Tax Treaties, Transfer Pricing and Financial Transactions Division
Centre for Tax Policy and Administration
Organisation for Economic Cooperation and Development
By email

PROPOSED ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

4 September 2016

Dear Sir / Madam,

By means of this letter, EY would like to share its comments on the public discussion draft on "BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments" (the Discussion Draft) as released by the OECD on 4 July 2016. We appreciate the opportunity to provide comments and to contribute to the public consultation and discussions regarding the guidance on the attribution of profits to permanent establishments (PEs). This letter presents the collective view of EY's global international tax network.

Our comments with respect to the Discussion Draft are structured two-fold. First, we provide our overarching comments to the Discussion Draft which we consider to be relevant in addressing issues that are not covered by the specific questions raised to the public commentators, as well as to frame an accurate response to those questions regarding the profit attribution to PEs under the fact patterns and examples provided in the Discussion Draft. The second section contains our responses to the specific questions raised by the Discussion Draft in connection with the examples provided.

We emphasize our concerns detailed below about a proliferation of PEs with limited to no profit attributed to them. This will create a major compliance burden for both multinational taxpayers and tax administrations, while increasing the risk of double taxation. This effect (whether intended or not) clearly goes beyond the potential base erosion and profit shifting (BEPS) activities that are the focus of the OECD's BEPS project and creates additional burdens on both the taxpayer and tax administration with no corresponding benefit for either party.

If you have comments or questions, please feel free to contact any of the following:

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Yours Sincerely,
On behalf of EY

John Hobster / Ronald van den Brekel

1. General comments to the Discussion Draft

Zero-profit PEs

It is expected that the lowered PE threshold of Article 5 of the Model Tax Convention (MTC) will result in an increase in situations where a taxpayer may have created a PE. The Discussion Draft recognizes that in some cases a taxpayer may have a so called "zero- profit" PE i.e. a PE where no profits are attributed to because there are no significant people functions performed by the PE. Further, the Discussion Draft acknowledges the additional compliance burden on the taxpayer that will result from the increased number of PEs, as well as the fact that other tax liabilities could also arise in connection with the creation of a zero-profit PE. This increased compliance burden is not only limited to the taxpayer, but also creates additional resource constraints on tax administrations that have to deal with the increased administrative burden in return for little or no additional taxable profits.

Clearly, such an outcome benefits neither the taxpayer nor tax administrations. As such, we urge the OECD to consider a pragmatic approach for dealing with zero-profit PEs. One possibility would be to provide an exemption to the creation of a PE if it is clear that no profit would be attributable to such PE under Article 7 of the MTC. In other words, a zero-profit PE should not be considered a PE, and therefore not trigger any filing or other administrative requirements. If this matter will not be solved by a further modification to Article 5 of the MTC, we urge the OECD to encourage tax administrations to address this by allowing an exemption for zero-profit PEs unilaterally through their domestic tax legislation. Such an action does not contradict the focus of the OECD's overall BEPS project and would reduce the barrier on cross-border trade and investment created by the lowered threshold for the recognition of PEs under Article 5 of the MTC.

We support the guiding principle that the allocation of profits to PEs should be based on people functions only. From a policy perspective, no profit should be attributed to a PE without people functions and therefore these situations should be exempted from PE status to prevent the proliferation of zero-profit PEs that do not benefit the taxpayer or the tax administration.

Coordinated application of Article 7 and Article 9 of the MTC

We are concerned about the possible negative side effects in the form of double taxation that may arise if a tax administration may disagree, or arrive at a different conclusion, when applying a singular analysis under either Article 7 or Article 9 of the MTC without considering the overall outcome that would result if an analysis under Article 7 and Article 9 of the MTC is performed in parallel, e.g. when a tax administration adjusts the profit of an dependent agent entity (DAE) without adjusting the profit of the dependent agent PE (DAPE).

Therefore we recommend further guidance be provided to tax administrations to ensure that a coordinated application of the analyses under both Article 7 and Article 9 of the MTC must be performed when examining a DAPE or DAE. Furthermore, taxpayers should be guaranteed access to dispute resolution mechanisms available and that access should not be restricted for reasons such as a reversal of burden of proof, or incorrect corporate income tax filing claims that may arise from a disagreement as to how Article 7 or Article 9 of the MTC have been applied.

Pre-2010 Article 7 of the MTC

The Discussion Draft asked what would be the conclusion if a profit attribution approach other than the 2010 Authorized OECD Approach (AOA) is applied. We have understood this to mean the OECD approach used pre-2010. As the OECD itself acknowledges that few countries have adopted the 2010 version and are unlikely to adopt the 2010 version in the future, we believe it is very important for the OECD to provide concrete guidance on situations where countries apply pre-2010 versions of Article 7, including but not limited to clarifying the application of the 2008 version of the AOA to pre-2010 versions of Article 7.

Clarification on the goal of the Discussion Draft

It is not entirely clear whether the guidance in the Discussion Draft will be included in further commentary to Article 7 of the 2010 MTC, or whether the guidance in the Discussion Draft will be incorporated in a future update to the OECD's 2010 Attribution of Profits Report. As such, clarification on this point would be helpful.

Use of examples

Although the use of various examples throughout the Discussion Draft is very useful in illustrating how profits should be attributed to DAPEs and fixed place of business PEs, additional guidance ought to be provided as well for other PEs not covered by the Discussion Draft. In particular examples illustrating how profits should be attributed to:

- PEs created by the application of the new "anti-fragmentation rule";
- DAPEs that provide services under ongoing contracts. In particular, should profits be attributed for periods following the period that the initial DAPE was created? The OECD should clarify the approach over the period of the service provision and whether the DAPE may deemed to have ceased to exist after the initial recognition criteria for the DAPE have been met; and
- DAPEs created by an entity that centrally performs activities on behalf of multiple local entities. The current Discussion Draft focuses on a local sales entity (SellCo) acting on behalf of a central entity (Prima) and thereby creating a DAPE of the central entity. However, multinationals today are also characterized by global organizational structures whereby certain activities are performed centrally on behalf of a number of local entities. Procurement and key account management are classical examples. Since under the new Article 5 those activities may potentially create DAPEs of the local entities in the country where the central activity happens, it would be helpful to have an example in the Discussion Draft.

Clarification on how the internal dealings were characterized is required, specifically for those examples relating to DAPEs. In Example 1, the construction of the profit and loss statements seems to presume that the dealing between the DAPE and the head-office is that of a buy-sell transaction as the sales in Country B were attributed to the DAPE. However, the facts of Example 1 are such that the dealing between the DAPE and head-office could also be seen as the provision of sales agent services. Example 1 contains no explanation as to why the dealing should not be seen as the provision of sales agent service. For completeness, the OECD should provide more guidance on the criteria used to characterize the internal dealing between the DAPE and the head-office since this

ultimately affects the construction of the hypothetical profit and loss statement of the DAPE and the determination of the most appropriate transfer pricing method.

Application of profit attribution guidance to the financial sector

Paragraphs 19-20 of the final version of the Report on Action 7 indicated *"…that there is a need for additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in this Report, in particular for PEs outside the financial sector."* Does this mean that the profit attribution guidance in the Discussion Draft would also apply to PEs created in a financial sector context, or does the OECD take the view that the attribution of profits in a financial sector context is sufficiently covered by the 2010 Attribution of Profits Report?

2. Response to specific questions

Question 1. Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.

We believe an analysis under Article 9 should first be conducted, as the analysis under Article 7 can only be concluded after an arm's length business transaction attributable to the DAPE has been determined under Article 9. A key starting point for an Article 9 analysis involves analyzing the contractual relation between the DAE and its counterparty. This is a critical component if the dealing between the DAPE and the head-office is to be hypothesized properly so that a proper analysis under Article 7 can be carried out. We recommend that the OECD provide guidance on this.

Question 2. Do you agree with the functional and factual analysis performed in Example 1 under the AOA?

We agree with the functional and factual analysis performed in Example 1 under the AOA subject to our general comments above on the need for further clarification on how the dealing has been characterized and the basis for allocating sales to the DAPE.

Question 3. Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?

We have two questions/observations here:

(a) Should the external sale be attributed to the DAPE (as a hypothesized entity) as a buy-sell dealing between the head-office and the DAPE, or should the external sale be attributed to the head-office, such that the DAPE is hypothesized as a sales agent (i.e., just as SellCo)?

(b) Attributing external sales to the P&L of the DAPE in case of SellCo not performing any functions that go beyond a sales agent might tempt tax administrations to attribute more than a sales agent remuneration to the DAPE.

Ad (a):

Paragraph 36 of the Discussion Draft states that the external sale is attributable to the DAPE, but no criteria supporting the attribution are presented. Although it appears plausible to attribute the external sale to the DAPE (given that it is the sales activity of SellCo that gives rise to the DAPE under Article 5) it is also equally possible under the right facts and circumstances to hypothesize the DAPE as a sales agent (given that the AOA requires hypothesizing the DAPE as a separate entity) especially with the lowering of the DAPE bar to include entities simply taking the lead role in negotiations. Attributing the external sale to the DAPE may be correct in Examples 2 and 3 (where SellCo acts like a buy-sell distributor), but in Example 1, SellCo does not perform any functions that go beyond what a sales agent would do in transactions between unrelated parties. In other words, SellCo in Example 1 "walks, talks and acts" like a sales agent. In this case, hypothesizing the DAPE as a sales agent would be in line with the AOA. If unrelated parties can have sales agent arrangements, why should a DAPE not be able to have this arrangement under the AOA? Moreover, the 2010 Attribution of Profits Report (paragraph 230 – 245, in particular paragraph 244) does not include any reference to a mandatory attribution of the external sale to the DAPE.

The OECD should provide more guidance on the attribution of the external sale to the DAPE, as this step is critical for three reasons:

- The attribution of the external sale determines the profit and loss construction of the DAPE, and hence the construction of profits. It is technically doubtful whether the profit of the DAPE can still be zero if the DAPE is hypothesized as a buy-sell entity, while the local agent entity is a sales agent.
- Some countries require a full accounting set-up even for a DAPE. Costs for implementing and running a full transactional accounting set-up for a (hypothesized) buy-sell entity are significantly higher than for a (hypothesized) sales agent.
- Characterization of the dealing between the head office and the DAPE is a prerequisite for applying the second step in the AOA, i.e., determining which transfer pricing method is the most appropriate method for setting the arm's length price for the dealing.

Ad (b):

The DAPE is hypothesized as a buy-sell entity reporting sales and cost of goods in its (hypothesized) profit and loss statement. At the same time, the example states that no assets, risks, and capital are attributable to the DAPE. If receivables, payables, or inventory were allocated to the hypothetical P&L of the DAPE, tax administrations might be tempted to argue that an additional funding return (similar to Example 2) would also need to be allocated to the DAPE which is not absorbed by the commission payment (i.e. the payment made to SellCo whereby the expense is then allocated to the DAPE), since that commission payment clearly does not include a funding return due to the fact that SellCo does not own any assets.

While the end result of the construction of the P&L is correct (i.e. zero-profit), we question whether the external sales amount should be allocated to the DAPE. The OECD should provide further guidance on the two conceptual issues discussed above.

Question 4. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

It is assumed that the wording of Article 7 referred to here is the pre-2010 version of Article 7 of the MTC.

The differences between the pre-2010 version and 2010 version of Article 7 of the MTC are in what might constitute a dealing. With the 2010 version of Article 7, and the full application of the AOA, this will include any occasion where a real and identifiable event has occurred (paragraph 134 of the 2010 Attribution of Profits Report). The only limitation to what might constitute a dealing is whether the dealing is of economic significance. In other words a threshold is applied.

The pre-2010 version of Article 7 of the MTC places greater restrictions as to what might constitute a dealing. This is partly due to an interaction of paragraphs 2 and 3 of the pre-2010 Article 7 which inter-alia limit the recognition of a dealing for general management functions and licenses for intangibles within an enterprise.

The question is how this difference between the pre-2010 and 2010 version of Article 7 of the MTC will affect the facts sets out in Example 1. In our view, much of the analysis for a hypothesized entity will remain the same. For the analysis it would be important to understand which dealings are to be recognized, but since there are no general management nor intangible dealings, the outcome would not be different under the pre-2010 Article 7. Given the number of treaties based on the pre-2010 Article 7, we recommend the OECD provide explicit guidance on this.

Question 5. In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?

If an arm's length price has been paid to the DAE under Article 9, then we agree that no further profits should be attributed to the DAPE in cases illustrated by Example 1.

Question 6. Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?

In Example 2, applying the guidance of BEPS Action 8-10 will first result in the commission payment due to SellCo already including a reward for the risks deemed to be assumed by SellCo but are contractually borne by Prima. This basically extinguishes the profits otherwise attributable to the DAPE, except for the funding return.

Example 2 raises three questions:

(a) Has the DAPE been correctly hypothesized as a buy-sell entity? (see our comments to Question 3)

(b) Has the guidance of BEPS Action 8-10 been applied correctly?

(c) Has an adequate funding return been calculated?

Ad (a):

Given that SellCo in Example 2 performs additional functions, e.g., it manages inventory levels and customer receivables risk, it is correct to hypothesize the DAPE as a buy-sell entity.

Ad (b):

Under the guidance on BEPS Action 8-10, SellCo has to be remunerated for assuming the inventory and accounts receivable risks. It is also allocated the financial consequences of these risks materializing (i.e. bad debt losses and inventory losses).

Ad (c):

It seems as if the funding return in Example 2 is only calculated based on the inventory allocated to the DAPE. As a hypothesized buy-sell entity owning inventory, we would expect that in addition to inventory, customer receivables and inter-company payables would be allocated to the DAPE. Therefore, the funding return as calculated in Example 2 would also need to take into account the total working capital balance (i.e. receivables plus inventory less payables).

Question 7. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

Our response to Question 4 is also applicable to the fact pattern in Example 2. In summary, the differences between the pre-2010 and 2010 version of Article 7 of the MTC should not have an effect on the fact pattern presented.

Question 8. In your opinion, what would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?

If SellCo does not have the financial capacity to assume these risks, then the party that has the capacity to bear and manage those risks under the functional analysis should be allocated those risks. Based on an Article 9 analysis, the risk would be allocated to SellCo, assuming SellCo has the financial capacity to bear the risk, because Prima does not manage those risks. If SellCo does not have the financial capacity to bear these risks, they cannot be allocated to SellCo. As a result, we have a situation where neither of the parties can be allocated the risk because one did not have control of the risk (Prima), while the other did not have the financial capacity to bear the risk (SellCo). However, this is not an Article 7 issue, but an Article 9 issue, addressed in paragraph 1.99 of the OECD Guidelines. The mere fact that for Article 7 purposes the functions performed by SellCo are relevant for the attribution of profit to the DAPE does not mean that the control performed by SellCo can be allocated to Prima for Article 9 purposes.

Question 9. What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?

Paragraphs 230-245 of the 2010 Attribution of Profits Report are related to the possibility of the DAE performing significant people functions related to risks and assets which are contractually borne by the non-resident enterprise. In those examples, the profit associated with the risks managed/controlled by the DAE would have to be allocated to the DAPE, while the DAE would not be remunerated for those risks as it does not legally bear the risks. In giving these examples, the OECD was assuming that the commission paid to the DAE did not include a remuneration for the risk control functions performed by the DAE. In other words, paragraphs 230-245 of the 2010 Attribution of Profits Report did not yet take into account the guidance for risk allocation under Action 8-10.

Any further update to the 2010 Attribution of Profits Report will need to include substantial revisions to paragraphs 230-245 to reflect the guidance of BEPS Action 8-10.

Furthermore, although the conclusion that the economic ownership has to be attributed to the DAPE might be correct based on the current guidance of the 2010 Attribution of Profits Report, we question whether the outcome is desirable from a tax policy perspective. The effect of it is that profit – the investment return – is attributed to the source country, without any significant people functions performed by the entity itself. As a result, international business – and tax administrations - would be confronted with a myriad of PEs, with limited extra benefits for source countries. It would be more practical to clarify that no profit can be attributed to a (DA)PE, unless people functions are performed by the entity itself. If there are zero profits to be allocated to the DAPE, then taxpayers should be exempted from having a PE and the compliance burden associated with it.

Question 10. Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?

In Example 3, the DAPE is created by virtue of the sales activities performed by an employee, and not by a DAE. Similar to Examples 1 and 2, the DAPE is hypothesized as a buy-sell distributor due to the functions of the employee being similar to functions performed by SellCo in Example 2.

The main difference between Example 3 and Examples 1 and 2 is that there is no related entity in the country which has to be remunerated in line with the Article 9. Hence, there is no interplay between Article 7 and Article 9 in Example 3. While in Example 2 the commission payment made by Prima to the DAE basically extinguishes the profits attributable to the DAPE (except for the funding return), this is not the case in Example 3 where the commission payment to the DAE is replaced by a salary payment to the employee creating the DAPE. As the salary payment to the employee is not subject to an analysis under Article 9 of the MTC, there will typically be positive or negative profits attributable to the DAPE in case of situations similar to Example 3.

Question 11. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

Our response to Questions 4 and 7 is also applicable to the fact pattern in Example 3. In summary, the differences between the pre-2010 and 2010 version of Article 7 should not have an effect on the fact pattern presented.

Question 12. Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?

We believe that the outcome of the analysis in Example 4 is not correct and would also create unnecessary practical difficulties. Once it has been established that under article 9 the risk allocation to Prima should be accepted, and the related control functions of Prima are performed by employees of Prima at the head office only, no profits should be allocated under article 7 to the DAPE. The DAPE is not performing any significant people functions. The functions performed by SellCo as the DAE have been adequately remunerated under Article 9.

Question 13. Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?

We agree that the profits in example 4 result from a partial attribution of risk to Prima's DAPE while the contractual risk allocation between Prima and SellCo was respected in the first place. However, as indicated in the answer to Question 12, we do not agree that this is the correct answer.

Question 14. Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?

We agree that the end result of the construction of the P&L in Scenario A of Example 5 is correct as it essentially reflects the reward for the economic ownership of the asset and the routine functions performed at the warehouse. However we question if under the AOA, the dealings constructed to

compensate WRU for the granting of rights to the intangibles used by the PE, the services in analyzing inventory provided to the PE, and the compensation for investment advice, are necessary in this fact pattern.

Step 1 of the AOA is to identify the internal dealing between WRU and its PE, and where the significant people functions are performed relating to the assets used and risks assumed.

In this case, WRU performs all the significant people functions relating to the business and risk in Country A. It is also the legal and economic owner of all intangibles relating to the warehousing activity. There are no significant people functions performed in Country W. There is only a warehouse that is used by WRU to hold the spare parts of its third party customers through which WRU partly carries on its business in Country W. Based on this fact pattern, the internal dealing between WRU and its PE should be constructed as the supply of the warehouse (as an economic asset of the PE) for WRU to provide inventory holding services to its third party customers, as well as the provision of related warehousing services provided by the PE to WRU's head-office. It would then be necessary to price this dealing and attribute to the PE a reward it for its (i) economic ownership of the warehouse and (ii) for the routine warehousing services performed. The end result of the profits in WRU's PE will be the same, however the construction of the profit and loss statements of WRU's PE to arrive at this outcome, will differ.

Additionally, we question whether the third party service transaction should be attributed to WRU's PE in this scenario, given that the outsourcing of these services has not been performed by WRU's PE in Country W, but have been performed by WRU's employees in Country A and therefore properly attributed to the head office and not the PE.

Question 15. Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?

We agree that WRU's PE should be attributed profits that reflect a return for the warehouse (asset) attributed to it and the routine functions it performs for WRU and that in this case, it would be correct not to attribute any of the third party fee income to WRU's PE since all significant people functions relating to this have been performed by WRU in Country A. Notwithstanding this, the dealing between the WRU and its PE should be clearly identified in step 1 of the AOA analysis. With respect to the return for the asset we refer to our answer to question 16 and 17.

Question 16. In particular, do you agree that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?

Question 17. Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?

We agree that in certain situations, based on the 2010 Attribution of Profits Report, economic ownership can be attributed to a PE, e.g. based on the use of tangible assets or the attribution of people functions performed by a DAE, without any people functions being performed by the PE. As indicated in our response to Question 9, we question whether the outcome is desirable from a tax policy perspective. It would be more practical to clarify that no profit can be attributed to a (DA)PE, unless people functions are performed by the entity itself. If there are zero profits to be allocated to

the DAPE, then taxpayers should be exempted from having a PE and the compliance burden associated with it.

Furthermore, paragraph 19 of the 2010 Attribution of Profits Report states that the consequences of attributing the economic ownership of assets under Step 1 for determining profits to be attributed under Step 2 may depend upon the type of asset and the type of business for which the asset is used. For example, economically owning a tangible asset used in a manufacturing process does not necessarily mean that the income from selling the goods produced using the asset are automatically attributed to the economic owner of the asset. This raises the question as to what level of return should be allocated under Article 7 to a PE that only has a mere economic ownership of an asset but does not perform any people functions.

Question 18. Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.

If there are no personnel operating at the fixed place of business PE, and significant people functions are performed by other parties in the jurisdiction of the PE for their own account, then these functions should not lead to the attribution of risks or assets nor profits to the PE.

Question 19. Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits to the PE of WRU?

This should not make any difference to the profit attribution outcome for the PE.

Question 20. What would the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

This concerns Example 5. Much of our answer to Question 4 is applicable here, although in scenario A, dealings to compensate the head-office for intangibles and for investment advice, may not be recognized under the pre-2010 Article 7. If the dealing would be determined as a warehousing service by the PE for the head-office, the dealing could be recognized. This stresses the importance of correctly determining what the dealings are, and whether the PE as a hypothesized entity would be allocated the sales income (with intangible and investment advice dealings from the head-office) or whether the head-office would be allocated the sales income (with the PE providing a service dealing).

Paragraph 35 of the commentary confirms that where the services of the PE are the same as supplied in the ordinary course of the enterprise's business or part of it that it will usually be appropriate to include a charge at the same rate applied to third party customers. Paragraph 36 then confirms that arm's length charges may be made in the attribution calculation where the services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise. These tests are different to that of the 2010 Article 7 threshold and may be seen it is suggested as less requiring of an arm's length price.

Question 21. Do commentators have suggestions for mechanisms to provide additional co-ordination for the application of Article 7 and Article 9 of the MTC to determine the profits of a PE, taking into account the considerations expressed above?

Coordination of the application of Article 7 and Article 9

The OECD should expressly state that tax administrations should not singularly apply either an Article 7 or Article 9 analysis upon their examination of the profits to be attributed to a taxpayer, but instead a coordinated and parallel examination should be performed. We are concerned about the possible negative side effects in the form of double taxation that may arise if a tax administration may disagree, or arrive at a different conclusion, when applying a singular analysis under either Article 7 or Article 9 and does not consider the overall outcome which would result if an analysis under Article 7 and Article 9 is performed in parallel. We envisage such situations arising where a tax administration performs an audit on only a dependent agent PE of an enterprise, and as a result of that audit, an upwards adjustment to that dependent agent PE's profits is assessed. Meanwhile, the dependent agent entity may have reported an arm's length reward under Article 9 of the MTC, however since the focus of the audit was only on the dependent agent PE the enterprise will suffer from the effects of double taxation

Moreover, the OECD must expressly require tax administrations to ensure that taxpayers must not suffer double taxation as a result of a tax administration performing a singular analysis either under Article 7 or Article 9 without considering the corresponding effect on the other analysis.

In this regard, further guidance must be provided to tax administrations to ensure that upon examination of either a dependent agent PE, or the dependent agent enterprise, that a coordinated application of both Article 7 and Article 9 analyses must be performed. Furthermore, taxpayers should be guaranteed access to all available dispute resolution mechanisms and not be barred from dispute resolution for reasons such as a reversal of burden of proof, or incorrect corporate income tax filing claims that may arise from a disagreement in the application of either Article 7 or Article 9.

Zero-profit PEs

As mentioned earlier, the OECD should consider a practical approach to dealing with zero-profit PEs to reduce the additional filing requirements and compliance obligations that will be created. We see several possibilities to address this:

- Create a specific exemption to the recognition criteria of PEs in cases where a zero-profit PE exists. In other words, a zero-profit PE should not be recognized as a PE, and any associated filing or compliance obligations are waived. As the changes made through the work under Action 7 has already been completed, and therefore this matter cannot be solved by further modification to Article 5, we urge the OECD to encourage tax administrations to address the exemption to zero-profit PEs unilaterally through their domestic tax legislation.
- Introduce a mechanism for local tax administrations to allow an existing resident taxpayer to specify or "elect" in its tax return that a PE of a related entity has been created in its jurisdiction and that the related entity has assessed that no profit is attributable to the PE. This election could override a local income tax return obligation for the PE and ensure that penalties (non-filing or compliance) would not be applicable if the election is made.

- Bilateral efforts between tax administrations should be encouraged to introduce an exemption to recognition criteria of DAPE's which would be created as a result of the activities performed by a DAE subject to the DAE being rewarded at arm's length. Such a clause can already be found in the protocol to the current Austria – Germany Income and Capital Tax Treaty.