

C/M/S/ Bureau Francis Lefebvre

CMS Bureau Francis Lefebvre

1-3 Villa Emile Bergerat,
92522 Neuilly-sur-Seine Cedex, France

T : +33 1 47 38 55 00
F : +33 1 47 38 55 55
info@cms-bfl.com
www.cms-bfl.com

Via e-mail

OECD Committee on Fiscal Affairs
For the attention of Mr Jeffrey Owens
jeffrey.owens@oecd.org.

Neuilly-sur-Seine, December 30, 2008

Subject: Comments on the Discussion draft on a new Article 7 (Business Profits) of the OECD Model Tax Convention

Dear Mr. Owens:

CMS Bureau Francis Lefebvre welcomes the proposals made by the OECD Committee on fiscal affairs but wishes to respectfully submit the following comments in response to the OECD's Discussion draft on a new Article 7 (Business Profits) of the Model Tax Convention.

1. Article 7 (Para. 3)

The new Model Convention would introduce the idea of "*free capital*", "*capital that does not give rise to a return in the nature of interest that is deductible in the first [...] State*". This would be a new concept, especially for enterprises other than banks.

We are however concerned by such proposal as we fear that it would result in double taxation. Most likely, the tax administration of the country of residence of the enterprise will disagree with the State of the PE as such concept is likely to be unknown in its domestic law; in addition, if it is known, it is very likely that it will be based on different criteria than those of the State of the PE.

Taking into account that neither the proposed new article nor the proposed Commentary sets forth the method that would be used for computing the amount of free capital that could reasonably be attributed to a PE, especially to non-banks, and that the proposed solution is non-binding for the competent authorities of the two States, we believe that the proposal is likely to increase the uncertainty for taxpayers.

Our preference would henceforth be to apply this concept only to banks for which it has a real meaning.

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Siège social / Head Office: CMS Bureau Francis Lefebvre – Avocats au Barreau des Hauts-de-Seine – 1-3, villa Emile Bergerat 92522 Neuilly-sur-Seine Cedex
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2. Commentaries on Article 7

(i) Para. 19: *"a functional and factual analysis is undertaken which will lead to [...] the identification of significant people functions relevant to the attribution of economic ownership of assets"*.

In this commentary, as well as in the Report on the Attribution of Profits to Permanent Establishments, we note that there is no special provision in order to deal with the particular situation of shares, for instance where shares are recorded as an asset of a PE.

Since the mere holding of shares does not require any people functions, we think that they should not be relevantly classified among other assets. We believe that recording the shareholding in the books of the PE adequately materialises the company's intention to give to the PE the economic ownership of shares.

Allocating the shares to the head office or to the PE should, in our view, be the free decision of the enterprise. We accordingly disagree with the statement against this position contained in Para. 32 of the Commentary on Article 10: we believe that the assertion against this position creates insecurity for taxpayers.

(ii) Para. 20: *"The application by analogy of one of the Guidelines' traditional transaction methods or, where such methods cannot be applied reliably, one of the transactional profit methods to arrive at an arm's length compensation [...]"*.

The OCDE is currently conducting a thorough review of the transactional profit methods - see, for instance, discussion draft 25 January 2008 - that could lead to modify the hierarchy between the different methods.

We therefore believe that the precision *"where such methods cannot be applied reliably"* should be deleted and rather replaced by a general reference to the results of this reflexion; it is preferable indeed that all conclusions are in line when they are all published.

(iii) Para. 23: *"Thus, for example, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits."*

This comment does not really increase security. For instance, in many jurisdictions, there is no obligation for the enterprises to have a contemporaneous documentation. In addition, when a taxpayer considers having no PE in a given country, no contemporaneous documentation is prepared. Finally, our view is that in case of a tax audit, due to the absence of documentation, the tax authorities might refuse to take into consideration certain "dealings".

(iv) *"Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that [...] the dealing presented in the taxpayer's documentation does*

not violate the principles of the approach put forward in the Report by, for example, purporting to transfer risks in a way that segregates them from functions."

We would like to stress that it is commonplace that two distinct entities transfer risks to each other without transferring functions (i.e. insurance contract, change coverage, factoring). It would not be appropriate to disregard the same possibility between the head office and the PE (and it would create additional insecurity).

(v) Para. 25: We understand from this Commentary that there should be a different treatment, regarding an asset, whether it is used or transferred.

If an asset (tangible or intangible) of the head office is used by the PE, the PE could deduct a notional payment for this use, but that notional payment could not be treated as an income of the head office under another article of the Model Convention and should accordingly not trigger a withholding tax.

On the contrary, in case of a transfer of asset between the PE and the rest of the enterprise, the appropriate article of the Model Convention would apply, because a change in use of an asset can be characterised as a "dealing" with the rest of the enterprise.

The combination of these commentaries is unclear and raises some questions; for instance, is it so even if the PE does not transfer (or receive) any cash for the asset? And if the PE benefits from the transfer without compensation, could this be viewed as an equity contribution to the PE?

(vi) Para. 28: *"Thus, [...] it is likely that the amount of taxable income on which an enterprise of a Contracting State will be taxed in the State where the enterprise has a permanent establishment will, for a given period of time, be different from the amount of taxable income with respect to which the first State will have to provide relief pursuant to Articles 23 A or 23 B."*

Our view is that the words *"for a given period of time"* should be deleted because they give the impression that the OECD considers that the difference will not last. On the contrary, our experience shows that there are permanent differences in the treatment of expenses.

With kind regards

CMS Bureau Francis Lefebvre