC would also appreciate the OECD undertaking further work on aligning the analysis under Article 9 and Article 7 of MTC to reduce the risk of conflicting interpretations. Article 7 of the MTC is based on similar assumptions to Article 9 (under step 1 of AOA, PE should be treated as a separate and independent entity enterprise, and remunerated based upon a comparability analysis using by analogy the guidance on TP methods).

Example 1

89. We believe that the Article 9 summary at paragraph 45 would be better expressed as the allocation of income and expenses between Prima and Sellco. Such an analysis is the proper outcome of the analysis and a delineation of the allocation between Sellco and Prima would be the clearest starting point for the subsequent Article 7 analysis allocation of profit or loss between Prima's Head Office and DAPE. The same point applies to Examples 2 and 4.

Example 2

90. In Example 2, Sellco undertakes additional functions and risks that will be compensated by an increase in the expected return. We found it difficult to understand the calculation of the Sales commission in the amount of “30”, until we reached Example 3, paragraph 66: “in accordance with the assumptions in Example 2 should, if it were a separate and independent enterprise, earn an operating margin of 4.5%”. The explanation on the calculation of the Sales commission should be included in Example 2 (or alternative reasoning included if it is not the same as Example 3).

91. We believe that footnote 10 is somewhat confusing in this example. While the OECD has made clear in the 2010 Report on Attribution of Profits to Permanent Establishments that it does not adopt a “single taxpayer approach”, the footnote seems to apply that this approach should be used, i.e. by stating that “when the analysis under Article 9 has already been performed to allocate risk to Sellco, the analysis under Article 7 will not attribute the risk to the DAPE”. Clarification on this point would be welcomed.

Example 4

92. We found the explanation of SPFs and free capital, and the rationale for the amounts attributed, difficult to follow in this example.
93. In addition, more guidance for determining whether a PE is appropriately capitalised would be welcomed.

Example 5

94. We would welcome it if the OECD could clarify its position on the attribution of the income derived from the selling of parts to third party customers. BIAC's understanding is that such sales would not be attributed to the PE (Warehouse), but we believe that this should be explicitly stated in order to mitigate the risk of disagreements between taxpayers and tax authorities on this point.

Questions in the draft

GUIDANCE ON PARTICULAR FACT PATTERNS RELATED TO DEPENDENT AGENT PERMANENT ESTABLISHMENTS ("DAPE")

1. **Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.**
    - BIAC agrees with the basic premise that if there is a DAE: (i) undertake an Article 9 analysis to determine the income and expenses of Company A and Company B, then (ii) undertake an Article 7 analysis to determine the income and expenses of Company A and Head Office and Company A DAPE.
    - This should be clearly stated in the final guidance to avoid any uncertainty regarding the order of application.
    - Additionally, as noted above in our general comments, we have reservations regarding the calculation of the Article 9 analysis, and request that the OECD take a proactive approach in encouraging solutions that could reduce the administrative burden.
    - The discussion draft does not adequately address the risk of double taxation in a host country where articles 7 and 9 overlap (in particular where the risks are not contractually allocated, but are delineated and allocated to the DAE under the Article 9 Analysis, and they are also managed through SPFs that are relevant for Article 7 Analysis). This should be addressed specifically in the guidance.
    - We believe that this sequencing not only provides the most clarity, on a basis consistent with the Action 7 objectives and principles, but may also be either necessary or of assistance, if local consolidated filing options are to be pursued.
    - As a practical matter we would suggest starting with a functional analysis of what is done in Country B and whether, within the context of the extended Action 7 PE concepts, that should be viewed as a domestic Article 9 supply to a DAPE which is thereby created, or as a cross-border supply to Country A (i.e. one which creates income in country B and expense solely in Country A, rather than expense in a Country B DAPE of the Country A host). It is not clear to us that there cannot be the "mirror image" domestic to domestic Country B supplies from the DAPE to the DAE (because local functions are carried on by the DAE) ,but if there can be such mirror image domestic functions, then those should also be identified. We would suggest that a logical sequence to subsequently follow is:

        (i) Make all Article 9 charges other than these domestic Country B to Country B charges;

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

(iii) Make Article 9 charges within Country B so as to separate local taxable profits/losses between local entities or presences.

- Alternatively, before the order re Article 9 and 7 analyses are considered, it may be worth providing taxpayers with the option of the performance of a broader functional analysis of DAE/DAPE (potentially leveraging the presumed Article 5 analysis). This analysis could be beneficial in terms of both efficiency and consistency (i.e. if no activities/risks were attributed to DAPE there would be no need for any Article 7 analysis and if activities/risks were attributed to DAPE it could be ensured that they differed from those attributed to DAE). The aim would be to avoid double counting of activities and/or risks in Country B and ensure that the activities/risks of DAPE are rewarded under Article 7 and those of DAE are rewarded under Article 9.

EXAMPLE 1

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

   - The analysis appears reasonable based on the limited facts of the example. The DAPE is not attributed risks because there are no SPFs performed by the DAPE on behalf of the non-resident enterprise; the DAPE is not attributed economic ownership of assets because there are no SPFs performed by the DAPE on behalf of the non-resident enterprise relevant to the attribution of economic ownership of such assets; there are no risks or assets attributable to the DAPE, so no capital is attributable to the DAPE.
   - However, the final guidance should provide clear direction and detail on the appropriate analysis that should be performed to reach these conclusions. In particular, the AOA does not rely on SPFs to attribute the economic ownership of tangible assets but instead presumes that the place of use should be "the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view."[4]
   - Since inventory is a tangible asset, attributing the economic ownership of inventory based on SPFs seems on its face to be inconsistent with the 2010 Report. It appears that the OECD is proposing a different rule for inventory. If this is the case, we believe

[4] Paragraph 75 of the 2010 Report.

it would be helpful to explicitly articulate it. This difference may be based on the fact that any value attributable to inventory is not attributable to its "use" in a conventional sense, but rather is attributable to decisions concerning what levels of inventory should be held, where it should be stored and at what price it should be resold. Thus, these SPFs are more important to the value of inventory than the place of "use". BIAC agrees with this implied analysis. In order to avoid different interpretations, it would be useful to articulate this as a special rule for inventory. Otherwise countries may take different positions based on existing paragraph 75 and this example. Such inconsistencies could lead to double taxation.

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

- While we appreciate that the end result is (in practice) that the DAPE is allocated a return equivalent to a sales agent (using distributor margin as a "proxy"), the DAPE activities outlined in paragraph 36 are clearly those of a sales agent. We do not believe that this is an appropriate basis for actually attributing economic ownership of the products being sold under a technical analysis under step 2 of the AOA, which is consistent with Article 7, given that neither sales nor cost of sales would be attributed to the DAPE if it was a distinct and separate enterprise performing sales activities.
- Furthermore, with regards to the remuneration of Sellco, we would like to highlight that in some situations with a similar fact pattern it would be appropriate that Prima pays Sellco for the services it performs on a cost plus basis instead of a commission fee. In particular, this would be the correct transfer price in the cases where Sellco is not that enterprise which decides whether to accept an offer. This scenario should be reflected in the final guidance accordingly.

4. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

- This, naturally, depends on the wording of the relevant treaty and the interpretation used in practice by the tax administration of the country of the PE. Generally, there is a concern that the country would use the method referred to in Article 7(4) of the older MTC and apportion some of the profit of the enterprise to the PE. This is particularly true of in Example 1, where zero additional profit is attributed to the PE but a non-AOA approach could attribute a higher profit.

- We refer to paragraphs 40 - 52 of our response regarding the limitations of the application of the discussion draft to countries who have not adopted the AOA and a request for all participating countries to do so.
- BIAC believes that countries should be required to commit to the AOA[5] if they are going to permitted to change their treaties to adopt the new, broader definition of a PE as part of the multilateral instrument.

5. **In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?**
    - Based on the facts provided and the absence of any SPFs, this is the correct answer and it is a positive sign from the OECD that this is used as the first example, because many DAPEs created by the changes arising from Action 7 will result in no additional profit arising, but additional unnecessary administrative burden for taxpayers and tax authorities. These scenarios could be more adequately handled by ensuring that an arm's length transfer pricing between Prima and Sellco is established either via a commission fee or a cost plus remuneration.

EXAMPLE 2

6. **Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?**
    - We are concerned that the example does not appropriately delineate the transaction that is being priced under Article 9, construct the dealings that are being priced by analogy under Article 7, or identify the most appropriate method for determining the transfer price by analogy under Article 7.
    - Several of the activities identified in paragraph 42 as Risk Control Functions (RCFs) for attribution of profits or losses to Sellco are then also identified in paras 49-50 as SPFs for the attribution of the same risks to DAPE (Footnote 10 appears inconsistent on this point). We suggest that this "double count" should be addressed by appropriate delineation and pricing under Article 9 to ensure that Article 7 analysis is only required where there are real, evident activities performed by Sellco on account of Prima and without such activities there would be no profits or losses attributable to the PE.

[5] Whether this would be the full or partial AOA would depend on which version of Article 7 is contained in the bilateral treaty that is being amended.

- It follows from the Article 9 analysis that all Sellco activity is performed on its own account as part of its service provision to Prima. It could thus be interpreted that there is no need for any Article 7 analysis, because following the delineation no additional functions have been performed on account of Prima. In those cases where the Article 9 analysis did identify Country B functions as being performed on account of Prima: (i) the Article 9 delineation would be a provision of staff by Sellco to Prima and the performance of the function by Prima; (ii) the consequential Article 7 analysis would then attribute Prima profits or losses to the DAPE based on those functions.
- At the same time, it should be recognised that this Article 9 analysis would involve a delineation of Sellco's activities as a high value credit management service provider to Prima, which entitles it to a premium fee while exposing it to an obligation to make good credit losses suffered by Prima.
- We refer to paragraphs 40 - 52 of our response regarding the limitations of the application of the discussion draft to countries who have not adopted the AOA and a request for all participating countries to do so.

7. **What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

    - This, naturally, also depends on the wording of the relevant treaty and the interpretation used in practice by the tax administration of the country of the PE. Generally, there is a concern that the country would use the method referred to in Article 7(4) of the older MTC and apportion some of the profit of the enterprise to the PE.
    - We refer to paragraphs 40 - 52 of our response regarding the limitations of the application of the discussion draft to countries who have not adopted the AOA and a request for all participating countries to do so.

8. **In your opinion, what would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?**

    - The answer should be determined by reference to the revised Chapter I of the TPG if the AOA is followed, and using that guidance, the risk should be allocated to the entity that actually manages and has the financial capacity to assume the risk. This may or may not be Prima in the example, as there is insufficient information to make the determination; this could result in a reduction in the fee to Sellco and an adjustment to the profit of the DAPE.

9. What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?

- A degree of complexity in Example 2 arises from attribution of the same functions to Sellco and to Prima. The same activities identified at Paragraph 42 as the RCFs for attribution of profits or losses to Sellco are then identified at Paras 49-50 as the SPF for the attribution of the same risks to DAPE (Footnote 10 appears inconsistent on this point). We suggest that this "double count" should be addressed by appropriate delineation and pricing under Article 9 to ensure that Article 7 is only in point where there are other activities (i.e. those not appropriately remunerated under Article 9) performed by Sellco on account of Prima and without such activities there would be no profits or losses attributable to the PE.
- For Example 2, it would follow from the above Article 9 analysis that all Sellco activity is performed on its own account as part of its service provision. There would be no need for any Article 7 analysis in the absence of any functions performed on account of Prima.
- In addition to the above, we have set out below a point on the simplification of this example. The OECD looks at the fact that there are SPFs relating to inventory risk and credit risk in the local affiliate and none at the Head Office. Based on that fact, it is suggested that the contracts with the local affiliate should be recharacterised, placing all the inventory risk and credit risk return (except for the funding return) into the contract, even where it was not in the actual legal contract. The Discussion Draft then infers that the controlling SPFs pull in (a) higher compensation for the local affiliate and (b) the assets and risks of the non-resident entity related to inventory and credit into the PE, but limit the return at the PE to a funding return. This could either (a) create a double counting of the funding return (where it is assumed that the local affiliate has the capacity to bear those risks) or (b) irrationally segregate the funding return when it should have gone to the local affiliate with everything else, leaving nothing in the PE. If the contract were to be recharacterised, we believe that the appropriate simplification would be to recharacterise it by transferring both the economic return on the specified risks and the funding return, leaving zero at the PE.

EXAMPLE 3

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

    - In this example there appears to be no incorporated entity in the host country[6], but an employee who operates in the host country is responsible for inventory decisions, credit terms and approving sales.
    - BIAC agrees that in this instance it is clear that no Article 9 analysis is required. BIAC also agrees with the approach taken in respect of the Article 7 analysis; the DAPE is remunerated the arm's length price that would be paid to a third party agent, which is calculated as a reasonable target operating margin of 4.5% with all other profits remaining in the head office.
    - However, BIAC is concerned that the examples neither construct the dealings nor identify the most appropriate method for determining the transfer price by analogy.

11. **What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?**

    - This, naturally, also depends on the wording of the relevant treaty and the interpretation used in practice by the tax administration of the country of the PE. Generally, there is a concern that the country would use the method referred to in Article 7(4) of the older MTC and apportion some of the profit of the enterprise to the PE.
    - We refer to paragraphs 40 - 52 of our response regarding the limitations of the application of the discussion draft to countries who have not adopted the AOA and a request for all participating countries to do so.
    - Per our response to question 4, BIAC believes that countries should be required to commit to the AOA if they are going to permitted to change their treaties to adopt the new, broader definition of a PE as part of the multilateral instrument.

EXAMPLE 4

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

[6] BIAC would welcome confirmation that there is no incorporated entity in the host country as it is not clear. The OECD commentary mentions that "Prima does not engage Sellco as its sales agent in Country B"; however, it is not clear from the OECD wording whether Sellco actually exists.

- In this example, Sellco takes on some of the credit risk and is given incentive payments for managing receivables and is remunerated accordingly under Article 9. But then under the Article 7 analysis, the DAPE is allocated a share of the risk return in proportion of its risk management costs under the proposed recharacterisation of the contract. Accordingly, it ends up with much higher profits (or losses) than where no risks are taken on. This is broadly in line with the ALP. However, the conclusion that Sellco's compensation may take the form of sharing in the potential upside and downside should not necessarily be the case.
- The Discussion Draft uses proportionate risk management costs to allocate the risk return between the principal and PE, which assumes that cost is directly representative of return. However, cost does not account for significance of decisions that are made, or whether the PE is implementing the principal's risk control strategy in a perfunctory way (pay differential may capture some of these disparities). The Example should make it clear that adjustments may be made for relative risk control rather than determined by cost alone.
- Example 4 also shows that a loss should also be allocated in the same way (under both Articles 9 and 7).

13. Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?

- In the case of Example 4, a similar argument applies to the Article 9 analysis as in relation to Example 2. Here, the fact of the incentive fee being based on credit performance is itself consistent with characterisation of the activity as being performed on Sellco's own account as a service.
- Additionally, as in Example 2, the Article 9 analysis would be a delineation of Sellco's activities as a high value credit management service provider to Prima which entitles it to a premium fee while exposing it to an obligation to make good credit losses (under the recharacterisation of the contract per the Discussion Draft).
- BIAC would welcome additional guidance on this example because, although the functions performed by Sellco in Example 4 are less extensive than the functions performed in Example 2, the profit attributed to the DAPE is much higher. This may be due to the difference between Article 7 and Article 9 on how to allocate risks, but this is not clear.

- Additionally, we would like to note that although we agree with the OECD's explanation, it is of some concern to business, as it creates a significant incentive for countries to find that SPFs are performed locally. Given the difficulty of performing the factual and functional analysis to the level of detail that may be required, it may be difficult for taxpayers to reach certainty and countries may assert profits attributable to SPFs when the taxpayer was of the view that those functions were not significant.

GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS ARISING FROM ACTIVITIES NOT COVERED BY SPECIFIC EXCEPTIONS IN ARTICLE 5(4)

EXAMPLE 5

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

- The language of the example does not make it clear that the AOA was properly applied to reach this result. BIAC's concern is that the general principle of the AOA is that the rewards of economic ownership are generated by SPFs. There is no reason to suppose that WRU is not continuing to exercise such functions in relation to the warehouse, albeit not in Country W, for example, in its selection of Wareco as a partner and its ongoing oversight of the Wareco contract. The dealings between the Head Office and the PE, as required by the AOA, have not been clearly set out in this example. Given the context, it is not clear why the PE is treated as having received all the customer revenue; if all the controlling functions are in Country A, the Head Office ought to receive all of the customer revenue.
- The Discussion draft states that the principle is to impute a return to the PE that is equivalent to the economic ownership of the warehouse. This makes the analysis that examines the principal's sales and cost of goods sold irrelevant, and therefore it should be excluded; the analysis in the Example should be limited to that of an arm's length return for owning a warehouse asset.
- Finally, the examples ought to point out that that the warehouse may not be in the country where the inventory is sold. In that case, the warehouse would not create a PE in the country of sale, and sales in another country cannot be attributed to that PE.

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

- A profit and loss statement in respect of these examples, as is provided for examples 1-4, would be welcomed.

- If assets should be attributable to the location of the SPFs, there is no rationale for treating tangible property differently from intangible property, in which case any "funding" return for the warehouse should appropriately go to WRU in Country A.
- In Scenario C, there are not even any routine people functions in Country W, let alone any SPFs. However, assuming that the warehouse is owned by WRU and used in its business, that would seem to constitute use for purposes of paragraph 75 of the 2010 AOA Report. In this case we would agree that the PE should receive a funding return for ownership of the warehouse. This should result in a smaller return to the PE compared to 5A or 5B. That difference is directly attributable to the profit received by the third party.
- We assume that there is no funding return on the inventory assets for the reasons described in our response to question 2. If so, this should be clarified when the guidance is finalized.
- The meaning of the word "streamlined" in paragraphs 97 and 101 is not clear and we request that the OECD clarifies this terminology.

16. In particular, do you agree that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?

- Whilst BIAC does agree, we believe that an *investment* return should be limited to situations where the principal is the legal owner of the warehouse and there are affiliated risk controlling SPFs in the country.
- If there is tangible property in the PE country which is used by the PE, then we would agree that, pursuant to paragraph 75 of the 2010 AOA Report, there can be a *funding* return on those assets even if there are no personnel of the non-resident enterprise operating in the PE.
- See below (response to question 17) regarding concerns on the differences between *funding* and *investment* returns.

17. Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?

- The simplicity of the streamlined approach in this example is welcomed, but its basis appears inconsistent with the AOA. The streamlined approach attributes an investment return to the PE as a reward for the economic ownership of the warehouse and has parallels with the attribution of a risk free return to a party for the passive provision of capital.

- If this is intended to be an approach that can be used to limit administrative costs, identifying an investment return based on comparable asset ownership investments could be considered.
- With respect to the quantification of the "return" on the tangible assets, the draft uses the phrase "investment return" in some places and "funding return" in other places. The difference between the two phrases is not clear. Whilst we agree that the PE should receive a funding return on its assets and a routine return service fee for the services rendered. If the active decision making is not in the PE country, the PE country should be limited to a funding return and not an investment return. Additional guidance on the difference between these concepts would be welcomed and help to reduce misunderstandings.
- Further, it should be highlighted that it might be the case that no profit should be attributable to the PE, as in Example 1.

18. Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.

- If there is no operational link between the SPFs carried out by other parties acting on their own account and the activities of the PE, then it is correct that there should be no attribution of profit under the AOA and assuming the wording and normal interpretation of Article 5(7).

19. Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits to the PE of WRU?

- There would not be a difference. This is a useful confirmation that a subsidiary or PE that provides a service at a fee that is arm's length is not entitled to any additional profit simply because of its related party status with another business within the overall enterprise.

20. What would the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

- This, naturally, depends on the wording of the relevant treaty and the interpretation used in practice by the tax administration of the country of the PE. Generally, there is a concern that the country would use the method referred to in Article 7(4) of the older MTC and apportion some of the profit of the enterprise to the PE.

- We refer to paragraphs 40 - 52 of our response regarding the limitations of the application of the discussion draft to countries who have not adopted the AOA and a request for all participating countries to do so.

EXPLORING ADDITIONAL APPROACHES TO CO-ORDINATE THE APPLICATION OF ARTICLE 7 AND ARTICLE 9 OF THE MTC

21. Do commentators have suggestions for mechanisms to provide additional co-ordination for the application of Article 7 and Article 9 of the MTC to determine the profits of a PE, taking into account the considerations expressed above?

- As noted above, the arm's length principle can be applied to SPFs, as this would be the case if the functions were outsourced to an unrelated party. This should mean the SPFs can be included, in many cases, in the Article 9 analysis where they are performed by a related party, which is the appropriate mechanism for allocating profit in related party dealings (thereby relieving Article 7 so that there is nil profit attributed to the PE).
- Where the SPFs are identified and remunerated under Article 9, and no amount is attributed to the PE, the principal should be able to disregard the existence of the PE and not be required to file a tax return (see comments above re a safe harbour exemption). Similarly, de minimis amounts that fall within Article 7, (and not squarely within Article 9), should be capable of being addressed through Article 9 if the principal chooses to avoid filing requirements and potential unintentional VAT/GST/wage tax consequences.

Appendix I: Examples of cases where non-application of the AOA has led to a departure from the arm's length principle

Specific Examples

Countries explicitly not following the AOA

In 2016, WTS Alliance[7] undertook a survey of 62 countries[8] approach to permanent establishments. It found that even before examples of "in practice" departures from the AOA are considered, a significant number of countries have not formally adopted the AOA (some of which are OECD/G20 countries):

- Austria
- Azerbaijan
- Bahrain
- Indonesia
- Iran
- Kuwait
- New Zealand
- Oman
- Qatar
- Russia
- Serbia
- Thailand
- Trinidad & Tobago
- United States of America
- United Arab Emirates
- Venezuela
- Vietnam

Rolls Royce (India)

The Indian Revenue attributed 75%-100% of the profit from the Indian contracts to the Dependent Agent PE (DAPE) in India. The Tax Tribunal and High Court attributed 50% of the global profit to manufacturing, 15% to R&D and the remaining 35% to sales/marketing. The entire 35% of the sales/marketing profit was attributed to the DAPE in India.

[7] WTS Alliance is a global network of tax advisory firms, with a presence in more than 90 countries.
[8] http://www.wts.de/en/content/global_wts_pe_study.php

Rolls Royce - Delhi High Court.pdf   Rolls Royce - Delhi Tribunal.pdf

Dell (Norway)

The Norwegian Revenue asserted that 60% of the profits attributable to Norwegian sales should be allocated to the DAPE in Norway.

Dell DAPE Norway Ruling.pdf

Zimmer (France)

While the French Revenue did not win the case, this was on the ground that under existing rules, the PE threshold had not been passed for a commissionaire structure. However, the French Revenue had argued that a profit split methodology should be used to allocate profits to the PE in this case.

Members' Anecdotal Evidence

China

It is expressly stated under the Chinese tax laws that deemed profit allocation methods can only be used when the AOA cannot be applied due to the lack of accounting materials etc. Nevertheless, in practice most PEs are taxed on the deemed profits allocating 15% to 50% of gross revenue to China.

The reasons for such a tendency are various: i) most PEs do not keep sound book accounts; ii) tax authorities tend to adopt a simpler method to tax PEs to reduce their administration costs; and iii) even taxpayers may tend to use deemed profit method to reduce their admin costs, in particular for those short-term projects with relatively high profit level.

Appendix II: Example Business Models

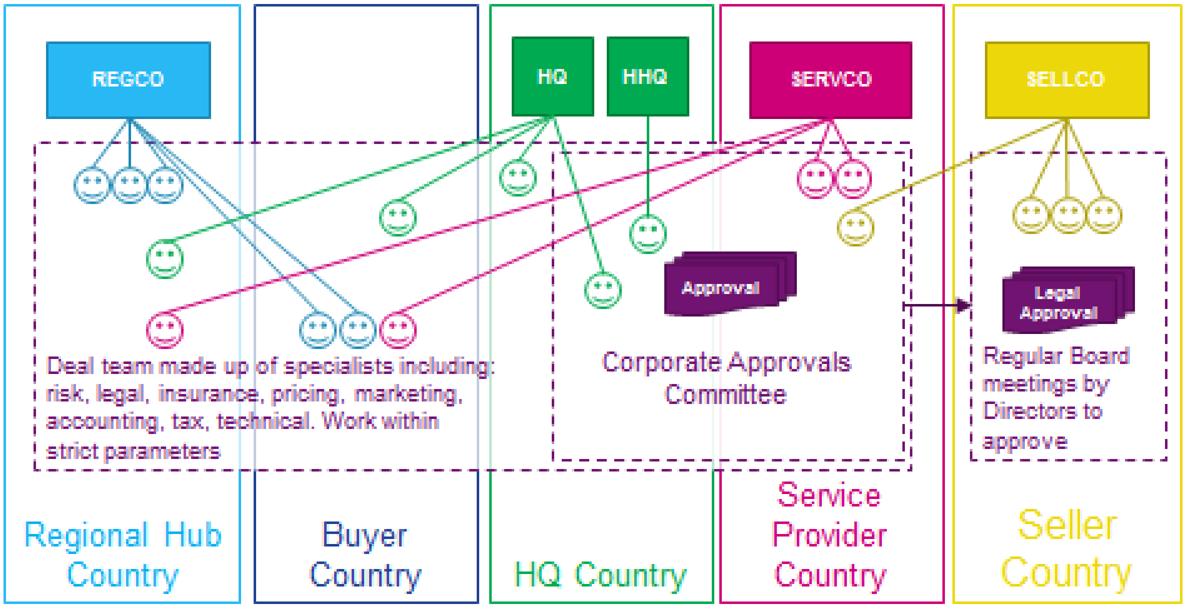
Example 1

This example highlights the difficulty of identifying in which countries the "principal role" is played in contract negotiations.

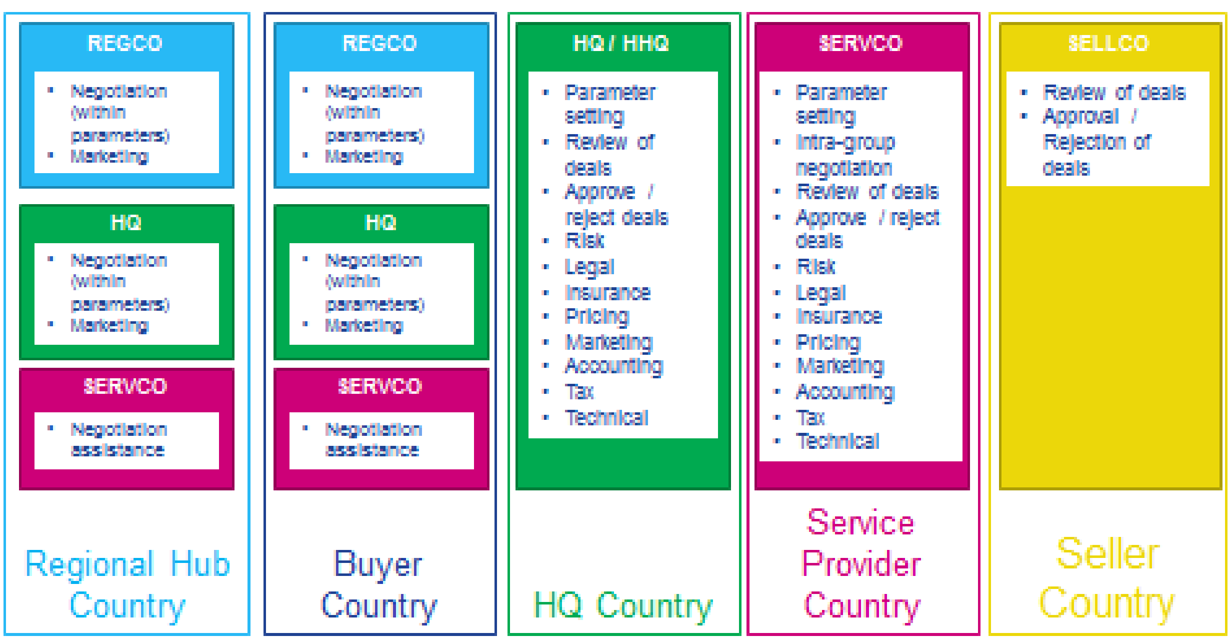
Background and overview

- In this example, employees from several companies will act in concert to negotiate the deal with the customer, although it will always be within parameters designed in advance with input from the business line Headquarters (HQ), the global group headquarters (HHQ), and a company employing specialists to determine appropriate specific deal terms (ServCo). All of these parameters were designed by individuals who were not travelling when setting the parameters.
- However, the negotiation is undertaken across several countries and involves a deal team made up of employees from a regional sales company (REGCO), the company that is actually selling the asset (SELLCO), HQ, and SERVCO. Approval (but not negotiation) is also required from HHQ on large contracts.
- These employees may be in any of a number of countries while negotiating the deal, including the country of the customer, the country where REGCO is incorporated, the country where ServCo is incorporated, the country where HQ is incorporated, or potentially any other country (for example in the country where the seller has its own PE). These functions may be undertaken remotely, via video or phone conference, or in person meetings with each other and/or the customer.

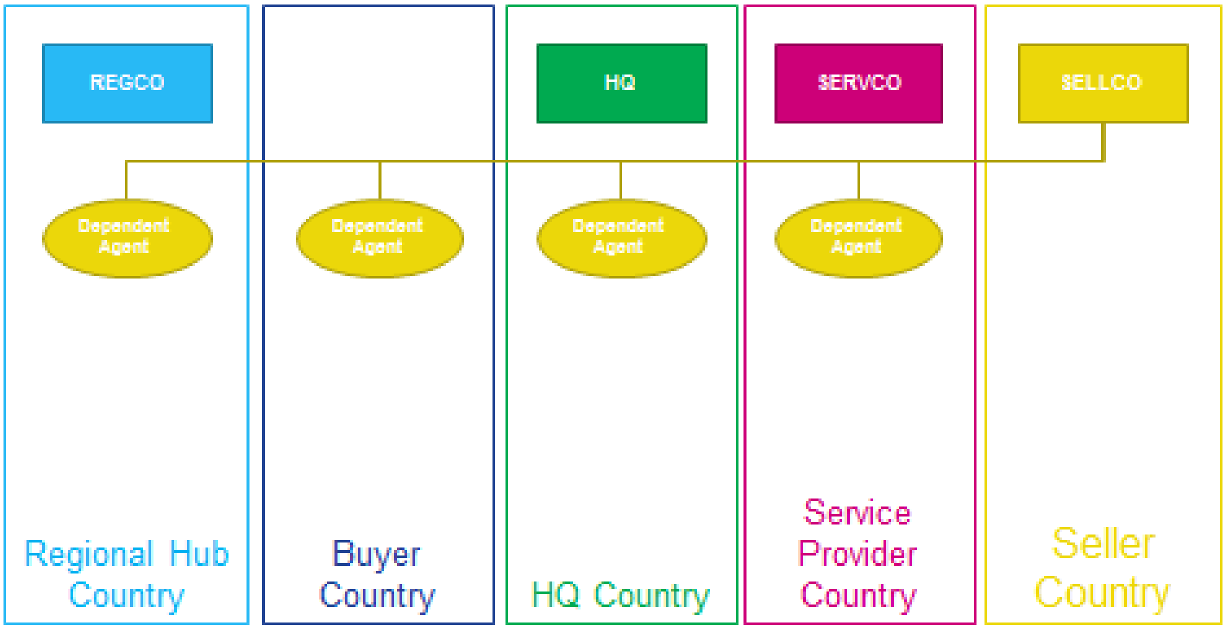
Locations of employees during deal negotiation



Locations (and entity) from which activities are undertaken



Potential PE's under revised Article 5



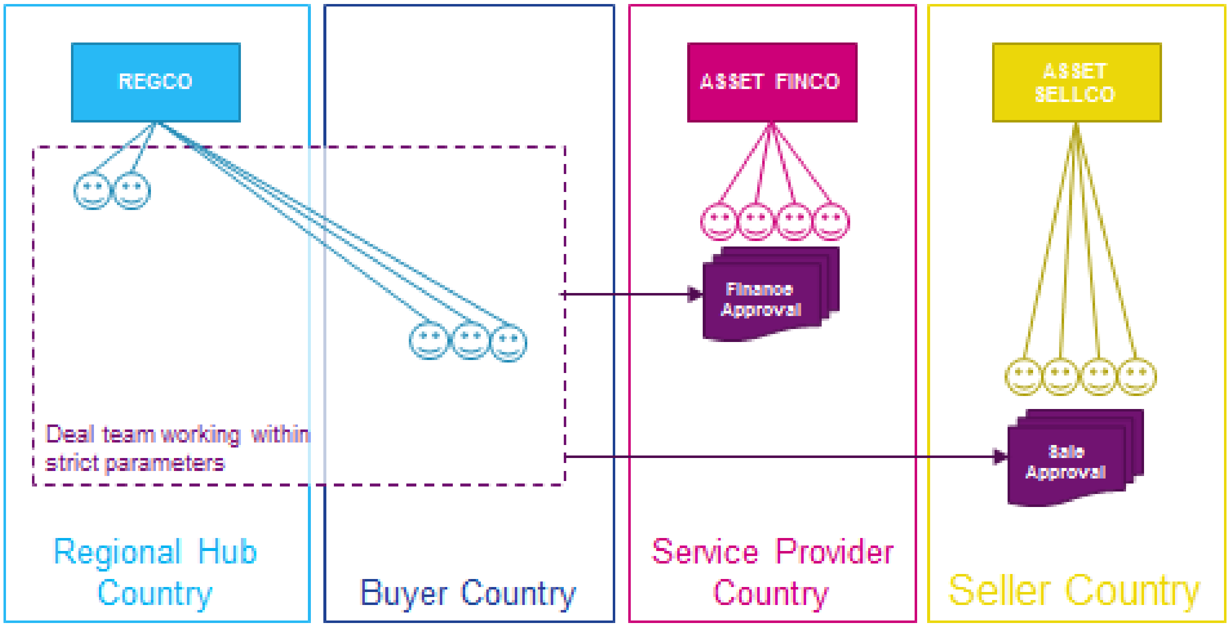
Example 2

This example highlights how multiple PEs within multiple countries could be created in relation to the same deal.

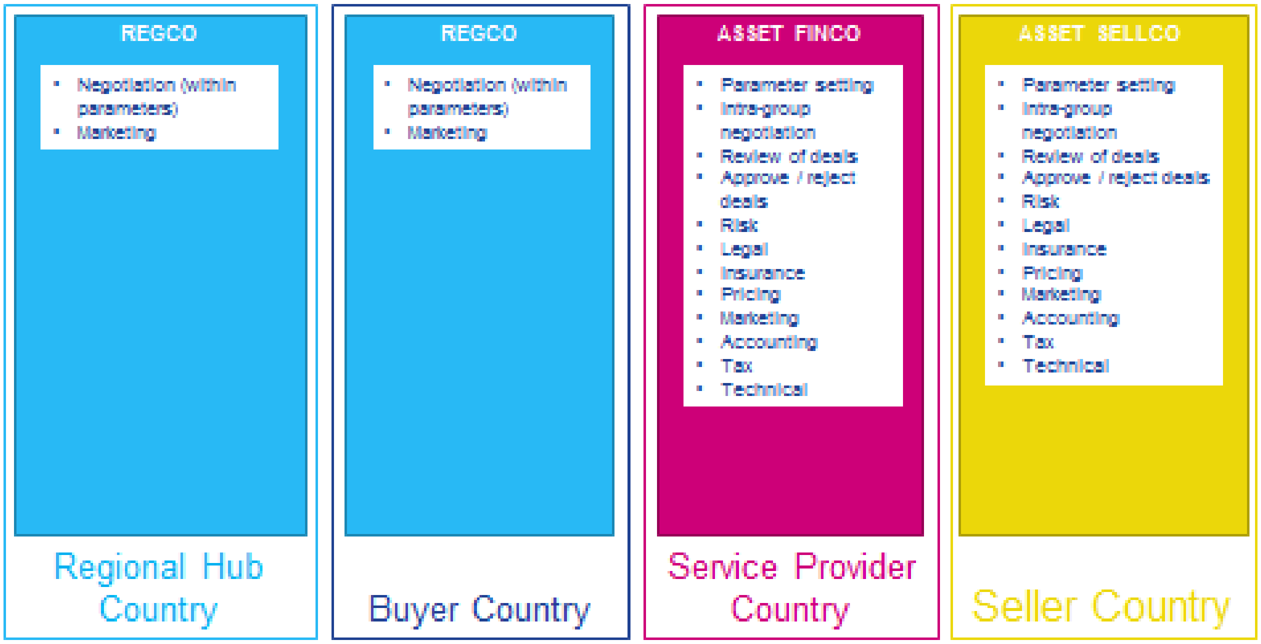
Background and overview

- In this example, an MNE sells assets, and also provides financing service to its customers. For regulatory and commercial reasons, one entity manufactures and sells assets (ASSET SELLCO), and another entity provides financing (ASSET FINCO).
- ASSET SELLCO and ASSET FINCO have developed strict parameters through which deals can be agreed, and undertake significant functions in their home countries to support deal completion. However, to ensure that the customer only has to deal with one party in their own country, sales and marketing activities are carried out by a regional sales company (REGCO) who contracts with both ASSETCO and FINCO for provision of marketing and sales services (currently remunerated on a cost plus basis).

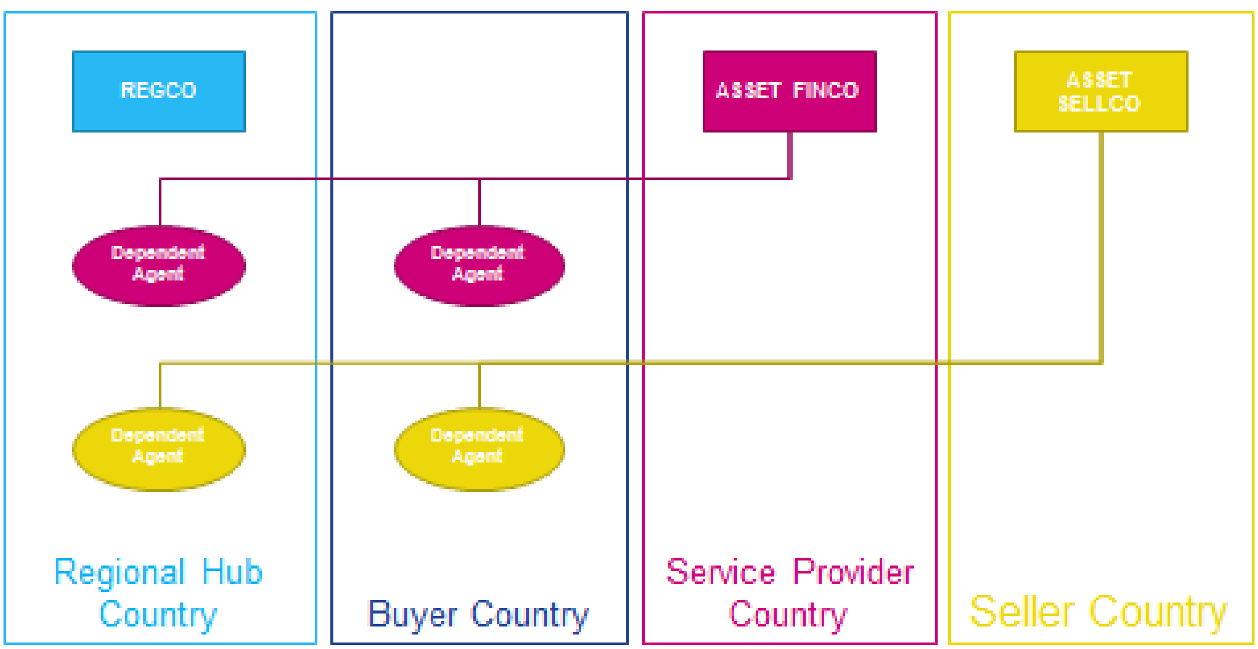
Locations of employees during deal negotiation



Locations (and entity) from which activities are undertaken



Potential PE's under revised Article 5



Example 3

This example highlights the complexity in valuation / allocation of pricing risk.

Background and overview

- FCO manufactures heavy engineering, high technology products in Country X.
- SCO (100% subsidiary of FCO in Country Y) supports sale of FCO products in Country Y functioning as a Sales Agent.
- Sales and Marketing activities are undertaken by SCO though it only has range bound authority on some terms and conditions.

Decision making matrix

Key Terms and Conditions	FCO	SCO	Commercial Rationale
Price … Discounts < 15% of List Price		✓	
Price … Discounts > 15% of List Price	✓		Decision impacted by global demand, factory capacity utilization
Payment Terms up-to 90 days		✓	
Payment Terms >90 days	✓		Negative impact on Working Capital due to mismatch between FCO's receivables and FCO's vendor payables
Liquidated Damages = contract price		✓	
Liquidated Damages > contract price	✓		Can have financial impact disproportionate to the Contract
Delivery Schedule	✓		No Manufacturing, Supply Chain resources in SCO since product manufactured by FCO
Performance Guarantee	✓		No Engineering resources in SCO; co-located at manufacturing facility in FCO
Warranty Period/ Scope	✓		No Engineering, Manufacturing resources in SCO

Potential issues

- If SCO is regarded as DAPE, how should profit be attributed to such DAPE, excluding return for functions and risks attributed to FCO outside Country Y?