Business and Industry Advisory Committee to the OECD

Comité Consultatif Economique et Industriel Auprès de l' OCDE

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Discussion Draft on the Attribution of Profits to Permanent Establishment - Part I (General Considerations) August 2004 ("the Draft")

Dear Sir:

In this letter, we address solely Part I of the OECD Discussion Draft on the Attribution of Profits to Permanent Establishment ("PE") ("the Draft"), presenting our comments and recommendations to assist in moving the general PE work toward an acceptable (to government and business) conclusion. We have limited our comments to Part I as we view Part I as being at a different stage of development, raising distinct, and more general, issues. We have coordinated with our many banking members, who have commented on Parts II and III either individually, or through their sectoral organisations, as well as through other professional bodies.

Regarding Parts II and III, we refer you to comments already submitted by these organisations. We fully share the sentiments expressed in these submissions that there are still many open issues meriting further discussion. We fully understand, and support, disappointment expressed therein that substantial, material comments from the financial services sector, expressed both in written submissions as well as at previous public consultations have not, in essence, been taken into account. It is difficult to understand how the concepts developed in the Discussion Drafts will be effective in practice without being more acceptable to the business and financial community.

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I. GENERAL REMARKS

The first, and perhaps most important, point with respect to Part I is our endorsement in principle of the “Authorised OECD Approach” (the “Approach” previously the “Working Hypothesis”) and the fundamentals of the methods set forth in Part I to apply it. The Approach reflects a deliberate attempt to rectify the problems arising under Article 7 of the OECD Model Tax Convention (“OECD Model”) in determining a consistent frame of reference for the interpretation and application of the PE concept. The treatment of a PE as a distinct and separate enterprise has both a strong base in historical international tax practice as well as in a theoretical foundation that will serve well in ensuring that the taxation of PEs comes within the purview of the arm’s length standard.

We also strongly endorse the effort to assert the primacy of the arm’s length principle by linking the attribution of profits to a PE with the 1995 OECD Transfer Pricing Guidelines (“1995 Guidelines”) as well as Article 9 of the OECD Model. Successful international tax policy requires not only a solid theoretical basis, but also a practical integration of the principles of application to related taxation areas. The historical work of the OECD and BIAC in the area of the arm’s length principle, as set forth in the 1995 Guidelines, reflects just such an effort. As business models change, and forms of transacting business become more complex, the need to re-evaluate, and extend that work in practical terms is essential. The arm’s length principle remains the touchstone for ensuring an objective, fair and consistent approach in taxing inter-affiliate transactions, hopefully resulting in the elimination of double taxation. Other taxation concepts and principles need to tie directly into this principle; otherwise, they will appear to be espousing inconsistent treatment across borders, and hence, the spectre of double taxation will arise. Attributing profits to PEs is certainly an area where this occurs. The conceptual link between attribution of profits to a PE and the arm’s length principle is apparent; it must be implemented in practice. The Draft is headed in the proper direction in this regard.

BIAC strongly believes that, with the application of the arm’s length principle on the basis of the separate entity approach, cases of double taxation can be reduced to a minimum in the future, since the countries are in basic agreement as to how transfer prices should be set between separate legal, but related, entities as the 1995 Guidelines demonstrate.

This expectation, and our endorsement thereof, is, nevertheless, subject to several caveats, which we set forth and discuss below.

In particular, BIAC is of the opinion that further analysis and discussion as to the practical application of the new Approach is required, to ensure that the theoretical concepts can be applied in practice by enterprises. Furthermore, it should also be ascertained if the tax

authorities (OECD and important non-OECD countries) are prepared, and willing, to follow the rules described in Part I of the Draft. As long as there is uncertainty over these two important aspects, it should be anticipated that the business community will not be amenable to the implementation of new concepts under which all the parties could find themselves confronted later with practical difficulties, particularly, situations of unresolved double taxation.

II. SPECIFIC COMMENTS

Implementation in domestic law and sufficient transition period:

As noted in your request to explore transition issues, it is obvious that the new Approach would create a major change in the way profits must be attributed to PEs, and relief from double taxation must be provided.

An urgent transitional issue in the application of the new Approach is the conflict created with current domestic laws. To ensure successful implementation of the Draft, domestic laws of most OECD countries must be amended to conform to the new Approach. We are concerned that this conflict will result in inconsistent use of the new Approach in ways that could undermine its substantive provisions. We request that Working Party 6 of the OECD Committee on Fiscal Affairs (OECD CFA WP6) provide the information as to how many countries in the OECD can, and will in due course, apply the new principles under their domestic law. In any event, all members should be encouraged to do so. The new Approach requires an attribution of profits in cases where no such profits have effectively accrued to either the PE or the head office situated in a particular country. This raises the question whether deemed profits unrealised in third party transactions, can be taxed under the domestic law of such countries, and, if not, whether those countries are prepared to renounce their taxation rights.

On the other hand, there are questions concerning how the residence country can relieve double taxation based on either the exemption or the credit method (Article 23 A, or 23 B). Must the relief be given based on the profits that have effectively been taxed, or on the profits that would result from the application of the new Approach? Furthermore, should the relief be based upon the taxable profits calculated under the rules of the residence country or those of the source country? Where the bilateral treaty rules are clear in that respect, the question still arises as to whether or not a residence country is prepared to accept the allocation made by the source country.

We suggest clarification of these important issues. In this connection, the new Approach should only become effective after its adoption by a large majority of member countries. They

should also be given a sufficient period to allow for the adjustment of their national tax systems and for the implementation of the newly created rules both by the enterprises and the tax authorities. Without a thorough discussion of the necessary adjustments required under domestic law and the change of many domestic regimes, it can be anticipated that the new rules will not be applied consistently in practice, with the result that the new Approach will lead to general confusion and additional cases of double taxation.

Implementation in bilateral tax conventions

There has been considerable discussion, both in the Draft and elsewhere, of the relationship between the new Approach and the text of Article 7 of conventions based on the OECD Model, as interpreted by various contracting states. We understand that the OECD CFA WP6 is in discussions with OECD CFA WP1 about the implications of the new Approach for the OECD Model and the Commentary.

This matter should be carefully addressed before the new Approach is widely adopted. One of the intended benefits of the new Approach is greater certainty and predictability in the determination of the profits attributable to a permanent establishment. Such certainty and predictability will be seriously compromised if there are doubts as to the enforceability of the Approach under the terms of existing tax conventions.

Similarly, there may be concerns under the specific versions of Article 23 adopted in various bilateral tax conventions as to the elimination of double taxation where the new Approach, or one of the embedded alternatives that comprise the new Approach, is adopted in a particular contracting state. This, too, requires careful consideration by the OECD CFA WP1.

Application of the 1995 Guidelines to PEs

The posture reflected in the new Approach regarding the application of the transfer pricing principles of the 1995 Guidelines is one-sided (dealing with the concerns of tax authorities), and it does not seem to provide the business community with the security that that it merits. As a means of avoiding double taxation in PEs, it should be clearly spelled out that the rules of the 1995 Guidelines must be applied to the extent possible (application by analogy) to the presumed method for the computation of profit attributed to PEs.

One of the relevant 1995 Guideline principles requires that “dealings” of an enterprise with its PEs are to be respected in much the same way as transactions between members of a multinational group, provided that such dealings are not inconsistent with the substance of the particular business transactions or activities. The tax authorities must, therefore, refrain

from restructuring actual transactions and documented dealings of the two parties involved (see Par. 1.36 and 1.37 of the 1995 Guidelines).

A second relevant 1995 Guideline principle is the recognition that transfer pricing is not an exact science and that, therefore, as long as transfer prices are within a range of comparable prices, no adjustment is necessary. In this respect, it is very important, that the enterprises are given sufficient flexibility (see par. 1.45- 1.48 of the 1995 Guidelines).

Those two important principles protect taxpayers against unwarranted adjustments of transfer prices by taxing authorities. In competent authority cases, the burden of proof lies with the country that proposes an adjustment, which is important in the interest of minimizing the likelihood of double taxation (See par. 4.17 of the 1995 Guidelines). In BIAC's view, these principles must also be respected in the area of attribution of profits to PEs.

In the following paragraphs, BIAC provides comments on a number of issues, where we are of the opinion that the Draft is either not clear or cannot be supported by the business community.

Priority of the approach chosen by the source state

BIAC seriously questions the basis of the conclusions contained in par. 36 and 144 of the Draft. If the Draft considers that more than one approach for attributing capital to a PE is consistent with the arm's length principle, then the capital allocation documented by the taxpayer, if generating an arm's length result, should be accepted. This approach in which the host country can choose an allocation of capital which then has to be accepted by the home country when providing for relief from double taxation (and the taxpayer when he calculates, for example, possible interest deductions for the PE) is just not supported by the OECD Model Convention and, in our view, in the Commentary, and such approach would be contrary to the arm's length principle. The provisions of paragraphs 32.1-32.7 of the Commentary to Article 23 relate to conflicts of qualification, but not to conflicts resulting from a different interpretation of the facts and circumstance (par. 32.5), nor to conflicts resulting from a different application of the principles of the functionally separate entity approach. We doubt whether the proposed approach will, in practice, avoid double taxation, and, on the contrary, we see the danger that it could produce double taxation by running counter to legitimate commercial practices of taxpayers across the globe. In the application of arm's length transfer pricing, no country has a priority over any other country in determining an arm's length result. Article 7 and Article 9 of the OECD Model are (two sided) attribution rules.

On the other hand, it is inconceivable to us that any country would be prepared to accept the proposition that the source country will have the right to determine not only the attribution of capital, but also the place at which the key entrepreneurial risk-taking functions are located and the manner in which the assets, risks and functions are to be allocated. Assurance of the OECD that countries would really follow such a novel concept is an important issue that has to be clarified early on.

BIAC would strongly advocate that business has a choice among possible arm's length solutions in this regard. In the analysis of assets, functions, risks, activities, conditions, etc., the approach of the enterprise under review should always be accepted if it is consistent with the arm's length principle. That does not mean that, for example, a management decision about the allocation of capital to a PE can be made in an arbitrary manner irrespective of the risks inherent in the PE (see par. 111).

On the other hand, we strongly disagree with the premise that the capital allocated to a PE could be higher than the capital of the entire enterprise (par. 129,138,139,140). This result just does not make sense. Although it is accepted that, under the new Approach, profits can be attributed to a PE irrespective of the overall profits realised by the enterprise, the tax authorities cannot allocate nonexistent profits. Thin capitalisation rules can only be based on the actual capital, which might have an impact on the deductibility of interest instead of profit allocation. Within the range of debt-to-equity ratios in arm's length situations (par. 126 of the Draft), the enterprise should be free to choose the method that best suits its facts.

More generally, we are concerned that the compromises reflected in the Discussion Draft in the form of various alternative approaches available to the source state, will lead to double taxation. Too much stress, we believe, is being placed on Article 23 and the goodwill of the state of residence. If double taxation is, eventually, avoided, this will only be after lengthy and complex competent authority mutual agreement procedures. It is not in the interests of either the business community or governments to multiply the number of competent authority cases.

Application to assets allocation

The need for flexibility, as stated in par. 167 of the Draft, in the area of capital allocation is also important for other intra-company transactions or relationships. For example, the question whether an intangible, used exclusively in a PE, but developed in the home country, is transferred or licensed should be left to the discretion of the enterprise. Third parties behave in both ways (see par. 205, 233). The analysis provided in the Draft is, therefore, only necessary if the taxpayer has not prepared clear and consistent documentation.

As a transitional rule, taxpayers should be allowed to create this documentation currently as regards to PEs which existed prior to the adoption of the new Approach by the OECD.

The use, of the so called “key entrepreneurial risk taking function”, to determine the allocation of assets, risk and capital, leaves room for a range of interpretations (e.g., par. 237), and the enterprise should be allowed to conduct its business within the range. An open ended “facts and circumstances” review of practices by taxing authorities is inappropriate.

Application to intra-company dealings recognition

In BIAC’s opinion, the Draft seems to be highly suspicious of the validity of various intra-company transactions and dealings (within a single entity). It is true that an enterprise cannot enter into legally binding agreements with itself, as can be accomplished between related companies. But if a hypothetical separate entity is subjected to tax, then hypothetical agreements giving effect to various intra-company arrangements that are documented in advance should also be the basis of evaluation by the tax authorities of the *bona fides* of such arrangements. The limitations set here by the Draft are unnecessary, and they lead to a one-sided application of the separate entity approach. If this approach is chosen, as it is supported by BIAC in principle, it should be consistently applied across the board.

The same is true as regards the allocation of economic ownership vis-à-vis legal ownership (see par. 86 of the Draft). The statements of the Draft in par. 66 and 67 seem to allow tax authorities to decide whether a dealing shall be accepted for tax purposes. If a clear and consistent documentation is required (and complied with), there is no need for greater scrutiny of a company’s internal (intra-company) dealings vis-à-vis inter-company transactions, and there is no justification for an increased scrutiny of “tax motivated transfers.” To BIAC, it is not clear what is meant by the phrase a “real and identifiable event and a dealing of economic significance”. It is inherent to the concept of “dealings”, as compared to actual transactions, that business realities and commercial practices must be given full weight. It should, therefore, be sufficient that the enterprise’s records clearly support the internal dealings; that such transaction be consistent with the substance of the business; and yield arm’s length results. Any other approach would clearly place an excessive burden on companies who will not be in a position to gain any certainty as to which of the many approaches in the Draft will be applied by each of the relevant tax authorities. Such excessive burden would contradict the arm’s length principle endorsed by the 1995 Guidelines.

The internal dealings of an entity should not be undermined by only accepting “real and identifiable events, e.g. physical transfers” (see par. 176), but should include all measures concerning functions, assets and risks, as long as they are consistent with the substance of

the business. “Dealings” are not, in our view, the same as “events”. It would also be excessive to always require that the dealings are properly reflected in the accounts of the enterprise. These “dealings” do reflect business realities but they are notional and may or may not be required or even allowed under accounting principles. For example, the statutory accounting rules of most states do not allow the booking of, for example, unrealised gains, and the same is true for domestic taxation rules. The appropriate signal is provided in par. 178, which accepts that intra-company dealings will include the conditions of such internal transactions, as spelled out, for example, in the entity’s accounting or other internal records, in the absence of a contract.

In the area of ownership and use of intangibles, the question of whether or not a PE is a joint or sole owner of intangibles proper (entitled to use the intangibles without paying compensation therefore), or perhaps, a contract manufacturer (entitled to an uplift on cost), will normally be evidenced by the internal “dealings” of the enterprise, again as evidenced by the books or records. Also, as to contract manufacturing, vis-à-vis in-house manufacturing, this is a generally determined by who bears manufacturing risk, which, in a single entity, is the entity; again evidentiary documentation can assign risk to a PE or head office.

The actual business dealings of the company must be the starting point and the basis of the analysis, not “just another point” taken into consideration, which is the impression created in some parts of the Draft (comp. par. 252 ff).

Relationship between the arm’s length approach and the functionally separate entity approach

Although the Draft reflects considerable effort, in comparing the results of the new Approach and of the application of the 1995 Guidelines in analogous circumstances, BIAC is of the opinion that this matter still requires further analysis. Under the arm’s length principle, it would be sufficient to determine whether or not a price is in line with an acceptable transfer price of unrelated parties. Between head office and PE, however, a dealing would have to be analysed by a functional approach. As it is mentioned in the case of an agency PE, there may be differences between the arm’s length price between two related enterprises and the profits allocation with respect to the same transactions between a PE and its head office. Such a result is not justified, and the OECD should clarify the matter.

The practical implications of divergences in result between the new Approach and the 1995 Guidelines must not be underestimated.

Elimination of the particular case of Dependent Agent PE

BIAC respectfully requests the OECD to seriously consider eliminating, at least at the current stage of the discussion, the entire chapter devoted to the subject of the agency PE (par. 266 –285). Agency PEs, as BIAC has described in its statement, dated June 30, 2004, addressing the recent proposals to change the Commentary to Article 5, raise difficult taxation issues for both business and tax administrations. OECD should limit application of this agency principle to cases where no separate enterprise exists in the other country, and, in no case, should extend this problematic approach. Otherwise, based on the broad uncertainties of the new "key entrepreneurial risk taking function" concept as well as the allocation of assets, risks and capital, many cases of double taxation are almost certain to occur. Furthermore, home countries could lose important taxation rights, which were, previously, almost never contested in international tax relationships.

BIAC requests additional consultations with OECD CFA WP1 and WP6, to further consider how the highly problematic outcome of having two taxable entities spring into existence (i.e., when a local taxpayer subsidiary is also considered to be a dependent agency and a deemed PE of its parent enterprises) can be avoided. We believe that OECD should make clear that no profit is to be allocated to an agent PE (and thus taxed to the foreign parent company) if the agent receives an adequate compensation in its own right for the handling of the risks, assets and capital of the principal. This would be a pragmatic approach, which has already been implemented in some tax treaties. We also do not believe that the same business activities could be governed by two approaches which - although based on the same principles (arm's length) – are different in their practical implementation and may result in different results. The work of OECD should not lead to an increase of multiple disputes in the area of agency PEs, without conducting a thorough discussion about the impacts on OECD member countries and MNEs.

III. RECOMMENDATIONS

Notwithstanding the extensive effort reflected in the draft, implementation of the OECD work regarding PEs remains problematic. The various conceptual and application issues described in this paper and in the papers of others bring with them monumental problems of putting the Approach to actual use. BIAC sees it as hazardous to finalise this now, without resolution of certain fundamental procedural, jurisdictional and transitional points.

We strongly believe that these reports *per se* cannot constitute a legal basis for such substantial changes in the taxation of PEs in international tax law. The question of whether or not the OECD Model Treaty, its commentary and the 1995 Guidelines should be changed to take into account this new Approach must be addressed, and a clear time target established.

Furthermore, OECD member countries must be provided sufficient time in which to adjust, where necessary, their domestic tax laws (as discussed above). We believe it is unworkable, from a legal position, that OECD member countries follow the recommendations in Parts I, II and III, without enacting these changes in their tax legislation.

Additionally, enterprises must also have sufficient time to adjust their structures as well as to analyse and document their dealings. We further request that OECD produce practical examples, which can be the subject of joint discussion between OECD CFA WP6 and BIAC to ensure that the new, somewhat theoretical, approaches of the Draft will work as expected in practice. Moreover, such examples are, we believe, necessary to convince enterprises that the concept is indeed viable. The questions of whether tax authorities and taxpayers will be able to reach common conclusions on typical cases concerning the new “figure” of the “key entrepreneurial risk taking function”, or on the allocation of assets, risks and capital in specific situations has to be tested against realistic examples before the new Approach is formally approved by the OECD for implementation in the OECD Model, Commentary and/or the 1995 Guidelines.

The overall assessment by the business community of the workability of the new Approach in the Draft will, we strongly believe, depend upon the acceptance by OECD that profit attribution to PE is not an exact science (as noted above), perhaps even less so than transfer pricing between the affiliates of an MNE group. In that view, it is crucial that tax examiners understood that the business decisions of an enterprise must be respected, and that all results within a reasonable arm’s length range should be acceptable. Under these conditions, the multiple approaches of the Draft can be quite useful, but only if both the home and host countries are prepared also to respect the commercial practices of the enterprises as to structuring and pricing of their dealings.

With respect to process, the Draft identifies the need to weave its concepts and principles into the various OECD guidance media. Accordingly, it will be important that the new material be reflected in Articles 5 and 7, and perhaps Article 9 of the OECD Model, and/or the Commentary thereto, as well as in the 1995 Guidelines. Before such changes are made, however, a broad consensus must be sought that the modifications are acceptable to both the tax authorities and the business community. To achieve such a broad consensus, further work is necessary.

BIAC suggests that the OECD Committee on Fiscal Affairs should not decide to approve the new Approach without also simultaneously establishing basic principles for implementation and transition, which we recommend be articulated with the release of the Reports. While consideration of the process going forward may take additional time to achieve, a clear

understanding of how the Guidance will be implemented is essential to maintaining the confidence and support of the business community in this important project. We also stress the importance of continued open dialogue with business before, during and after the commencement of the implementation phase.

We look forward to further discussion regarding this important project, and stand ready to respond to any questions you may have regarding the above comments.

Yours Sincerely,

Richard M. Hammer
Chair
BIAC Committee on Taxation and Fiscal Affairs