2121 41st Avenue
Suite 301
Capitola, CA 95010
PHONE 831.465.8204
FACIMILE 831.465.9384

www.svtdg.org
info@svtdg.org

September 5, 2016

VIA ELECTRONIC TRANSMISSION

Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA
TransferPricing@oecd.org

Re: Comments on July 4, 2016 OECD Public Discussion Draft on BEPS Action 7
Additional Guidance on the Attribution of Profits to Permanent Establishments

Dear Sirs or Madams,

The Silicon Valley Tax Directors Group ("***SVTDG***") hereby submits these comments on the above-referenced Public Discussion Draft ("**PDD**"). SVTDG members are listed in the Appendix of this letter.

Sincerely,

Robert F. Johnson

Robert F. Johnson
Co-Chair, Silicon Valley Tax Directors Group

I. Introduction and summary

A. Background on the Silicon Valley Tax Directors Group

The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley, that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace.

B. Summary of recommendations

Because the PDD has used the 2010 AOA as its reference point, we generally do the same. However, to ensure the final guidance will be considered relevant to the many treaties that do not yet incorporate the 2010 version of Article 7, we think it very important for the guidance to confirm that the analysis provided will also apply under treaties with the pre-2010 version of Article 7, or to explain any differences in outcome, as appropriate.

1. Recommendations on guidance on fact patterns related to DAPEs

We provide four general comments on the guidance.

First, we recommend the authorized OECD approach ("***AOA***") should, in the context of associated enterprise PEs, be revised to better align with the *2016 TPG*, especially regarding risk attribution. The *2010 Report on the Attribution of Profits to Permanent Establishments* (the "**2010 Report**") by its terms must comport with the 2016 post-BEPS version of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (the "**2016 TPG**"). If the AOA under the *2010 Report* takes into account changes to the *2016 TPG*, a very strong argument can be made that the attribution of risks to an associated enterprise dependent agent PE ("***DAPE***") under the AOA should, in cases in which the dependent agent enterprise ("***DAE***") has the financial capacity to assume the risks, be materially the same as the allocation of risks between a nonresident enterprise ("***NRE***") and the DAE under Article 9. As a consequence, in the context of attributing profits to an associated enterprise DAPE as a result of risk attribution, we believe the host country's taxing rights in many cases will be exhausted by ensuring an arm's length compensation to the DAE.

The discussion of attribution of risks under the AOA has a counterpart in the attribution of intangibles. We recommend, second, the AOA also be revised to better align with the *2016 TPG* regarding intangibles attribution. The *2016 TPG* is relevant under the AOA to the attribution of intangibles and to the attribution of profits to a PE, which strongly suggests there should be consistency with the outcomes of an Article 9 determination of arm's length profits of the DAE. In the context of attributing profits to an associated enterprise DAPE as a result of intangibles attribution, we believe the host country's taxing rights in many cases will again be

exhausted by ensuring an arm's length compensation to the DAE. In effect, allocation of the return on the intangibles to the DAE under Article 9 should eliminate any attribution of a return on the economic ownership of the intangibles to the DAPE under Article 7.

Third, we believe the facts of Examples 1 & 2 are typical of those likely to arise in the context of MNEs, especially as a result of lowering the PE threshold under Article 5(5) and Article 5(4) under BEPS Action 7. In these Examples the host country's taxing rights are exhausted (or virtually exhausted) by ensuring an arm's length compensation to the DAE under Article 9. In these sorts of common situations the host country will collect tax under Article 9 but no more (or very little more) tax under Article 7, but the NRE would face a variety of compliance burdens. We accordingly recommend, third, the OECD consider revising the guidance on attribution of profits to PEs to recommend not proceeding with Article 7 enforcement actions in situations in which no or de minimis profits would be attributable to PEs.

Fourth, we recommend the OECD adopt a new paragraph in Article 5[1] allowing a NRE that would otherwise be treated as having a PE as a result of host country activities of a closely related person to avoid such treatment if the NRE and the resident enterprise (i) make a binding election pursuant to which the latter agrees to recognize profits equal to the sum of those profits otherwise attributable to the PE and any arm's length profits the resident enterprise would have based on functions performed on its own account; and (ii) execute intercompany arrangements pursuant to which the resident enterprise charges the NRE, and the NRE pays, an amount such that the total profits recognized by the resident enterprise are described in (i). This provision, if availed of, would ensure the host country collects from the resident enterprise the same total tax it would if the PE existed, yet result in the NRE having no PE, no filing obligation, and no corporate income tax liability in the host country arising from activities conducted on the NRE's account by the resident enterprise or at its premises.

We also provide responses to particular numbered questions, referencing where applicable our general comments.

2. Recommendations on guidance on attribution of profits to PEs arising from activities not covered by specific exceptions in Article 5(4)

We provide general comments on the guidance. We discuss the issue under the AOA of attributing tangible property to the place of use rather than to the place where significant people functions ("***SPFs***") relating to the property are performed. We ask for clarification that notional payments associated with "dealings" aren't taken into account for withholding purposes. We

[1] An alternative route to achieve the same goal could be for the competent authorities of two Contracting States to enter into a mutual agreement under Article 25(3) to provide the same approach, and we recommend that the OECD endorse this alternative route as well.

also request clarification of the Examples relating to a return the NRE is entitled to for any control and/or oversight of the workforce made available to run the PE.

We also provide responses to particular numbered questions.

II. SPECIFIC CONCERNS WITH THE *PDD*

A. Comments on guidance on particular facts patterns related to DAPEs

1. General comments

a. The AOA should, in the context of associated enterprise DAPEs, be revised to better align with the *TPG*, especially regarding risks

i. Summary and consequences

The *2010 Report* relies critically on the *TPG* in an ambulatory way[2]—i.e., in particular, changes made in § I.D ("Guidance for applying the arm's length standard") of the *2016 TPG* must be reflected in how the AOA is applied. When changes to § I.D of the *2016 TPG* are taken into consideration in applying the AOA, a very strong argument can be made that—in the context of associated enterprise DAPEs,[3] as discussed in Examples 1, 2, and 4 of the *PDD*—the attribution of <u>risks</u> to a DAPE under the AOA should, in cases in which the DAE has the financial capacity to assume the risks, be <u>materially the same</u> as the allocation of risks between an NRE and the DAE under Article 9.

In the context of an associated enterprise DAPE, a general consequence of such material similarity is that, with respect to determining profits attributable to such a DAPE arising from <u>risk</u> attribution, contrary to ¶ 240 of the *2010 Report*, the host country's taxing rights <u>in many cases will be</u> necessarily exhausted by ensuring an arm's length compensation to the DAE under Article 9.[4] This will be the case <u>either</u> if Article 9 analysis proceeds first (in which case risks allocated from the NRE to the DAE couldn't, strictly, also be attributed from the NRE to the

---

[2] *2010 Report*, Preface ¶ 10 ("[This *2010* Report] has been based upon the principle of applying by analogy the guidance found in the [*TPG*] for purposes of determining the profits attributable to a PE. To the extent the [*TPG*] are modified in the future, this [*2010 Report*] should be applied by taking into account the guidance in the [*TPG*] as so modified from time to time.")

[3] That is, a DAPE arising under Article 5(5) because of activities performed by an associated dependent agent enterprise (i.e., an associated DAE).

[4] The profit profiles under Article 9 (using the arm's length standard in the *2016 TPG*) and under Article 7 (determining the profits attributable under the AOA, which again relies on the *2016 TPG*) depend on the most appropriate transfer pricing methods for evaluating pricing of the accurately delineated transaction (Article 9) and profit attribution (Article 7), which in theory might differ. If risks allocated under Article 9 are consistent with those attributed under Article 7, however, it's difficult to envision a situation in which those methods differ to any significant extent.

DAPE, so Article 7 analysis is moot), or Article 7 analysis proceeds first (in which case risks attributed to the DAPE as a result of activities performed by the DAE give rise to an arm's length payment from the DAPE to the DAE under Article 9, leaving no related profit in the DAPE).

We note also the further complexity introduced by the form of compensation chosen for the arm's length pricing under Article 9 (regardless of which transfer pricing method is most appropriate). Contingent pricing forms can have the effect of shifting risks between associated enterprises.[5] Any such shifted risks should in principle also be taken into account under the AOA.

In the context of an associated enterprise DAPE, a specific consequence of such material similarly is that the "spread around" risk attribution of the AOA should be changed to more closely approximate the "all-or-nothing" risk allocation of the *2016 TPG*. In Example 4 the risk allocation under Article 9 (using the 2016 TPG) should match the risk attribution under Article 7 (using the AOA).

ii. Attribution of risks to an associated enterprise DAPE under the AOA will in many cases match the allocation of risks between an NRE and the DAE under Article 9

The *2010 Report* states that a requisite functional and factual analysis is the foundation of a two-stage attribution of risks to a PE under the AOA:

> The functional and factual analysis will [1] initially attribute to the PE any risks inherent in, or created by, the PE's own [SPFs] relevant to the assumption of risks and [2] take into account any subsequent dealings or transactions related to the subsequent transfer of risks or to the transfer of the management of those risks to different parts of the enterprise or to other enterprises.[6]

That is, [1] there's an initial attribution to the PE of risks based on the PE's own SPFs; for an associated enterprise DAPE the relevant SPFs will be those performed by the DAE on behalf of the NRE.[7] This is followed possibly by [2] the subsequent shifting of risks, or of management of risks, either within the enterprise or to other enterprises.

---

5 *See*, OECD Public Discussion Draft on BEPS Actions 8–10 *Revised Guidance on Profit Splits*, ¶ 6.

6 *2010 Report*, ¶ 21 (emphasis added).

7 *2010 Report*, ¶ 47.

SPFs relevant to [1] initial attribution to a PE of risks are those requiring "active decision-making with regard to the acceptance and/or management" of the risks.[8] Under the *2016 TPG*, delineation of the actual transaction involves determining which party or parties bear each economically significant risk, meaning determining which party controls the risk and has the financial capacity to assume the risk.[9]

Regarding [2] the subsequent shifting of risks, or the management of risks, within the enterprise, the *2010 Report* states—

> Being attributed risks in the Article 7 context means the equivalent of bearing risks for income tax purposes by a separate enterprise, with the attendant benefits and burdens, in particular the potential exposure to gains or losses from the realisation or non-realisation of said risks. This raises the question of whether, and if so, in what circumstances, dealings resulting in the transfers of risks should be recognised within a single entity so that risks initially assumed by one part of the enterprise will be treated as subsequently borne by another part of the enterprise. The circumstances in which it is possible to recognise such a transfer are discussed in Section D-2(vi) ["Recognition of 'dealings'"].[10]

The referenced § D-2(vi) of the *2010 Report* discusses how to adapt the *TPG* to the PE context, and concludes the functional and factual analysis "will require the determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the dealing."[11] The discussion of intra-enterprise dealings is noteworthy—

> A dealing takes place within a single legal entity and so there are no "contractual terms" to analyse. However, the [AOA] treats "dealings" as analogous to transactions between associated enterprises and so the guidance in [¶¶ 1.52–154 of the *2010 TPG*—entitled "Contractual terms"] can be applied in the PE context by analogy. . . . Further, [¶ 1.48 of the *2010 TPG*] notes that "in line with the discussion below in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk." Paragraph 1.49 [of the *2010 TPG*] goes on to note that "an additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of

---

8 *2010 Report*, ¶ 22. *See also*, ¶ 25, which, in the context of a sales PE example outlined in ¶ 23, reiterates the "the [SPFs] relevant to the assumption of risks are those which involve active decisionmaking."

9 *See*, *e.g.*, *2016 TPG*, ¶ 1.60.

10 *2010 Report*, ¶ 21 (emphasis added).

11 *2010 Report*, ¶ 178.

> such an allocation in arm's length transactions. In arm's length dealings it generally makes sense for parties to be allocated a greater share of risks over which they have relatively more control.[12]

In addressing intra-enterprise dealings that might shift risk, the *2010 Report* thus references segments of the *2010 TPG*, dealing with risks, that were extensively overhauled in the *2016 TPG*.[13] Significantly, risk shifting [2] should also align with control of risks.

The *2010 Report*'s guidance on the AOA's [1] initial attribution of risks, and [2] possible subsequent shifting of risks, or risk management, overlaps with guidance in the *2016 TPG* on control of risk. Control of a risk under the *2016 TPG* means having—

> the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decisionmaking function.[14]

These requirements for control of risk under the *2016 TPG* are arguably materially the same as the "active decision-making" required for initial attribution of risks, and the control required for subsequent shifting of risks (or risk management), under the AOA. At a minimum, we think it unlikely in practice a tax authority could suitably parse and apply the two standards to reach materially different outcomes.

For an associated enterprise to bear risk under the *2016 TPG*, the bearer must—in addition to controlling the risk—have the financial capacity to assume it. A consequence of risk attribution under the AOA is that the part of the enterprise performing SPFs relevant to risk assumption are attributed sufficient capital to support the risks—i.e., that part of the enterprise is deemed to have the financial capacity to assume the risk.[15] Accordingly, under Article 7 (AOA) initial attribution, and possible intra-enterprise shifting, of risks to a DAPE should be consistent with the Article 9 (*2016 TPG*) allocation of risks to the DAE if the DAE has the financial capacity to assume the risk. Risks allocated from the foreign enterprise to the local enterprise under Article 9 should not then be attributed to the foreign enterprise's PE under Article 7, nor can the related assets be treated as economically owned by the PE.

---

[12] *Id.*, ¶ 179 (emphasis added).

[13] *See also*, *Id.*, ¶ 182, ("Once the above threshold has been passed and a dealing recognised as existing, the [AOA] applies, by analogy, the guidance at [¶¶ 1.48–1.54 and 1.64–1.69 *2010 TPG*].")

[14] *2016 TPG*, ¶ 1.65.

[15] *2010 Report*, ¶ 47.

b. Attribution of intangible property assets, and profits, under AOA as compared with arm's length profits under Article 9

The above discussion relating to attribution of risks, and corresponding profits, under both the AOA and under Article 9 in the context of an associated enterprise DAPE has a counterpart for the attribution of intangible property.

Under Article 7, the AOA attributes economic ownership of intangible property to a DAPE by considering SPFs performed by the DAE, in particular considering SPFs relating to risks applicable to the intangible property (entailing application of the *2016 TPG*).[16] The AOA then allocates sufficient capital to the DAPE, and then determines profits attributable to the DAPE's ownership of attributed intangible property and capital using Article 9 principles (again applying the *2016 TPG*).[17]

By comparison, an Article 9 analysis using the *2016 TPG* respects legal ownership of intangible property, but hinges the legal owner's entitlement to profit from exploiting such intangible property on the legal owner's (i) performance and control of D-E-M-P-E[18] functions; (ii) provision of D-E-M-P-E assets, including funding; and (iii) assumption of risk relating to D-E-M-P-E of the intangible.[19] To the extent an associated enterprise engages in (i), (ii), or (iii), it must be compensated by the legal owner on an arm's length basis for its contributions.

The use of the *2016 TPG* for determining both attribution of intangible property, and attribution of profits, under the AOA to an associated enterprise DAPE suggests there should be consistency with the outcomes of an Article 7 determination of profits attributable to the DAPE and an Article 9 determination of the arm's length profits of the DAE (assuming the DAE has the financial capacity to absorb any risks associated with intangible ownership). As we stated above in connection with the attribution of risks under the AOA, at a minimum we think it unlikely in practice a tax authority could suitably parse and apply the two standards to reach materially different outcomes. Also as stated above, risks (including those relating to intangibles) allocated from the foreign enterprise to the local enterprise under Article 9 should not then be attributed to the foreign enterprise's PE under Article 7, nor can the related assets be treated as economically owned by the PE.

---

16 *2010 Report*, ¶ 80.

17 *2010 Report*, ¶¶ 183–223.

18 Development, enhancement, maintenance, protection, and exploitation.

19 Intangible property fares differently under an Article 9 analysis than does risk. The *2016 TPG* doesn't directly address (shifting) economic ownership of intangibles (focusing instead on determining entitlement to profits from exploiting the intangible), but it addresses determination of risk bearing.

Given the importance of the use of intangible property in multinational enterprises, we recommend the OECD revise the PDD—and issue it for comment and review—to include examples addressing attribution of intangibles, and related profits or losses, to an associated enterprise DAPE.

c. The OECD should recommend no Article 7 enforcement action be undertaken in situations in which no or de minimis profits would be attributed to any PE

In Example 1, no profits are attributed to the associated enterprise DAPE because no risks or assets are attributed to the DAPE under the AOA. In Example 2, ignoring a small funding return associated with attributed economic ownership of inventory, no profits are attributed to the associated enterprise DAPE because, although risks and economic ownership of assets (and sufficient capital) are attributed to the DAPE, the DAPE must pay an appropriate arm's length fee to the DAE to compensate it for risks it assumes under an Article 9 analysis. In Example 2, a de minimis profit attributable to the DAPE comes from a routine funding return related to economic ownership of inventory.

The facts of these examples are, we believe, typical of those likely to arise in the context of MNEs, especially as a result of the 2016 lowering of the PE threshold under Article 5(5) and Article 5(4) under BEPS Action 7. These examples aptly demonstrate the principle that in typical associated enterprise DAPE fact patterns—largely contrary to the assertion in the *2010 Report*[20]—the host country's taxing rights will be virtually exhausted by ensuring an arm's length compensation to the DAE under Article 9. It's possible to construct hypothetical associated enterprise DAPE examples in which residual non-de minimis profits attributed to the DAPE remain after it pays arm's length compensation to the DAE (e.g., Example 4, but see comments below). We think the fact patterns in such examples would, however, be extraordinary and certainly atypical of those found among our members.

This prompts the broader policy question of whether it's sensible to pursue Article 7 enforcement actions, deeming the existence of associated enterprise PEs, if the host country's taxing rights in the majority of situations will be virtually exhausted by ensuring an arm's length compensation to the relevant in-country associated enterprise. In these situations enforcement ensures theoretical concerns will have been met, but at the practical expense of no or de minimis additional tax revenue being collected by the host country, and of increased host country reporting obligations by the NRE and/or DAE. We accordingly recommend the OECD revise guidance on attribution of profits to PEs to recommend not proceeding with Article 7 enforcement actions in situations (commonplace, we believe) in which no or de minimis profits would be attributable to a PE.

---

[20] *2010 Report*, ¶ 240.

d. We recommend Article 5 be amended to provide that no PE be deemed to exist in certain situations involving closely related enterprises

As noted, Examples 1 & 2 present (common) situations in which a host country's taxing rights will be exhausted (or virtually exhausted) by ensuring an arm's length compensation to the associated enterprise DAE under Article 9. This prompts the observation that there's no practical relevance—in terms of tax collected by the host country—to deeming the existence of a PE in a situation in which the host country can recover (just) from the DAE the same amount of tax it otherwise could from both the DAE and the PE. In this case the host country is made whole on tax collected, and the NRE avoids additional compliance burdens accompanying the existence of a PE. Lower burdens would also be put on tax administration resources in the host country.

The OECD previously acknowledged the possibility that host countries may wish to adopt an approach under which they collect from a DAE an amount of tax calculated by reference to the activities of both the DAE and the PE.[21] Such an approach has been successfully implemented in practice by some countries.[22]

To this end, we recommend the OECD adoption in Article 5[23] the following new paragraph:

> 8. Notwithstanding the preceding provisions of this Article, activities conducted in a Contracting State by a person that is closely related to an enterprise or through a fixed place of business of any such person shall not cause such enterprise to have a permanent establishment in that State if the enterprise and the person jointly make a binding election pursuant to which the profits of such person which may be taxed in that State shall be equal to the sum of the profits such person would have and the profits that would be attributable to any such permanent establishment of the enterprise in the absence of such election. It is understood that the

---

21 *2010 Report*, ¶ 246 ("[N]othing in the [AOA] would prevent countries from using administratively convenient ways of recognising the existence of a [DAPE] and collecting the appropriate amount of tax resulting from the activity of a [DAE]. For example, where a [DAPE] is found to exist under Article 5(5), a number of countries actually collect tax only from the [DAE] even though the amount of tax is calculated by reference to the activities of both the [DAE] and the [DAPE].").

22 *See*, *e.g.*, IRS press release IR-INT-1999-13, regarding the competent authority agreement between the United States and Mexico to ignore the existence of a Mexican PE in certain cases in the maquila industry, if the taxpayers agreed the Mexican maquila enterprise would pay tax to Mexico not only on its own arm's length profit but also on an amount determined by reference to what profits of the U.S. enterprise's Mexican PE would have been.

23 An alternative route to achieve the same goal could be for the competent authorities of two Contracting States to enter into a mutual agreement under Article 25(3) to provide the same approach, and we recommend that the OECD endorse this alternative route as well.

> enterprise and person that make the binding election provided under this paragraph shall ensure that the conditions established between them produce a result that is consistent with the effect of the election, and it is further understood that such conditions shall be considered to be consistent with conditions that are made or imposed between independent enterprises for purposes of the provisions of the domestic law of each Contracting State and Article 9 of this Convention.

This provision would allow a NRE that would otherwise be treated as having a PE in a host country to <u>avoid</u> being treated as having such a PE (and thus avoid the need to comply with host country tax and reporting obligations) in certain circumstances and provided certain conditions are met. The provision would potentially apply only for Article 5(5) DAPEs (i.e., PEs arising from activities of a person closely related to the NRE and resident in the host country) or from activities conducted at the premises of such a person (e.g., a so-called "fixed place of business PE" under Article 5(1)).

To achieve such "no PE" treatment, the provision requires the resident enterprise and the NRE to enter into:

[i] a <u>binding election</u> that provides the resident enterprise agrees to recognize profits, if any, equal to the sum of the profits attributable to the PE of the NRE that would exist in the absence of the binding election, based on functions undertaken on that NRE's account (taking into account assets and risks attributed to the PE, and necessary "free" capital to support them), plus arm's length profits, if any, the resident enterprise would have in the absence of the binding election, based on functions undertaken by that resident enterprise on its own account (taking into account its own assets and risks) and

[ii] <u>intercompany arrangements</u> providing that where the binding election is made, the resident enterprise shall charge the NRE, and the NRE shall pay, an amount such that the total profits recognized by the resident enterprise are equal to the arm's length profits, if any, the resident enterprise would recognize in the absence of the election, plus the profits, if any, attributable to the PE the NRE would have in the absence of the election. While the latter amount depends under the AOA on assets, risks, and capital deemed owned, assumed, or contributed, respectively, to the PE, such intercompany arrangement would not need to delineate such deemed assets, risk, or capital.

If, for example, a resident enterprise performs services in a host country on behalf of a closely related NRE, those services could cause the NRE to have a PE in the host country under the normal operation of Article 5(5) if they fall within the activities covered by that provision. Suppose the profits attributable to that PE under the AOA would be 100, before any deduction for the arm's length service charge payable to the resident enterprise. Suppose further the arm's length charge for those services under Article 9 would be 88, and the arm's length profit

recognized by the resident enterprise from receipt of that payment would be 8, after deduction for its own costs of 80. That would leave 12 of profit attributable to the NRE's PE, and a total profit of 20 taxable by the host country (i.e., 8 in the hands of the resident enterprise and 12 in the hands of the NRE). If, however, the enterprises were to make the binding election authorized by proposed Article 5(8), the NRE would agree to increase its payment to the resident enterprise from 88 to 100, and the resident enterprise would agree to be taxable in the host country on a total amount of 20. The host country would be entitled to collect tax on the profit of 20 from the resident enterprise, and the NRE's country of residence would agree to allow the NRE a deduction for the full payment of 100 to the host country's resident enterprise.

This provision would, if availed of, result in the NRE having no PE, no filing obligation, and no corporate income tax liability in the host country arising from activities conducted on the NRE's account by the resident enterprise or at its premises. The NRE would be entitled to deduct amounts accrued under the intercompany arrangement with the resident, discussed above. This provision wouldn't eliminate a PE, filing obligation, or corporate income tax liability in a host country arising from a NRE's own activities or operations in that country unrelated to a PE arising from a resident enterprise's activities or premises.

2. Responses to questions raised

[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.

We believe Article 9 analysis (between a NRE and an associated enterprise DAE whose activities give rise to a DAPE) should be done before Article 7 analysis, but the final results should strictly be the same regardless of order. Article 9 analysis (under the *2016 TPG*) is, of course, relevant in general to the second step of the AOA—determining profits attributable to the deemed separate and independent PE.[24] But in the context of an associated enterprise DAPE, it's "necessary to determine and deduct an arm's length reward to the [DAE] for the services it provides to the [NRE] (taking into account its assets and risk if any)."[25] The arm's length reward earned by the DAE from the NRE is determined under an Article 9 analysis. Accordingly, the Article 7 analysis involves determining arm's length payments under Article 9.

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

[24] *2010 Report*, § D-3, ¶¶ 183–226.

[25] *2010 Report*, ¶ 234.

Generally, yes, but more explanation could be given regarding characterization of the dealings between the Head Office and DAPE and the underlying rationale for attributing economic ownership of assets (inventory and marketing intangibles) to the Head Office.

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

We agree the DAPE has no profits, but it's attributed neither risks nor economic ownership of assets. It's unclear in Example 1 why the DAPE is deemed to earn sales revenue (from which various costs are backed out to arrive at a pre-determined profit—either zero or a funding return on assets attributed). This comment is applicable more generally, but it's especially apt in a situation in which no SPFs are performed in the host country. The *PDD* should be revised to accommodate this.

[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?

It's not possible to answer this question meaningfully without some understanding of the relevant approach applied.

[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, this is the appropriate conclusion, entirely consistent with the AOA in the *2010 Report*.

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

No. Doing Article 9 analysis first results in Sellco being allocated credit risks (and costs) and inventory risks (and costs), and Sellco earns a return for this risk (and cost) bearing. These risks (and costs) accordingly aren't borne by Prima and can't be attributed to the DAPE.

[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?

It's not possible to answer this question meaningfully without some understanding of the relevant approach applied.

[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?

The *2016 TPG* provide—

> In exceptional circumstances, it may be the case that no associated enterprise can be identified that both exercises control over the risk and has the financial capacity to assume the risk. As such a situation is not likely to occur in transactions between third parties, a rigorous analysis of the facts and circumstances of the case will need to be performed, in order to identify the underlying reasons and actions that led to this situation. Based on that assessment, the tax administrations will determine what adjustments to the transaction are needed for the transaction to result in an arm's length outcome. An assessment of the commercial rationality of the transaction based on Section D.2 may be necessary.[26]

If, in Example 2, Sellco hasn't the financial capacity to assume inventory and credit risks, it would under the *2016 TPG* not be entitled to the full return it would otherwise get if it had such capacity. Instead, Sellco would be compensated for its service functions, the full risk would remain within Prima and would be attributable to the DAPE as appropriate in light of the functions performed by Sellco on Prima's behalf, and the DAPE's profit would be adjusted accordingly.

[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?

In § II.A.1.b we explained that Article 9 analysis can allocate risks (based on control functions); Article 9 analysis strictly <u>respects</u> legal ownership of (intangible) property, but can allocate profits relating to the property to associated enterprises performing functions, bearing risks, or using assets related to D-E-M-P-E functions. By contrast, Article 7 analysis using the AOA can attribute economic ownership property and related profits, but in doing so the AOA relies on the *2016 TPG* in both stages (i.e., determining both attribution of economic ownership of property, and attribution of profits). We believe the AOA should be revised so there's consistency with

[26] *2016 TPG*, ¶ 1.99.

the outcomes of an Article 9 determination of the arm's length profits of the DAE as a result of understanding D-E-M-P-E functions performed by the DAE (assuming the DAE has the financial capacity to absorb any risks associated with intangible ownership). The different formal treatment—respect of legal ownership but allocation of risks and profits (Article 9) versus attribution of risks and economic ownership, and profits—should produce the same results. In other words, risks allocated from the foreign enterprise to the local enterprise under Article 9 (e.g., from Prima to Sellco in Example 2) should not then be attributed to the foreign enterprise's PE under Article 7, nor can the related assets be treated as economically owned by the PE.

We recommend the PDD be revised to clarify the difference, if any, between the "funding return" in Example 2, and the "investment return" in Example 5.

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

We agree. It would help to give a better explanation of any dealings between the Head Office and the DAPE.

[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?

It's not possible to answer this question meaningfully without some understanding of the relevant approach applied.

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

No. Note first that the contingent fee arrangement between Prima and Sellco results in risks being shifted to Sellco.[27] Allocation of risk (and cost) under an Article 9 analysis (which should be done first) should be consistent with attribution of risk (and cost) under Article 7 (assuming this is done first). Risks (and costs) allocated from Prima to Sellco accordingly aren't borne by Prima and can't be attributed to the DAPE. No other risks should be attributed under the AOA from Prima to the DAPE that aren't allocated to Sellco under Article 9. The DAPE's P&L is thus wrong.

[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

[27] *See*, OECD Public Discussion Draft on BEPS Actions 8–10 *Revised Guidance on Profit Splits*, ¶ 6.

> *difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?*

We agree the difference in Example 4 arises because the outcome of how Article 9 analysis allocates risks between the NRE and the DAE differs from how Article 7 analysis attributes risk from the NRE to the DAPE. Normatively, however, this result is wrong. As discussed in § II.A.1.a, above, the AOA should be revised take into account changes to § I.D of the *2016 TPG* regarding risk allocation. If this is done we believe no material differences between risk allocation and risk attribution will arise.

B. Comments on the attribution of profits to PEs arising from activities not covered by specific exceptions in Article 5(4)

1. General comments

In Scenarios A–C the profits attributable to the PE "reflect the reward" for the warehouse asset, economic ownership of which is attributed to the PE. The *2010 Report* noted "there is a broad consensus that assets generally are to be attributed to the part of the enterprise which performs the [SPFs] relevant to the determination of economic ownership of assets."[28] The *2010 Report* also stated, however, that "there was a broad consensus among the OECD member countries for applying use [as opposed to SPFs] as the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view."[29] This choice for tangible assets was justified on the grounds that over the useful life of the tangible asset the deductions allowable in the case of economic ownership (depreciation and interest payments (to the extent the asset is debt financed)) as compared with leasing (lease payments) "may not differ significantly in practice."[30] While we understand the simplicity afforded by tangible asset place-of-use attribution under the AOA, we think undesirable consequences could flow from blanket application of such rule, particularly if there's a mismatch between location of tangible-property SPFs and location of use. We accordingly recommend the AOA be revised to more clearly permit both approaches to tangible-property attribution.

In Scenario A the P&L for the PE reflects payments for three "dealings" between the PE and Head Office, including payments for "cost of workforce" and "fee to WRU for know-how and software." We recommend the *PDD* be revised to clarify the recognition of such notional

---

[28] *2010 Report*, ¶ 18 (emphasis added).

[29] *Id.*, ¶ 75 (emphasis added).

[30] *Id.*

payments is relevant only to the attribution of profits to the PE, but not for withholding purposes.[31]

In Scenario A the profit attributable to the PE reflects a deduction for a payment (of 22) by the PE to the Head office for "cost of workforce." This profit includes "the reward for . . . the routine functions performed at the warehouse,"[32] and these functions presumably include the operation of the workforce using know-how and software provided by WRU. In Scenarios A & B (and presumably C, too) the workforce used in Country W to run the warehouse "have no specialised knowledge."[33] Under the *2010 TPG* an assembled workforce is treated as an asset but not an intangible,[34] and Scenarios A & B presume the PE has use of this asset (in Scenario A, as a result of the payment of 22 for "cost of workforce"). The facts of Scenarios A & B (and presumably C, too) suggest some SPFs relevant to the control and/or oversight of the warehouse workforce are performed in the WRU Head Office. We recommend the *PDD* be revised to clarify that to the extent SPFs relevant to the operation of the warehouse workforce (a routine asset) are performed by WRU Head Office employees, the Head Office—not the PE—would be entitled to a return appropriate for the SPFs.

While the analysis in the three Scenarios was informative, it would be helpful if the analysis in the *PDD* were revised to include a discussion of how the (full) AOA under the 2010 Article 7 applies and a discussion of how the (partial) 2008 AOA applies.[35]

2. Responses to questions raised

Our responses below reflect the assumption the (full) AOA under the 2010 Article 7 applies. Our responses should also be read in light of our general considerations, above, especially regarding economic ownership of assets.

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

---

[31] *See*, *e.g.*, *2010 Report*, ¶ 203.

[32] *PDD*, ¶ 93.

[33] *PDD*, ¶ 89.

[34] *2016 TPG*, ¶¶ 1.152–1.156.

[35] By the "(full) AOA" we mean the application of treaty provisions based on Article 7 of the 2010 OECD Model Tax Convention by reference to the associated Commentary and the *2010 Report*. By the "(partial) 2008 AOA" we mean the application of treaty provisions based on Article 7 of the 2008 OECD Model Tax Convention by reference to the associated Commentary and the *2008 Report on the Attribution of Profits to Permanent Establishments*. We note that the "full" and "partial" versions of the AOA may differ on a limited number of issues.

We agree.

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

We agree.

[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?

Assuming economic ownership of such assets is appropriately attributable to the PE, we agree.

[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?

We agree. The investment return might be estimated using third-party rental data from a comparable asset.

[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.

We agree. This interpretation is, we believe, the most sensible reading of Article 7, the Commentary on Article 7, and the AOA.

[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?

No. See, however, our comment above regarding the extent to which SPFs relating to the control and/or oversight of the warehouse workforce are performed in the WRU Head Office.

[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?

It's not possible to answer this question meaningfully without some understanding of the relevant approach applied.

C. Exploring additional approaches to co-ordinate the application of Articles 7 & 9 of the MTC

[20] 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?

Yes. In this letter we recommend Article 7 analysis under the AOA be revised to make attribution of risks and property consistent with the guidance in the *2016 TPG*. The framework for determining profits attributable to a PE—based on the fiction the PE is a functionally separate and independent enterprise, and applying Article 9—is best maintained by ensuring consistency with the *2016 TPG*. We also recommend Article 5 of the MTC be changed[36] to include a new paragraph 8, allowing a NRE and a closely related person in a source country to make a binding election, and maintain their intercompany arrangements, so as to ensure the host country collects the same tax it would if the closely related person gave rise to a PE, yet resulting in no PE being deemed to exist. This simplification would reduce compliance burdens for the NRE, and also lower burdens on tax administration resources in the host country.

[36] An alternative route to achieve the same goal could be for the competent authorities of two Contracting States to enter into a mutual agreement under Article 25(3) to provide the same approach, and we recommend that the OECD endorse this alternative route as well.

Accenture
Activision Blizzard
Acxiom Corporation
Adobe Systems, Inc.
Advanced Micro Devices, Inc.
Agilent Technologies, Inc.
Amazon.com
Apple Inc.
Applied Materials, Inc.
Autodesk
Bio-Rad Laboratories, Inc.
BMC Software
Broadcom Limited
Brocade Communications Systems, Inc.
Cadence Design Systems, Inc.
Chegg, Inc.
Cisco Systems, Inc.
Dolby Laboratories, Inc.
Dropbox Inc.
eBay, Inc.
Electronic Arts
EMC Corporation
Expedia, Inc.
Facebook, Inc.
FireEye, Inc.
Fitbit, Inc.
Flextronics
Fortinet
GE Digital
Genentech, Inc.
Genesys
Genomic Health, Inc.
Gilead Sciences, Inc.
GitHub
GLOBALFOUNDRIES
GlobalLogic, Inc.
Google, Inc.
GoPro, Inc.
Groupon
Harmonic
Hewlett-Packard Enterprise
Hewlett-Packard Company
Ingram Micro, Inc.
Integrated Device Technology, Inc.
Intel Corporation
Intuit, Inc.
Intuitive Surgical
KLA-Tencor Corporation
Lam Research Corporation
LinkedIn Corporation
Marvell Semiconductor, Inc.
Maxim Integrated
Mentor Graphics
Microsemi Corporation
Microsoft Corporation
NetApp, Inc.
Netflix, Inc.
Oracle Corporation
Palo Alto Networks, Inc.
Pandora Media, Inc.
PayPal Holdings, Inc.
Pivotal Software, Inc.
Plantronics, Inc.
Pure Storage, Inc.
Qualcomm, Inc.
Rovi Corporation
salesforce.com
SanDisk Corporation
Sanmina-SCI Corporation
SAP
Seagate Technology
ServiceNow, Inc.
Snapchat, Inc.
Symantec Corporation
Synopsys, Inc.
Tesla Motors, Inc.
The Cooper Companies
The Walt Disney Company
Trimble Navigation Ltd.
Twitter, Inc.
Uber Technologies
VMware Corporation
Xilinx, Inc.
Yahoo!
Yelp, Inc.