

The BEPS Monitoring Group

Comments on the Public Discussion Draft on ADDITIONAL GUIDANCE ON ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

These comments have been prepared by the [BEPS Monitoring Group](#) (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. These comments have not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. They have been drafted by Jeffery Kadet, with contributions and comments from Tommaso Faccio and Sol Picciotto.

SUMMARY

This discussion draft (DD) deals with attribution of profits to a host country resulting from changes to the taxable presence requirement in the definition of a permanent establishment (PE) in BEPS project's Action 7. Although generally clear and well reasoned, it is of limited usefulness in our view, for two main reasons. These comments explain these shortcomings and suggest how they could be corrected.

First, it applies only to the 2010 version of the OECD model convention, which introduced the 'authorised OECD approach' (the AOA) for attribution of profits to a PE. The AOA attempts to extend to PEs as far as possible the independent entity principle as applied to associated enterprises within a multinational enterprise (MNE). A number of OECD countries have not accepted the AOA, and it has also been generally rejected by developing countries. One reason for this is that the independent entity principle is especially inappropriate for a PE, which by definition is part of the same legal entity. Hence, few actual treaties are based on the AOA, and this is also true for most national tax law rules which would apply to entities resident in non-treaty countries. States, especially developing countries (whether or not they decide to join the Inclusive Framework for BEPS), should not be pressurised into adopting the AOA. Instead, the UN Committee of Tax Experts, in liaison with the OECD, should develop its own revisions to the commentary to the UN treaty model consequent on the changes to the PE definition introduced by Action 7. Further work is clearly necessary, by a wider range of countries, and adopting a broader approach, to produce guidance that would be of use to tax payers and tax authorities, especially in the bulk of cases where the AOA is not applicable.

Secondly, the examples provided in the DD adopt a very restricted approach, which assumes that all or most significant people functions take place in the non-resident entity, and hence attribute only limited profits to the PE. They include some illustrations of when aspects of inventory and credit risk management may take place in a PE, but significantly the examples

include no discussion of other sales-related functions such as marketing and advertising, which are instead assumed to be controlled by the non-resident entity, with no relevant local input. Similarly, the examples are silent regarding core business functions conducted in host countries that are often found in modern MNE business models. These simple examples may be relevant to relatively small firms based almost entirely in their home countries, which employ a foreign sales agent. But they are entirely unrealistic in relation to most large MNEs and their modern business models, which aim to be both global and local. No MNE can operate effectively by centralising virtually all its significant people functions and all its core business functions at a distance from its customers and suppliers, as is assumed in the examples provided here. Indeed, there are many well known examples of MNEs which employ significant staff in host countries engaged in both customer-facing and many core business functions. The failure of this DD to discuss such situations suggests a lack of consensus on how to deal with them, which may regrettably exacerbate the likelihood of conflicts even between OECD countries.

As the DD is now drafted with its focus on the AOA and its unrealistically simple examples, its effect is to strengthen the BEPS mechanisms used by many MNEs. This contradicts the mandate for the BEPS project, which is to align taxation and value creation.

GENERAL REMARKS

Status of these proposals

1. This discussion draft (DD) proposes some consequential measures resulting from the proposals under Action 7 of the BEPS Action Plan. These Action 7 proposals resulted in some changes to the definition of a Permanent Establishment (PE) in article 5 of the OECD Model Tax Convention (the Convention), which specifies when a foreign resident company may be treated as having a taxable presence in the host country. These changes essentially concern (a) when a legal person (including a related entity) acts as a dependent agent by regularly being involved in concluding contracts on behalf of the foreign company (a dependent agent PE, or DAPE), and (b) when the foreign company maintains a stock of goods, e.g. in a warehouse for delivery. This DD concerns the appropriate attribution of profits to these types of PEs, under article 7 of the Convention.
2. This DD addresses only the methodology for such attribution of profits under what is known as the Authorised OECD Approach (AOA). The AOA was introduced only in 2008, with the support of a majority of OECD countries, resulting in extensive changes to article 7 of the Convention and to its Commentary of 2010. Nevertheless, some OECD countries (Chile, Greece, Mexico, New Zealand, Portugal and Turkey) reserved their right to continue to use the previous version, as did non-OECD countries (Argentina, Brazil, China, Hong Kong-China, Indonesia, Latvia, Malaysia, Romania, Serbia, South Africa and Thailand). The AOA was not accepted by the UN Committee of Tax Experts, so that the 2011 version of the UN Model Double Taxation Convention treats the attribution of profits to a PE in a significantly different way from the 2010 OECD Convention.
3. These are not minor differences, but reflect a fundamental difference in approach, which is long-standing. The AOA introduced a significant strengthening of the independent entity principle, by aligning the methods for attribution of profits to a PE under article 7 with those for associated enterprises under article 9. These are based on analysing the ‘functions performed, assets used and risks assumed’ by the various portions of the non-resident taxpayer in the host country and elsewhere as if they were separate legal entities, treated as elaborated in the OECD Transfer Pricing Guidelines. The changes introduced by the AOA

involved a significant reduction of host country rights to tax business profits generated partially or wholly within the host country, in favour of the country of residence.

4. The BEPS Action Plan stated clearly that:

‘While actions to address BEPS will restore both source and residence taxation in a number of cases where cross-border income would otherwise go untaxed or would be taxed at very low rates, these actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income.’

In our view this commitment has not been fully respected; the selection of measures to strengthen source or residence taxation in the BEPS project outcomes has generally tended to disfavour source taxation. In particular, the changes to the Transfer Pricing Guidelines have emphasised the functions of ‘control’ of activities such as R&D, and of risk. The changes to the PE definition in Action 7 go the other way, by strengthening taxation at source, although not to any great extent. However, their impact would be limited much further if countries are required to apply the AOA for the attribution of profits.

5. It should be made very clear that the proposals in the current DD affect only the 2010 version of the Convention and its Commentary. Although specific questions have been included in the discussion draft concerning non-AOA approaches to determining the profits of a PE or DAPE, all examples and discussion assume that the AOA is applicable. The changes, therefore, by their terms, apply only to treaties based on the 2010 version of the Convention. Countries and specific bilateral treaties that do not use that model should not be committed to applying this DD’s approach to article 7, though of course some of the concepts introduced in this DD may have applicability to applying non-AOA approaches.

6. On a broader note, countries should not be considered as accepting a commitment to introduce the AOA, or in any way be pressurised to do so. This is particularly important for developing countries which may join the Inclusive Framework as BEPS Associates. They are joining at a late stage of the process, which will inevitably limit the extent to which they can ensure that their concerns are taken into account. However, they have been assured that they can contribute on an equal basis to the continuing processes of standard setting, which includes the current DD.

2. Further work required.

7. While attribution of profits under the AOA is the focus of the discussion draft, the vast majority of future situations confronting taxpayers and tax authorities will not involve the AOA. Rather, where a treaty is applicable, it will likely have in effect some pre-AOA version of Article 7. Further, many MNEs, whether through normal tax planning or complicated profit-shifting structures, make sales and perform services through companies resident in low-tax jurisdictions which have no treaty applicable, so that their PEs and DAPes would come under local law within host countries. Where there is no applicable tax treaty, of course, the AOA will again be inapplicable.

8. With this situation in mind, we suggest two things:

First, we suggest that the applicable OECD Working Groups liaise with the UN Committee of Experts on International Cooperation in Tax Matters, which should review its version of article 7 and commentaries, in light of the changes to article 5 resulting from Action 7.

Second, in conjunction with the UN Committee of Experts, we suggest that consideration be given to providing broader principled guidance and examples that

would be of use to taxpayers and tax authorities, no matter whether a treaty is involved or not and no matter whether the AOA or a pre-AOA approach is applicable.

9. In regard to the need for more and broader guidance, we note that many host countries, even where a tax treaty is applicable, have only vague rules at best for making PE profit calculations. This will be especially true for DAPes. Recognizing this, the OECD Commentary could in many cases provide important background and guidance to tax authorities attempting to apply their vague rules on determining the profits of a PE or DAPE. With this in mind, it would be a great benefit for all countries, and especially the less sophisticated developing countries, if more examples could be included in the Commentary that will focus on the significant people functions that do in fact occur within source countries for some of the common MNE business models. Such examples would be of great assistance to taxpayers in calculating the PE and DAPE profits that they will declare and to tax authorities attempting to review the reasonableness of such declared profits. In our view it is regrettable that, perhaps because this DD focuses on the AOA, the examples it provides reflect some of the content of the 2008 report that gave rise to the AOA. That report, which reflects business models now ten to fifteen years old, tends to stress simple examples which assume that the PE or DAPE does not have significant people functions. Today in the real world, such simple examples will most typically be factually untrue.

10. For instance, there are many MNE businesses where core business functions are conducted through service agreements with local related party group members. Providing some examples with fact patterns that include various significant people functions that are typically found would be very helpful. We of course understand that the present examples have been drafted in a limited and simplified fashion to assist the Working Groups in the drafting of new Commentary and to encourage comments from interested parties. This has resulted in the restrictive assumptions in Examples 1 through 4 which give limited functions to the DAPE in the host country in relation to inventory management and extension of credit to customers. It is also notable that these examples assume that other sales-related functions such as marketing and advertising, which add significant value to sales, are controlled by the non-resident entity, and merely implemented locally by the sales entity. From a guidance perspective, though, it is critical that future Commentary amendments take a much broader approach within the examples and reflect many of the significant people functions that are typically conducted within host countries within commonly used MNE business models. The absence of such examples in this DD does not reflect the way many MNE businesses operate, and suggests a lack of consensus among OECD countries, which will regrettably lead to conflicts.

11. The Example 5 warehouse case with its three Scenarios is excellent. However, what would be very helpful for many countries, and could apply to numerous MNEs, would be a warehouse and local support example that reflects the manner in which many MNEs conduct internet-based businesses. For example, the many MNEs that sell hard and soft products and that provide various services through internet platforms maintain extensive local operations to provide both customer support and quick delivery of physical products. These local activities are so much a part of the core business being conducted that such MNEs will have a PE or DAPE in many host countries. These local activities are not in any way preparatory or auxiliary to the overall business activity of the enterprise. Regarding attribution of profit to such PEs and DAPes, examples and discussion should mention not only the attempt to identify arm's length answers under the traditional transactional methods (CUP, resale, and cost-plus), but also the use of transactional profit methods (TNMM and profit-split method). There should also be discussion of formulary approaches where an applicable treaty allows it (or no treaty applies) and it is customarily used in the particular country, as allowed in the

pre-AOA para 4 of Article 7, which is widely applicable in treaties especially those of developing countries.

12. Whereas the warehouse in Example 5 Scenario B is owned by WRU, we suggest that a similar example be included for an internet-based business that involves a host country subsidiary that is performing these core functions for the overseas MNE parent or other group member, so that the example involves a DAPE.

3. Highly Subjective Situations

13. Whether it is the more complex case of Example 4, involving inventory and credit management functions, or Example 5 that involves know-how, software, and various home office services benefiting the PE, there are many situations where any allocation will be very subjective and subject to considerable risk of taxpayer/tax authority disputes. Recognizing this, guidance regarding two approaches would be very helpful.

First, guidance should be provided for application of the profit-split method to determine the profit attributable to the PE or DAPE. We believe that there will be many subjective and complex cases where the profit-split method will be most appropriate transfer pricing method under the circumstances.

Second, many existing treaties in pre-AOA para 4 of Article 7 allow in certain circumstances the application of an apportionment formula to an enterprise's total profits to determine profits attributable to the PE or DAPE. Guidance should be provided here as well. (See further comments in our response to question 4.)

4. Inclusion of Examples that Reflect Actual MNE Conduct of Business

14. The very simplified examples in this discussion draft seem to be relevant only for relatively small firms based almost entirely in one country, which may employ an agent to facilitate foreign sales. They are frankly largely inappropriate for most MNEs by not addressing the reality of how such firms are in fact operating. If this simplistic approach finds its way into the Commentary and other guidance, then taxpayers will prepare tax filings and unsophisticated tax authorities will review them with these simplified examples in mind.

15. Examples 1 through 4 assume that Prima is an operating company. In contrast, many MNEs record their revenues not within real operating group members but through cashbox and tax haven companies, having few employees or operations of their own. These companies often rely on intercompany service agreements with operating related parties for many of their core business functions. Guidance should be provided to consider such situations so that taxpayers can more appropriately prepare tax filings and tax authorities in source countries will be able to review those filings and approach these issues more intelligently and knowledgeably.

16. The basic facts for Example 1 include that 'there are no significant people functions performed by Sellco on behalf of Prima in Country B relevant to the attribution of Prima's assets and risks to the DAPE'. This is not only an oversimplification, it will be factually wrong in most cases. Yes, maybe the final analyses and decisions regarding worldwide marketing and production strategies will be made by management in Prima's home country, but they will in virtually all cases receive important contributions of information, analysis, and support from DAE personnel in Country B. The DAE personnel are also typically the people who are conducting these various business functions and in direct contact with customers, suppliers, etc. Further, it will commonly be the case that Prima management personnel will periodically travel to Country B where they learn more 'on the ground' that adds to their ability to develop and implement their marketing strategy. They may also be

involved in major customer presentations and in maintaining customer relationships or be involved in major transactions during their visits. To ignore all this and simply say in the example that the MNE group as a whole has no significant people functions conducted in Country B is simply wrong. No MNE can operate effectively by centralising its main significant people functions at a distance from its customers and suppliers.

17. Example 2 in para 48 states, in part: ‘The functional and factual analysis under Step 1 of the AOA shows that Sellco undertakes all the functions involved in identifying customers, soliciting and placing orders and it also implements locally the marketing and advertising strategy devised by Prima.’ Then, in para 51, regarding activity attributed to the DAE, there is no mention of these Sellco functions and activities. Only the inventory and credit functions and the necessary capital needs are discussed. This apparent ignoring of all these Sellco functions simply understates their importance and the value of their activities in many of today’s MNE business models. We suggest that the example specifically include these functions within para 51 and other appropriate portions of the example.

18. Further, the artificial contractual allocation of risk through the Prima/Sellco service or other intercompany agreement defining the relationship of Prima and Sellco does not define the various activities and risks that the MNE as a whole is taking with respect to Country B. That these can be different is of course emphasized in the respective Article 9 and Article 7 analyses and discussions for each example. However, the emphasis on the Article 9 analysis takes attention away from the more important Article 7 analysis.

19. With this in mind, the MNE has invested money and energy in setting up the DAE and employing and training its personnel. The MNE is selling products through the DAE’s efforts and extending credit to Country B customers. As a unified group, the MNE is conducting a full risk-bearing business in Country B and not only the artificially limited risk undertaken by the DAE through the intercompany agreements. Example 1 should be changed to show this and to result in some appropriate level of DAE income that reflects the full risk-bearing business nature of its activities and therefore cannot in any realistic circumstances be zero.

20. For example, regarding sales and credit risk, there may be a high-level person in the home country approving sales and making final credit decisions, but there will be personnel in the local country who identify and decide which local customers are worth pursuing for possible sales. These personnel will likely meet with and interview many of the local prospective customers, making local decisions on which of them are solid enough to consider offering to Prima as potential customers. These DAE personnel will also select information to communicate to the home country management both on overall local conditions and on specifics with respect to each potential customer. This is all part of control and implementation of the MNE’s sale of products and assumption of credit risk. The risk undertaken and the potential benefit to the MNE as a whole are not limited to the usual ‘limited risk’ and cost-based service fee defined in the intercompany agreement between the non-resident and the DAE. Example 1 or some additional example to be added must reflect this reality and not some imaginary simpleton situation that would virtually never be found in real life.

21. Examples 1 through 4 include as fact that the local dependent agent (whether Sellco or an employee) does ‘not create any local marketing intangibles in Country B. Sales channels are generic and not specialised.’ The background that has caused the G20 to initiate the OECD managed BEPS project has been the extraordinary success of MNEs in shifting profits from the countries in which value is created, whether through innovation, production, or customer sales and services. Many of these MNEs conduct proprietary businesses that involve both new technologies and business models that are anything but generic and unspecialized.

22. Considering this, assuming for all examples that there are no local marketing intangibles in Country B and that the sales channels are generic and not specialized serves to terribly restrict the relevance of these examples. These examples must be amended to reflect the reality that most MNEs' local country marketing, sales, and support operations do significantly reflect and apply the proprietary technologies, proprietary business models, and proprietary product/service knowledge of their well-trained and experienced personnel, some of whom are local and some of whom may have been transferred from the home country or other countries where the MNE conducts major operations. These operations not only reflect significant profit-earning people functions, but they also result in the creation of local marketing intangibles (e.g. customer list, know-how, etc.) and their impact on the attribution of profits to permanent establishments must be recognised and addressed in this guidance.

SPECIFIC COMMENTS

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.

Response:

We believe that accurately delineating the actual transaction between the non-resident enterprise and the DAE under Article 9 as a first step is absolutely the wrong approach. The primary reason is that it takes focus away from the much more important issues and calculations of how the MNE is conducting business within the applicable host country. A secondary, though no less important, reason is that the Article 7 analysis on an MNE-wide basis allows the analysis to focus solely on actual activities of group personnel and agents and real third-party contracts and dealings, ignoring the normally tax-motivated intercompany agreements on which intercompany transactions are based. This first step can often be completed relatively expeditiously and avoids in many cases getting bogged down in the terribly subjective analysis of an Article 9 intercompany pricing analysis. As indicated below, in many cases, by conducting the Article 7 analysis first, tax authorities will determine that no Article 9 analysis is needed.

Regarding the primary reason, MNEs are operated as centrally managed worldwide businesses. It is a mere legal fiction that their activities are attributed amongst a number of related group members, since such attribution is generally based on tax-reduction objectives rather than on any real commercial or non-tax legal objectives.

With this in mind, we believe that placing the analysis of the related party transaction as the first step takes away from the more important steps of determining what activities the MNE is conducting in the host country and the overall profits from all of that MNE's activities that occur with respect to that host country where it has either an actual PE or a DAPE. We therefore strongly recommend the following steps in this specific order:

Step One: An analysis of the business conducted and the activities performed in the host country of all MNE group members ignoring legal entity lines. This analysis would reflect the centralized manner in which MNEs generally manage their business. This analysis is not only important for ultimately determining attribution of profits under Article 7, but it also provides a big picture perspective for each host country tax authority to identify non-resident MNE group members that might not appear in isolation to have either a PE or a DAPE. Thus, it is an important step to achieving one of the goals of the Action 7 Final Report, which is to prevent the avoidance of PE status through the splitting up of contracts to take advantage of the exception of paragraph 3 of Article 5.

Step Two: The determination of the worldwide profits attributable to the combined activities of all MNE group members for the relevant products and services sold into or provided to customers in that host country or that otherwise relate to activities in that country.

Step Three: The determination of the MNE's profits attributable to the MNE's business and activities actually conducted in the host country. This determination would reflect the AOA approach, but applied to the MNE as a whole and not to any one group member.

Step Four: An Article 9 analysis of the activities of each group member so as to determine the arm's length charges necessary to determine the respective profits of the one or more DAEs and the deduction allowed to the PE or DAPE of the non-resident group member(s).

As for the second reason, Example 4 is an excellent demonstration of the importance of focusing first on the MNE as a whole. In Example 4, both Prima and Sellco conduct significant people functions regarding credit terms, the extension of credit, and the recovery of customer receivables. Attempting to determine a specific answer regarding the relative contributions and values applicable to each group member will be very subjective and likely be a matter of contention between tax authorities and MNEs. (See para 73 on page 23 to illustrate the subjectiveness and consequential potential for disputes.)

By focusing first on the MNE as a whole and the respective activities of MNE personnel and agents in the host country and elsewhere, a tax authority may be able to minimize the subjective areas of serious potential dispute as they delineate the nature of the MNE's presence in the host country and attach relative values to the actual functions performed. (See paras 80 and 81.) Further, the tax authority can determine the extent of any potential Article 9 issue by simply comparing the MNE's profits from its business and activities actually conducted in the host country (Step Three above) with the profits already reported by the DAE that relate to its activities conducted on behalf of the DAPE. If the difference is found to be immaterial or otherwise insufficient to merit the extensive and resource-intensive transfer pricing audit procedures that would be required, then the tax authority can choose to not conduct any Step Four Article 9 analysis. This would save considerable time and expense both for tax authorities and for MNEs.

As a further point on this, assume that the Step Three analysis yields a profit of 100 when the DAE has reported profits of 75, so that in the absence of any Article 9 adjustment the DAPE profit will be the remaining 25. In deciding whether to initiate analysis under Article 9 to arrive at the most theoretically correct respective DAE and DAPE profits, the applicable host country tax authority might appropriately consider what tax differences will arise where the 75/25 profit split changes to, say, 100/0, 90/10, or 65/35. Assume, for example, that the host country applies the same income tax rate to both resident and non-resident taxpayers and also imposes a branch remittance tax that places branch profits in the same economic position as a local subsidiary's earnings that are subject to a dividend withholding tax. In such a case, the local country tax authorities may appropriately choose to refrain from making any Article 9 analysis and simply impose tax on the DAPE's 25 of profits and the DAE's 75 of profits. On the other hand, if there is no branch remittance tax imposed on the DAPE's profits or if the effective tax rates differ for some reason, the tax authorities may choose to initiate an Article 9 analysis.

It may of course be added that there will be some cases where an MNE has contractually limited the risk of a DAE and provided a service fee based on a cost-plus or similar arrangement that protects the DAE from loss. Where the MNE has not been as profitable as expected, it may well occur that the DAE profits will exceed the Step Three profits, thereby

causing a DAPE loss. In such situations, tax authorities will seldom see any need to initiate an Article 9 analysis to adjust the relative incomes of the DAPE and the DAE.

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

Response:

We do not believe that the functional and factual analysis performed in Example 1 is reasonably representative of reality within centrally managed MNEs. As such, we believe that its assumptions not only cause an incorrect answer, but they are seriously misleading and will result in a continuation of BEPS tax motivated structuring.

From para 24: ‘Prima selects the sales agent, monitors its performance and makes decisions on whether to continue, adapt or terminate the relations with the sales agent.’ These activities from para 24 are then used as part of the rationale in para 30 and are also found in Table 1 within Annex 1.

While it may be factually true that a parent company like Prima will always have a choice to form its own subsidiary to house certain functions or alternatively to identify and hire an unrelated party for such functions, this is truly meaningless in related party situations. As such, this right and authority in the hands of Prima should be ignored in any analysis. By pointing it out as a separate fact in para 24 and in Table 1 in the Annex, and especially including it as a factor in para 30, the example implies that this is an important factor that should affect the Prima/Sellco transfer pricing analysis. We believe that it is misleading to give any importance to this. It should be eliminated as a factor.

From para 24: ‘Sellco is responsible for identifying customers, soliciting and placing customer orders and processing customer orders with Prima.’ Sellco, though, is not performing the functions of setting sales strategy and sales targets nor is it setting pricing policy. These top-level functions, which are performed by Prima, are an important part of the overall conclusion of Example 1 that there are no significant people functions performed by Sellco on behalf of Prima. (See para 34.)

True, many MNEs operate with management centralized in the home country or in regional headquarters making major company-wide or region-wide decisions that are then implemented in each country. However, these centralized managements do not operate in a vacuum sending their decisions out from the center. They have continual day-to-day dialogue and reporting from personnel in each country who contribute to the bases of data and other information on which they make their decisions. The local country subsidiaries’ employees, including both local management and other personnel, contribute significantly in gathering data and information, applying judgment on what data and information will be relevant, and providing their local knowledge and insight. They also, on a daily basis, are implementing the centrally made policy decisions through their judgment in identifying potential customers, determining how to approach these prospects, and then using their product and other skills and knowledge to close sales and provide services. It is also the information they gather and their own professional judgment that will be the basis for the ultimate sales and credit decisions that personnel at Prima will make.

It may be added that the legal, cultural, and business practices differ to a greater or lesser extent within each country. The local country subsidiaries’ employees without doubt make judgments and recommendations to decision makers overseas regarding how central company policies and business models should be set and implemented for their respective countries. This is not mere information gathering by a clerk without thought or analysis; it is rather an

important and significant people function that cannot be ignored in either the Article 7 or Article 9 analyses.

For the above reasons, Example 1 is misleading in suggesting that the situation as described will result in no significant people functions being performed by Sellco in its DAE capacity on behalf of Prima's DAPE. Example 1 should be rewritten to reflect at least a few of the real people functions that are being performed within the host country with a resulting amount of DAPE profit.

In making the above comments, we recognize that the 2010 Report on the Attribution of Profit to Permanent Establishments comments in para 233:

In particular, it should be noted that the activities of a mere sales agent may well be unlikely to represent the significant people functions leading to the development of a marketing or trade intangible so that the dependent agent PE would generally not be attributed profit as the "economic owner" of that intangible.

This comment, however, which was included in this 2010 update of the 2008 report, was likely written in the course of work conducted over the previous several years such that it is based on knowledge of business practices that are now ten to fifteen or more years old. Current practices of MNEs and the business models they use require realistic examples that will provide real guidance to taxpayers on how to calculate income attributable to PEs and DAPes, as well as to tax authorities on the factors and matters they must include in their review of such PEs and DAPes.

It should be added that in some situations, of course, the personnel at Prima are truly making these sales and credit decisions. However, in many cases, if not a majority of cases, whilst contractual agreements between Prima and Sellco would require Prima to approve every sale to customers made in Country B through the review of the customer's creditworthiness, the Prima personnel in reality are merely rubber-stamping the 'recommendations' made by Sellco.

Since determining whether mere 'rubber-stamping' is occurring is very difficult for any local tax authority, we strongly recommend that Example 1, when used in future finalized guidance, assume that "rubber-stamping" is the case and that the burden of proof is on the MNE to factually demonstrate that its sales and credit approval functions are truly occurring outside the country of sales.

We note that there are also cases where only certain types of sales are effectively reviewed by Prima (e.g. where the sale value exceeds a set amount). We consider that specific guidance should be provided to address these situations.

In addition to the above, we believe that the real commercial risk of an MNE group with respect to its activities in a host country is not being adequately reflected whenever a local commissionaire, agent, or other service provider earns a relatively lower commission or service fee due to limited risks being included in the applicable agreements. An example will help explain this concern.

Say that an MNE, resident and headquartered in country A, has separated its centrally managed operations amongst its group members so that the group member (X) making product sales to customers in country B has no local activities or employees of its own in country B. To support its sales to country B customers, X contracts with Y, another group member resident in country B, to provide various support operations. These various support functions could include, for example, marketing activities, sales support efforts, local warehousing and delivery, etc. Further, Y could be legally a commissionaire, an agent, or

only a service provider. Under the contractual relations between X and Y, Y is at limited risk so that the commissions or service fees it receives are relatively low reflecting its low level of assumed risk. Assume for purposes of this discussion that the commissions or service fees are at arm's length.

Assume that, under the current Article 5 definition of PE, X has no PE in country B, but will have a DAPE under the future expanded Article 5 definition. For both simplicity and to clearly illustrate a key point, assume that X's DAPE is considered to include solely the activities that Y is conducting for X.

Y will of course be taxable in country B on its own profits, which as noted above are based on its arm's length commissions and/or service fees received.

Before the expansion of the Article 5 PE definition, X as an overseas seller has no PE and will be free of any country B tax. After the Article 5 expansion, X will have a DAPE and will be taxable in country B, but on what?

Y's level of profits from its activities reflect its contractually lowered assumption of risk. Assume that in this particular case Y will get paid at least its expenses incurred plus a limited profit element no matter whether its services result in any sales for X or whether it inventories, warehouses, or delivers any of X's products, since it contractually bears very limited risks. On the other hand, X's profits from those same activities conducted by Y reflect X's full commercial business risk. If X sells insufficient product to recoup its local expenses in country B (i.e., the commissions and services fees paid to Y), then X will have a loss. If X sells plenty of product, then X will be the sole beneficiary with Y receiving no additional commission or service fees.

Clearly, X is in business to make profits. It believes that paying for Y's activities will allow it to make sales and a profit on sales to customers in country B. The point of course is that the value of Y's local activities to X, an overseas seller, is much higher to X since X is taking the business risk of paying Y for these local support operations irrespective of how many local sales are made. The portion of X's profits (assuming of course that X has made some sufficient level of profits) that will be attributable to its DAPE cannot be the same as the limited risk commissions and service fees earned by Y under its artificial limited-risk position. Commercial business risks, even if only the efficiency and competency of how Y conducts its business activities, are being factually undertaken within country B through the actions of the Y personnel and must be recognized in the AOA Article 7 DAPE analysis. There will be no efficiency or competency risk issue for Y since Y will receive its cost-plus income irrespective of how it conducts its business. On the other hand, X's DAPE will fully benefit from Y's efficiency and competency or will suffer from the lack thereof. Thus, there clearly are risks attributable to the DAPE.

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

Response:

For the reasons expressed in the response to question 2 above, i.e. that there are factually significant people functions being conducted in any typical MNE situation by Sellco in the host country and that there are DAPE commercial risks in excess of those assumed by Sellco, we do not agree with this approach of showing no profit or loss within the DAPE.

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?

Response:

Example 1 makes no reference to home office services or IP used by the DAPE. Accordingly, there is no issue of any notional payment under the AOA that would not be appropriate under the pre-AOA methods. However, the pre-2010 OECD Model Tax Convention and many existing treaties do include the following para 4 in Article 7:

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

For those many countries that have customarily applied an apportionment formula to an enterprise's total profits, this paragraph of course continues to allow its application.

Since relatively few countries have instituted the AOA approach, and many tax treaties still include this para 4, for guidance to be relevant to most MNE taxpayers and countries, it should reflect the application of formulae that are appropriate for commonly used business models. In our view, this should be developed by the UN Committee of Experts, which is the custodian of the older, and still more widely used, version of article 7. However, we do encourage the OECD, with its expansion of BEPS Associates, to provide useful and appropriate guidance.

The BEPS Monitoring Group submitted detailed comments on 6 February 2015 regarding the profit-split method and how it could be simplified for commonly used business models. This BMG recommended approach is also appropriate for the Article 7 analysis where this para 4 applies. We recommend that this approach be explained in future Commentary amendments with the inclusion of appropriate examples.

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?

Response:

For the reasons expressed in the response to question 2 above that there are factually significant people functions being conducted in any typical MNE situation by Sellco in the host country country, we do not agree that showing no profit or loss within the DAPE is appropriate. Further, even if the DEA were to perform no significant people functions, as explained in the response to question 2, the DAPE's commercial risks in excess of those assumed by Sellco again require that there be at least some DAPE profits where the DAE operates under an intercompany agreement that limits the risks it undertakes.

6. Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?

Response:

We agree that the AOA is being applied to the stated facts in Example 2. However, we believe that the example is not consistent with reality, and is thus misleading for taxpayers and tax authorities for the reasons expressed in the above response to question 2. There are

additional factually significant people functions being conducted in any typical MNE situation by Sellco in the host country that are in addition to those significant people functions described in Example 2 for inventory and credit matters. We recommend that the Example should include these significant people functions

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?

Response:

See above response to question 4.

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?

Response:

As a first comment, this question 8 provides an excellent example of why our response to question 1 strongly recommends that the Article 7 analysis be made first on an overall MNE basis without regard to which group member is doing what.

By performing first an overall MNE Article 7 analysis to determine the group-wide profits attributable to the MNE's business and activities actually conducted in the host country (Step Three as described in the response to question 1), the analysis is made without any need to address such subjective and difficult to determine matters such as this 'financial capacity' issue. Rather, a tax authority can simply compare the results of this Step Three with the actual profits reported by the DEA and can decide if any difference is worth the additional work of an Article 9 analysis.

Now we focus on the specific issue raised in this question 8 regarding what, if any, consequences arise if Sellco does not have the financial capacity to assume the inventory and credit risks. (Example 2 in para 42 states with respect to both inventory risk and credit risk: 'On the assumption that Sellco has the financial capacity to assume the risk, ...')

We believe that in the context of the Example 2 factual situation there are no consequences at all to the various analyses and tax results from Sellco's lack of financial capacity.

While it is entirely appropriate to treat a "cashbox" company as having no financial capacity within a transfer pricing analysis, in the case of a group member like Sellco in Example 2 that is conducting real activities through its own personnel, the fact must be recognized that Prima, as the controlling parent of the MNE, has full power to create whatever financial structure it desires for Sellco and to place as little or as much assets and risks as it desires within Sellco. Given this taxpayer control, tax results must be based on actual activities and physical assets and not on what is artificially controllable through MNE decisions and agreements that have primarily tax-motivation and little or no legal or operational motivation or effect.

With the above in mind, we recommend that the para 32 phrase, 'on the assumption that Sellco has the financial capacity to assume the risk', be eliminated from any BEPS guidance as articulated in future amendments of the Model Tax Convention and its Commentary and the Transfer Pricing Guidelines in situations like this. It must be made clear in this type of circumstance that financial capacity of the company that is factually performing the activities will not affect the transfer pricing analysis.

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?

Response:

We are not concerned by 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 significant people functions that result in the attribution of economic ownership of assets to the DAPE. We are also unconcerned 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.

Our reading of the guidance in the 2010 Attribution of Profits Report, in particular of paragraphs 230 to 245, is that the conclusions in Example 2 are founded on the example's too simplified fact pattern. As explained in our response to question 2, we are concerned both that significant people functions commonly found to occur in host countries in common MNE business models are treated as if they do not exist and that actual business risks attributable to the DAPE may be ignored in some limited-risk Sellco situations. We strongly recommend that expanded examples in future guidance confront and clarify these issues as explained in our response to question 2.

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

Response:

We agree with the construction of the profits and losses of the DAPE within the limited factual situation of Example 3.

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?

Response:

See above response to question 4.

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

Response:

We agree with the construction under the AOA of the profits or losses of the DAPE within the limited facts of Example 4.

The discussion in para 81 assumes an appropriate sharing of credit risk based on the sharing of significant people functions measured by the respective contributions to credit management costs for Country B customers. Where there are such significant people functions both within the host country and outside it and there is an absence of reasonable objective bases for sharing specific risks such as those risks considered in this Example 4, it

would be helpful to indicate in this example or a similar example in future guidance that the profit-split method is an alternative which should be considered.

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?

Response:

We agree that profits or losses within the DAPE will arise because of contractual allocation of risk within intercompany agreements that differs from the actual activities of the DEA and the non-resident. See our comments on this issue in the response to question 2 above.

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

Response:

We agree that the construction of the profits or losses of the PE in Scenario A of Example 5 is in accordance with the AOA. However, given that most treaty situations will not involve the AOA, plus many Scenario As may occur where there is no treaty in effect, some discussion and guidance of the pre-AOA approach and of the possible application, where appropriate, of the profit-split method would be very helpful to many.

In particular, with the differing treatment under the AOA and pre-AOA approaches of payments for know-how and software and the fees for services that will include profit elements, such additional guidance is particularly important. We believe that the OECD should not, so to speak, merely keep its head in the sand and ignore the fact that the AOA will seldom be applicable.

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

Response:

Same response as for question 14, except for the following with respect to Scenario C.

In the response to question 2, there is discussion regarding situations where real commercial risk attributable to host country significant people functions is not being adequately reflected in the price paid to the local commissionaire, agent, or other service provider because of a relatively lower commission or service fee resulting from contractually limited risks. In such cases, there could well be additional profits attributable to the PE.

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?

Response:

Yes, under normal circumstances, there should be an appropriate return for any assets, whether tangible or intangible, that are factually a part of the PE or DAPE. The nature of the return and the calculation of the amounts of return would depend on the facts.

We can imagine that there might be occasional exceptions to this. For example, if WRU lost all its customers in Country W and continued only minimal activities in Country W to maintain its owned facilities and seek out new customers, then there should normally be no return recognized by the PE from these assets.

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?

Response:

In general, we agree. We understand, though, that the streamlined approach refers only to return from the physical asset. In the case of Scenario B where there are activities, even if only routine activities, there would also be attributed to the PE appropriate return for those routine services. Thus, the total profits of the PE in Scenario B would reflect both the routine activities and the ownership of the warehousing facility, the return from which would be determined under the streamlined approach.

For Scenario C, the arrangement with Wareco would determine whether there might be any additional profit attributable to the PE in addition to the return on the property. See response to question 15 regarding risk attributable to host country significant people functions not being adequately reflected in the price paid to Wareco.

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.

Response:

We do not agree, since significant people functions performed by commissionaires, agents, and other service providers such as Wareco will most typically be compensated in a manner that does not provide either the benefits or the risks of the non-resident's business. See the responses for questions 2 and 15.

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?

Response:

The comments in our responses to questions 2, 15, and 18 apply here. With Wareco earning a cost-plus fee for services, the commercial business risk related to all functions performed by Wareco personnel is born by WRU. As such, there would be additional profits to attribute to the PE of WRU.

20. What would the conclusion [be] 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?

Response:

With the exception of the possible application of a formula apportionment approach, we do not see for Scenario C any significant differences between the AOA approach and other approaches. See our response to question 4.

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?

Response:

We believe that the ordering approach suggested in our response to question 1 is the best approach to achieve simplification (since that will mean that in many cases no Article 9 analysis will be required) and to focus both taxpayers and tax authorities on the overall relationship of the MNE with the host country, thereby resulting in more accurate voluntary reporting of profits and better and more efficient reviews of taxpayer's operations and reported profits.