

VIA ELECTRONIC TRANSMISSION  
FROM PROF. DR. I.J.J. BURGERS TO DR. JEFFREY.OWENS@OECD.ORG

Dr. Jeffrey Owens  
Director, CTPA  
OECD  
2, rue André Pascal  
75775 PARIS  
France  
LDB/im

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Dear Dr Owens,

I hereby provide you with comments to the revised draft for a new Article 7 OECD as well the electronic copy of my article in Florida Tax Review December 2009: “The New Approach on profit allocation, a step forward towards neutral treatment of permanent establishments and subsidiaries”. My comments focus on the Commentary. The proposal for the new Art. 7 OECD sufficiently reflects what is intended with the functionally separate entity approach. The addition of a corresponding adjustment mechanism similar to that of paragraph 2 of Article 9 not only will ensure that all cases of double taxation will be eliminated, but also that the legal form – permanent establishment or subsidiary – will be treated equal in this respect.

My main comment concerns the explanation of the reasons why the OECD did not choose for deeming the permanent establishment as subsidiary. Paragraph 84 of the 2008 Report on the Attribution of Profits to Permanent Establishments mentions:

“it should be noted that the aim of the AOA approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. There are generally economic differences between using a subsidiary and PEs. Application of the authorized OECD approach will not achieve equality of outcome between subsidiaries and PEs where there are economic differences between them. The legal form chosen, PE or subsidiary, may have some economic effects that should be reflected in the determination of taxable profits”.

I suggest adding this important clarification to the Commentary to the new Art. 7 OECD as this would improve transparency.

Moreover I suggest changing the wording of the explanation.

All arguments mentioned in the 2008 OECD Report on Attribution of Profits to Permanent Establishments and previous Drafts boil down into the following argument for differences in treatment of permanent establishments and subsidiaries in respect of the functional analysis:

**legal requirements posed to subsidiaries that have nothing to do with people functions should not be deemed to apply to permanent establishments.**

Due to differences in legal requirements the determination of the tax base for permanent

establishments differs from that of subsidiaries. The most important other legal difference, to wit the fact that a contract is not available for internal delivery of goods, services and assets, should not result in a different determination of the tax base of a permanent establishment compared to that of a subsidiary as this difference concerns the performance of people functions. The people functions performed, associated risks and capital required to perform these people functions are the same whether performed by a permanent establishment or by a subsidiary. The functionally separate entity approach requires that functions and management of risks performed by people in the permanent establishment should be analyzed. It also attributes to the permanent establishment economic ownership of assets for which people in the permanent establishment perform the significant functions relevant to the economic ownership of assets. Moreover it attributes a certain amount of capital to the permanent establishment, not because legal reality requires so, but because economic reality is that functions cannot be performed and risks cannot be taken without capital. Differences in legal requirements caused by differences in legal form may result in a different economic reality that is not the result of people functions. It is for this reason that such differences should not be neutralized or disregarded. The functionally separate entity approach only requires similar treatment of permanent establishments and subsidiaries in respect of people functions and the risks inherent to significant people functions, as well as the allocation of assets used for fulfilling the functions. It does not require deeming legal requirements to apply to permanent establishments that apply to subsidiaries and not to permanent establishments and that have nothing to do with people functions.

In respect of the comparability analysis there may also be reason to distinguish between permanent establishment and subsidiaries, as may be more profitable than a subsidiary due to possibilities of efficient capital utilization, risk diversification and economies of scale a permanent establishment. This argument was mentioned in par. 55 of the 2004 Draft Report on the Attribution of Profits to Permanent Establishments, but for reasons not clear to me was not included in the 2006 Draft nor in the 2008 Report.

In my view the explanation of the differences between permanent establishment and subsidiaries in respect of profit allocation would therefore be better reflected if the explanation provided in paragraph 84 would be rephrased as follows:

“It should be noted that the aim of the AOA approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. Legal requirements for permanent establishments differ from those for subsidiaries, a difference that is not directly related to people functions performed by permanent establishments or subsidiaries and the assets and capital needed to perform these functions and therefore should not be neutralized or disregarded in applying the functionally separate entity approach. Moreover, a permanent establishment may be more profitable because of possibilities of efficient capital utilization, risk diversification, economies of scale, etc. and therefore the comparability analysis may result in differences in prices to be taken into account for similar functions performed by permanent establishments and subsidiaries.”

Finally I suggest that the Commentary to the new Article 7 OECD should not only include a reference to the 2008 Report for a detailed guide as to how the profits attributable to a permanent establishment should be determined under the provisions of (the proposed) Article 7 (2) OECD (see paragraph 17 of the 2009 Draft). It should also provide for an overview of the most important consequences of applying the functionally separate entity approach such

as the overview in paragraph 4 of my article in Florida Tax Review December 2009 in order to improve the transparency of the consequences of the functionally separate entity approach.

I hope that these suggestions will be of use for you.

Yours sincerely,

Prof. Dr. I.J.J. Burgers

Professor of International Tax Law Faculty of Law and Professor of Economics of Taxation  
Faculty of Business and Economics University of Groningen, the Netherlands.