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January 30, 2013

BY EMAIL

Tax Treaties
Transfer Pricing and Financial Transactions Division
OECD/CTPA

Sent by e-mail: taxtreaties@oecd.org

Re: Consultation response to the Revised Proposed Changes to the Commentary on Article 5 (Permanent Establishment) of the OECD Model Tax Convention

Dear Sirs/Mesdames,

The International Bar Association would like to take this opportunity to comment on the Revised Proposed Changes to the Commentary on Article 5 (Permanent Establishment) of the OECD Model Tax Convention, which were released in October 12, 2012.

The International Bar Association (IBA), the global voice of the legal profession, includes over 45,000 of the world's top lawyers and more than 205 Bar Associations and Law Societies worldwide. The IBA is registered with OECD with number 1037 55828722666-53.

We are submitting our comments on behalf of the IBA Taxes Committee which has 1037 members from around the world. This committee formed a Working Group to respond to the original Consultation, and did so in February of last year. Members of the Working Group reviewed the revised proposals and have additional comments, which are enclosed with this letter.

The comments made in this report are the personal opinions of the Working Group members and should not be taken as representing the views of their firms, employers or any other person or body of persons apart from the IBA Taxes Committee of which they are a member.

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Sincerely yours

/s/ 

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INTRODUCTION

The OECD has released a revised version ("Revised Proposal") of the recommendation on the interpretation and application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention and invited comments by January 31, 2013.

The IBA Taxes Committee responded to the first draft of the proposals in February 2012 and our representative attended the meetings thereon in September, 2012. The IBA Taxes Committee acknowledges with thanks the revisions and improvements reflected in the Revised Proposal.

The IBA Taxes Committee stands by our entire original submission; however, in the interest of efficiency, we want to highlight some particular areas that in our view continue to require attention. Accordingly, we make additional comments on the Revised Proposal.

COMMENTS ON REVISED PROPOSAL

General Comments

Business restructurings that involve the conversion of full-fledged manufacturers or distributors in a particular jurisdiction (herein the "local" jurisdiction) to contract or toll manufacturers or limited risk distributors imply, in general, the de-localization of risks and assets, which generally leads to a reduction of the profits attributable to the converted local entities / subsidiaries, which have transferred the relevant risks and, in some cases, assets to a principal.

While the assessment / analysis of such business restructurings should focus on whether the allocation of profits in the restructured local enterprise is consistent with the arm's length principle having regard to the post-restructuring functions, assets and risks, we have observed that tax authorities in some local jurisdictions instead allege that the new principal has a PE there to which the pre-restructuring profit is still attributable.

Although the IBA Taxes Committee acknowledges the right and responsibility of local tax authorities to verify that the substance of a restructuring has occurred and the parties' dealings are, in fact, consistent with the restructuring transactions, we are concerned that the mere fact that a valid business restructuring has taken place can lead local tax authorities to challenge structures that would have remained undisputed if the multinational group undertaking the business restructuring had adopted the new business model from the outset. For example, we observe that, in general, in the absence of a business restructuring, a toll manufacturer, whether or not affiliated with the other contracting party, is not considered to give rise to a PE of such party. In our view, the indirect attack on business restructurings through allegations that a PE has been created is inappropriate if a PE would not have been alleged but for the business restructuring.

The IBA Taxes Committee is also concerned that when a local entity conducts more than one activity for a principal (for example, a toll manufacturing activity and marketing activities in respect of manufactured goods), tax administrations and courts of some countries assert that the principal has a permanent establishment even if no PE would have existed had the same activities been conducted by different local entities. The mere conduct of more than one activity by a single local entity should not give rise to a finding of PE if no PE exists when each activity is evaluated on its own.

Finally, the IBA Taxes Committee is concerned that some jurisdictions are inappropriately determining that a PE exists as a consequence of the conduct of activities of a preparatory or auxiliary nature, which otherwise do not give rise to a PE, simply because such activities require certain regulatory formalities to be completed.

Specific Comments

In view of the foregoing, the IBA Taxes Committee makes the following specific comments on the responses to questions 2, 16, 20 and 22, which are intended to clarify circumstances giving rise to a PE and to avoid findings of PE that, in our view, are inappropriate and not consistent with the Model Treaty provisions and the Transfer Pricing Guidelines.

- **Question 2**

  - Recommendation of the Working Group - paragraph 11 of the Revised Proposal

    The IBA Taxes Committee suggests that the proposed new paragraph 4.2 of the Commentaries be revised to include the following statement after the second last sentence of 4.2: "***This conclusion would be the same even if the supplier or contract-manufacturer had been converted from a full-fledged manufacturer as a consequence of a business restructuring***".

    Additionally, the IBA Taxes Committee recommends that all references to contract manufacturers be extended to include toll manufacturers.

- **Question 16**

  - Background-Paragraph 96 of the Revised Proposal

    The IBA Taxes Committee agrees with the clarifications of the Revised Proposal in paragraph 96, as they reflect the reality of many kinds of transactions. However, we recommend the clarifications include a statement that if ancillary activities require the performance of additional ancillary activities, such as regulatory formalities, such additional ancillary activities do derogate from the preparatory or ancillary character of the main activities in question.

The typical case is that of the maintenance of stock of goods for storage, display or delivery, which sometimes is permitted only with the fulfilment of statutory or regulatory legal requirements. Examples of these supporting ancillary activities include: (i) securing authorization allowing for the importation of the goods into the jurisdiction where they will be stored, displayed or delivered; and (ii) securing regulatory compliance for goods which are subject thereto. If a country requires that a permit be secured to hold a given item or a process be followed to import the goods that will be held for storage, display or delivery, such ancillary activities should not change the preparatory or auxiliary nature of the storage, display or delivery activities.

While this may seem clear, we have encountered problems in practice. Therefore, we urge the OECD to make the clarification we recommend above.

- **Question 20**

  - Background- Paragraph 116 of the Revised Proposal

    The IBA Taxes Committee agrees with the comments in this paragraph, but recommends the Revised Proposal explicitly state that no PE exists merely because a local entity conducts two or more separate activities, none of which taken singly, would give rise to a PE.

    Additionally, we recommend that the OECD clarify that, where a local entity is considered to constitute a PE in respect of one activity but not in respect of other, separate activities, then the income otherwise not attributable to the PE should not be so attributed merely because of the conduct of the other activities which do not give rise to a PE.

    We request these clarifications taking into account uncertainties in light of certain decisions, such as the recent decision of the Spanish Supreme Court (Case DSM Nutritional Products Europe Ltd, number 1626/2008; Date: January, 12th 2012), hereinafter "DSM case". The decision of the Supreme Court in the DSM case raises questions regarding the interpretation of PE and the determination of profits attributable thereto.

    The DSM case involved a business restructuring whereby a fully-fledged manufacturer (the "Subsidiary") became a contract manufacturer which, at the same time, promoted the sale of goods of the principal. The remuneration to the Subsidiary was:

    a) for the contract manufacturing: cost + margin.

b) for the promotion of goods: commission calculated as a percentage of sales.

The evidence showed that the Subsidiary did not have the authority to conclude contracts in the name of the Taxpayer and that the Taxpayer did not itself own or operate a fixed place of business. The Supreme Court held that the Subsidiary was a dependent agent of the principal constituting a fixed place of business PE because it manufactured the goods and promoted their sale, following the instructions given by the principal While we do not disagree that, under certain facts, arrangements of a taxpayer with a local entity may be found to result in the local entity's fixed place of business being deemed to be a fixed place of business of the taxpayer, we believe that such a finding should be based on facts actually showing more than that the local entity performed low risk routine functions under group guidelines for a relatively small portion of the profit.

Additionally, the Supreme Court stated that:

> *"In response to the allegation that the tax base should only include the normal manufacturing margin, the judgment states that there are isolated activities that were not determining factors when deciding whether or not a permanent establishment exists (specifically the sales activity) but once the existence of a permanent establishment has been recognized, the profit deriving from the sale of products must also be included.*
>
> *This determination must be maintained despite the extensive argument presented in defense of the second contention, since the judgment considers that the promotional activity is attributable to the permanent establishment and, it should be added, regardless of who is responsible for concluding the agreements and setting prices, ... "*

Although the Revised Proposal addresses Article 5 and not Article 7, became the concept of "attributable" is closely related to the concept of a PE, we wish to request clarification that the concept of "attributable" should not be so broadly construed as to include profits that are properly viewed as attributable to arm's length dealings by a PE with the local entity.

Accordingly, we recommend that the OECD clarify the Revised Proposal as we have recommended above.

- **Question 22**

  - Recommendation of the Working Group-Paragraph 123 of the Revised Proposal

    The IBA Taxes Committee suggests adding a statement at the end of the paragraph 123 of the Revised Proposal as follows: "The reduction of risks associated with a particular business activity in favour of another group company (principal) in the framework of a business restructuring would not by itself mean that the stripped enterprise is to be viewed as an agency PE under paragraph 5."