



Business and Industry Advisory Committee to the OECD

Comité Consultatif Economique et Industriel Auprès de l' OCDE

Paris, 3 November 2005

Dear Jeffrey,

As indicated in prior correspondence, BIAC and its members continue to work to make the PE Attribution of Profits project more practical and workable.

The OECD and the Working Parties have previously received our views on the difficulties of the KERT concept as a method of attributing profits. We believe that examples are a much better means of approaching the issues around attribution than through highly theoretical and abstract commentary.

Our submissions of 10 May and 31 May 2005 covered the KERT and related difficulties, while our 5 October 2005 submission amplified those comments, as they relate to Dependent Agents. Enclosed is another set of examples that have a different focus. The purpose of these examples is to help redirect the approach of the PE attribution project to be more in line with the various other principles and provisions of international taxation in the Model Convention and OECD guidelines. The best approach is to bolster the relationship between Article 9 (and the Transfer Pricing Guidelines) and Article 7, by reverting to a proper transfer pricing analysis under them.

Many thanks to the CBI (lead), the USCIB, and other BIAC member organizations for their hard work on these examples, which we hope and expect will be of significant value to this work.

Yours Sincerely,

Richard M. Hammer
Chair

Patrick J. Ellingsworth
Vice Chair

Mr. Jeffrey Owens
Director
OECD Centre for Tax Policy and Administration

Cc: Thomas R. Vant, Secretary General, BIAC



BIAC Submission on OECD Discussion Draft of the Report on the Attribution of Profits to a Permanent Establishment - Part I

November 3, 2005

I. INTRODUCTION

In previous discussions between BIAC and the OECD on international tax issues we have been asked to provide examples of modern and constantly evolving commercial operations to improve understanding of business practice and consideration of appropriate tax treatment. In light of this we provide below several examples which we hope will be of use in discussion with business as the OECD moves forward in considering changes to Part I of the Discussion Draft on the Attribution of Profits to Permanent Establishments (PE), and also the deliberations of the Joint WP1/WP6 Working Group on Business Restructuring. We realise that this is an iterative process but we hope that our comments will be fully reflected in any textual changes to the Model Treaty Commentary which may be made. Ideally the OECD and business will agree on suitable wording to avoid any possible future misunderstanding especially as OECD Member Governments and business share the aim of persuading other non-Member Governments to adopt OECD international tax norms.

We would begin by referring you to the sentiments and thoughts expressed by BIAC in our letter of 5 October to you on Article 5(5). We understand the OECD concern to be that certain "objectionable business restructurings" have been undertaken where there is no change in the functional or risk profile of the entities involved and, yet, where profits are purported to move from one country to another. We acknowledge that OECD members see this as a real problem to be dealt with in a manner that restores confidence between business and government in the workings of international agreements on taxation of cross-border transactions. In a global economy, however, changing manufacturing patterns and practices, different customer needs, and other considerations lead to certain business restructurings where there is a true shifting of functions. We believe that it is important therefore for fiscs not to impede ordinary, valid, restructurings so as not to impair normal business development.

We further understand that fiscs believe that in certain of these "objectionable" cases, a dependent agent PE may also arise (as also spelt out in the 5 October BIAC letter), and that some amount of attribution may be appropriate under Article 7 of the OECD Model Treaty. However, we would emphasize that a business restructuring never, automatically, gives rise to a dependent agent PE. Furthermore, in cases involving two separate entities we believe, both as a legal matter and as a practical matter, that a transfer pricing adjustment under Article 9 between associated enterprises will be more efficient and less disruptive for business, while completely protecting the taxing jurisdiction. Thus, even where an Article 7 attribution could possibly be used, it would still be more efficient to use Article 9 for the whole amount. We would emphasize, however, that even if Article 9 and Article 7 were both sought to be used, the aggregate amount of the adjustment and attribution should not exceed the amount that would have been earned by an unrelated party in the distributor's country

performing the same functions. That is to say, additional profit, over and above any arm's length amount, should not be attributed from the supplier company.

As we are sure you are aware, the use of dependent agent PEs, can cause significant problems for business, and create administrative complexities for tax authorities where there are already two entities involved, including the creation of a third taxpayer, the requirement to file another set of returns, the possibilities of penalties, and spill over into other taxes (particularly VAT). Yet, because transfer pricing can be adjusted whether the distributor is a dependent agent PE or not, all of this complexity does very little for the tax authorities. We believe that dependent agent PE's arise only infrequently in this setting, and would ask you to consider simplified procedures for accounting for any required attribution where a dependent agent PE does exist – perhaps by making that accounting an obligation of the existing entity in that country.

Therefore, in the spirit of trying to accommodate both the legitimate concerns of governments, as well as the practical concerns of business, we offer the following examples:

- In those involving Countries B-F, a number of common types of business restructurings are looked at. In each case, while there has been a business restructuring, no dependent agent PE exists. Also, because appropriate transfer pricing has been applied, there is no Article 9 adjustment to be made.
- In the example involving Country G, the transfer pricing is not appropriate. Therefore, an arm's length adjustment is required. However, A exercises no functions in Country G. Therefore, even if it were to be determined that a dependent agent PE exists (based on an analysis of A's control of G, and G habitually entering into contracts in A's name), no attribution should be made under Article 7, and any adjustments should be made only under Article 9.
- In the example involving Country H, H enters into contracts in the name of A and performs services for A with respect to property that A maintains in Country H. If it were to be determined that a dependent agent PE exists (e.g., based on control and contracting authority), some attribution under Article 7 might be made. However, even in this case, it seems that the most, if not all, of the transfer pricing discrepancy could and should be made up through an adjustment under Article 9, because of the functions carried on by H. The result should be the same in either case, and, in any event, the total amount allocated could be less than but cannot exceed the arm's length compensation earned by a full service independent distributor in Country H.

The examples were created to analyze the tax treatment of the ongoing business after the restructuring, rather than the taxation of the restructuring. Although the examples therefore do not discuss the taxation of the restructuring, we acknowledge that the entities engaging in the restructuring must give proper tax effect to any transfers of tangible or intangible property that occur as a result of the restructuring and that tax authorities have the right to impose income tax on the gain realized in such transfers.

We do hope that these examples – and the accompanying commentary in this note – are helpful. As we noted above, the business community does recognize the concerns of some OECD fiscs that in some extreme cases the asserted impact of business restructurings on profits and tax obligations seems rather aggressive. However, we would ask the OECD and its members generally to use the traditional – and appropriate – methods of dealing with these problems under Article 9, rather than encouraging the discovery of dependent agent PE's and then using Article 7, with all the practical and administrative issues that that raises for business.

II. EXAMPLES

1. No attribution of affiliate profits required where affiliate sales agent is adequately compensated under arm's length principles

The A group, headquartered and incorporated in Country A, is in the business of manufacturing and selling product A which is tangible personal property. After various acquisitions, the A group moved from a decentralised business model to a centralised business model in order to meet changing customer demands, to capture synergies and opportunities to reduce costs. In this new business model, the following functions have been centralised: procurement, supply chain management, product management, marketing, pricing, and credit and collection (the "Centralised Functions"). The Centralised Functions are performed by A employees who are located in Country A. The group manufactures goods in Country A and maintains in Country A an inventory of finished goods awaiting shipment to customers in Country A.

A sells its goods through local sales affiliates incorporated and operating in countries B, C, D, E and F. The activities of the local sales affiliates are: gathering market information; promoting products with potential customers in their market; maintaining relationships with existing customers (e.g., answering questions on product application, deliveries, quality issues); assisting A with negotiations with customers; and, assisting with the collection of receivables. Contracts with customers are concluded by A, apart from contracts with customers in Country B and Country C. The customer contract includes among other items, the agreed sales price list, and the terms and conditions under which the sales will be made.

- Country B. Sales personnel of affiliate B are allowed to negotiate and agree on prices, terms and conditions with customers as long as they are within the guidelines that have been issued by A. If the customer wants lower prices (e.g., by more than x% a certain nominal amount), or different terms and conditions than those set out in the guidelines, sales staff are obliged to obtain approval from A before they can sign the contract. Customers send their Purchase Orders (PO) to B. If received by B, it will review and process the PO and, if in accordance with the contract, will issue a confirmation to the customer. During the term of the contract, sales personnel of B are allowed to agree to further discounts, or vary terms and conditions as long they stay within the guidelines issued by A. B sends invoices to the customer in its own name. Goods are shipped directly from A to the customer, but title passes (momentarily) through B. A and B have agreed upon a distribution agreement, meaning that B is selling in its own name, but effectively for the account (and risk) of A. For its activities, B is remunerated by using a transfer price method that is based on a functional analysis, for example, a discount on the average net customer sales price.
- Country C. The affiliate is performing similar activities as in Country B, but C works under a commissionaire agreement in a civil law jurisdiction, meaning that C is selling in its own name (invoices are issued in the name of C) but for the account of A. Title to the goods passes directly from A to the customer. For its services, C receives a commission fee based on its sales.
- Country D. Sales contracts are concluded by A. D's role is limited to helping/facilitating the negotiations (e.g., providing information, relaying details of the offer from A to the customer and responses from customers on offers etc). Once the contract is signed, customers send their POs either to D or directly to A. If D receives the PO, it will review and process the PO. Invoices are sent out by A. From time to time, D may grant the local customer an additional discount (e.g., x% on the agreed sales prices, or a nominal amount) or extend payment terms (e.g., by another y days), based on

specific detailed guidelines provided by A. A and D have agreed on a commission agent agreement. D is remunerated on a commission fee basis.

- Country E. Contracts are concluded by A. E's role is helping and facilitating the negotiations (similar to D). E does not have the authority to negotiate on price, terms or conditions, or accept orders that deviate from those in the signed sales agreement. Customers send their POs to either E or A. If sent to E, E will review the order and send it on for processing. If it is in line with the terms and conditions of the agreement, E may send the customer a notification. A and E have agreed a commission agent agreement. E is remunerated on a cost-plus basis.
- Country F. Contracts are concluded by A. F's role is helping and facilitating the negotiations (similar to D). Customers send their POs to F, which passes the POs to A without change. If accepted, A notifies F who in turn notifies the customer. A and F have agreed a representation agreement. F is remunerated on a cost-plus basis.

Commentary

The arm's length level of remuneration that is appropriate for each affiliate will vary in light of the specific functions carried on by each. In each case the sales affiliate is not concluding contracts in the name of A and therefore cannot constitute a dependent agent permanent establishment (PE). Notwithstanding the clear language of Article 5 of the OECD Model Tax Convention, if it is argued that such a PE were to be recognised, in none of the above examples can any profit earned by A be allocated to the sales affiliate. The functions performed by the sales affiliates consist of marketing and customer relations—functions that are adequately compensated in the computation of the arms' length fee. Other functions that contribute to A's profit are performed by A itself in country A. There is no factual or functional basis for attribution of a portion of A's profit to any of the other entities or countries.

2. Adjustment where sales affiliate not adequately compensated under arm's length principles

- Country G. Subsequently A acquires G in Country G. G was previously an independent, unrelated distributor for multiple producers that made all decisions, undertook all market research, had all risk, and entered into its own contracts with customers. In order to conform G with the rest of the group, contracts with G's customers will be negotiated by G but entered into and approved by A (but that approval is always to be given according to their arrangement). In all other respects, however, G will continue to deal with customers as it always did and will have the power to vary terms and price from the standard conditions and list price. A specifically acknowledges G's authority to bind it to sales contracts in the commission arrangement between A and G (and G habitually exercises this authority). Further, G's sole source of income to fund its activities is the cost plus based commission for its sales and market research functions. As an independent entity, G previously made an annual profit of 4z. A now compensates G on a cost-plus arrangement, resulting in a profit of 1z. Review of comparable entities (i.e. entities incurring similar risks and providing similar services in the same jurisdiction) engaging solely in uncontrolled transactions indicates that an arm's length range for G would be within a range of 1.5z to 3.5z. Thus, the remuneration level of 1z is lower than what unrelated parties would agree.

Commentary

In this case, it appears that G habitually concludes contracts in the name of A but the facts do not establish whether G's activities are subject to detailed instructions or comprehensive control by A, such that G might be considered the dependent agent of A (a matter, however, for determination in all events under Article 5(5) of the OECD Model Tax Convention).

G is not being properly compensated for the activities that it performs, as 1z is assumed to not be within the range of arms' length compensation for the services rendered to A. It is important to note that the historic compensation that G received before A acquired G is not relevant to the determination of whether the compensation that G receives after the event is at arm's length. A new transfer pricing analysis – in this example, involving a comparison with comparable uncontrolled entities providing similar services – is the only appropriate method for determining the appropriate transfer pricing. A transfer pricing adjustment, under Article 9 of the OECD Model Tax Convention, based on an analysis of comparable transactions or by appropriately utilizing the profit-based methods specified in the OECD Transfer Pricing Guidelines, for such services should be made to reflect the fact that G is not being properly compensated for the various business functions and risks it is undertaking (regardless of whether G is a dependent agent of A). This is an appropriate remedy reflecting the fact that the original arrangements did not reflect an arm's length arrangement.

If G were a dependent agent of A and were habitually to conclude contracts in the name of A so as to cause A to have a permanent establishment in Country G, it would, nevertheless, be inappropriate to allocate any portion of A's profit under Article 7 of the OECD Model Tax Convention to a permanent establishment in Country G. A does not directly perform any functions in Country G and, after adjusting the income of G to compensate G properly for the functions that it performs and risks it assumes, the proper amount of the aggregate income from A and G is subject to taxation in Country G.

- Country H. H in Country H has been a wholly owned subsidiary of A for many years. H was formerly a distributor that acquired goods from A in a buy-sell arrangement. A and H have agreed to restructure their relationship. Specifically, it has been agreed that the legal arrangement between A and H will change from a buy-sell to a commission agent arrangement under which A will in the future invoice H's customers for A's goods. The intercompany agreement between A and H specifically provides that H may act in the manner outlined above and A acknowledges that H's actions in entering into contracts are binding upon A (and H habitually exercises this authority). H's sole source of income is the commission paid to it in connection with the sales invoiced by A relating to sales in Country H. H, however, will continue to deal with customers as it always did (except with regard to invoicing), and will have the power to vary terms and price from the standard conditions and list price without obtaining prior approval from A. The inventory of H will be transferred to A, but will remain in a warehouse in Country H that will be managed by H personnel, although, in this respect, under the close management and control of A. Thus, inventory risk and receivable risk with relation to the inventory will continue to be managed for A by H. As an associated enterprise, prior to the restructuring H made an annual profit of 4zz, which was consistent with the annual profits being earned by comparable entities performing the same functions and incurring the same risks during those years. A now compensates H on a commission basis, resulting in a profit of 2zz. A review of comparable arrangements indicates that a remuneration level of in a range of 2.5zz to 3.5zz is what unrelated parties would agree to.

Commentary

In this case, while invoicing will be done by A, H is otherwise operating as it did before the restructuring. Whether H is the dependent agent of A is a matter for determination under Article 5(5) of the OECD Model Tax Convention.

In any event, based upon a review of comparable arrangements H appears not to be appropriately compensated for the activities that it performs (as 2 zz does not appear to be within the range of arms' length compensation for the services rendered to A). If so a transfer pricing adjustment, under Article 9 of the OECD Model Tax Convention, could be made based on an analysis of comparable transactions or by appropriately utilizing the profit based methods specified in the OECD Transfer Pricing Guidelines and taking into account the fact that A has assumed inventory and receivables risks (regardless of whether H is a dependent agent of A). Again, as noted in the case of G, it is a transfer pricing analysis, not the historic compensation of H, that is relevant to the determination of whether the compensation that H receives after the restructuring is at arm's length.

If H were a dependent agent of A and were habitually to conclude contracts in the name of A so as to cause A to have a deemed permanent establishment in Country H, most, if not all, of any transfer pricing adjustment could and should be made with respect to H (the commission agent), not by allocating profit of A to the dependent agent PE. If A were deemed to have a permanent establishment in Country H and an allocation were nevertheless to be made with respect to A, the only portion of A's profit that can be attributed to such permanent establishment is the income associated with the assets that A owns and carries in Country H and the functions that A performs in Country H. Under any circumstances, however, any amounts allocated to that PE, when taken together with H's income (as adjusted under article 9), could be less than, but cannot exceed, the amount of the arm's length compensation for the functions performed and risks incurred by a full service independent distributor in Country H, as determined by application of the Transfer Pricing Guidelines.