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Dear Mr. Owens,

VNO-NCW, the Netherlands Employers Federation, representing the large majority of small, medium and large enterprises in The Netherlands is pleased to send their comments as requested (on OECD website) on the Discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention.

VNO-NCW observes in the Draft a number of generally supportable principles as outlined below but is particularly concerned about the trend, again confirmed in this Draft, to increase the administrative burden and costs of complying with international tax rules. This is especially disturbing when one realises that The Netherlands is front runner in the OECD concept of Enhanced relationship between taxpayer and Revenue where both Revenue and taxpayer aim to reduce their compliance burden by increased transparency.

Moreover, VNO-NCW is more than concerned about the lack of consensus between OECD Members in this Draft resulting in the likelihood that no access can be obtained to the MAP procedure if we follow the wording in article 25-1 of the Model Tax Convention ("Model"). After all, art.25-1 does not refer to actions of States resulting in double taxation but rather to "taxation not in accordance with the provisions of this Convention". Consequently, non-alignment of interpretation of the Model means simply no access to dispute resolution; a highly undesirable result in times of rapidly increasing globalisation. Such consequence can be avoided by inserting a reference to "avoidance of double taxation" in article 25-1 as a result of different interpretation of the Model terms by the Contracting States.

VNO-NCW has the following more detailed comments on the Draft.

### **Opening remarks**

The *Discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention*, dated 7 July to 31 December 2008 (the Draft) contains a number of generally supportable principles, such as the preference for the separate entity approach, the move toward alignment with general transfer pricing principles, and the OECD's clear rejection of the Force of Attraction principle. There are, however, areas of significant concern arising from this Draft and earlier OECD papers. The Draft follows on from the *Report on the Attribution of Profits to Permanent Establishments*, dated 17 July 2008, which discussed the application of the Authorized OECD Approach (AOA) to transfer pricing on Art. 7 of the Model Treaty. The text of Article 7 was considered to be inconsistent with the AOA in certain areas, and the Draft was released with the aim of aligning Art. 7 of the Model Treaty with the AOA. Given the historical context for the Draft, what follows is therefore an overview of significant concerns which remain from the Draft, the AOA and the *Report on the Attribution of Profits to Permanent Establishments*, dated 17 July 2008 (collectively the OECD Papers) in relation to Art. 7 of the Model Treaty. Indeed, it is worth noting specifically at this juncture that concerns remain with parts of the AOA, and that certain principles contained therein will have to be subjected to further scrutiny before agreement is reached that the AOA is truly workable at a practical level.

Before turning to specific examples, it is worthwhile noting some of the key uncertainties that exist from a commercial perspective as a result of the OECD Papers.<sup>1</sup>

- The extent to which fiscal authorities will adopt the AOA and the nature of any reservations which may be incorporated in treaties as a result; how domestic law of particular countries may be amended, and the transitional provisions, if any, which may be incorporated. There could be additional complications where an enterprise has more than one PE, as the changes made by different fiscal authorities are unlikely to be synchronised.
- The nature of unforeseen tax charges which may arise as a result of the transition from existing practice to the AOA; and the impact past conduct/documentation may have in formulating the profit profile/ opening balance sheet of a PE under the new regime.
- The practical question of the level of historical evidence that is available to support the businesses view of profit attribution under the new regime (particularly in regard to the economic ownership of intangibles). Indeed,

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<sup>1</sup> One fundamental which is worth bearing in mind for the purposes of what follows is that, from a commercial standpoint, a single enterprise will often have various PEs located in a number of different jurisdictions.

the level of historical evidence sought looks likely to not only significantly increase the compliance burden for business, but to also add to the uncertainty around whether the business has done enough to be adjudged compliant.

- Funding issues for PEs will be exposed to more uncertainties, as no single preferred methodology has been identified by the OECD.
- OECD model treaty commentary changes in regard to the new approach are supposed to not conflict with the previous commentary, but rather to reflect “modern day multinational operations and trade”<sup>2</sup>. However, where the existing commentary no longer reflects modern day multinational operations and trade – which is bound to happen in certain circumstances due to the time differential between when the existing commentary was drafted and the state of play in the current commercial market – it is possible that some changes will in fact impact on the current tax treatment. There is also the issue of ambulatory tax interpretation in instances, for example, where significant people function was not such a significant factor in the past.

The result of the issues noted above, coupled with the comments below, will be a significant increase in transfer pricing work, especially but not only in the initial period when functional and factual analysis is undertaken to establish the economic ownership of various assets etc. An element of uncertainty has also been introduced due to the lack of specific guidance in certain areas. This increased work and level of uncertainty, and corresponding probable requirement for additional resources, is expected to necessitate additional costs for business, a not an insignificant concern in times of economic growth but especially in the current economic climate. Moreover it is likely that review of the compliance documentation requires significant additional and highly skilled staff for Revenue Authorities of OECD Members.

Below we present an overview of specific examples of the more problematic issues identified as a result of the changes outlined in the Draft and the associated OECD Papers. The examples have been broadly split into three parts, issues arising in the areas of Transfer Pricing Methodology, Funding Concepts and Intangibles/ Royalties.

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<sup>2</sup> Clause 4; *Report on the Attribution of Profits to Permanent Establishments*, dated 17 July 2008

## **Transfer Pricing Methodology**

### **Retrospective nature of the required analysis**

A functional and factual analysis is required for implementation of the functionally separate entity approach. It appears that this analysis will need to be retrospective in order to impute commercial terms of dealings in order to ascertain, for example, the economic ownership of intangibles at the date of transition from the previous treatment to the AOA.

There are no guidelines as to how far back a functional analysis would extend in order to determine an appropriate starting position from which to determine economic ownership and such matters under the new approach. Presumably each case will be judged on its merits, and ultimately the evidence will need to be sufficiently robust for all relevant tax authorities to take the same view on matters such as dealings, allocation of risk, value and profit attribution.

The difficulty of this should not be underestimated. Under English law, for example, contracts between two legal entities may sometimes be established in the absence of a written contract by deducing risks and responsibilities from the conduct of the parties and other such factors. However, such contract proceedings can be very difficult, as a court needs convincing evidence in order to determine that there was a 'meeting of the minds' on key terms. Even greater difficulties will be faced by business in regard to the transition to a functionally separate entity approach where no written legal agreements exist and the parts of the enterprise dealt with each other on a non-contractual basis.

The functional and factual analysis is the foundation of the new authorised OECD approach to profit attribution. However the challenges include the absence of written contracts and a contractual 'mindset', only one 'party' and also that the arrangements between Head Office and the PE were probably largely focussed on compliance with prevailing tax law (e.g. apportionment of costs etc rather than a full transfer pricing approach). For these and other reasons it might not be possible to compile a compelling functional analysis to support the future profit attribution methodology in spite of significant resources being deployed. There will also be the need to convince at least two tax authorities to take the same view on whatever evidence is available in respect of supporting the proposed starting position. (Note there may often be more than one PE and the 'allocation' of economic ownership etc may therefore involve several tax authorities.) Previous experience of discussions with tax authorities (e.g. during audits and for APAs) shows that this is a potentially contentious area, even when the functional and factual analysis is based on an existing legal framework. Where no contracts underpin the transaction it is to be expected that there will be even more debate.

In particular there may be little evidence about which part of an organisation bore 'risk' as this is an issue that had little relevance. The rule of law had to

be complied with; attribution and determination of risk was not really relevant in the area we discuss in the Draft. The functional analysis may therefore need to make a retrospective case for where risk was borne based on few facts and little evidence.

The new approach links risk to significant people functions whereas it might have been assumed by business and tax authorities in the past that the Head Office substantially bore the risk in past years because it supplied funding to the PEs and ‘employed’ senior management who were responsible for strategies (though not necessarily for local decision making in accordance with head office guidelines, often made in conjunction with discussions with head office i.e. ‘active decision making’<sup>3</sup>).

### **Separation of business components**

The new approach seems to separately deal with

- Risk (including significant people functions relating to risk),
- Assets (including significant people functions relating to assets),
- Funding

In practice there are links between them. For example although capital might follow risks the net assets position seems a better starting point.

### **Other factors**

Although the report notes that it is not the intention to impose more burdensome documentation, significant resources will be required to establish initial positions and that the robustness of the analysis might be called into question by tax authorities if the evidence is not compelling. This will especially be the case where it is necessary to retrospectively deduce the substance of a dealing e.g. is the transfer of an asset a ‘sale’, ‘lease’ or ‘licence’<sup>4</sup>.

Conclusions will need to be drawn about whether part of the organisation has been acting in a support or other role. For example, whether the conditions were comparable to, say, those of a contract researcher or owner.

As noted, it may be, in practical terms, an insurmountable challenge to unearth sufficient evidence to ensure that the retrospective functional and factual analysis is carried out in a sufficiently thorough and detailed manner as is required.<sup>5</sup> In this respect VNO-NCW suggests that in case OECD

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<sup>3</sup> Clauses 25 and 27; *Report on the Attribution of Profits to Permanent Establishments*, dated 17 July 2008

<sup>4</sup> Clause 234; *Report on the Attribution of Profits to Permanent Establishments*, dated 17 July 2008

<sup>5</sup> Clause 96; *Report on the Attribution of Profits to Permanent Establishments*, dated 17 July 2008

decides to accept retroactivity, the period of such look back is at least defined to a limited number of years (eg. 3 years).

## **Funding**

Turning now to a prime example of an area where significant ambiguity exists under the proposals, namely funding and the resulting attribution of profits to a PE. It seems a safe assumption that the goal of any enterprise is to achieve consistency between the aggregated position under the various new methods and the funding levels shown in the statutory accounts. However, this is probably not possible where an enterprise has a number of PEs in a variety of jurisdictions.

It is difficult, without working through a number of detailed scenarios, to determine whether or not the guidance on funding can actually produce an integrated and workable solution for the following reasons:

- There is no single agreed approach for several key issues e.g. the attribution of free capital or interest bearing debt of an enterprise
- A number of standalone rules, such as those in the PE host tax authority's local legislation, can impact the way that statutory capital is structured
- Differences exist in how adjustments may be made for disallowed interest etc
- The potential flow through impact of a tax adjustment on one part of the enterprise on the other parts of that enterprise will need to be understood in variety of potentially complex scenarios.

A key commercial question is whether the aggregated position of the PEs/branches and Head Office can be reconciled to the statutory accounts/ profit position of the enterprise as a whole, how uncertain the outcome might be, and how much effort will be involved to achieve this.

Regardless of the existence of any statutory 'branch accounts' that might be in existence, effectively a new 'tax' balance sheet will need to be drawn up at the time of transition. This will be based on the retrospective 'functional and factual analysis' that is undertaken in accordance with Part I, and appears unlikely to correspond with the existing branch accounts because the AOA assumptions used for the new tax balance sheet will differ from the historical tax approach used for statutory reporting purposes.

## **Capital Attribution and funding the operations of the PE**

Whether a PE is considered under or over capitalised will depend on the rules and practices in the host country. First the tax balance sheet is determined following the retrospective functional and factual analysis and the resulting functions, assets and risks are valued, subsequently the 'arm's length' amount of free capital needs to be determined for each PE. The level of free capital

will vary assuming different parts of the enterprise conduct different businesses, perform different functions, carry different risks (as a result of significant people functions). It is also unclear at this time how valuations under the AOA, of goodwill for example, will fit with accounting standards and whether a tax authority would base its funding approach on accounting standards or the economic approach used under the AOA?

The consultation process was not able to determine a single agreed approach for attributing free capital. A number of methods were considered (and each can be appropriately applied in certain circumstances). The report therefore simply articulates guidelines as there is no agreed approach for attributing free capital.

Because no single method has been agreed, business is left with a high degree of uncertainty. The use of the relevant Mutual Agreement Procedure (MAP) to resolve such issues is suggested, however, apart from the resources required to take advantage of this process, the outcomes might be uncertain, and may also have flow through effects for the allocation process for other PEs in the enterprise, an effect which may not be acceptable to the host country fiscal authority for the other PE. (We may see the emergence of more tri-angular cases.) Each attribution method in isolation can possibly achieve the result of splitting the funding consistently between the Head Office and the PE. However different methods can be agreed by business and the relevant tax authorities for each of an enterprise's PEs. Thus the aggregated position of the PEs and Head Office will not reconcile for the purposes of a single tax balance sheet, nor the statutory accounts. Unless there is an integrated solution, the taxpayer will likely incur double taxation.

### **Additional Funding Points**

The report also notes that there is more than one method to attributing the interest bearing debt of the enterprise and to determining the rate of interest to be applied to the debt (i.e. in establishing the arm's length amount of interest in the PE). Neither the tracing approach nor the fungibility (allocation of a proportion of funding) approach is fully endorsed as neither is recognised as providing a total solution. Again there is no single approach; it is recognised that some countries might apply tracing, others fungibility, others a mixture of these two methods e.g. tracing for big-ticket items.

'Interest bearing' debt can include internal interest 'treasury dealings' (assuming this is not in relation to free capital) assuming the retrospective functional and factual analysis shows that there are related significant people functions relevant to determining the economic ownership of the cash or financial asset.

## **Intangibles/ Royalties**

The proposals for determining the ownership of shares in, or rights to use of, intangible assets seem likely to provoke significant disagreement between countries. Intangibles are often seen as a noteworthy driver when attributing profits and their allocation has therefore become an increasingly sensitive issue.

The treatment of intangibles was not discussed in the early drafts of the *Report on the Attribution of Profits to Permanent Establishments*. Although a commentary is now included in the final report, establishing the need to retrospectively determine the economic ownership interest of intangibles within a single company will be a challenge for many companies. Again a (retrospective) functional and factual analysis will be required and this no doubt will be influenced by the relatively recent focus on the creation of marketing intangibles.

The emerging view appears to be that economic ownership may be influenced by functions performed not at the level of senior management<sup>6</sup> rather at the level of ‘active management’. However, it might not be sufficient to merely determine the economic owner. It appears likely that a valuation of intangibles interests might be required (e.g. for opening ‘balance sheet’ purposes in assessing financing and for buy-in/buy-out purposes pursuant to a deemed cost contribution arrangement where there are several PE or other economic owners of that intangible). The tax impacts of the ‘acquisition’ or ‘recognition’ of intangibles by a PE will depend on the relevant tax laws and is therefore not addressed in the report. Again, where an enterprise has a number of PEs in a variety of countries, there is a likelihood that different views will be taken by the relevant tax authorities such that the consolidated value for the entity as a whole, whether or not reflected in the balance sheet, might differ from the aggregate of the amounts in the various tax balance sheets. Different treatment under the relevant tax laws may in turn lead to double taxation.

It is notable that withholding tax and similar implications of imputed ‘royalties’ are outside the scope of the report. The report only considers the amount of profit to be attributed, rather than the tax nature of the profit components<sup>7</sup>, but this leaves a significant level of ambiguity for business at this time.

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<sup>6</sup> Clause 118; *Report on the Attribution of Profits to Permanent Establishments*, dated 17 July 2008

<sup>7</sup> Clause 238; *Report on the Attribution of Profits to Permanent Establishments*, dated 17 July 2008

## **Closing Remarks**

There is much to be supported in the general approach taken by the OECD, however significant, basic and detailed review needs to take place. Furthermore, VNO-NCW urge OECD to seek consensus in detail on all issues before finalising and publishing a new commentary to article 7 in particular and to the OECD Model in general.

This Draft requires a significant change to avoid deterioration of the tax climate by increased the compliance costs for the taxpayer and the review and assessment costs for the Revenue Authorities amongst OECD Members. The additional costs, plus the inevitable uncertainty of outcome in respect of many issues, will undoubtedly cause commercial harm going forward; this is structural and not limited to the current financial climate.

There is a real risk that the proposals in their current form will result in increased double taxation, which fundamentally brings into question the scope of the obligation to relieve double tax. After all, paragraph 6 of the Introduction in the July 2008 version of Model Tax Convention refers as the aim of the Model to “effectively resolve the double taxation problems existing between OECD Member countries”. The current Draft has set a first step in a long journey to achieve consensus and clarity. We trust it will not be a journey leading to double taxation.

VNO-NCW is much prepared and willing to work together with the OECD to undertake the review and work together to achieve a lasting result: providing clarity, reduced occurrences of friction between OECD Members and most noteworthy, no double taxation at lower compliance costs than taxpayer and Revenue have today.

Yours sincerely,

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