UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

September 2, 2016

VIA EMAIL
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Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 7 – Additional Guidance on the Attribution of Profits to Permanent Establishments ("discussion draft")

Dear Mr. VanderWolk,

USCIB is pleased to provide comments on the OECD's discussion draft on BEPS Action 7 – Additional Guidance on the Attribution of Profits to Permanent Establishments ("discussion draft").

Executive Summary

USCIB believes that the examples in the discussion draft reach correct conclusions in most cases. The discussion draft should, however, be modified to:

- More closely follow the AOA – the discussion draft does not identify the dealings between the permanent establishment and the non-resident enterprise, a necessary step in applying the AOA;
- Provide guidance on how the 2008 version of the AOA would apply to the examples;
- Limit the ability to adopt the PE changes as part of the multilateral instrument to those countries that accept the AOA for purposes of attributing profit;
- Clarify how economic ownership of inventory is determined -- the discussion seems to apply a significant people function test, rather than the general rule based on the place of use of the tangible property;
- Recommend the adoption of simplifying administrative practices.

General Comments

The mandate under Action 7 is to provide additional guidance on how the rules of the Authorized OECD Approach (AOA) apply to the new forms of permanent establishment (PE) created by the BEPS changes to Article 5 without making substantive modifications to those rules.

Given this mandate, USCIB believes it is important to frame the new guidance consistently with the existing guidance provided by both the 2008 and 2010 Reports on the AOA.

The first step in applying both the 2008 and 2010 versions of the AOA is hypothesizing the PE and identifying the "dealings" between the PE and the rest of the enterprise. This requires a disciplined analysis of the functions, assets and risks that are treated as part of the PE. It is important to determine where the relevant significant people functions really take place. Once that functional analysis has been done, then the dealings between the head office and the PE need to be constructed.

The dealings are critical to the application of the AOA because the dealings form the basis for step two, determining which transfer pricing method is the most appropriate method. The most appropriate method will depend on the type of dealing that is constructed. That is, for example, whether the dealing is a sale to a distributor or the provision of a service by a contract service provider, will influence the determination of the most appropriate method.

The examples in the discussion draft seem to skip over these steps. The functional analysis is essentially replaced by factual assumptions, which is necessary given that these are examples. However, the next step – construction of the dealings – is also omitted. In performing the analysis under Article 7, the first three dependent agent permanent establishment (DAPE) examples start with 100% of the sales income in the DAPE without any analysis of why that approach is correct. This may be a holdover from the "old" DAPE definition under which the DAPE had to conclude contracts on behalf of the non-resident. In that case it might make sense to conclude that the "dealing" was a sale by the head office to the DAPE followed by a sale by the DAPE to the third party customer. If that was appropriate under the prior definition of a DAPE, it is no longer necessarily appropriate under the new definition. The dealing needs to be defined based on the functional analysis and the dealing will not always be a sale by the head office to the DAPE, followed by a sale by the DAPE to third parties. In some cases, the most appropriate characterization of the dealing between the head office and the DAPE may be a sale to a limited risk distributor. In other cases, the most appropriate characterization of the dealing between the head office and the DAPE would be the provision of a service and the payment of a commission to a service provider. This underscores the need to characterize the activities of the hypothesized separate entity in step one to facilitate the search for comparables in step two.

The fourth DAPE example addresses only the mechanism to split profits and losses between the DAPE and the head office, and is ambiguous whether or not the full attribution of profits analysis for the DAPE starts with external customer revenue. This ambiguity is created due to the absence of a statement of the "dealing" between the head office and the DAPE in this example.

Once the dealing is identified, the second step of the AOA is the identification of the most appropriate transfer pricing method and application of that transfer pricing method by analogy to the dealings between the DAPE and the non-resident enterprise. Again, the discussion draft glosses over the choice of transfer pricing method. The most appropriate method would involve the use of a method typically used for pricing that type of sale or service that was characterized based on the dealings in the first step. In many cases this would be an application of the transactional net margin method. In cases where customer revenue is appropriately attributed to the DAPE, the relevant comparability analysis normally would be comparable to limited risk distributors.[1] USCIB believes that even if relevant facts need to be assumed, it is important to articulate the choice of method because that step is a fundamental part of the analysis.

The examples' omission of the complete AOA analyses creates ambiguities. In particular, Examples 2 and 4 appear to double-remunerate risk-control functions performed by the DAE. This apparent double-remuneration may reflect conceptual errors in the examples (i.e., the Country B operations are rewarded twice for the same functions, assets and risks), or it may be attributable to omitted facts. Absent any differentiation of the activities performed by the DAE for its own account from those performed on behalf of the non-resident enterprise, one simply cannot tell. Whatever the explanation, the aggregate reward to Country B risk-control functions should reflect their value.

As discussed below, USCIB believes that the examples reach correct results in many cases. However, we also believe that the discussion draft should be revised to conform more closely to the AOA and to distinguish the DAE's activities as a principal from its activities as an agent.

USCIB also believes that if the guidance to be provided is to be useful in the greatest number of cases, it should be based upon the version of the AOA which is most likely to be applicable under bilateral treaties in the near to medium term. The discussion draft indicates that its guidance was developed by reference to Article 7 in the 2010 version of the OECD Model Tax Convention (MTC), and under the principles set out in the 2010 Commentary to the MTC, and the 2010 Report on the Attribution of Profits to PEs (i.e., the so-called "full AOA"). In practice, however, the Article 7 of most bilateral treaties likely to be applicable in the near to medium term will be based on the pre-2010 MTC. The discussion draft acknowledges as much by noting

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[1] We note that in the DAPE context, even limited risk distributor comparables almost certainly will require adjustments, as the DAPE is allocated only assets and risks, but no functions. This is implicitly recognized in Examples 1 and 2, as the COGS amount is derived as a residual.

that relatively few treaties include the 2010 version of Article 7, a number of OECD and non-OECD countries have expressly noted their intention not to include the 2010 version of Article 7 in their treaties, and the inclusion of the 2010 version of Article 7 in the UN Model has been expressly rejected by the UN Committee of Experts on International Cooperation in Tax Matters.

For treaties with the pre-2010 version of Article 7, OECD Council Recommendation 2008(106) recommended that OECD member countries follow, when applying the provisions of such bilateral treaties, the guidance in the 2008 Report to the extent that its conclusions do not conflict with the 2008 Commentary on Article 7 (i.e., the so-called "partial AOA"). The Recommendation similarly invited non-OECD member countries whose treaties were drafted on the basis of the pre-2010 MTC to take account of the Recommendation's terms. The "partial AOA" implemented under the 2008 Commentary includes most of the features of the "full AOA".[2] For certain dealings, however, it retains the language of the pre-2008 Commentary, which stops short of "full AOA" treatment.[3]

With respect to the partial AOA as implemented under the 2008 Commentary, all OECD countries other than New Zealand agreed with the conclusion that the 2008 Report represents internationally agreed principles and, to the extent that it does not conflict with the 2008 Commentary, provides guidelines for the application of the arm's length principle incorporated in the pre-2010 version of Article 7. Of the 30 non-OECD countries that published their positions on the 2008 MTC, a number expressed a preference for treaty text that differed from the pre-2010 Article 7, but for treaties that included the pre-2010 Article 7, only Chile and India disagreed with the conclusion that the partial AOA should be applied in attributing profits to PEs under treaties with that text.

Accordingly, USCIB believes that, as a practical matter, the discussion draft's guidance on the attribution of profits to the new PEs would be much more useful (i.e., of much broader applicability) if it included an analysis based upon the partial AOA as implemented under the 2008 Commentary, and extending that analysis to the full AOA under the 2010 MTC. In our view, given the extent of the overlap between the partial AOA and the full AOA and the simple nature of the examples, the conclusions under both the partial AOA and the full AOA ought to be the same. Noting that would significantly expand the usefulness of the guidance.

USCIB is concerned that countries may wish to adopt the changes to the PE standard without committing to follow the AOA on profit attribution. USCIB urges the OECD to reject this position. These changes are part of a unified approach to treaty interpretation and it does not

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[2] For example, it expressly incorporates the AOA's 2-step approach, including its functional analysis and the recognition and pricing of "dealings". It acknowledges that PE accounts are a starting place for attributing profits, but confirms that the accounts must be reviewed to ensure that they align with substance and reflect arm's length pricing. It expressly incorporates the 2008 Report's guidance on the attribution of profits to dependent agent PEs (DAPEs). It incorporates the requirement for the PE to have adequate "free capital".

[3] See, e.g., paragraphs 33-40 in relation to dealings in the form of goods, intangibles, and services.

make sense to permit the expansion of the PE definition without agreement on how profit is attributable to those activities. Thus, with respect to the expansion of the PE definition, the multi-lateral instrument should only be open to those countries that commit to the AOA.

The discussion draft does not indicate what form the final guidance on the application of the AOA to new PEs will take, nor what status it may have. Inasmuch as the existing guidance on the AOA (i.e., the 2008 Report relevant to the pre-2010 Article 7 and the 2010 Report relevant to the 2010 Article 7) is the subject of an OECD Council Recommendation (i.e., Council Recommendation C(2008)106), USCIB hopes that the new guidance will effectively become a supplement[4] to the existing guidance and that the Council Recommendation will be updated to reflect the incorporation of the new guidance into the existing guidance. While Council Recommendations are not legally binding, the OECD indicates that "practice accords them great moral force as representing the political will of Member countries and there is an expectation that Member countries will do their utmost to fully implement a Recommendation." Such an approach would provide desired certainty to taxpayers, at least vis-à-vis OECD Member country tax administrations, on the manner in which the AOA will be applied to the new PEs, thereby minimizing risks of double taxation. Of course, USCIB would also greatly welcome a similar expression of political commitment on the part of non-OECD countries to the agreed application of the AOA to the new PEs.

USCIB recommends that the final guidance on BEPS Action Item 7, if patterned on the discussion draft, state that it is not controlling with regard to banks, global trading operations, or insurers, i.e., sectors that were separately addressed in Parts II, III and IV of the 2010 Attribution of Profits Report. For those sectors, the 2010 Attribution of Profits Report incorporates the concept of key entrepreneurial risk taking functions ("KERTs"), which result in the economic ownership of income-producing assets (loans, derivative contracts, insurance contracts, etc.). This is distinct from the more general formulation of the AOA that applies in Part I ("significant people functions applicable to the assumption of risks" and "significant people functions relevant to the economic ownership of assets"). See 2010 Attribution of Profits Report (Part I), para. 16 (in non-financial sectors, people functions relevant to economic ownership of assets and incidence of risks may deviate; in financial sectors, they tend to be aligned with each other). While the principles that guide the AOA under Part I are the same principles that guide Parts II, III and IV of the 2010 Report, the guidance under Part II, III, and IV is tailored to the financial services industry and the conclusions of that guidance should not be revisited.

Finally, USCIB observes that the detailed P&Ls constructed even for the discussion draft's simplified examples suggest the need for a refinement of the analysis that may be difficult for

[4] USCIB believes that the guidance should be a supplement to both the 2008 Report and the 2010 Report; that the existing Council Recommendation should be updated; and the 2008 Commentary and current Commentary should be updated to refer to the updated reports.

taxpayers to implement as a practical matter in real world situations. Such a potential level of refinement may also give rise to extensive controversy and enhanced risk of double taxation.

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.

USCIB believes that Article 9 of the MTC, when applicable, should be applied before Article 7. For example, in cases where customer revenue will be allocated to the DAPE, in most cases the arm's length payment to the DAE will be an expense also attributed to the DAPE. Accordingly, it will be necessary to determine that arm's length payment before the tax accounts of the DAPE can be created.

USCIB also believes that countries should be encouraged to adopt simplifying mechanisms that would permit a local affiliate to file a return that reflects the total profit attributable to both the local affiliate and the PE. Applying Article 9 first would be more consistent with the simplifying approaches.

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

USCIB strongly agrees that the DAPE is not attributed risks because there are no significant people functions performed by the DAPE on behalf of the non-resident enterprise; that the DAPE is not attributed economic ownership of assets because there are no significant people functions performed by the DAPE on behalf of the non-resident enterprise relevant to the attribution of economic ownership of such assets; there are no risks or assets attributable to the DAPE, so no capital is attributable to the DAPE.

While we agree with this outcome, we think that the analysis should be expanded. In particular, the AOA does not rely on significant people functions to attribute the economic ownership of tangible assets but instead presumes that the place of use should be "the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view."[5]

Since inventory is a tangible asset, attributing the economic ownership of inventory based on significant people functions seems on its face to be inconsistent with the general presumption in both the 2008 and 2010 Reports. It seems that the OECD is implying a different rule for inventory. If that is the case, it would be useful to explicitly articulate it. This difference may be based on the fact that any value attributable to inventory is not attributable to its "use" in a conventional sense, but rather is attributable to decisions concerning what levels of inventory should be held, where it should be stored and at what price it should be resold. Thus, these

[5] Paragraph 75 of the 2010 Report.

people functions are more important to the value of inventory than the place of "use". USCIB agrees with this implied analysis as an alternative or exception for inventory to the "place of use" presumption. In order to avoid different interpretations, it would be useful to articulate this as a special rule for inventory. Otherwise countries may take different positions based on existing paragraph 75 and this example. Such inconsistencies could lead to double taxation.

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

USCIB strongly agrees that the example reaches the correct result; that is no additional profit (beyond that which is already taxable under Article 9) is attributable to the DAPE. USCIB is not clear, however, on how the AOA was applied to reach this result. In applying the AOA, the example identifies of functions performed, assets used, and risks assumed by the PE and the attribution of free capital to the PE. This is supposed to be followed by identifying any dealings between the PE and the non-resident enterprise, and characterizing the activities of the DAPE hypothesized separate entity, before identifying the most appropriate transfer pricing method and applying that method by analogy. The example does not identify the "dealings" between the non-resident enterprise and the DAPE and does not characterize the activities of the hypothesized separate entity. Perhaps this part of the analysis is assumed – given that all of the value creating activities are occurring at the head office – perhaps there are no "dealings", which is why no profit would be attributable to the DAPE.[6] However, if there are no "dealings", then although the answer would be the same, no profit would be attributable to the DAPE, why would the starting point be third party sales in Country B? It seems that the example assumes that the dealing must be a sale by the non-resident enterprise to a low-risk distributor. If so, this should not be assumed but should be explained and justified and the activities of the DAPE appropriately characterized. In our view, another and possibly better view, would be to recognize that the "dealing" takes the form of the PE providing sales agent services to the home office, but since Sellco as a separate enterprise fully performs the sales agency functions, there is no profit left over to tax at the PE for that function; however the sales revenue would then be attributable directly to the home office.

USCIB is concerned about a possible back-door application of the "force of attraction" concept. The first example states that third party sales in Country B are 200. Presumably these are sales in which Sellco participated in some fashion although that is not explicitly stated. This should be clarified, so that the example does not lend implicit support to the force of attraction principle.

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[6] If there are no dealings, should there be a PE at all? USCIB is aware that the definition of a PE is beyond the scope of this discussion draft, but the difficulty of applying the AOA to this example shows the flaws of the expansive PE definition.

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?

USCIB is believes that the answer would depend on the language of the particular treaty. It is, therefore, not possible to provide an answer in the abstract. However, as stated in the general comments section of this letter, USCIB believes that the OECD should consider providing guidance on whether and if so how the answer would differ if the partial AOA of the 2008 report applied. USCIB also believes that countries should be required to commit to the AOA[7] if they are going to permitted to change their treaties to adopt the new, broader definition of a PE as part of the multi-lateral instrument.

5. In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?

Yes. The entire premise of the BEPS project has been that taxation ought to follow value creation. If the DAE is not performing "significant people functions applicable to the assumption of risks" or "significant people functions relevant to the economic ownership of assets" with respect to the nonresident enterprise, there cannot be any profit (or loss) attributable to the DAPE, as there are no assets or risks allocated to the DAPE. In that case, the only transfer pricing analysis required is to determine the arm's length return to the DAE, which would be based on its own functions, assets and risks.

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

USCIB believes that this example is flawed because the example does not delineate the transaction that is being priced under Article 9, construct the dealings that are being priced by analogy under Article 7, characterize the activities of the hypothesized separate entity, or identify the most appropriate method for determining the transfer price by analogy under Article 7.

The premise of this example is that the contract between Prima and Sellco is not respected because Prima does not in fact control the inventory or credit risk and therefore the transaction must be recharacterized before it is priced. The example does not, however, explain how the transaction would be recharacterized. In our view, because Sellco is bearing all the risk related to the sales, Sellco would be treated as a full-risk distributor. Prima would be treated as selling the inventory to Sellco in exchange for a note. If that is the proper characterization of the

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

transaction under Article 9, then query whether there is a PE at all? If Prima and Sellco had initially structured the transaction as a sale to a full-risk distributor, then there would be no PE because a full-risk distributor is not acting as dependent agent.

Assuming that there is a PE even if Sellco is treated as a full-risk distributor under Article 9, it is not clear that any additional profit should be allocated to the PE. As described in paragraphs 43 and 44, the only profit in Prima's PE relates to the funding of the inventory. If the funding decisions are made at the head office, then that profit should not be attributable to the PE, even if one exists. Funding the inventory is different from bearing the inventory risk and having the financial capital to bear this risk and there is no indication in the example that these functions (and capital) are not in Prima's head office.

In addition, Example 2 raises the risk of double counting the same profit. This is clearer in table 2 which sets forth the functional and factual analysis of example 2. Under the category of inventory risk[8] for purposes of Article 9, the inventory risk is allocated to Sellco. The inventory risk is also attributed to the DAPE for purposes of Article 7. This seems inconsistent. If Sellco is assuming the risk under Article 9, then it would seem those people functions are performed on its own account and not in its capacity as a dependent agent of Prima. If the functions are not performed on behalf of Prima, then the income from those activities should not be attributable to the PE.

The example does not actually double count those profits because the DAPE profits are reduced by a sales commission to Sellco, nevertheless the example includes the same income, attributable to the same activities, in the taxable income of two different entities (Sellco under Article 9 and the DAPE of Prima under Article 7). In practice this is likely to lead to confusion, double counting and double taxation.

The treatment of the funding return also creates the possibility of double counting. Under the Article 9 portion of the example Prima is entitled to a return of 2 to reflect its funding return with respect to the inventory and Sellco deducts that 2 from its Country B income. When we turn to the Article 7 portion of the analysis, the DAPE earns that funding return. If Country A and Country B take different views of the transaction, then double taxation is likely. For example, if Country A accepts that the transaction is characterized as described above and concludes there is no PE, because Sellco is a full-risk distributor and not a dependent agent, then Country A would conclude that it should tax the funding return of 2. If Country B asserts the income is taxable as described in Example 2, then both Country A and Country B would tax the funding return.

In the Article 7 portion of the analysis capital is attributed to the DAPE to support the inventory risk and the economic ownership of the inventory and the credit risk and the economic

[8] This is also true for receivable risk in example 2.

ownership of the receivables[9]. The inventory and credit risk was attributed to Sellco because Sellco both controlled the risk and *had the financial capacity to bear the risk.* So, capital to support the risk is *already in Country B*. Attributing the risk to the DAPE along with free capital to support that risk would over allocate capital to Country B. This over allocation would result in too much profit being attributed to Country B.

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?

See the answer 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?

It is not clear from the question whether the question relates to Article 9 or Article 7. The Article 7 analysis should be relatively straight forward, that is the capital should follow the risk and the DAPE would be allocated capital to support those risks. It is not clear how the new transfer pricing guidance would resolve this issue for purposes of Article 9.

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?

USCIB's response to these questions is part of our critique of Example 2 contained in the response to question 6. To summarize, USCIB is not certain whether the conclusions are consistent with the 2010 Report. The Article 9 analysis of this example effectively says that, in substance, Sellco is acting on its own account in selling to customers, since it bears the inventory and credit risk. One might conclude that there is no PE at all, since Sellco is not acting on behalf of Prima. But even if there is a PE, footnote 10 of the discussion draft provides that:

> Given that the Article 7 analysis is presented for purposes of this example as independent of the Article 9 analysis, Step 1 of the AOA does not take into account that, under Article 9, the inventory risk has been allocated to Sellco and that Prima receives a

[9] While the economic ownership of both the inventory and the receivables is attributed to the DAPE, the example only computes a funding return on the inventory. USCIB believes this is correct, but considers that the OECD should explain the distinction between the treatment of inventory and the treatment of receivables.

funding return to Prima for the functions it performs in relation to inventory. When the analysis under Article 9 has already been performed to allocate risk to Sellco, the analysis under Article 7 will not attribute the risk to the DAPE.

This seems to be exactly opposite of the analysis contained in Example 2. USCIB believes that the footnote 10 (and footnote 11 for purposes of credit risk) are correct and therefore it is incorrect to allocate economic ownership of the inventory and the receivables to the PE and to attribute to a funding return to the PE on that basis.

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

Please see the comments above in response to question 3. USCIB believes that an appropriate amount of profit is attributed to the PE but is concerned that the examples do not construct the dealings and do not identify the most appropriate method for determining the transfer price by analogy.

10. 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?

See the answer to question 4.

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

Please see the comments above in response to question 3. USCIB believes that an appropriate amount of profit is attributed to the PE but is concerned that the examples do not construct the dealings and do not identify the most appropriate method for determining the transfer price by analogy.

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?

Yes, USCIB agrees with this explanation. This is actually a very troubling result, not because it will lead to incorrect answers when properly applied, but because it creates a significant incentive for countries to find that some significant people function is performed locally. Given the difficulty of performing the factual and functional analysis to the level of detail that may be required, it may be difficult for taxpayers to reach certainty and countries may assert profits attributable to significant people functions when the taxpayer was of the view that those functions were not significant.

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

In this particular fact pattern, with no significant people functions occurring at the PE, USCIB agrees with the conclusion that the net profit for the PE is only a routine return for the service, including a funding return for the ownership of the warehouse. It is not clear to us, however, that AOA was properly applied to reach this result. In Example 5A, the non-resident WRU in Country A performs all significant people functions with respect to its warehouse located in Country W. WRU has employees in Country W which operate the warehouse but have no specialized knowledge. The example assumes that a permanent establishment exists, consisting of a fixed place of business and the business of WRU is partly carried out through that fixed place of business. The example attributes the economic ownership of the warehouse to the PE, citing paragraph 75 of the 2010 AOA Report for allocating the economic ownership of tangible assets to the location of use rather than to the location of the people functions making the decisions relevant to the economic ownership. This attribution is consistent with the 2010 Report.

The example does not construct the "dealings" between the PE and the non-resident enterprise. Rather, the example proceeds to calculate the profit of the PE on the assumption that the PE receives all the revenue from the third party customer and pays WRU in Country A for services and intangible rights and then takes deductions for its depreciation and other expenses. It is important to note that the example claims that it is allocating WRU's "profit" from the warehouse services, but since that number has not been reduced by the labor or depreciation or interest allocation, the starting point is really WRU's customer revenue for the warehouse services.

The initial critical question is what is the dealing between the head office and the PE? Is the service remuneration properly viewed as (a) paid by the third party customers to the PE, with the PE deducting notional payments to the head office or (b) paid by the third party customers to the head office, with the head office making service payments to the PE? The terminology used in paragraph 92 is not helpful in this regard, referring to "the profits of WRU" rather than "the revenue". If the proper characterization of the dealing is that third party customers make payments to the PE and the PE makes notional payments back to the head office for know-how, software, services, investment advice, and potentially rent for the warehouse premises,[10] then we believe the correct phrase should be "the revenue of WRU". However, this is not necessarily the correct "dealing". It might be more appropriate to characterize the dealing as the receipt of revenue from third party customers by the head office with the PE receiving a fee

[10] If the acquisition and funding of the warehouse premises were controlled from the head office, then the most appropriate dealing could be a lease of the premises to the PE. If the acquisition were controlled by the PE in a way that the PE was considered the owner of the premises, then depreciation expense would be allocated to the PE.

for its services and a return attributable to the economic operation (if the premises were considered leased) or ownership (if the premises were considered owned) of the warehouse.

Correctly identifying the “dealings” and characterizing the activities of the PE is important because the identification of the “dealings” and characterizing the activities leads to the choice of the most appropriate transfer pricing method and its application by analogy. Identifying the “dealings” in this case as provision of warehousing services by the PE and the use of an asset owned or leased by the PE, should lead to the same result, but may simplify the transfer pricing analysis.

In the prior examples, the economic return was allocated to the location with the control functions. In this case, the control functions for both making the decision on the warehouse itself and the inventory in the warehouse are performed at the head office. This would seem to indicate that the economic return for the warehouse and inventory should be located at the head office and not the PE.

However, paragraph 75 of the 2010 AOA Report states “there was a broad consensus among the OECD member countries for applying use as the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view.” As a result, the use of the warehouse in Country W attributes the economic ownership to the PE rather than to the head office.

USCIB believes that it is important to note that the internal dealings between the PE and other parts of the enterprise are postulated solely for the purpose of attributing the appropriate amount of profit to the PE. (See paragraph 173 of the 2010 AOA Report.) Thus, internal dealings between the PE and other parts of the enterprise are not subject to withholding taxes because there can be no royalty or any other payments between a head office and a PE because they are simply parts of the same entity. To the extent that some countries participating in the BEPS project do not accept this answer, then structuring the dealings to minimize these disagreements would further the goal of consistent interpretation of these BEPS guidance.

Finally, we think that the examples should point out that the warehouse may not be in the country where the inventory is sold. In that case, the warehouse would not create a PE in the country of sale, and sales in another country cannot be attributed to that PE.

Scenario B - Warehousing as an internal function of the business

Scenario C - Warehousing as an internal function of the business carried out by a separate enterprise

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

As a general comment, we would find it helpful if Example 5 Scenario B and C also showed the numerical solution, similar to Examples 1-4.

USCIB agrees with the conclusion reached in Scenario B that the net profit for the PE is only a routine return for the service and a funding return for the ownership of the warehouse.

With respect to Scenario C, there are not even routine people functions in the PE. However, assuming that the warehouse is owned by WRU and used in its business, that would seem to constitute use for purposes of paragraph 75 of the 2010 AOA Report. In this case we would agree that the PE should receive a funding return for ownership of the warehouse. This should result in a smaller return to the PE compared to 5A or 5B. That difference is directly attributable to the profit received by the third party.

We assume that there is no funding return on the inventory assets for the reasons described in our response to question 2. If so, this should be clarified when the guidance is finalized.

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?

If there is tangible property in the PE country which is used by the PE, then we would agree that, pursuant to paragraph 75 of the 2010 AOA Report, there can be a <u>funding</u> return on those assets even if there are no personnel of the non-resident enterprise operating in the PE. It is not clear what the difference is between an investment return and a funding return in this context. With respect to intangible assets, if there are no controlling functions in the PE country, those assets should be attributable to the location of the controlling functions and not the location of the PE.

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?

USCIB agrees with the streamlined approach, subject to clarification of “investment return” compared to “funding return”. In fact, we would recommend that countries be allowed to take the streamlined approach one step further and allow WRU to make a payment of that return to a local tax resident, pushing the income into an already tax compliant entity and forgoing the requirement for any additional tax compliance on the part of the hypothetical PE.

It appears that the "streamlined approach" actually is a determination made on the appropriate "dealing" in this case, without describing it as such. We suggest that this "approach" be described as a "dealing" rather than an approach which implicitly is an exception to the normal rule.

With respect to the quantification of the “return” on the tangible assets, the draft uses the phrase “investment return” in some places and “funding return” in other places. USCIB is not clear on the difference between the two phrases. USCIB agrees that the PE should receive a funding return on its assets and a routine return service fee for the services rendered. If the active decision making is not in the PE country, the PE country should be limited to a funding return and not an investment return, if there is any difference.

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.

USCIB agrees with this conclusion.

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?

USCIB believes that there would not be any difference.

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

See the answer to question 4.

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

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

As noted in our response to Question 17, USCIB believes that there are possibilities for further streamlining and simplification in this area which would benefit both tax administrations and taxpayers. We would suggest that, given the low rates of return attributable to PEs in the examples and that economic returns are being attributed to control functions in the dependent agent resident, the OECD should suggest that countries can simplify their administrative burdens and the taxpayer’s compliance burden by attributing all of the income that would be allocated to the PE to the dependent agent resident entity and eliminate the need for the hypothetical PE (which now has no income) to file local tax returns. This would cut the number of tax audits in half, remove major VAT administrative complexities and double taxation risks, while maintaining the appropriate direct and indirect tax revenue for the resident state.

Sincerely,

William J. Sample
Chair, Taxation Committee
United States Council for International Business (USCIB)