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Dear Mr. VanderWolk,

Discussion Draft: attribution of profit to permanent establishments

PricewaterhouseCoopers International Limited on behalf of its network of member firms (PwC) welcomes the opportunity to comment on the OECD's *Public Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments*.

As an overall comment, we view the paper as providing helpful guidance which can be used to evaluate inter-company arrangements in light of BEPS Action 8-10 and to understand what additional profit, if any, would be allocated to permanent establishments (PEs) arising following a lowering of the PE threshold. We also agree that the lowering of the PE threshold under BEPS Action 7 does not modify the nature of a deemed PE and that in many cases the additional profits which would be attributable to new PEs would be minimal.

However, we do see profit attribution as an incredibly complex area, and feel that the complexity of these issues is potentially hidden through the use of overly simple examples in this paper where a number of the difficulties we find in practice have been assumed away. We have made a number of comments on points on the detail and in response to the questions which we include later, but wanted to take the opportunity to elaborate on a few key points we feel still need to be addressed.

We see areas of significant subjectivity within the existing AOA where further guidance would ensure better uniformity of application between tax authorities and recommend that this paper should not be seen as the conclusion of the OECD's work on profit attribution. We suggest that there be an ongoing process of discussion and work to ensure greater guidance and clarity on a number of areas of the AOA within a timeline which allows careful consideration of the issues. Given the likely increase in instances of PEs, further clarification is necessary in order to reduce the subjectivity and likelihood of double taxation. Our earlier comments on Action 7 highlighted that we thought it essential that Article 5 and Article 7 were considered together. Instead, we have seen a significant lowering of the PE threshold without due consideration to whether this lowering of the threshold will result in a change of profits attributable. We expect that this will lead to many more PEs with accompanying uncertainty as to how tax authorities will apply the multitude of profit attribution approaches that are taken (e.g. in local legislation, differing local interpretations of the AOA, etc.). Whilst the Discussion Draft is an important step in that direction, as noted, we urge the OECD to continue working with stakeholders after the BEPS papers are finalized to develop critically needed detailed guidance in a deliberative process.

Related to the above point, a crucial area of uncertainty for taxpayers which remains unresolved is the acceptability of a common set of standards for applying Article 7 (i.e. the AOA) given how few countries currently have adopted the AOA. The recent consultation on BEPS Action 15 (relating to the Multilateral instrument) was specific in requesting that there be no comments in relation to the scope of the provisions of the Multilateral instrument.

However, we think it is important to make the point that if standardising the wording and interpretation of Article 7 is not included in the multilateral instrument then, given the significant lowering of the PE threshold resulting from Action 7, we expect that the frequency and significance of double taxation in relation to PE issues will exponentially increase.

A particular concern we have with the guidance is that having performed exercises to apply the AOA to several non-financial services (FS) businesses, a clear identification of SPFs remains difficult, particularly where in most cases both parties (PE and head office) are involved in managing the risk or asset to some extent. In this regard, Example 4 has re-introduced the concept of split SPFs without adequately addressing the complexity of accounting for this from a balance sheet perspective and the associated systems constraints most groups would face. Whilst, in theory, contributions from numerous parties may be an accurate representation of the functions undertaken across a group and can sometimes be useful in splitting certain asset returns at a high level, our practical experience has made it clear that split SPFs can also lead to significant complexity through creating multiple asset owners. In particular, the application of split SPFs (i.e. KERTs) in the financial sector (with specific allocation of the SPFs to certain assets) has been shown to be onerous (given that there was not always a common standard for the relevant tax and accounting policies which would be applied to the attribution of balance sheet). This particular point was discussed extensively as part of the OECD public consultation process on the AOA at a Geneva conference. At this conference, the view was taken that, as a practical alternative to split SPFs, there should be a single asset "owner" for each class of asset (i.e. attribution of an asset class in accordance with the balance of SPFs) with the other jurisdiction with SPFs rewarded for their contribution but without attribution of assets and it would be helpful if the OECD could confirm that this is an acceptable approach. As the paper stands, it offers no guidance on how to avoid these practical difficulties which have previously been recognised by the OECD . We have made suggestions in relation to this point in response to Question 12.

As a general matter, the examples shown are simple when compared to most business arrangements we see in practice. Whilst we can see why this was carried out (i.e. to show the principles of guidance) the examples disguise the complexity of applying these principles in practice, the development of further examples in coordination with stakeholders as part of a continuing project independent of the BEPS actions should be a priority in the next year.

As we note in our response to question 3, we think it is very helpful that the guidance clarifies that under the AOA, where there is a sales agent and the functional analysis supports it, the Cost of Goods Sold may be a dealing which is treated as a 'balancing figure' to ensure an appropriate level of reward is earned by the DAPE which is treated as the tested party (effectively treating the relationship as that of principal for the manufacture and IP ownership selling to a routine distributor). This is a key difference between the AOA and local practice in many territories. In this view, there would be some concerns with acceptability of the "balancing figure" by tax authorities in countries where such balancing figures are not recognised or regulated by domestic tax rules in a PE or non-PE context.

As requested, we focus the remainder of our comments on answering the specific questions posed in the Discussion Draft.

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.**

It is necessary that Article 9 is applied on all transactions an entity has with related parties before Article 7 is applied. In many of the client cases we have seen, the head office entity will have several transactions with different related parties, not just with the dependent agent enterprise, and it is important to ensure that the starting point for the profit attribution is the correct amount of profit taking into account the contribution of other related parties entities. In addition to this, there are a number of related tax issues which need to be considered when thinking about the order of analysis, including:

- Withholding taxes, customs duty and indirect taxes could be applicable on certain payments from a dependent agent enterprise to a head office. The treatment of remittances from a PE to a head office for these taxes in many cases is not the same as would be the case in a separate entity situation - it is therefore important that the dependent agent enterprise is making arm's length payments to the head office to ensure these taxes are correctly accounted for.

- We are aware of some examples where territories levy different corporate tax rates on companies versus branches, so again ensuring the dependent agent enterprise is making arm's length payments is important.

- A number of territories have domestic transfer pricing legislation where it is necessary to ensure that any transactions between a local dependent agent enterprise and local PE are arm's length.

- Finally, loss utilisation rules in different territories may differ between companies and PEs which means it is important to analyse the arm's length level of profit in the dependent agent enterprises versus the PE.

To conclude, we consider that the Article 9 analysis is a prerequisite of the Article 7 analysis. This ordering does not influence the outcome of the Article 7 analysis, but rather enables the appropriate application of the arm's length principle under Article 7.

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

We have two comments where clarification in the example would be helpful.

There is currently no mention of the location of warehousing for inventory for sale to customers in Country B. If there were a warehouse in Country B we query whether inventory would be allocated to the PE based on the place of use concept in p. 75 of the AOA (even though SPFs for inventory are located in Country A).

Paragraph 34 explains that no assets or risks have been allocated to Sellco as there are no SPFs performed by Sellco. However, there is no specific narrative on allocation of rights and obligations and we note that sales income, which derives from the right/obligation of the customer contracts, has been allocated to Sellco which implies that Sellco has an SPF in relation to customer contracts. However, the facts state that while Sellco does liaise with customers, Prima is responsible for setting pricing, determining marketing strategy, and approving all orders. We suggest the reasons for the allocation of customer revenue to the PE are elaborated on further in the example as it is not completely clear to us why this conclusion was reached and perhaps the facts in the example could be adapted to support the allocation to Sellco.

As a more general point, the guidance on rights and obligations in the AOA is limited to one paragraph (p.98) and yet in our experience the outcome on the PE P&L can be very significant depending on whether certain transactions with external parties are allocated to the PE or not. In particular, this applies in relation to cases where there is a question as to whether external sales revenues or IP licences with external parties would be attributed to a PE. In our view, further guidance in this area is needed.

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

Yes, subject to our comments in relation to the allocation of inventory and sales revenue in relation to Question 2.

In particular, it is very helpful that this example makes it clear that, where there is a sales agent whose functions are sufficient to lead to the conclusion that sales revenue should be allocated to the DAPE, the Cost of Goods Sold may be a dealing which is treated as a 'balancing figure' to ensure an appropriate level of reward is earned by the DAPE which is treated as the tested party in this example.

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?

Under pre-AOA approaches where there is a restricted concept of independence and a direct / indirect approach for allocation of profits (revenues and expenses), it would be unlikely that it would be accepted that there would be profit on intra-enterprise transactions and in addition there would be restrictions on deductibility of certain payments (interest, royalties and similar payments). While we do not suggest the following approach leads to a fair reward for the contributions of the parties and do not agree it as an alternative to the AOA, we have seen the following approaches taken in by various tax authorities:

- the sales income of the DAPE is likely to remain the same as shown in the example;
- that COGS might be cost of manufacture of goods solely allocable to the Prima enterprise in relation to goods sold in Country B;
- some allocation of Prima expenses might be allowed (e.g. head office staff, and in some cases cost of internal development of intangibles) if incurred for the purposes of DAPE;
- it is unlikely that a COGS dealing calculated as a 'balancing figure' to reach a target return in DAPE would be allowed, in any case it would be unlikely that any such balancing figure would be higher than the third party cost to Prima;
- it is unlikely that any charge for use of intangibles would be deductible for the DAPE;
- the level of profitability as a margin in the PE is likely to be much closer to the overall Prima margin;
- given the PE profits could be earned only from transactions with third parties (or with associated enterprises) and no profit would be earned from a transaction between the PE and the enterprise it would prevent the PE from being attributed a profit if the entity itself had made a loss;
- in a more extreme scenario, all profits derived from the territory of the DAPE, whether coming from the DAPE activities or other activities performed by Prima could be subject to DAPE attribution allowing minimum deduction in the DAPE territory. This relates mainly to tax jurisdictions that are not OECD members where in a number of cases their treaties follow the UN Model Tax Convention; and
- this and other non-AOA cases may lead to potentially unresolvable double taxation cases, particularly where in practice each of the tax authorities relies on and accepts a different set of rules concerning PE profit attribution.

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, we agree with this statement. Although note that with a complete absence of SPFs we would not expect there to be a PE in the first place, i.e. for a dependent agent PE to exist personnel of the PE would generally be leading sales negotiations. Aligned with this in Example 1 the analysis indicates Sellco has SPFs in relation to customer contracts as a right and obligation, otherwise there would not be a basis for allocating sales income to Sellco in an Article 7 analysis.

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

Yes, subject to our comments in relation to the allocation of sales revenue in relation to Question 2. However, we note that in reality it would be very unusual in an MNC context that responsibility for these areas would be entirely devolved to a sales agent as for efficiency reasons they tend to be managed or there is oversight on a regional or global basis. In particular in the case of inventory where the Prima is the manufacturer, it is likely Prima would be involved in inventory decisions and this therefore makes it hard to see wider applicability of the conclusions for the Article 9 analysis presented. See answer 9 below for more discussion on this point.

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 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?**

The first part of this question seems relevant only for the Article 9 analysis. According to BEPS Actions 8-10 (p1.98-1.99), an entity needs to have both control over risk and the financial capacity to bear the risk in order to earn the associated returns. If Sellco does not have the financial capacity to bear the risk then it is hard to see how that risk could be allocated to Sellco, and it would remain with Prima assuming Prima has some level of control over the risk. However, under an Article 9 analysis following Actions 8-10, Sellco's remuneration would still need to reflect its functions in relation to controlling credit risks and if Prima's only role was providing funding to support the risk (i.e. no control functions performed) then Prima would only be entitled to a risk free funding return relating to the capital required to support the credit risk. When considering other types of risks and assets the analysis of an appropriate functional return could become extremely complex.

If the risk were not allocated to SellCo under the Article 9 analysis, due to lack of financial capacity, then we do see that a difference could potentially emerge between the Article 9 and Article 7 analysis due to a need to give a funding return under an Article 9 analysis which would not be the case under an Article 7 analysis. Given this situation is likely to be far more common than the one presented (i.e. a sales agent would generally not have the financial capacity to bear such risks) we suggest the example is adapted to reflect this.

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 Example 2 all responsibility and decision making associated with the relevant risks are made by Sellco. In this case, and putting to one side the considerations discussed in question 8, we agree that the allocation of risk is the same in the Article 9 and Article 7 analysis in this simplified case.

We suggest the guidance in paragraphs 241 and 242 are reviewed as the conclusion of this analysis as it is currently worded, under what appears to be similar facts to Example 2, leads to the allocation of additional income to the DAPE rather than the dependent agent enterprise (i.e. the additional income is taxed in the PE of the non-resident rather than in the local sales agent subsidiary).

However, we think there are many cases where the concept of "control over risk" as set out in p1.65 of the final BEPS Action 8-10 report will not align with the concept of "SPF" in the AOA. This is illustrated well by the example in p.1.70 of the final BEPS Action 8-10 report. In this case, the investor is seen to be controlling the risk through what could potentially be a relatively infrequent level of intervention and supervision of the fund manager. As long as sufficient monitoring occurs, the day to day activities are performed, and risks within parameters are managed by the fund manager. In the case of the SPF concept, our interpretation is there seems to be a much greater focus on the decision-making being active if it is to count for SPF identification, including the suggestion that economic ownership of assets and risks will often be determined by functions performed below the strategic level of senior management given that this is the level at which the active management occurs and where the ability to actively manage the risk lies (AOA Part I, p. 86, 87, 94). Although made in the context of the discussion on intangible assets, the following statement reiterates in relation to identifying an SPF in the PE: "in short, the key factor is whether the PE undertakes the active decision making with regard to the taking on and active management of the risks" (Part I, p. 91).

The outcome of Example 2's exercise to attribute profit through the AOA does not demonstrate any division between the SPFs required for economic ownership of an asset and the "risk adjusted" return due on that asset. In effect the SPFs for the inventory and credit risk are treated in a similar way to how Key Entrepreneurial Risk Taking ("KERT") functions are treated in Parts II, III and IV of the AOA (i.e. it is the risk accepting and management functions that determine attribution of asset and risk) (Part II, para 8). Whilst it is not clearly stated in Part I, the drafting of Part I of the AOA suggests that there could be a difference between the SPFs relevant for control over risk and economic ownership for certain assets (Part I, para 70, 72). This suggests that SPFs for the inventory risk and economic ownership of inventory may differ – it would be helpful to have an example setting out how SPFs in the case of certain assets meeting this criteria may differ (i.e. in cases where the SPFs for economic ownership of assets and allocation of risk may differ). In the absence of this more general detailed guidance on the definition of an SPF for risk and asset purposes we would expect that, in the absence of clear guidance and for practical ease, one or both of two approaches may be adopted in applying the AOA. For example, it could be assumed that, for the purposes of practical application of Article 7 and Article 9, that the SPFs relevant to the economic ownership of assets and control of risk are the same in all circumstances (i.e. SPFs become equivalent to KERTs). Alternatively, it could be assumed that the risk control threshold required as part of the Article 9 analysis is equivalent to the SPF threshold required through the AOA.

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

Yes.

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?

See 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?

Example 4 presents facts which are, of the examples, closest to those which we would expect to arise for a typical MNE. The example helpfully highlights at paragraph 80 that the Article 9 analysis and Article 7 analysis do not necessarily result in the attribution of risks. In this case the SPF relating to credit risks and economic ownership of the associated receivables is considered to be undertaken by the DAPE of the Head Office created by Sellco. This is then clarified to state that Prima also undertakes some activity that should be considered to qualify as a SPF. This clarification appears to be on the basis that Sellco's decision making ability is limited by the guidance provided by Prima and therefore Sellco should not be considered to be assigned all the value for the decision making. In the context of the Article 7 analysis, there are considered to be split SPFs and so there is then a split of return on the receivables and fees paid to Sellco between Prima and the DAPE created by Sellco. We have provided our comments on the importance of split SPFs in our covering letter.

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?

We agree there may be a difference in profits which arise under the two analyses resulting from the difference in attribution of risk under the two approaches.

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

The explanation in p.92 of the discussion draft implies that 62 is the profit of WRU deriving from third parties (although not sure if this is meant to say revenue). We would question why the third party profit/revenue is allocated to the PE as from the earlier narrative the SPFs in relation to customer contracts would be based in WRU head office and therefore allocated as a right/obligation to WRU head office. We cannot see a basis for allocating this income to the PE and instead we would characterise the dealing between WRU head office and WRU PE as a service dealing where WRU PE profits might equate to a return on the warehouse asset and return for routine functions.

We note, that in many countries who do not follow the AOA, the fee for know-how and software might not be deductible in the PE and that no margin would be allowed on the fee for services.

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

In Scenarios B and C we assume the inventory held in the warehouse is owned by WRU (whereas in Scenario A it was owned by WRU's customers). As suggested in the discussion draft and aligned with our comments above in relation to Scenario A, we see no basis for allocating customer revenues to the PE and instead suggest a service fee dealing, although some additional return on inventory may be required for the PE for the same reason as discussed in our response to 2.

In relation to Scenario C we agree with the comments in p. 101-102 in the discussion draft, subject to our comments in Question 16 below.

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?

BEPS Actions 8-10 implies that where a party to a transactions performs no control functions over an asset and no control over associated risks it will generate no more than a risk free return. For example this would be the case with a 'cash box' performing no functions. As result, and to be consistent with this guidance, in a situation where there is a PE with no personnel it is hard to see how the profits attributable to that PE would exceed zero after it receives a risk free return and then any funding costs and investment management services are remunerated.

As a result, we would suggest the most streamlined approach in these situation is the default that in the absence of any people the return to the PE would be zero. Otherwise there is potential that the outcome would be inconsistent with Actions 8-10.

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?

Please see response to Question 16 for our alternative suggestion.

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.

Yes

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, subject to our separate comments about calculation of a return on assets in Question 16.

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?

A key difference would be that some tax authorities would take the approach of the allocation of local source income minus deductible expenses, please see answers to Question 4 and Question 14 for further comments.

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 explained in response to question 1, we see it is as essential that Article 9 is applied first for a number of reasons outlined.

Our key suggestion would be mechanisms to simplify the tax filing procedures for DAPEs. In particular, the adoption of legislation to allow the Dependent Agent enterprise to file on behalf of a non-resident within its existing corporation tax filings. This might also include legislation where tax authorities could allow the Dependent Agent enterprise taxpayer to notify on behalf of the non-resident that there is a PE with no profit attributable, and be considered to have fulfilled their local tax filing requirements, unless specifically directed to file an additional separate tax schedule or return by the tax authorities. Where there are locally taxable PE profits, these could be incorporated within the corporation tax filings of the dependent agent enterprise in a similar way as is typical for overseas branches of the local enterprise.

In addition, a further suggestion related to the above would be that if a dependent agent PE issue were to arise, and the local dependent agent enterprise were to include in their transfer pricing documentation an analysis of why the profits attributable to any dependent agent PE were zero, this would provide penalty protection for taxpayers in relation to the non-resident having a failure to notify the relevant tax authority in relation to chargeability to corporation tax in that territory.

We look forward to discussing any questions you have on the points we raise above or on other specific matters raised by respondents to the Discussion Draft and would welcome the opportunity to contribute to the discussion as part of the public consultation meeting in October.

Yours faithfully,

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