PUBLIC COMMENTS RECEIVED ON THE DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS – PART I (GENERAL CONSIDERATIONS)[1]

Taxation Committee of ICC United Kingdom

Comments on the Discussion Draft on the "Attribution of Profits to Permanent Establishments"

1. I have been asked to write to you on behalf of the Taxation Committee of ICC United Kingdom with our comments on the Discussion Draft. ICC UK is a body which represents a wide range of major industrial and commercial companies in the UK, together with many major accountancy and law firms and other professional organisations. The Taxation Committee has more than 140 members from such organisations.

2. In the comments which follow we have focused only on areas where we disagree with either the approach adopted or conclusions set out in the Discussion Draft.

General Approach of the Discussion Draft

3. Our first major area of concern is as to the fundamental approach adopted in the Discussion Draft. Whilst it is ambitious to put forward the "working hypothesis" as to what is regarded as conceptually the preferred approach for attributing profit to a permanent establishment under the business profits articles of double taxation treaties, the Discussion Draft is seriously inadequate in its consideration of how such an approach is actually to be implemented in OECD countries. The way in which permanent establishments are actually taxed depends on a complex interaction of double taxation treaty provisions with domestic tax laws concerning the taxation of branches. Such domestic laws vary significantly from country to country within the OECD.

4. The adoption of the approach indicated in the working hypothesis in a number of areas, will require amendment to the business profits articles and other relevant provisions of the applicable double taxation treaty and also amendments to domestic tax laws in order to ensure that they also operate in the way envisaged by the working hypothesis. This is notably the case in the choice between whether the "relevant business activity" or "functionally separate enterprise" approaches should be applied and in seeking to impute profits to a mere purchasing function carried on by a permanent establishment. The renegotiations of existing double tax treaties to include the necessary amendments together with making appropriate changes to domestic legislation to harmonise their operation with the approach of the working hypothesis will represent an enormous task for OECD countries and it is difficult to envisage that this could be successfully completed in the foreseeable future.

---

1. Please note that comments received on the "Discussion Draft on the Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions" are ***also*** included in this document, as these comments may also be of interest when examining Part I of the Discussion Draft on the Attribution of Profit to a Permanent Establishment.

5. It should be particularly noted that it will be wholly unacceptable to seek to implement the approach of the working hypothesis by simply revising the commentary to the OECD Model Convention and the OECD Transfer Pricing Guidelines. It is not accepted that changes to the Commentary to the Model Convention can change the way in which double taxation treaties apply so as to increase a taxpayer's liabilities from that which applied when the relevant treaty was originally negotiated. As is noted later in these comments, the implementation of the working hypothesis could lead to substantial increases in tax liabilities, as compared to the current position in many instances. This will be regarded as wholly unacceptable in the absence of actual renegotiations of the treaty terms.

6. A more realistic approach than that adopted by the working hypothesis would be to seek a consensus as to a common interpretation of the existing business profits article of the OECD Model Convention.

The "Relevant Business Activity" and "Functionally Separate Entity" Approaches (Paragraphs 14 to 37)

7. We disagree with the conclusion that the "functionally separate enterprise" approach is to be preferred to the "relevant business activity" approach for two reasons. Firstly, we consider that the relevant business activity approach with a broad interpretation of the meaning of business activities is the only correct interpretation of the existing wording of Article 7, paragraph 1 of the Model Convention and, correspondingly, many double taxation treaties. Secondly, the operation of the functionally separate enterprise approach as envisaged in the Discussion Draft will lead to a totally inequitable result in many instances. A company could incur substantial tax liabilities through a permanent establishment in a particular country even though the overall business activity of which the permanent establishment is part may be incurring large losses or where the company has not actually undertaken any transactions at that stage with third party customers/clients. This could result in major increases in tax liabilities for companies as compared to the existing situation.

8. It is not considered appropriate to regard a permanent establishment as exactly equivalent for tax purposes to a separate subsidiary company in all instances. Whilst it is accepted that branches should not be subject to discriminatory taxation, as compared to separate subsidiaries, the approach to taxing permanent establishments should reflect the practical differences between the two forms of business organisation. A separate subsidiary company is a deliberately created structure such that the multinational enterprise can expect to have to follow the consequences of the structure they have created. The taxation of permanent establishments, however, will often represent the artificial division of what is a single global enterprise in order to ascertain the taxing rights of the countries involved in its operation and this may not accord with any deliberately created structure. This is particularly the case where a permanent establishment is deemed to exist, such as where a single travelling salesman has authority to conclude contracts or a single employee providing services to a client creates a permanent establishment through the occupation of particular space in the client's premises for an extended period. The operation of the functionally separate enterprise approach in such instances would often give rise to taxation results which widely diverge from the actual business results.

9. For the above reasons, the relevant business activity approach is considered to be the only approach which can give taxation results properly reflecting the actual business activities.

Oversight Functions of Head Office (Paragraph 126)

10. We do not consider that any of the oversight functions of a head office should be treated as analogous to activities undertaken in the capacity of a shareholder in the multinational enterprises group context, as distinct from activities analogous to those of a service provider. As was indicated in the

previous section relating to the "relevant business activity" and "functionally separate enterprise" approaches it is not appropriate to consider a permanent establishment to be equivalent to a separate subsidiary company for taxation purposes. In practice the activities of the head office and the permanent establishment will frequently be closely integrated and such oversight functions an essential part of the costs of the activity of the permanent establishment.

Internal Interest Dealings of Non Financial Institutions (Paragraphs 157 to 161)

11. We are concerned as to the conclusions that "non financial institutions should not impute interest on internal movements of funds, but that there should instead be an attribution of an appropriate amount of the actual interest expense of the whole enterprise. The difficulty with the suggested approach is that it will often not accord with the actual accounts which will be prepared for the branch of a non financial institution. This concerns, in practice, the branches of general manufacturing and trading companies and other types of business outside of the financial sector. The branch accounts of such companies will already typically take account of the small movement of funds in relation to the provision of goods and services within the enterprise. These would represent ordinary trading balances on which interest would not normally be charged unless left as outstanding for periods beyond normal credit terms. There may, however, also often be actual loans between the head office or other branches of the enterprise and a particular branch. Branch accounts will often reflect an arm's length interest charge in such instances. The logical approach for the working hypothesis would be to follow the accounts in such cases as this will give the simplest and most logically acceptable approach. The suggestion in the Discussion Draft that an appropriate amount of the actual interest expense of the total enterprise should be attributed in such cases would give rise to a need for complex calculations involving information from a number of different countries and would be directly contrary to one of the objectives of simplifying the taxation of permanent establishments.

Attribution of Profit to a Permanent Establishment by Reason of the Mere Purchase of Goods or Merchandise for the Enterprise (Paragraphs 181 to 183)

12. We would strongly disagree with the opinion of member countries of the Steering Group that the current prohibition of the attribution of any profit to such activities in Article 7(5) of the Model Convention is not consistent with the arm's length principle and is not justified.

13. Case law on the taxation of branch activities in a number of countries does not attribute profit to such a purchasing function. This is because it is recognised that it is the selling activity which fundamentally creates the trading profit. The suggested approach would be directly contrary to such normal practice.

14. The implementation of the suggested approach would also lead to inconsistencies between what are, in practice, equivalent structures. For example, two identical purchasing functions could give rise to completely different tax results. There is no logical reason why a purchasing function which is combined with other business activities should give rise to an attribution of taxable profits where carrying on the function in an identical way but separated from the other business activities gives rise to no liability.

15. Paragraph 182 refers to the fact that there is little difference in principle between the purchasing of goods or merchandise and the other activities set out in Article 5(4) of the Model Convention, such as the collection of information, which are not sufficient by themselves to create a PE. We agree with this conclusion, but the logical action flowing from it would be to **extend** the scope of paragraph 5 of Article 7 to also cover these other activities within Article 5(4) rather than remove this article. This would avoid the

need for companies to divide up such activities amongst separate companies and locations to avoid creating a taxable permanent establishment.

Implementation

16. As noted at the beginning of this letter the Discussion Draft is inadequate in not having fully addressed how the ideas it is putting forward are actually to be implemented in OECD countries. As indicated there, we would recommend a fundamental review of the viability of the working hypothesis approach as it is considered to be too ambitious to be able to achieve actual implementation in the foreseeable future. A more limited agenda with full consideration of what steps will be needed in each OECD country in order to implement the changes would be a preferred approach.