UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

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VIA EMAIL
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Re: USCIB Comment Letter on the OECD Revised Discussion Draft on BEPS Action 7: Prevent the Artificial Avoidance of PE Status

Dear Ms. de Ruiter,

USCIB[1] is pleased to have this opportunity to provide comments[2] on OECD's revised discussion draft (hereinafter "RDD") on BEPS Action 7.

General Comments

USCIB is disappointed with the RDD; although the RDD makes some concessions to business concerns, we continue to believe that the proposals set forth in the RDD, if adopted, will increase uncertainty and in the absence of adequate dispute resolution, will likely lead to increased double taxation which will create a significant barrier to cross-border trade and investment. These concerns were set forth at length in our letter of January 6, 2015. Our views are unchanged; the concerns set forth in that letter have not been adequately addressed by the RDD.

USCIB believes that the lack of clarity in the RDD is due, at least in part, to some countries preferring ambiguity. That is, they do not want business to be able to plan up to a clear line and avoid PE status. Intentionally adopting ambiguous rules is inappropriate for a number of

[1] USCIB promotes open markets, competitiveness and innovation, sustainable development and corporate responsibility, supported by international engagement and prudent regulation. Its members include top U.S.-based global companies and professional services firms from every sector of our economy, with operations in every region of the world. With a unique global network encompassing leading international business organizations, USCIB provides business views to policy makers and regulatory authorities worldwide, and works to facilitate international trade and investment.

[2] Je n'ai fait celle-ci plus longue que parce que je n'ai pas eu le loisir de la faire plus courte. Blaise Pascal.

reasons. First, companies need to know whether they have a filing obligation, particularly if, as in some countries, criminal penalties exist for failure to file. Second, the PE line is supposed to define the agreed upon taxing jurisdiction between the two countries; if the line is unclear how can a country know when it is ceding taxing jurisdiction to the other country?[3] This is especially problematic in the context of the Multilateral Instrument under Action 15 (MLI) because countries will not have an opportunity to identify and resolve discrepancies in the course of bilateral negotiations.[4] If the line is unclear, and therefore essentially unagreed, dispute resolution will be impossible. Third, if the line is acceptable to a country, then the fact that a company decides to stay below that line should not raise any policy issues for that country. Fourth, if the line is unclear, companies may decide to engage less with the local economy because of this uncertainty. Companies are already beginning to restructure to account for possible BEPS outcomes and these decisions may reduce the global footprint of some companies and perhaps have an impact on global trade and investment.

<u>Principal Policy Concerns</u>

Concerns newly raised by the revised discussion draft

The RDD is not a consensus document. The Action 7 deliverable will likely be implemented through adoption of the MLI. To the extent this is not a consensus document the minority view ought to be reflected in the Action 7 deliverable, so that the MLI can provide options that would permit those countries that disagree with the majority view to implement those views in the MLI. Failure to reflect those views would essentially cut those countries out of the MLI and require those countries to renegotiate each bilateral treaty. As the OECD has pointed out, renegotiating each treaty will mean that the changes to address BEPS issues will not be addressed for many years. Countries should not be forced to choose between their legitimate policy decisions and being able to participate in the MLI. Business has a stake in this decision, because the minority view may result in more certain outcomes. Even if these more certain outcomes are only adopted in a minority of cases, that would improve the business climate in those jurisdictions where this choice was made and such a result should be possible under the MLI.

Paragraph 8 of the revised discussion draft provides “nothing in the proposals included in this discussion draft should be interpreted as reflecting the views of the OECD or of any country concerning the interpretation of the existing provisions of the OECD Model Tax Convention and

[3] Treaty negotiators ought to want these boundaries to be clear and political bodies that approve treaties and exercise the taxing jurisdiction remaining to that country should insist on clarity otherwise they cannot know the appropriate scope of their taxing jurisdiction.
[4] This is an important function of bilateral negotiations and in their absence more clarity is necessary in any model provisions that may become part of the MLI.

of treaties in which these provisions are included." USCIB understands that this sentence is intended to mean that the new proposals cannot be read to support similar policy results under the existing Model and existing treaties. We are concerned, however, that this caution is not strong enough. Some countries may try to assert that the language of the existing Model supports the creation of PEs in cases addressed by the proposals. These positions should be explicitly rejected. Retroactive changes to tax law should be disfavored for reasons of fundamental fairness. Most of the changes proposed by the revised discussion draft require changes to the language of Article 5 to implement.[5] These changes should be prospective only and should also be accompanied by a significant transition period to allow taxpayers to restructure in response to the changes.

The last paragraph on page 7 and paragraph 57 of the revised discussion draft both indicate that the Article 5 changes will go forward and there will be follow-up work on attribution of profits under Article 7. This work will begin after September 2015 and be concluded by the end of 2016 which is the deadline for concluding the work on the MLI.

USCIB welcomes the acknowledgment that work on profit attribution under Article 7 is important and will be taken up. We believe, however, that changes with respect to the definition of PEs and profit attribution to those PEs should move in tandem because the amount of the profit attributed to a PE should inform the decision on the creation of a PE. USCIB has repeatedly made the point that if very little profit is attributable to an activity and the administrative costs associated with establishing the financial systems that permit PE reporting are significant, business will restructure to avoid those administrative costs. Thus the amount of profit likely to be attributed to a PE should be taken into account in determining the scope of the PE rules, particularly in those cases where FDI is reciprocal. It seems unlikely that this has happened at this point, since the profit attribution rules have not been reconsidered in light of these changes.

Second, it is critical that there be appropriate stakeholder input on the issue of profit attribution. Therefore, this issue should not be included in the work of developing the MLI. As we understand the development of the MLI, it is intended to be a government-to-government process with no avenue for private participation. Profit attribution is the most important issue

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[5] USCIB understands that some countries believe that Article 5 paragraph 4 can currently be read to achieve the result proposed by the revised discussion draft. This view is inconsistent with the plain language of the article ("the term "permanent establishment" **shall** be deemed not to include") and the longstanding interpretation of those provisions, as confirmed by the stated agreement of Working Party 1 reflected in the October 2012 discussion draft on The Interpretation and Application of Article 5 (Permanent Establishment). Countries should not be permitted to "bootstrap" a flawed argument with retroactive application of new treaty language and commentary.

in any PE discussion and therefore it is critical that businesses and other stakeholders have input into the development of any proposals on profit attribution.

Concerns held over from the first discussion draft

The proposed rules would significantly lower the threshold at which an enterprise of the state of residence would be considered to have a PE in the other ("source") state. The exact scope and intent of the rules is unclear, but USCIB expects that adoption of the proposed rules would result in the proliferation of PE assertions.

As a substantive matter, the adoption of the rules proposed in the RDD would create PEs from little, if any, activity by the nonresident enterprise within the so-called "source" jurisdiction. If the foreign enterprise performs no functions and assumes no risks itself in the local jurisdiction, then the only activities to look to are those performed by other parties, whether a local affiliate, independent agent or dependent agent. Creating a PE from these activities and attributing profit to it would result in double taxation. This double taxation would be especially pernicious because it would be a case of the same country taxing the same income twice.

The rules proposed in the RDD would create significant uncertainty. Recently, particularly in Western Europe, authorities have been asserting criminal liability (including at the individual non-resident director level) for failure to file tax returns when the tax authorities asserted a PE existed. Individuals should not be at risk of criminal penalties when the rules are subjective and/or uncertain.

The PE proposals also fail to recognize the bilateral nature of tax treaties. PE rules that restrict the ability of a so-called "source" country to impose tax are particularly appropriate in the context of trade relationships in which the flow of foreign direct investment runs both ways. Each country will be both benefitted and burdened by rules restricting the creation of PEs. The proposals are, therefore, particularly inappropriate in the context of economies where FDI is reciprocal. We believe the proposed rules would create significant burdens with no significant net tax impact between the treaty partners[6] in such cases.

Lowering the PE threshold will inevitably give rise to additional disputes both as to the existence of a PE and the profits attributable to it. Taxpayers, therefore, must have access to effective dispute resolution procedures. USCIB continues to believe that mandatory binding arbitration is necessary to improve currently ineffective dispute resolution. If dispute resolution continues to be ineffective, maintaining a higher PE threshold is essential because ineffective dispute resolution will lead to increased unresolved double taxation. In determining the costs of these proposals, the OECD should consider the impact of disputes and dispute

[6] This is why it is important to consider profit attribution at the same time as development of the PE rules.

resolution. These costs may be significant and business will seek to avoid them. These high costs will all have a negative impact on cross-border trade.

Artificial avoidance of PE status through *commissionaire* arrangements and similar strategies

Dependent agent rule

The RDD proposes to adopt Option B, which USCIB considered preferable to the other options contained in the first discussion draft, but only if essential terms are clearly defined. In USCIB's view, the RDD may be proposing the language of Option B, but the Commentary is interpreting it in such a way that effectively the standard contained in Option A is proposed to be adopted. USCIB strongly opposed Option A because it was exceedingly ambiguous and overbroad.

Paragraph 32.6 of the proposed Commentary provides: "the phrase "concludes contracts or negotiates the material elements of contracts" ***must be interpreted in the light of the object and purpose of paragraph 5, which is to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise.***" This is not far from the language in Option A, which would have applied if a person "***habitually engages with specific persons in a way that results in the conclusion of contracts"***. Thus, Option B is seemingly interpreted to reach the activities that would have been a PE under Option A.

Proposed paragraph 32.4 of the commentary on Article 5 (Box page 14 of RDD) provides: "The phrase "concludes contracts" focuses on situations where a contract is legally concluded by a person. A contract may be concluded without any active negotiation of the terms of that contract; this would be the case, for example, where a contract is concluded by reason of a person accepting, on behalf of the enterprise, the offer made by a third party to enter into a standard contract with that enterprise. Also, a contract may be concluded in a State even if that contract is signed outside that State; where, for example, the conclusion of the contract results from the acceptance, by a person acting on behalf of an enterprise, of an offer to enter into a contract made by a third party, it does not matter that the contract is signed outside of that State." It is not at all clear what exactly an enterprise has to do to conclude a contract. If a contract is not signed, is it clear that it has been accepted? How would that be proved? If the contract is not valid unless it is in writing, is a signature required? In that case would signature outside of a State control?

Proposed paragraph 32.5 of the commentary on Article 5 (Box page 15 of RDD) provides: "The phrase "or negotiates the material elements of contracts" is aimed at situations where contracts that are essentially being negotiated by a person in a given State are subject to formal conclusion, possibly with further approval or review, outside that State. The fact that the key ingredients of the contractual relationship have been determined in the relevant State is

sufficient to treat these contracts in the same way as if they had been formally concluded in that State. For purposes of that rule, "the material elements" of contracts may vary depending on the nature of the contract concerned but would typically include the determination of the parties between which the contract will be concluded as well as the price, nature and quantity of the goods or services to which the contract applies."

Proposed paragraph 32.6 of the commentary on Article 5 (Box page 15 of RDD) in part, provides: "The paragraph applies to a person who acts as the sales force of the enterprise and, in doing so, makes or accepts contractual offers even if standard contracts are used for that purpose." There is a long example illustrating this principle involving an online business that concludes with the following: "The fact that SCO's employees cannot vary the terms of the contracts does not mean that there is no negotiation but rather means that the negotiation of the material elements of the contracts is limited to convincing the account holder to accept these terms."

The scope of these proposals is very unclear and potentially very expansive. The person must be acting on behalf of the enterprise in a State but it is not clear what that person must be doing. Personnel in a market jurisdiction may perform a wide variety of activities towards a potential customer base in the jurisdiction, including any or all of the following: market development; demand generation; education; marketing; sales solicitation; negotiation; returns; training; service; repair; and support. One could argue that all of these activities are intended to help the principal sell products and therefore are captured by these paragraphs of the proposed Commentary. Under a standard that looks to negotiation and conclusion of contracts, not all marketing activities should create a PE, but under the RDD the standard remains exceedingly unclear.

In particular, the relevance of the facts in the online business example are unclear. Is it essential that SCO's employees' remuneration is partially based on the revenues derived by RCO? If the employees of SCO only have contact with RCO's large customers, is there any impact on the vast majority of RCO's sales, if those customers have no contact with SCO? Paragraph 34 of the proposed Commentary seems to have some type of force attraction rule, but its scope is not clear. If this rule is implemented through the MLI, would the fact that a particular bilateral treaty follows the UN Model change the extent of any force of attraction rule?

Finally, the RDD fails to recognize that large sales may have sales/negotiating teams in multiple countries leading to one sale. In such a case, how is the income to be divided to ensure that double or multiple taxation is to be avoided?

USCIB welcomes the recognition that a distributor, including a low-risk distributor, is not a dependent agent.[7] We believe that, for further certainty, language excluding distributors from the dependent agent rule should be included in Article 5 itself and not just the commentary. The rule should be expanded to include distributions of licenses and services. This is especially important when the distinction between goods, intangible property and services is as unclear as it may be in the digital economy. Finally, as discussed below, we are concerned that this rule is substantially undercut by the anti-fragmentation rule.

In our prior comments USCIB requested that the Focus Group clarify the clause concerning the negotiation of material elements of the contract by reference to actual business models. We provided the following suggestions:

- Material elements. Guidance will be necessary as to what elements of contracts are to be regarded as "material". Depending on the type of transaction, a business may consider a wide variety of contractual provisions to be material, in other cases those same elements may not be considered material. This will make the test very subjective and tax administrations may assert that an element is a material element, when the business believes it is not. In some cases, different persons in an organization will be responsible for negotiating different material terms (for example the sales organization may have responsibility for pricing while the legal group would have responsibility for indemnities), so guidance will be necessary as to which set of negotiations is the determinative one for PE purposes.

- Marketing or sales solicitation. It should be clarified that all marketing, sales solicitation, demand generation, and other customer-facing activities that do not involve the actual negotiation of terms of sale are not described by this text.

- Rate cards. It is common for enterprises to authorize local representatives to communicate prices to potential customers through rate cards, which may include pre-agreed discount ranges. The local personnel normally will have no authority to deviate from the ranges prescribed on the rate card. This should not be regarded as "negotiation", due to the absence of authority of the local personnel to deviate from agreed terms. Business policies which require escalations for approval of deviations by management personnel located outside of the market jurisdiction should be sufficient to establish that no PE would arise in the market state if behavior is consistent with the policy. As this suggestion has thus far not been adopted, it will be necessary to determine the profit attributable to the PE which should be determined based on the variation permitted under the rate card and not the entire profit from the sale.

- Standard contracts. Many enterprises sell their goods and services through standard contracts, including online contracts. Since the terms of those contracts are not

[7] RDD box page 16, proposed Commentary, paragraph 32.12.

negotiated, it should be confirmed that Option B cannot apply to any sales made pursuant to standard contracts. Again, the RDD has not adopted this proposal. If local staff make potential customers aware of standard terms, but are not otherwise involved in the negotiation or conclusion of contracts, what additional profit above the amount already allocated to the local affiliate for marketing support can be allocated to the deemed PE resulting from the activities of the local affiliate? USCIB is concerned that the countries intend to allocate 100% of the profit from any sale to the deemed PE. Such a result likely will not properly reflect the functions, assets and risks of the related entities.

The above suggestions have largely been rejected. It is difficult to see how a standard relating to negotiation of material elements of a contract can be satisfied when there is no conclusion or negotiation, at least as those terms are commonly understood. It seems as if the OECD by its interpretation of what it means to conclude or negotiate the conclusion of material elements of the contract has essentially adopted Option A and, therefore, any activity that ultimately results in the conclusion of contracts can be considered a PE.

USCIB wishes to reiterate that the OECD should expressly state that the purpose of the amendment being proposed is to change the existing international standards on the allocation of taxing rights on cross-border income. This is important in order to ensure that tax administrations cannot argue that these proposed changes are merely clarifications of existing treaty provisions. The proposed rules are in response to a string of cases lost by tax authorities. Not only would these rules reverse those losses, but they would also sweep many additional activities into the scope of the proposed PE rules. It would be a grossly unfair to attempt to use the proposed rules to expand taxing jurisdiction on past activities in such circumstances.

Independent agent rule

USCIB agrees with BIAC comments on this topic. In our view it is possible for connected enterprises to act independently of each other. This is certainly the case when the standard is at least 50% and therefore the connected party could be counter-balanced by an unrelated joint venture partner who would have an interest in ensuring the relationship was entirely arm's length. Further, a more stringent rule should not apply to related parties than unrelated parties. We also agree with the BIAC suggestion that if countries are concerned with abuse, a rebuttable presumption or other form of anti-abuse rule would be appropriate. An absolute prohibition on independent agent status is not an appropriate response to whatever concerns countries may have.

Artificial avoidance of PE status through the specific activity exemptions

USCIB objected to the option E, which the RDD proposes to adopt, because this proposal would create uncertainty with respect to every item on the list, would lead to a proliferation of PEs

and a proliferation of disputes concerning whether a PE exists. Certainty of outcome is an important principle for business and subjecting all the items on the list to a subjective test will increase uncertainty. Because the RDD supports this option it is necessary to articulate a standard for consistently determining whether an activity is preparatory or auxiliary and to include many examples. The proposed commentary[8] is inadequate.

Proposed paragraph 21.1 retains language from the existing Commentary. This language has always been ambiguous. Because taxpayers and tax administrators now must apply that language to determine whether the items listed in Article 5 paragraph 4) are preparatory or auxiliary this ambiguity is now more important and must be resolved.

The proposed Commentary attempts to do this with some circular rules and a few examples. While the examples that are provided are generally somewhat helpful, they are likely to be inadequate to address the many issues that will likely arise as these rules are implemented.

With respect to the warehousing example,[9] the facts in the example posit that R owns the warehouse in State S. Is this fact important? We do not believe that in most cases R will own the warehouse. It is much more likely that a foreign entity, either related or unrelated, will own and operate the warehouse. If this is the case, will R have a PE in State S? The example should also make clear that the PE only exists in the country in which the warehouse is located. The situation of regional warehouses is common. The proposed Commentary should make clear that a warehouse cannot create a PE in relation to sales outside of the country where the warehouse is located nor can sales outside the country where the PE is located be attributed to that PE.

The OECD should clarify that the example provided in proposed Commentary paragraph 22.3. Would the answer differ if the enterprises were connected parties? USCIB is concerned that the proposals under the anti-fragmentation rules would automatically result in a PE, even if the facts were identical to the first part of the example, where no PE is considered to exist. Under the arm's length principle, results should not differ if related and unrelated parties engage in identical transactions. If there are significant differences, the proposals will distort economic decisions by forcing taxpayers to use unrelated parties. This may increase costs (other than taxes) and discourage cross-border trade and investment.

USCIB's earlier letter provided extensive comments on why neither a purchasing office nor an office that collects information should be considered a PE. We stand by those comments and believe that even if Option E is ultimately adopted, the OECD should provide extensive comments indicating when a PE should not be considered to exist.

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[8] Proposed commentary paragraph 21 through 30 of the RDD.
[9] RDD box on page 24, proposed Commentary paragraph 22.

Fragmentation

In our earlier letter USCIB objected to both options on the grounds that they would significantly undercut the concept of separate entity reporting and create vastly different results for enterprises dealing with related vs. unrelated parties, undercutting the arm's length standard, which the Action Plan continues to support. In order to avoid these results, companies may reconfigure their operations in ways that might be inefficient and therefore harmful to global trade and investment.

USCIB is very concerned about the continuing lack of clarity and potential scope for a broad interpretation of the language "complementary functions that are part of a cohesive business operation."[10] Given that this proposal would significantly undercut the separate entity principle, it should be framed as an anti-abuse provision that should not apply in the absence of evidence of abuse.

USCIB is also very concerned that this language is broad enough to create PEs when most of the activities of the non-resident connected party take place outside of the local jurisdiction. It is critical that these rules not be used to attribute excessive profits to minimal activities. USCIB remains concerned that so-called "source" jurisdictions will use these rules to attribute profits to the market jurisdiction when value is created by functions, assets and risks outside of the market. Such aggressive assertion of these rules will likely result in double taxation. Business needs an effective mechanism to resolve these disputes, which we believe are inevitable given the lack of clarity.

It is also not clear how this proposal interacts with existing paragraph 7 of the OECD Model. In essence, that paragraph provides that controlled companies do not create PEs for each other. The concept expressed in a parenthetical in Example B, that a local country enterprise has a PE within its own country and those activities could form the basis of PE for a connected party should be carefully considered before adoption. In USCIB's view this converts a transfer pricing issue into a PE issue and essentially creates a second transfer pricing issue under Article 7.

Example B also raises a series of issues that are unaddressed. First, is the answer different if RCO does not own the warehouse? USCIB believes that it is unlikely that RCO would in fact own the warehouse, so if the answer is different that should be made clear. This is also a case where the profit attribution and PE issues should be considered together. It is unlikely that significant profit would be attributed to the maintenance of inventory in the warehouse. Additionally, would the answer differ both with respect to the PE issue and the profit attributable to SCO if SCO held title to the inventory while it was in the warehouse (particularly if the warehouse were owned by an unrelated party)? It seems that the goal of this example

[10] RDD box on page 31.

may be to attribute some profit from bearing the inventory risk either to SCO or to a PE of RCO within Country S. If SCO, in fact, bears the inventory risk, then that would be appropriate. However, the inventory risk may remain with RCO depending on the contractual terms between RCO and SCO. If for example SCO took title to the inventory in the warehouse, but was able to return unsold inventory to RCO would RCO bear the inventory risk?

Example B also seems to undercut the decision, which USCIB supports, set forth in proposed paragraph 32.12 of the Commentary on Article 5.[11] That paragraph provides that the activities of a distributor are to be distinguished from the activities of dependent agents and that the activities of a distributor do not create a PE on behalf of the enterprise from which it acquires goods. If, however, in the case of connected parties, the distributor will be considered to create a PE because their activities are part of a cohesive business enterprise, then distributors will, in fact, create PEs in many cases involving connected parties even though the dependent agent rules are inapplicable. Is this really appropriate? In our earlier letter USCIB raised a series of examples that ought to be addressed so that taxpayers could understand the scope of the anti-fragmentation rule; none of those examples have been addressed. Without repeating those examples here, we ask for guidance as to whether a PE would be created in those common cases.

Overlap with VAT rules

USCIB urges the OECD to include explicit language in the Article 5 Commentary providing that its proposals to cut the common link between PE determinations and VAT registrations. USCIB understands that there is agreement between Working Parties one and nine that such a link should not exist, but that there is a preference to wait until after the 2015 Action 7 work is completed before making this clear in the guidance to Article 5. This issue is very important to the business community and given that there is agreement and it should not be difficult to solve we suggest the inclusion of the following language in Article 5 of the Commentary:

> The term "permanent establishment" as used in the OECD Model Income Tax Treaty is a distinct concept from the "VAT establishment" term used in the International VAT/GST guidelines, such that the existence of one should not in itself result in the other. In addition, while companies might have to register for VAT in order to comply with their national VAT obligations, such registration in itself should not trigger the creation of a permanent establishment for purposes of Article 5.

[11] RDD box on page 16.

Thank you for this opportunity to comment.

Sincerely,

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