

**Asia
Pacific**Bangkok
Beijing
Hanoi
Ho Chi Minh City
Hong Kong
Jakarta
Kuala Lumpur
Manila
Melbourne
Shanghai
Singapore
Sydney
Taipei
Tokyo**Europe &
Middle East**Almaty
Amsterdam
Antwerp
Bahrain
Baku
Barcelona
Berlin
Bologna
Brussels
Budapest
Cairo
Dusseldorf
Frankfurt / Main
Geneva
Kyiv
London
Madrid
Milan
Moscow
Munich
Paris
Prague
Riyadh
Rome
St. Petersburg
Stockholm
Vienna
Warsaw
Zurich**North & South
America**Bogota
Brasilia
Buenos Aires
Caracas
Chicago
Chihuahua
Dallas
Guadalajara
Houston
Juarez
Mexico City
Miami
Monterrey
New York
Palo Alto
Porto Alegre
Rio de Janeiro
San Diego
San Francisco
Santiago
Sao Paulo
Tijuana
Toronto
Valencia
Washington, DC

January 21, 2010

Mr. Jeffrey Owens
Director
Centre for Tax Policy and Administration
Organisation for Economic Co-operation and Development
2, rue André-Pascal
75775 Paris Cedex 16
France

Re: Revised Draft Article 7 and Commentary

Dear Mr. Owens:

We are writing to share the comments of the Treaty Policy Working Group on the Revised Discussion Draft of a New Article 7 of the OECD Model Tax Convention, released on 24 November 2009 (the “2009 Draft”). The Treaty Policy Working Group is an informal association of large global companies based throughout the world, which represent a broad spectrum of sectors. Our member companies began working together in 2005 to analyze and address tax policy and administration concerns relating to permanent establishment, profit attribution, transfer pricing, and related issues. The development of clear guidance reflecting an international consensus on permanent establishment profit attribution is critically important to us, as global companies seeking to avoid double or unexpected taxation and the resulting uncertainty and cross-border controversies.

The 2009 Draft of a new Article 7 text and accompanying Commentary (the “2009 Draft Commentary”) make many significant improvements to the initial 2008 draft. We would like to express our appreciation for the serious consideration given by the OECD to the concerns identified by the Treaty Policy Working Group and others regarding the initial draft and for your attention to many of those concerns.

Our comments on the 2009 Draft focus on three points of particular interest to Treaty Policy Working Group members:

1. Double Tax Relief Issues

OECD Member States have confirmed in the 2009 Draft a much clearer and broader commitment to ensuring relief from double taxation for adjustments relating to permanent establishment profit attributions. Relief from double taxation in the permanent establishment context is a significant and growing concern for global

Mr. Jeffrey Owens
January 21, 2010
Page 2

companies, as such assessments grow in number and magnitude. This is, therefore, a particularly important improvement over the initial draft.

The 2009 Draft proposes both a general approach for double tax relief and, in paragraphs 66 and 67 of the accompanying Commentary, an alternative mechanism. As we understand it, the general approach requires the non-adjusting State to provide double tax relief for any adjustment proposed by the other State, provided that the non-adjusting State and the taxpayer agree that the Authorised OECD Approach (“AOA”) has been properly applied. The alternative approach permits the non-adjusting State to require competent authority discussion of any proposed adjustment under Article 7, even if it agrees that the proposed adjustment falls within an arm’s length range under the AOA.

At first impression, the general approach is appealing. It is intended to ensure relief from double taxation in an efficient manner, without need for recourse to competent authority consideration. Treaty Policy Working Group members believe, however, that the alternative approach is likely to prove preferable in practice, for two reasons.

First, even under the general approach, it seems likely that proposed adjustments of a material nature will routinely be challenged as non-arm’s length and referred to the competent authorities, as is currently the case with transfer pricing adjustments. Therefore, the benefits of guaranteed, automatic relief seem unlikely to materialize to the extent predicted, as both mechanisms would likely result in competent authority consideration of many cases.

Second, we believe that the general approach would likely have the effect of encouraging tax administrations to be more aggressive in proposing adjustments under Article 7, both in moving quickly so as to gain the presumption of corresponding relief from the non-adjusting State and in proposing adjustments at an extreme end of a wide range. We believe that the general approach could, consequently, create unintended incentives that would give rise to additional disputes and make them more difficult to resolve.

For these reasons, the Treaty Policy Working Group has a general preference for the alternative approach described in paragraphs 66 and 67. Our support for the alternative approach is, however, contingent on clarification of one potential interpretive issue. That issue relates to the interpretation reflected in the following Observation at paragraph 73 of the 2008 Commentary on Article 7:

“In the case of Japan and the United States, a taxpayer who seeks to obtain additional foreign tax credit limitation must do so through a

Mr. Jeffrey Owens
January 21, 2010
Page 3

mutual agreement procedure in which the taxpayer would have to prove to the Japanese or the United States competent authority, as the case may be, that double taxation of the permanent establishment profits which resulted from the conflicting domestic law choices of capital attribution methods has been left unrelieved after applying mechanisms under their respective domestic tax law such as utilisation of foreign tax credit limitation created by other transactions”.

The interpretations reflected in this Observation would raise two concerns if applied in the context of Article 7 generally:

1. They appear to require that all taxpayers go through a competent authority proceeding before claiming relief from double taxation in connection with Article 7 adjustments, and
2. They appear to permit the competent authority of the non-adjusting State to allow relief only if the taxpayer demonstrates that the profit attribution adjustment at issue has resulted in double taxation in that particular year that remains unrelieved after the taxpayer has utilized all of its available foreign tax credit limitation (including carryforwards and the like from other years), whether related to the adjustment at issue or not.

We would be very concerned if a similar interpretation were adopted in connection with the new Article 7 Commentary, through an Observation or otherwise.

Our first concern is that a literal reading of the proposed interpretation might require competent authority consideration of all Article 7 adjustments, no matter how immaterial. We question whether requiring all such cases to go to the competent authorities as a precondition for claiming double tax relief would be consistent with tax treaty provisions, which do not impose such preconditions. In some countries, such a requirement could also be inconsistent with applicable domestic rules regarding the coordination of double tax relief provisions and mutual agreement procedures. In any event, we believe there is serious doubt whether current competent authority resources in most countries would prove adequate if all Article 7 cases were routinely referred to them.

As for the second concern, we believe that the 2008 Observation introduces a novel concept of double taxation that is inconsistent with the double tax relief provisions of tax treaties. As we understand it, this interpretation would require the taxpayer to demonstrate two points: (1) that it has suffered “actual” double taxation in the year

Mr. Jeffrey Owens
January 21, 2010
Page 4

concerned, after using all available foreign tax credit limitation from whatever source and taking into account its credit carryforwards and the like, and (2) that any remaining double taxation can be traced to the particular permanent establishment adjustment at issue.

We understand that this approach might be applied by some countries to take the position that they have no obligation to provide double tax relief under Article 7 of a treaty if the taxpayer could utilize a net operating loss or foreign tax credit carryforward in the particular tax year at issue, or carry back a foreign tax credit to utilize excess foreign tax credit limitation generated in a prior year. We are concerned that this approach would result in double taxation in numerous cases. By definition, carryforwards and carrybacks relate to activity in other years. Article 7(3) principally addresses the obligation to eliminate double taxation on profits that have been subjected to tax by the adjusting State in the current year. Failing to grant double tax relief in that year means that a permanent mismatch would be created, because the same profits would be taxed currently by one State and, as an economic matter, also by the other State at some point when all other tax attributes have been utilized. There is no apparent basis to assert that double tax does not exist in a particular year due to the availability of attributes carried over from other years.

We understand that the proposed interpretation may also reflect a view on the part of some that “actual” double taxation does not arise until the taxpayer’s global effective foreign tax rate exceeds the maximum domestic rate. For example, a U.S. taxpayer with 400 of overall profit may have two branches, one in the Netherlands (assume a tax rate of 25.5 percent) and one in the U.K. (assume a tax rate of 28 percent), to each of which the taxpayer attributes 100 of profit, all of which is regarded as foreign source income. Assume further that the Dutch tax authorities attribute an additional 50 to the Dutch branch. The current year U.K. tax is 28, and post-adjustment the current year Dutch tax is 38.25. Assuming no U.S. adjustment to increase the reported 200 foreign source income, the total effective foreign rate post-adjustment is 33.125 percent—less than the maximum U.S. rate of 35 percent. However, it is clear that 50 of the profit taxed by the Netherlands has been subject to double tax, as that is income which the Netherlands asserts is attributable to the Dutch branch but that the taxpayer asserts should be taxable only in the United States. It would, therefore, be inappropriate in this example for the United States to deny double tax relief under its treaty with the Netherlands on the basis that there is no “actual” double taxation as long as the effective foreign tax rate is below 35 percent.

The interpretation reflected in the 2008 Observation has not historically been applied to Article 7 cases and is not proposed to apply for purposes of Article 9 transfer

Mr. Jeffrey Owens
January 21, 2010
Page 5

pricing cases or other treaty provisions. It is not clear what the technical basis and policy justification would be for taking a different approach under Article 7.

We do not believe that this interpretation is widely shared by OECD Member States, which could make it very difficult or impossible to achieve mutual agreements that relieve double taxation. We, therefore, respectfully urge all OECD Member States to confirm that this interpretation will not be applied to the new Article 7 and its Commentary and to withdraw, where applicable, the 2008 Observation in paragraph 73 of the existing Article 7 Commentary.

2. Notional Charges and Related Issues

The discussion of notional charges in the 2009 Draft confirms an important principle: that, unless explicitly permitted by an applicable bilateral treaty, withholding taxes may not be imposed, and deductions may not be denied, in respect of charges deemed made by a permanent establishment under the AOA. While it would have been preferable for the OECD to prohibit these practices outright, paragraph 27 of the 2009 Draft Commentary helpfully confirms the OECD's general rejection of such practices, absent a special bilateral treaty provision. We appreciate the confirmation of this important point.

3. Documentation Issues

Despite much comment and detailed discussion at the September 2008 OECD Consultation on Article 7, the 2009 Draft Commentary continues to refer to the taxpayer's documentation as a "useful starting point". Documentation may, therefore, be accorded less deference in the Article 7 context than under the OECD Transfer Pricing Guidelines in the intercompany context. The 2009 Draft Commentary also continues to state that documentation may be disregarded if the documented position is seen as inconsistent with the AOA.

Treaty Policy Working Group members continue to believe that documentation prepared by taxpayers for Article 7 purposes should receive a higher degree of deference. In addition, the Commentary should take into account more fully the fact that a taxpayer may not have had an opportunity to prepare contemporaneous documentation if the assertion that it had a permanent establishment comes as a surprise. While we appreciate the reluctance of tax administrations to promise deference to the taxpayer's documentation in every case, the level of skepticism reflected in the 2009 Draft Commentary regarding the value of the taxpayer's documentation seems at odds with its strong urging that such documentation be prepared.

Mr. Jeffrey Owens
January 21, 2010
Page 6

* * *

Please do not hesitate to let us know if we can provide further information or be of assistance in any way.

Sincerely,

Carol A. Dunahoo

Gary D. Sprague

For the Treaty Policy Working Group

cc: Mary C. Bennett
Jacques Sasseville
Caroline Silberztein