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Re: *Discussion Draft on a New Article 7 (Business Profits)
of the OECD Model Tax Convention*

Dear Mr. Owens:

On 7 July 2008, the Committee on Fiscal Affairs (CFA) of the Organisation for Economic Co-operation and Development (OECD) released a consultation document setting forth a draft of a revised Article 7 and commentary on the OECD's Model Tax Convention. The draft Article and commentary are the second part of the CFA's implementation of the conclusions of Parts I, II, and III of the Report on the Attribution of Profits to Permanent Establishments.¹ On behalf of Tax Executives Institute, I am pleased to respond to the OECD's request for comments. While TEI commends the OECD for updating Article 7 and the commentary, we are concerned that the proposed revisions will increase uncertainty for taxpayers and taxing authorities thereby increasing the number of disputes between taxpayers and taxing authorities and between the taxing authorities themselves.

TEI Background

Tax Executives Institute was founded in 1944 to serve the professional needs of business tax professionals. Today, the organization has 54 chapters in Europe, North America, and Asia. As the preeminent international association of business tax professionals, TEI has a significant interest in promoting tax policy, as well as in the fair and effi-

¹ *OECD Report on the Attribution of Profits to Permanent Establishments* (17 July 2008).

cient administration of the tax laws, at all levels of government. Our 7,000 members represent 3,200 of the largest companies in the United States, Canada, Europe, and Asia.

Executive Summary

TEI commends the OECD for updating Article 7 and its commentary. TEI supports the OECD's efforts to ensure uniformity in the methods for attributing profits among associated enterprises governed by Article 9 and the methods for attributing profits between a Head Office and a Permanent Establishment (PE) governed by Article 7.

TEI also supports the implementation of practical profit attribution methods and ensuring that tax administrators' approaches are consistent with the concepts in the authorised OECD approach. A threshold question is how to ensure that the underlying dealings between a PE and the Head Office (and the rest of the enterprise as well) are valid and properly documented. Once documented, the profits can be properly allocated. TEI does not, however, support imposing more stringent profit allocation methods or documentation requirements on dealings between a PE and Head Office under Article 7 than apply to transactions among associated enterprises under Article 9. Hence, TEI urges the OECD to provide additional guidance on acceptable documentation of underlying dealings in order to discourage Member States from imposing more stringent profit allocation methods, documentation, or other requirements for PEs.

In addition, because of the legal and tax uncertainties associated with the inadvertent creation of PEs, most companies will either purposefully establish an entity to conduct business within a particular jurisdiction or minimize their activities to ensure that a PE is not created. Despite taxpayers' best efforts to comply with myriad jurisdictional rules to which they are subject, the business activities in a particular jurisdiction may exceed the *de minimis* thresholds for permitted preparatory or auxiliary activities and a PE may be inadvertently created. Where that occurs, taxpayers likely may not have available the documentation and records to support a proper attribution of profits. As a result, TEI urges the OECD to consider providing guidance on the conditions that would afford taxpayers a grace period to satisfy documentation requirements.

Next, despite the assurances in the proposed commentary that relief should be afforded where two states attempt to tax the same profits, the lack of a direct mechanism requiring full relief from double taxation ensures (1) a greater risk of double taxation and (2) divergent treatment of group companies and PEs. As a result, we urge the OECD to consider adopting a measure similar to Article 9(2) directly in Article 7.

Finally, notwithstanding the legal fiction that a PE is a separate and independent enterprise, a notional charge is not equivalent to a cash payment. Hence, TEI urges the OECD to eliminate proposed paragraph 26 from the commentary.

TEI also offers specific comments to clarify the effective date of the application of the proposed commentary, the allocation of asset costs, the treatment of Dependent Agent PEs, and the treatment of employee costs under Article 15.

Background on Article 7 Revisions

Proposed Article 7(1) of the OECD Model Tax Convention on Income and Capital provides that the profits of an enterprise of a Contracting State (*i.e.*, the residence state) shall be taxable only in that State unless the enterprise carries on business in another Contracting State (*i.e.*, the source state) through a PE. If the enterprise carries on business through a PE in the source state, the profits attributable to the PE may be taxed by that State.

Under proposed Article 7(2), the profits attributable to the PE are the profits the PE might be expected to make, in particular in dealings with other parts of the enterprise, as if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used, and risks assumed by the enterprise through the PE and through other parts of the enterprise.

Paragraph 2.3 of the discussion draft notes that the principles underlying Article 7, especially paragraph 2, have a long history in the Model Tax Convention. Even though the longstanding separate entity and arm's-length principles are embedded in the article, the practices of the OECD and non-OECD countries in respect of the attribution of profits and the interpretations of Article 7 vary considerably. To minimize uncertainty for taxpayers and increase consistency of interpretation among tax administrations, the OECD released a series of discussion drafts on the Attribution of Profits to Permanent Establishments.² In 2008, the OECD released its *Final Report on the Attribution of Profits to Permanent Establishments*³ and concluded that a new version of Article 7 should be included in the Model Tax Convention to fully incorporate the principles in the report.

TEI commends the OECD's efforts to update Article 7 of the Model Treaty and the related commentary. References to the OECD's 1995 Transfer Pricing guidelines

² TEI is pleased to have submitted comments on the *Discussion Draft on the Attribution of Profits to a Permanent Establishment — Part I (General Considerations)*, issued 2 August 2004.

³ *OECD Report on the Attribution of Profits to Permanent Establishments* (17 July 2008).

throughout the revised article's commentary underscore the OECD's commitment to the principled and uniform treatment of associated enterprises (*i.e.*, subsidiaries) under Article 9 and Permanent Establishments (PEs) under Article 7. In addition, efforts to close the gap between the theoretical concepts in the commentary and the effective application of the rules by OECD and non-OECD countries are welcome. Finally, the new article and commentary firmly reject the "force of attraction" rule applied by some countries for determining the profits of a PE. By rejecting that rule, the number of instances of double taxation should be reduced.

As a representative of large, complex multinational enterprises (MNEs), TEI supports the development of effective rules to govern international taxation. In order to be effective, the Model Treaty and its commentary should reflect sound tax policy principles, be as simple as possible, easy to administer, and eliminate double taxation. Where the rules reflect these principles, the interpretations by tax administrations, taxpayers, and ultimately the courts will be more consistent. As important, the Model Treaty and its commentaries should, where practicable, align with common business practices by respecting the taxpayer's books and records where (1) they are consistent with the functional and factual analysis and (2) the profit attributed to the PE falls within the range of results of comparable separate and distinct enterprises. We offer a number of specific recommendations to clarify the proposed commentary and make the rules more effective.

Is there a PE?

The attribution of profits under Article 7 can and should only be undertaken after the existence of a PE has been established under Article 5. Regrettably, in proposing optional articles, paragraphs, and commentary in respect of Articles 5 and 7 that satisfy the desires of member and non-member taxing authorities, the OECD is creating substantial uncertainty for businesses and exacerbating the potential for double taxation. TEI believes the OECD should strive to develop uniform rules so that similar situations are treated consistently. Where countries have fundamental objections to specific articles or paragraphs, the countries should use the formal objection or reservation procedures to note their differences with the OECD's Model Treaty.

Multiple Versions of Article 7 Commentary Creates Confusion

Currently, there are three versions of commentary on Article 7 of the Model Treaty: the pre-2008 commentary, the 2008 revised commentary approved by the CFA and incorporated in the 2008 version of the Model Treaty, and the new proposed commentary that would be released along with the revisions to Article 7. The pre-2008 commentary should apply to treaties ratified prior to 2008 and may continue to apply unless superseded by a new agreement. The new proposed commentary would



seemingly only apply to treaties that adopt the new Article 7. The legal effect of the 2008 revised commentary on treaties with the existing Article 7 is problematic. The OECD is of the view that the 2008 revised commentary is effective immediately since it is part of an agreed OECD process, but it is unclear whether Member States or their courts will agree about its application to extant treaties. At a minimum, member countries should specifically indicate the degree to which they will follow the interim, 2008 revised commentary.

In addition, where the new proposed commentary is silent on issues and examples that were addressed in the pre-2008 commentary to old Article 7, we believe it would be beneficial to permit taxpayers and tax administrators to cite the pre-2008 commentary as persuasive and take it into account. TEI urges the OECD to confirm this as well as to clarify the application of the pre-2008, revised 2008, and new proposed commentaries to existing and new treaty provisions in order to ensure more uniform and consistent interpretation of the new Article 7 and its commentary.

Ensure Consistency between Articles 7 and 9 for Transfer Pricing

In the discussion of the transfer-pricing analysis and principles for the allocation of profits between a PE and Head Office, the proposed commentary for Article 7 repeats many concepts, phrases, and requirements from Article 9 and its commentary, paraphrases others, and omits still others. As a result, some of the details and requirements for establishing an arm's-length price or documenting the dealings and transfer-pricing methods are inconsistent between PEs under Article 7 and related companies under Article 9. Indeed, the Article 7 commentary seemingly requires *every* risk and *every* asset to be analyzed in minute detail. To minimize confusion, ensure that the transfer-pricing analysis and principles are consistent between Articles 7 and 9, and avoid creating more stringent documentation requirements for PEs under Article 7, we urge the OECD to cross-reference Article 9 and its commentary as much as possible. Different phrasing and words should be reserved for situations where necessary to take account of differences between a PE and a subsidiary.

1. Paragraph 2.23 of the discussion draft states:

Dealings between the permanent establishment and other parts of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. This implies a need for greater scrutiny of these dealings than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist and considering the uniqueness of this issue, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing.



Regrettably, this statement may encourage tax administrations to request more data from MNEs for documentation of a PE's profit attribution than is currently required for transfer pricing documentation on transactions between associated enterprises under Article 9. Neither OECD Member States nor businesses will benefit from documentation requirements for dealings with a PE over and above those already required for Article 9 purposes. Consequently, TEI urges the OECD to add a sentence to the end of paragraph 2.23 confirming that the documentation requirements under Article 7 should be no more stringent than the documentation requirements under Article 9.

2. Paragraph 2.18 of the discussion draft states the general principle that

... the attribution of profits to a permanent establishment under paragraph 2 will follow from a calculation of the profits (or losses) from all its activities, including transactions with unrelated enterprises, transactions with related enterprises (with direct application of the 1995 Transfer Pricing Guidelines) and dealings with other parts of the enterprise.

Although we agree with the general principle, a PE will often undertake simple functions, have fewer risks, and hold fewer assets than the Head Office or associated enterprises. Unless a profit split or a comparable uncontrolled price (CUP) is the best transfer pricing method to apply in a particular situation, TEI believes that *only* the activities of the PE should be analyzed in detail. For example, if a tax authority determines that a PE is engaged in a toll-manufacturing or minor service activity, the cost-plus method should be applied to the PE's activity without further analysis of the activities undertaken by the Head Office. The suggestions in the commentary that all the activities of the Head Office and PE must always be analyzed together would significantly increase the documentation requirements under Article 7 beyond those imposed under Article 9.

3. Paragraph 2.13 of the discussion draft states that the analysis of the PE's activities should take "into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprises." Although a high level review of all the functions, assets, and risks of all the parties to a transaction or dealing is often necessary to determine which party in a transaction or dealing should be the tested party, the OECD should clarify that when the taxpayer documents the expected arm's-length profit of a tested party, only the functions, assets and risks of the *tested* party are required to be analyzed in depth.

4. Paragraphs 2.34-2.36 of the discussion draft acknowledge that general and administrative fees are deductible by a PE, including a profit element for the Head Office. TEI commends the OECD for this clarification, but again recommends that the

commentary be clarified to state that when the taxpayer documents the expected arm's-length profit of a tested party, only the functions, assets, and risks of the *tested* party are to be analyzed in depth.

OECD's Current Review of Transfer Pricing Methods

As part of its ongoing monitoring of the implementation of the 1995 Transfer Pricing Guidelines, the CFA is currently examining the application of transactional profit methods.⁴ The consultation document indicates that the OECD is considering elevating profit-split methods from the current status as methods of last resort because the use of profit-split methods is more prevalent than anticipated under the guidelines. Since there is no sound tax policy reason for treating dealings under Article 7 differently from transactions under Article 9, the wording of the second bullet point of paragraph 2.20 of the discussion draft may need to be revised upon release of the final report on Transactional Profit Methods. Indeed, it might be easier to cross reference the 1995 Transfer Pricing Guidelines rather than paraphrase the concepts in this paragraph. Adopting TEI's recommendation would also simplify the process for future updates to Article 7 and its commentary.

Paragraph 2.23

Paragraph 2.23 of the discussion draft seemingly encourages the tax authorities to challenge the functional risk and asset attributions developed by taxpayers as well as the documentation prepared to support the risk and functional analysis. We have several concerns about paragraph 2.23.

First, to provide better overall balance to paragraph 2.23, TEI urges the OECD to add a statement that the tax authorities should not interfere with or second guess the business decisions a taxpayer makes in structuring its business arrangements.

Second, the first bullet point under paragraph 2.23 states that tax authorities should give effect to a taxpayer's documentation to the extent the documentation is consistent with the economic substance of the activities taking place *within the enterprise* as revealed by the functional and factual analysis. To be consistent with the arm's-length pricing principles in Article 9, it is not always necessary to consider the dealings of the entire enterprise; only the dealings of the PE as the tested party should be reviewed.

Finally, the third bullet point of proposed paragraph 2.23 states that taxing authorities should give effect to a taxpayer's documentation of its PE's dealings to the

⁴ *Transactional Profit Methods — Discussion Draft for Public Comment* (25 January 2008).

extent they do not purport to “transfer risks in a way that segregates them from functions.” Arm’s-length parties often segregate risks from functions through the use of insurance. Hence, the third bullet point contradicts the “commercial reality” that the second bullet point emphasizes as the touchstone for respecting a PE’s dealings. To reduce uncertainty, minimize controversies between taxpayers and tax authorities (as well as between tax authorities), and reduce the potential for double taxation, we recommend that the first and third bullet points of proposed paragraph 2.23 be deleted. The second bullet point provides the taxing authorities with sufficient guidance on when a taxpayer’s business arrangements should be respected or challenged.

Inadvertent PEs – Reducing the Scope of Controversy and Increasing Compliance

Where a taxpayer’s activities in a particular jurisdiction rise to a level that a PE is unintentionally created, the documentation of the PE’s functions and risks will rarely be readily available. To minimize the scope of controversy ensuing from the assertion of a PE by taxing authorities, TEI recommends that OECD consider proposing a “grace period” of, say, 12 to 24 months from the point at which a PE is determined to exist. During the grace period, the enterprise of which the PE is a part should be afforded the opportunity to undertake a functional and factual analysis and develop transfer-pricing documentation without incurring penalties. By according taxpayers a grace period from documentation penalties, the implications of a PE determination would be reduced and taxing authorities and taxpayers would better analyze the facts dispassionately and agree on the threshold question whether a PE exists under Article 5. Once a PE is determined, the taxing authorities and taxpayers would then address the profit attribution issues under Article 7 with the grace period affording taxpayers the time necessary to develop proper documentation. To prevent abuse of TEI’s proposal, the grace period should be accorded only where the taxpayer can demonstrate (i) that it had reasonable basis to believe that no PE existed and (ii) reasonable procedures and processes (*e.g.*, written manuals or standard operating procedures) were in place to ensure that PEs are not inadvertently created.

Allocation of Assets

Revised Article 7(2) states that the profits attributable to a PE are “the profits it might be expected to make in dealings with other parts of the enterprise if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed” Regrettably, the proposed commentary affords little or no guidance on the allocation of an asset’s use to a particular location. TEI believes it would be helpful for the proposed commentary to include a statement that the location of an asset shown on a taxpayer’s books and records is entitled to a rebuttable

presumption that the taxing authorities may overcome. Thus, if the taxpayer's books and records show that the assets are part of the PE, the assets should, absent other facts, be determinative of the asset's location. Conversely, if the assets are shown on the Head Office's books, they should be presumed to be part of the Head Office.

The Article's focus on the location of an asset's use for the attribution of profits will also create practical challenges and potential confusion in application, especially (i) where the legal and beneficial ownership of an asset are in separate jurisdictions, (ii) where the costs of ownership or development are incurred in a different jurisdiction from its use, or (iii) where the costs are incurred in a different period than the asset's use. For example, in a temporary PE, such as one involved in the installation of machinery or construction activities, the PE may not wish to purchase or import equipment or other assets from the Head Office or associated enterprises in order to perform its construction or installation activities. Where the temporary PE uses the assets of the enterprise in the temporary location, the attribution of the profits to the PE would better reflect the arm's-length principle by assigning an imputed arm's-length lease cost from the head office (or associated enterprise) to the PE rather than assigning ownership of an asset to the PE and then attempting to assign the assets' costs, depreciation, and financing expense to the PE.

Even more challenging than allocating the use of tangible assets under a deemed leasing arrangement with the Head Office (or other parts of the enterprise) is allocating the use of intangibles under a license. Indeed, the proposed rules for attributing the costs and income relating to the use of intellectual property should be substantially clarified. Specifically, paragraph 3.14 (relating to the commentary on Article 12, paragraph 21), paragraph 3.16 (relating to Article 13), paragraph 3.23 (relating to Article 21), and paragraph 3.25 (relating to Article 22) of the discussion draft are all affected by looming, but unaddressed issues in the proposed commentary: When should intellectual property be attributed to a PE and, if so, is a notional buy-in required? For most limited function PEs, we believe that would be an extraordinarily complex and unnecessary undertaking. More broadly, the discussion draft fails to address the proper treatment of the costs of any asset attributed to a PE that has been fully depreciated or amortized or, in the case of an intangible asset cost, has never been capitalized. Those costs are an important element of determining the net profit of the PE.

Proposed Provisions Providing Relief from Double Taxation Are Insufficient

Adjustments of transactions between associated enterprises often give rise to economic double taxation. Article 9(2) of the Model Tax Convention provides that where State A adjusts the profits of an enterprise that have already been subjected to tax in State B, then State B shall make an appropriate adjustment to relieve the double

taxation. Regrettably, there is no similar standard adjustment mechanism in Article 7 for adjustments of attributions of profit between a PE and the enterprise to which it belongs. Instead, Article 7(3) provides a mechanism only for attributing capital and determining the amount of free capital and deductible interest expense for each jurisdiction. In addition, paragraphs 2.40, 2.41, 2.49, and 2.50 (among others) suggest that in the absence of a direct adjustment mechanism comparable to Article 9(2), taxpayers should be able to obtain relief from double taxation through Article 23 (either a profit exemption under (A) or a foreign tax credit under (B)), or Article 25 (Mutual Agreement Procedure).

We have several concerns with the proposed relief from double taxation under Article 7. First, the proposed “free capital” concept in Article 7(3) is wholly untested, especially outside of the banking and financial industries where few taxpayers are subject to regulatory requirements that specify the amount of capital necessary for the risks inherent in a business.⁵ As a result, there will be numerous controversies between Member States and taxpayers over the amount of “free capital.” TEI recommends that the OECD consider expressly limiting Article 7(3) to financial institutions. At a minimum, free capital should not be attributed to PEs on a notional or contingent basis, but only when the tax authorities can demonstrate that it is actually used by the PE.

Second, despite the assurances in the proposed commentary that relief should be afforded where two states attempt to tax the same profits, the lack of a direct mechanism *in the Article* requiring full relief from double taxation ensures (1) a greater risk of double taxation and (2) divergent treatment of group companies and PEs. Paragraphs 53 and 67 of the commentary discuss *optional* provisions that the Member States may wish to negotiate in bilateral treaty discussions, but the Model Treaty includes no recommendation apart from affording taxpayers relief under Article 23 (*i.e.*, either with an exemption or foreign tax credit relief). TEI believes this is insufficient

⁵ New proposed Article 7(3) provides a mechanism for reaching agreements between source and residence states for adjustments to the allocation of the “free capital” of a PE. The relief accorded under the proposed Article 7(3), however, would only apply where there is no conflict between the national laws of the countries and the Head Office state agrees that the method used by the PE state produces an arm’s-length result. These conditions are currently not part of Article 9(2). Paragraph 2.53 of the discussion draft acknowledges this indirectly by providing an additional paragraph that treaty negotiators *could* – but are not required to – adopt to resolve double taxation issues. Regrettably, the recommended provision in paragraph 2.53 is optional and the subsequent commentary in paragraphs 2.54-2.69 of the discussion draft heightens rather than ameliorates our concerns. Hence, we reiterate the recommendation that the commentary should unequivocally state that relief from double taxation within the meaning of the Model Convention requires that the residence and source country agree on the amount of income, expense, and capital attributable to a permanent establishment. Otherwise, the competent authorities may interpret the commentary in a fashion that permits them to avoid making the hard choices necessary to reach a compromise on the allocation of the tax base.

guidance to the Member States and insufficient relief for taxpayers.

Indeed, if the general theory of revised Articles 5 and 7 is to treat the PE as though it were an independent part of the enterprise, the most efficacious means of assuring relief from double taxation would be to incorporate a provision similar to Article 9(2), which is a time-tested mechanism for providing relief for associated enterprises, in Article 7.⁶ As a result, we urge the OECD to consider adopting an all-encompassing measure similar to Article 9(2) for Article 7. Alternatively, one of the optional provisions set forth in paragraphs 53 or 67 of the commentary should be included in the Article. Of the two, paragraph 53 is the most closely modelled after Article 9(2) and is a better approach since it imposes a legal obligation to accord relief whereas paragraph 67 leaves the matter to the mutual agreement procedure. At a minimum, the commentary should include an unambiguous statement that relief from double taxation requires a source country and a residence country to reach agreement on the amount of income, expense (including the interest expense from attributed capital), and the amount of attributed (and free) capital of a PE. Providing relief solely through a foreign tax credit (or exemption) mechanism under Article 23 is no substitute for a full and comprehensive mutual agreement of the amount of income and expense attributable to a PE.

Withholding Taxes on Notional Payments

Paragraph 2.25 of the discussion draft states the general principle that Article 7(2) is restricted to the determination of the profits attributable to the PE and does not create notional income that a Contracting State may tax under other treaty articles. Paragraph 26 of the discussion draft notes that, as a matter of domestic law and the application of the separate and independent enterprise fiction to PEs, some States may equate the treatment of notional charges (*e.g.*, for imputed rent or interest) with an actual payment. Paragraph 26 states that such States may wish to negotiate a provision “according to which charges for internal dealings should be recognised for the purposes of Articles 6 [Income from Immovable Property] and 11 [Interest].” In a side note to paragraph 26, the CFA observes that the domestic law of very few member countries provides for source taxation of notional charges and the Committee will monitor the issue to determine whether to develop and issue an alternative provision addressing withholding on notional charges.

Notwithstanding the legal fiction that a PE is a separate and independent enterprise, a notional charge is not equivalent to a cash payment. Consequently, TEI opposes the imposition of withholding taxes at source on notional charges. We regret

⁶ As important, TEI urges the OECD to include a strong recommendation that Article 9(2) relief be provided in all OECD-based conventions. Many OECD members’ treaties lack the Article 9(2) relief

that the inclusion of paragraph 26 in the commentary may encourage Member States to adopt domestic laws requiring withholding on such charges that will likely lead to an increase in the number of disagreements between Member States and between Member States and taxpayers. We urge the OECD to eliminate paragraph 26 from the commentary.

Dependent Agent PEs

Paragraph 26 of the new Commentary to Article 7 in the 18 July 2008 Update to the Model Treaty incorporates the principles relating to Dependent Agent PEs set forth in Section D-5 of the Report on the Attribution of Profits to Permanent Establishments. As noted in TEI's 12 October 2004 comments in respect of the OECD's discussion draft on Part I of the Attribution of Profits Report, we are concerned that the application of the principles in Article 7 to an unplanned, deemed dependent agent PE under Article 5(5) may result in excessive compensation to the source country because it is difficult to distinguish between the provision of services to the principal/foreign company for a fee and the provision of services *on behalf of* a principal/foreign company.

Paragraphs 19 and 20 of the discussion draft set forth a two-step analysis for attributing profits to a PE. First, the functional and factual analysis described in paragraph 19 is undertaken and then under paragraph 20 transactions with associated enterprises are priced using the 1995 Transfer Pricing Guidelines. Although we agree with the analysis for attributing an arm's-length profit for the services provided on behalf of the nonresident enterprise by the deemed PE, nearly every MNE will already have planned and provided what it believes to be an arm's-length compensation for a dependent agent's business activities taking into account all the local costs of the dependent agent for its activities. As a result, the profits attributed to the PE under new Article 7(2) will necessarily be excessive because the dependent agent's costs attributable to its PE business were already covered by the related party income from the enterprise. In other words, before the deemed PE was asserted by the taxing authority, the planned arm's-length remuneration of the dependent agent's business already provided an appropriate return on all the costs of the source country activities.

To preclude an excessive allocation of profit to the source country of a deemed PE arising from the activities of a related-party dependent agent, the profits of the dependent agent and the deemed PE should be considered at the same time. TEI recommends that the two-step profit attribution in paragraphs 19-20 of the discussion draft be clarified in order to take account of the profits already provided by the enterprise to the dependent agent PE.

In addition, paragraph 16 of the Commentary on Article 5, which is discussed at paragraphs 3.4 to 3.5 of the discussion draft, should similarly be clarified. Since wholly

intra-group services provided by an entity to a nonresident will generally not create a PE for the nonresident under Article 5 – and assuming that the entity providing the services has been compensated in accordance with Article 9 principles – there should be no additional profit attribution under Article 7 for those internal services where a PE is asserted. Only a dependent agent’s provision of services to third parties (*i.e.*, customers or suppliers) on behalf of the nonresident should give rise to an allocation of additional profits to the PE under Article 7. In other words, where a related party is providing wholly internal services to its nonresident enterprise, that service activity is not part of the “business” activity of the PE on behalf of the nonresident and thus should not be part of a functional and factual analysis that gives rise to an additional profit allocation under Article 7. In TEI’s view, only those services provided (or relating) to third parties and made on behalf of the nonresident enterprise should be considered part of the PE’s business activity and attract an additional profit allocation based on the Article 7 functional and factual PE analysis.

Article 15 – Employee Costs

Under Article 15(2)(c) of the Model Treaty, salaries and wages “borne” by a PE will trigger a tax liability for the individual employees. Where a deemed PE is asserted, there will be considerable uncertainty about whether the PE has “borne” such costs and, consequently, whether employees are taxable in the state of residence or the PE state. In order to minimize uncertainty, TEI recommends that the OECD clarify that a *deemed* allocation of costs to a PE under Article 7 does not trigger a tax liability for individual employees unless (1) the compensation has been specifically allocated to that PE in the accounts of the taxpayer or (2) there is evidence that the wages were not included in a charge out in order to avoid taxation of the particular employee in the PE country. The mere deeming of costs to an asserted PE (whether deemed or a fixed place of business) for purposes of computing the profits attributed under Article 7 should not give rise to a presumption that such costs are actually borne by the PE for purposes of Article 15. If a deemed cost allocation under Article 7 were to lead to a presumption that the costs are “borne” by the PE, the protection afforded to individuals by the 183-day rule would be negated. In TEI’s view, where deemed services are supplied *to* the PE by the enterprise, the deemed charges for such services are not salaries and wages *borne* by the PE. Hence, the distinction between intra-company services and cost charge outs (*i.e.*, costs borne by the PE) requires clarification.

Conclusion

TEI appreciates this opportunity to present its views on the Discussion Draft on the new proposed Article 7 (Business Profits) of the OECD Model Tax Convention. These comments were prepared under the aegis of TEI’s European Direct Tax Committee whose Chair is Johann Müller. If you have any questions about the

submission please contact Mr. Müller at +45 3363 4374 (or johann.muller@maersk.com),
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