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January 9, 2015

VIA E-MAIL

Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA
2, rue André Pascal
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France

Re: Comment letter on the OECD Public Discussion Draft *BEPS Action 7: Preventing the Artificial Avoidance of PE Status*

Dear Ms. de Ruiter,

This letter is in response to the request for comments on the OECD Public Discussion Draft *BEPS Action 7: Preventing the Artificial Avoidance of PE Status*, issued October 31, 2014. I'm writing to share the views as representative of, and on behalf of the Information Technology Industry Council ("ITI"),[1] the Semiconductor Industry Association ("SIA"),[2] the Silicon Valley

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1 ITI is an advocacy and policy organization for the world's leading innovation companies. ITI navigates the relationships between policymakers, companies, and non-governmental organizations, providing creative solutions that advance the development and use of technology around the world. *See* Appendix A for a list of ITI's members.

2 SIA represents U.S. companies involved in research, design, and manufacture of semiconductors. Semiconductors are a foundation of the information technology sector and essential to modern communications, entertainment, national defense, health care, transportation, and other aspects of the world's economy. SIA works to encourage policies and regulations that fuel innovation, propel business, and drive international maintain a thriving semiconductor industry in the United States. *See* Appendix B for a list of SIA's members.

Tax Directors Group ("SVTDG"),[3] the Software Finance and Tax Executives Council (SoFTEC),[4] and TechNet.[5]

Respectfully submitted,

Rod Donnelly

Rod Donnelly
Partner

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[3] SVTDG represents U.S. high technology companies with significant presence in Silicon Valley dependent on R&D and worldwide sales to remain competitive. SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace. *See* Appendix C for a list of SVTDG's members.

[4] SoFTEC is a trade association providing software industry focused public policy advocacy in the areas of tax, finance, and accounting. SoFTEC represents the leading developers of software and is the voice of the U.S. software industry on tax issues. *See* Appendix D for a list of SoFTEC's members.

[5] TechNet is the U.S. bipartisan network of CEOs and senior executives promoting the growth of the technology industry by advocating a targeted policy agenda at the federal and state level. TechNet's diverse membership of over 60 companies includes every part of the technology industry. *See* Appendix E for a list of TechNet's members.

I. Introduction and summary

We thank the Focus Group on the Artificial Avoidance of PE Status ("***Focus Group***") for preparing the *Public Discussion Draft—BEPS ACTION 7: PREVENTING THE ARTIFICIAL AVOIDANCE OF PE STATUS* ("**Action 7 PDD**") and for asking interested parties to give written comments. The *Action 7 PDD* is, we appreciate, an interim step—describing strategies identified, and options considered, by the Focus Group—and doesn't represent the consensus views of the CFA or its subsidiary bodies. As an interested party, we accept the CFA's invitation to comment on the options considered in the *Action 7 PDD*. We restrict our comments to three of the five topics addressed in the *Action 7 PDD*—artificial avoidance of PE status through *commissionaire* arrangements and similar strategies,[1] artificial avoidance of PE status through the specific activity exemptions,[2] and profit attribution to PEs and interaction with action points on transfer pricing.[3]

The work done by the Focus Group is a mandated piece of the overall BEPS Action Plan. In considering whether and, if so, how to change rights of a "source" Contracting State to tax income earned by an enterprise of another Contracting State it's appropriate to look at all aspects of what constitutes a nexus sufficient to warrant allocation of income taxing rights to the source State. Options for change to Article 5 should be entertained, however, <u>only if</u> they don't have as an effect unreasonably changing existing international standards on allocation of tax rights on cross-border income, if they're sufficiently precise to enable both tax administrations and taxpayers to know in most situations with some degree of certainty whether nexus exists, if they're not overly expansive by creating nexus either in common commercial *non-*

[1] Section A of the *Action 7 PDD*.

[2] Section B of the *Action 7 PDD*.

[3] Section E of the *Action 7 PDD*.

commissionaire situations (such as those involving buy-sell or limited-risk distributors) or in situations in which an intermediary isn't substantially involved negotiating the contracts, if they condition nexus only on business activities conducted in that State, and if they're not motivated by broader BEPS concerns better addressed by other measures. Moreover as a practical matter options for change to Article 5 should be entertained <u>only if</u> new PEs covered by such options are likely to be attributed a non-de minimis amount of profits under Article 7, measured by comparison with the burden and expense of compliance imposed on taxpayers and of verification imposed on tax authorities.[4]

The options for Article 5 changes described in the *Action 7 PDD*—at least for the two topics we comment on[5]—fail one or more of these requirements. These options must accordingly be rejected. Below we describe these fundamental flaws of options for changes to Article 5, ¶¶ 4, 5, and 6. If in spite of these flaws the Focus Group decides to proceed with some form of the options, we point out the least flawed options and suggest changes that could be made to certain options to mitigate some harmful effects.

A. Summary of comments on options addressing *commissionnaire* arrangements and similar strategies

OPTIONS A–D deem a dependent agent PE by mixing and matching two requirements for the level of involvement an intermediary must have in the contracting process with two requirements for the substance of the contracts. The requirements for the level of intermediary involvement and the requirements for the substance of the contracts are too imprecise. The *Action 7 PDD* explains that the first requirement common to OPTIONS A & C (that an

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4 Of course, once a PE threshold is set, it would apply both to loss and gain years of a PE.

5 Proposed changes to dependent agent PE provisions in Article 5, ¶¶ 5 & 6, and proposed changes to PE exemptions in Article 5, ¶ 4.

intermediary "habitually engages with specific persons in a way that results in the conclusion of [certain] contracts") means that "[t]he determination of whether the intermediary's interaction with specific persons results in the conclusion of a contract would require a direct causal connection between that interaction and the conclusion of the contract." The inquiry of whether such a "direct causal connection" exists would be new to tax law, has been difficult to resolve in other areas of the law where it's applied, and the inherent imprecision would lead to disputes not easily resolved, thereby discouraging cross-border commerce. The first requirement common to OPTIONS B & D can be met if an intermediary "habitually . . . negotiates the material elements of [certain] contracts," but it's unclear how one determines what the "material elements" of a given contract are, and also unclear what level of intermediary participation in negotiation is required. The second requirement common to OPTIONS A & B is that the contracts are "for the transfer of the ownership of, or for the granting of the right to use, property owned by [the enterprise for which the intermediary is acting] or that the enterprise has the right to use, or for the provision of services by that enterprise." It's unclear whether this language—intended to address *commissionnaire* arrangements—might be interpreted so broadly as to capture intermediaries acting as buy-sell distributors for foreign enterprises. The second requirement common to OPTIONS C & D is that the contracts "are on the account and risk of the enterprise," because of (by virtue of) "the legal relationship between [the intermediary] and the enterprise." The requirement that the contracts be "on the account and risk of the enterprise" introduces in tax treaties a new concept with no commonly understood definition, thus raising the specter of a tax authority interpreting the phrase to apply to situations, going beyond *commissionnaire* arrangements, such as buy-sell or limited-risk distributorships.

The imprecision in OPTIONS A–D would create uncertainty, dampen cross-border commerce, lead to protracted tax audit disputes and Competent Authority proceedings, and decrease the likelihood of Contracting States agreeing on the existence of a dependent agency PE. Uncertainty could also lead to tax authorities selectively targeting businesses.

These requirements are too expansive. Regarding the requirements for the level of involvement of a putative agent in the contracting process, depending on how broadly the phrases "in a way that results in" or "negotiates the material elements of" are interpreted, OPTIONS A–D could deem dependent agent PEs in situations involving mere sales-support affiliates. Regarding the requirements for the substance of the contracts, depending on how broadly the phrases "for the transfer of the ownership of, or for the granting of the right to use, property owned by [the enterprise for which the intermediary is acting]" or "on the account and risk of the enterprise" are interpreted, OPTIONS A–D could reach beyond *commissionnaire* arrangements and deem dependent-agent PEs in situations involving limited risk distributors that take ownership from a foreign enterprise of products being distributed. Neither of these common commercial arrangements, we believe, should give rise to a dependent agent PE.

OPTIONS A–D would, we believe, change existing standards on the allocation of taxing rights on cross-border income, although the *Action 7 PDD* asserts these standards weren't directly targeted. The *Action 7 PDD* justifies changing the current definition of PE to address low- or non-taxed cross-border income, but the existence (or not) of a PE should in principle depend only on the degree of nexus a foreign enterprise has in a Contract State, not on the foreign enterprise's tax rate.

Commissionnaire arrangements can be more narrowly targeted with more limited changes to Article 5, ¶ 5. We suggest some general language for this purpose, and also a treaty-by-treaty approach that would reference relevant language in the applicable commercial law to identify *commissionnaire* arrangements.

Each of OPTIONS A–D proposes the same change to Article 5, ¶ 6, giving an unqualified exception to the existence of an independent agent if a person "acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises." We recommend that this change be withdrawn and the existing concept from the Commentary—that the extent of a person's exclusivity is only a factor to be considered in determining independent agency status—should be retained. The proposed bright-line unavailability of independent agency can unduly harm businesses that lack visibility about the client bases of agents (or their assignees), and in any case presumes a level of coordination among associated enterprises not always found.

B. Summary of comments on options addressing specific activity exemptions

We recommend that no changes be made to the PE exemptions in Article 5, ¶ 4. The nominal goal of Action 7 is to develop changes to the definition of PE to prevent the "artificial avoidance" of PE status, and Action 7 calls out specifically "the use of . . . the specific activity exemptions." None of the PE exemptions either modified (OPTION E) or deleted (OPTIONS F–H) from ¶ 4 are per se artificial, yet the *Action 7 PDD* bases justification for the proposed ¶ 4 changes on the alleged ground that various aspects of ¶ 4 may potentially give rise to the artificial avoidance of the PE threshold. We point out, in the discussion below, flaws with the proffered justifications for the OPTIONS.

The thrust of OPTIONS E–H is to remove some or all of the bright-line rules for PE exemptions in ¶ 4 and replace them with facts-and-circumstances determinations of whether the relevant activities are preparatory or auxiliary. But there's almost no helpful guidance in the Commentary on when activities might be considered preparatory or auxiliary, and the resulting uncertainty is likely to dampen cross-border investment by businesses. OPTIONS F–H are for this reason marginally preferable to OPTION E in that only some of the specific activity exemptions would be affected in the former (assuming continuing possible qualification for the PE exemption through ¶ 4*e*)). Without further helpful guidance on determining whether activities are "preparatory or auxiliary," uncertainty in making such determinations could—as in the case of imprecision & expansiveness in OPTIONS A–D—lead to tax authorities casting a very broad PE net, or selectively targeting businesses.

Importantly, the *Action 7 PDD* doesn't consider whether profits likely attributable to PEs created by the proposed ¶ 4 changes might be relatively small, and outweighed by administrative costs and burdens associated with such PEs.

C. Summary of comments on profit or loss attribution to PEs and interaction with action points on transfer pricing

According to the *Action 7 PDD*, no substantial changes would be need to be made to existing rules on the attribution of profits or losses to a PE (under the Authorised OECD Approach ("***AOA***")) if the proposals included in the *Action 7 PDD* were adopted. Nothing in the AOA signals a need for modifying guidance on determining profits or losses attributable to a PE if the underlying PE threshold is changed, and we recommend that the scope of the AOA—which is relatively untested—not be broadened as part of Action 7.

The AOA would, we believe, determine that relatively little profit (or even loss) would be typically attributable to many of the "new" PEs deemed to exist if proposals in the *Action 7 PDD* were adopted. In such cases the profits attributable might well be outweighed by increased administrative costs and burdens associated with such PEs, resulting in a dampening of cross-border commerce, contrary to a central purpose of tax treaties. Accordingly, we recommend the PE Focus Group reject changes to the PE threshold that would in typical commercial settings have low profits (or even losses) attributable to "new" PEs deemed.

We ask that proposed changes to Article 5, ¶ 5 lowering the PE threshold be accompanied by a discussion of how the AOA would apply in typical commercial situations. In particular, we ask the Focus Group to provide guidance on when—in representative "new" PEs created by the proposals—significant people functions exist that would warrant attribution of assets and/or risks and thereby attribution of profits or losses to the dependent agent PEs in excess of an appropriate arm's length payment to the relevant (associated) dependent agent enterprise. We recommend that the PE Focus Group reverse the signaled presumption in the *Action 7 PDD* that "new" PEs deemed to exist if the proposals were adopted would necessarily have profits attributable to them. It would, we believe, be more appropriate to clarify that—in the context of activities performed in typical *commissionaire* arrangements—no presumption should arise that any profits or losses attributable to such a PE are other than routine. Finally, we recommend the Focus Group clarify—consistent with guidance in the AOA—that no presumption should arise that personnel whose activities give rise to a dependent agent PE necessarily perform and control functions, or control risks, related to the development, enhancement, maintenance, protection, or exploitation of any intangibles involved in PE transactions.

II. Specific concerns

A. Options addressing *commissionnaire* arrangements and similar strategies

1. Flaws with OPTIONS A–D as they affect Article 5, ¶ 5

a. OPTIONS A–D are too imprecise

i. Language common to OPTIONS A & C

OPTIONS A & C deem a dependent-agent PE if an intermediary "habitually engages with specific persons in a way that results in the conclusion of [certain] contracts." The requirement that an intermediary's actions "result[] in the conclusion of contracts" would—presumably with the hope of lowering the dependent-agent PE threshold—introduce in tax treaties a concept entirely untested in tax settings. The *Action 7 PDD* translates this requirement by stating that "[t]he determination of whether the intermediary's interaction with specific persons results in the conclusion of a contract would require a direct causal connection between that interaction and the conclusion of the contract."[6] This explanation isn't especially helpful in a tax setting. The requirement that there be "a direct causal connection" between an action and a result is commonplace in tort law, where it's sometimes rephrased as requiring the action be a "proximate cause" of an injury (tort). In tort law this apparently simple inquiry has led to much case law from which it's difficult to draw general principles. To our knowledge this inquiry has never been applied to contracts in a tax setting, nor is it clear that it practicably could be applied. For any given contract many different combinations of an intermediary's actions might be found to be directly causally linked to the conclusion of the contract, so could potentially be held to "result[] in the conclusion of contracts." Barring further clarification, a risk exists, for example, that tax authorities could assert that negotiation of any single provision of a contract—whatever the materiality—results in the conclusion of the contract in the sense that "but for" negotiation of

6 Emphasis added.

the provision the eventual contract wouldn't have been concluded. In this vein another possibility is a tax authority asserting remote "upstream" activities—e.g., marketing personnel arranging online advertising that could be demonstrated to attract (contract-concluding) customers—result in the conclusion of contracts. Thus, the proposed language in Options A and C regarding habitually engaging with specific persons in a way that results in the conclusion of contracts is imprecise enough to be open to interpretations that affect many more situations than those cited as justifying a change to Article 5(5) (i.e., commissionaire structures and situations involving the use of a local sales force "to negotiate and effectively conclude sales with prospective large clients"[7]). It is also very unclear how profit should be attributed to such a murkily defined activity.

ii. Language common to OPTIONS B & D

OPTIONS B & D deem a dependent-agent PE if an intermediary "habitually concludes [certain] contracts, or negotiates the material elements of [such] contracts." The first alternative requirement—that the relevant person "habitually concludes [certain] contracts"—is similar to a requirement in the current definition of a dependent-agent PE.[8] The plain meaning of this alternative requirement is relatively straightforward, and we think guidance could be given in the Commentary to flesh out the common understanding of this phrase. The second alternative requirement—that an intermediary "negotiates the material elements of [such] contracts"—is, however, unclear for two reasons for which the *Action 7 PDD* gives no explanation. First, and most obviously, it's unclear what the "material elements" of a contract are. Who determines what they are—the taxpayer, or the tax authorities of each Contracting State? One would expect,

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7 Action 1: 2014 Deliverable—*Addressing the Tax Challenges of the Digital Economy*, ¶ 151.

8 That is, the requirement that the relevant person "has, and habitually exercises . . . an authority to conclude [certain] contracts . . . ."

e.g., contracts for the sale of goods would have as material elements price and quantity, and that delivery terms would be non-material, but between these hopefully un-contentious conclusions lies a no man's land. Do the "material elements" depend on the facts and circumstances of the contract, so that an intermediary in a Contracting State negotiating the <u>same</u> elements of two <u>different</u> contracts may be deemed a PE in one instance but not the other? Could it even be that materiality isn't only contract specific, but also <u>customer</u> specific, so that a PE springs into existence because a handful of customers find, e.g., warranty provisions to be material? For a bilateral tax treaty, will the Competent Authorities readily agree what the "material elements" of a contract are? Further, the plain meaning of the phrase "negotiates the material elements of [such] contracts" is that <u>all</u> material elements must be negotiated, but the PE Focus Group would have to clarify this to prevent mis-application by a tax authority.

Second, the phrase "negotiates the material elements" is unclear. To what extent must an intermediary <u>participate</u> in negotiations to be treated as having negotiated? An intermediary that doesn't either solely or almost solely negotiate each of the material elements—whatever they might be—shouldn't be held to have negotiated such elements. This is because OPTIONS A–D focus on situations in which intermediary activities "effectively result in the conclusion of contracts,"[9] signaling an emphasis on what in substance is being done. The phrase "negotiates the material elements" would thus have been better written "substantially negotiates the material elements." Without signaling clearly that a high degree of intermediary participation is needed there's a risk of multiple claims of taxing jurisdiction—with associated complex "profits attributable to" problems and risk of double taxation—in situations in which negotiations of the same contract are done by different persons in multiple jurisdictions.

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9 *Action 7 PDD*, ¶ 4.

Contract negotiation often involves both an initial stage during which a potential customer gets comfortable enough with approximate "element" ranges to invest further resources in negotiation, then a subsequent stage during which convergence is negotiated on each element. An intermediary simply negotiating within precise ranges dictated by a foreign enterprise isn't in effect participating in the initial stage, and shouldn't be held to have substantially negotiated such elements.

The current definition of a dependent-agent PE suffers from neither of these shortcomings.[10] Thus, the proposed language in Options B and C regarding "habitually negotiating" the "material elements" of a contract introduces ambiguities that would make it very difficult to identify with precision when a PE exists or how much profit to attribute to the PE.

iii. Language common to OPTIONS A & B

A PE arises under OPTIONS A & B only if the referenced contracts are "for the transfer of the ownership of, or for the granting of the right to use, property owned by [the enterprise for which the intermediary is acting] or that the enterprise has the right to use, or for the provision of services by that enterprise". This language certainly makes sense under the existing dependent-agent PE standard, where a PE exists only if the contract concluded by the agent legally binds the principal to the customer in a sales, leasing, or services transaction.

On the assumption, however, that this language is intended to cover a broader category of cases, if only in order to apply to *commissionnaire* structures where the contract concluded by the intermediary with the customer does not bind the principal (and does not even have the

10 *See, e.g.*, Commentary on Article 5, ¶ 33.

principal as a party), one has to ask how broad the new category would be and whether it could sweep in routine commercial distribution arrangements that do not involve *commissionnaires*. For example, could it apply to an intermediary acting as a buy-sell distributor of goods for a foreign enterprise? It shouldn't. The BEPS Action Plan prefaced Action 7 with an expression of discontent with taxpayers moving to *commissionnaire* arrangements from situations in which a "local subsidiary traditionally acted as a distributor,"[11] so local affiliate buy-sell distributors should not be targeted by Action 7 proposed changes to the definition of PE in Article 5. Would the fact that such a distributor, unlike a *commissionnaire*, typically takes title to the goods, even if only on a flash title basis, before passing title to the customer in a sales transaction mean that sales contracts by such intermediaries would not be considered contracts "for the transfer of the ownership of . . . property owned by the enterprise"? If the proposed language is not intended to sweep in distribution arrangements where the intermediary takes title to the goods being sold, that should be made very clear by the OECD. If on the other hand the proposed language is intended to be broad enough to sweep in such distribution arrangements, the OECD should explain whether that would be the case across the board or only in some situations, and where the dividing line would fall. The potential scope of the proposed language is also very unclear in the context of leasing and services transaction, where there is not even the possibility of relying on a standard such as direct passage of title to know when a foreign enterprise might be treated as having a PE by virtue of a contract between an intermediary and a customer to which the enterprise itself is not a party.

[11] BEPS Action Plan, p. 19.

iv. Language common to OPTIONS C & D

A PE arises under OPTIONS C & D only if the referenced contracts "are on the account and risk of the enterprise," because of (by virtue of) "the legal relationship between [the intermediary] and the enterprise." The requirement that the contracts be "on the account and risk of the enterprise" introduces in tax treaties a new concept. The *Action 7 PDD* doesn't explain what this phrase means. The phrase sometimes finds use in the context of a transfer of an interest in property to or from a person—e.g., "trading in stocks . . . for the account and risk of the taxpayer"[12]—that seems akin to a tax sale or purchase—i.e., transfer of the benefits and burdens of ownership. No commonly understood definition of the phrase exists, however. In particular it's unclear precisely how the phrase would apply in civil law jurisdictions to find a dependent-agent PE in the case of a *commissionnaire* arrangement—a primary target of the proposed change to ¶ 5—where an agent acting on behalf of an undisclosed principal generally doesn't bind the principal, unless the phrase is intended to cover cases where the intermediary does not bind the principal. But this raises the question of how broadly the phrase is intended to apply beyond the current dependent-agent PE standard of binding the principal. The lack of clarity raises a risk of a tax authority considering the phrase elastic enough to apply to situations, going beyond *commissionnaire* arrangements, in which an intermediary gets tax ownership of property, such as buy-sell or limited-risk distributorships, thereby affecting much more cross-border commerce. Such an effect would go beyond leveling the playing field between common law undisclosed principal and civil law *commissionnaire* cases and would move the goalposts of the source-residence State taxing allocation for both common law and civil law jurisdictions. Moreover, even if an agreed-upon definition of the phrase existed, it's unclear how it would

[12] U.S. Treasury Regulation § 1.864-2(c)(2)(i)(c).

apply, for example, to services or leasing transactions, where passage of title to property is not at issue.

v. Consequences of imprecision in the definition of a dependent-agent PE

The consequences of imprecision in the conditions triggering the deeming of a dependent-agent PE are serious. Businesses need certainty on the tax consequences of their operations and investments in any country. Uncertainty about whether intended operations in a jurisdiction will give rise to a PE can only dampen cross-border cross-border commerce. Businesses can face criminal and civil (e.g., VAT) penalties for failing to carry tax compliance burdens associated with a PE. Businesses that fail to accurately assess PE risks for tax provisioning purposes risk accounting regulatory violations and shareholder litigation.

Imprecise dependent-agent PE triggering conditions will surely also result in unnecessary time spent on audits by tax administrations and taxpayers. The effect of such imprecision will, in Competent Authority proceedings, decrease chances of Contracting States agreeing an enterprise of one State has a PE in the other State, thereby increasing chances of juridical double taxation,[13] contrary to the avowed main purpose of the OECD MTC.[14]

[13] A prerequisite for application of Article 7, ¶ 3—whose purpose is to avoid double taxation on profits attributable to a PE—is agreement a PE exists.

[14] OECD MTC, Introduction, ¶ 3.

b. OPTIONS A–D are too expansive

Each of OPTIONS A–D has a first requirement triggered by a certain level of involvement in the contracting process by a putative dependent agent,[15] and a second requirement triggered by the substance of the contract itself.[16]

Regarding the first requirement, BEPS Action 7—*Prevent the Artificial Avoidance of PE Status*—describes its justification, in part, as situations in which sales contracts are "negotiated and concluded" by the sales force of a local subsidiary without the profits from the sales being taxable to the same extent as they would be if the sales were made as a distributor. Depending how broadly the phrases "in a way that results in" or "negotiates the material elements of" are interpreted, OPTIONS A–D could deem dependent-agent PEs in common commercial situations involving mere sales-support affiliates.

Regarding the second requirement, BEPS Action 7 further explains that "[i]n many cases" the above-described situation has led enterprises to replace buy-sell subsidiaries with "commissionaire arrangements." Regarding the second requirement, depending on how broadly the phrases "for the transfer of the ownership of, or for the granting of the right to use, property owned by [the enterprise for which the intermediary is acting] or that the enterprise has the right to use, or for the provision of services by that enterprise" or "on the account and risk of the enterprise" are interpreted, OPTIONS A–D could reach beyond *commissionnaire* arrangements and deem dependent-agent PEs in common commercial situations involving limited risk

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15 OPTIONS A & C require the putative agent to habitually engage "with specific persons in a way that results in the conclusion of [certain] contracts." OPTIONS B & D require the putative agent to "conclude[] contracts, or negotiate[] the material elements of contracts."

16 OPTIONS A & B refer to contracts in the name of the enterprise, for the transfer of ownership rights in property held by the enterprise, or for services performed by the enterprise. OPTIONS C & D refer to contracts that "are on the account and risk of the enterprise."

distributors that take ownership from a foreign enterprise of, for example, products being distributed.

These common cross-border commercial arrangements are potentially put at deemed PE risk under OPTIONS A–D, but weren't targeted in the BEPS Action Plan, nor should they be considered "artificial," nor should they give rise to deemed dependent-agent PEs.

c. OPTIONS A–D upset existing international standards on the allocation of taxing rights for no rational policy reason

The *Action 7 PDD* "actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income." While the *Action 7 PDD* proposals mightn't be "directly aimed" at upsetting such international standards—which have existed for over 50 years[17]—they've nonetheless scored a direct hit on them. Businesses have during this half-century expanded global operations, tailoring operations country-by-country using a blend of associated and unrelated enterprises, in good faith reliance on bilateral treaty networks imposing relatively precise nexus requirements as a condition for "source" country taxation of profits. In proposing to change the PE threshold in a way that's imprecise and expansive, the *Action 7 PDD* would in a fell swoop require dismantling much of such structuring, forcing businesses to expend significant resources to restructure without knowing precisely what nexus level triggers source-country taxation rights, and with no adequate policy rationale for why the PE-net has been so broadened.

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[17] Article 5, ¶ 4 of the 1963 OECD MTC provided that "[a] person acting in a Contracting State on behalf of an enterprise of the other Contracting State—other than an agent of an independent status to whom paragraph 5 applies—shall be deemed to be a permanent establishment in the first-mentioned State if he has, and habitually exercise in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise."

The *Action 7 PDD* explains that the BEPS Report and the Action Plan assert that the current definition of PE must be changed to address situations in which "cross-border income [that] would otherwise go untaxed or would be taxed at very low rates."[18] In so tipping its hand, the *Action 7 PDD* thus proposes lowering the PE threshold because in some cases cross-border income is subject to low- or non-taxation. The existence or non-existence of a PE should in principle depend only the degree of nexus a foreign enterprise has in a Contracting State. It shouldn't depend on the tax rate of the foreign enterprise.

Lowering the PE threshold potentially affects all cross border income, whatever tax rate it's subject to. In proposing to lower the PE threshold, the *Action 7 PDD* thereby asserts, for income taxation purposes, the primacy of a "source" State over that of a residence State even in situations in which profits received by a foreign enterprise are subject to high tax—i.e., a situation not triggering concern in the BEPS Report.

Lowering the PE threshold because in some cases cross-border income is subject to low- or non-taxation is in any case a crude way for dealing with situations far better treated with more specific approaches. A CFC regime, for example, can be precisely tuned to the tax rate imposed on income received.[19] Continuing efforts could be made to deter Contracting States from enacting harmful tax practices, encouraging them to condition implementation of preferential tax regimes based on substantial activities.[20] A jurisdiction could simply choose not to sign a bilateral tax treaty with another jurisdiction in a situation where there's little risk of double

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[18] *Action 7 PDD*, ¶ 3. *See also* ¶ 26, *Examples 1 & 2*, discussed below, which argue for non-applicability of PE exemptions in Article 5, ¶ 4 because of low- or non-taxed cross-border income.

[19] *See, e.g.*, §§ 4201, 4202, & 4211 of H.R. 1, 113th Cong., 2d Sess. (*Tax Reform Act of 2014*).

[20] BEPS Action 5: 2014 Deliverable—*Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*.

taxation or could build into the treaty the right to amend the bargain if the treaty partner's domestic law changes to remove or substantially reduce the risk of double taxation.

d. *Commissionnaire* arrangements can in any case be targeted by a simple change to Article 5, ¶ 5

As an alternative to OPTIONS A-D, the language of Article 5, ¶ 5 could be changed to target c*ommissionnaire* arrangements. The *Action 7 PDD* defines such an arrangement loosely as "one through which a person sells products in a given State in its own name but on behalf of a foreign enterprise that is the owner of these products."[21] The OECD's concern with *commissionnaire* arrangements largely stems from the fact that in civil law jurisdictions, in a situation of indirect representation, an agent acts in its own name and contractually binds itself, but not the principal (enterprise), to a third party that therefore can't enforce the contract against the principal.[22] In this situation the agent doesn't conclude a contract in the name of the principal—the agent concludes a contract but the principal primarily performs under the contract. Various wordings could deal with this situation.[23] One example would be: "habitually concludes sales contracts with customers resulting in direct transfer of ownership of property from the enterprise to such customers." This language clearly wouldn't deem a dependent agent PE to arise in situations involving limited risk distributors (who contract for themselves and own property transferred to customers)) or sales-support affiliates (who neither conclude contracts), but would deem a *commissionnaire* arrangement to be a dependent-agent PE. As a more targeted alternative, the OECD could also recommend that Contract States negotiating Article 5 reference

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21 *Action 7 PDD*, ¶ 6.

22 Avery Jones and Ward, *Agents as Permanent Establishments under the OECD Model Tax Convention,* European Taxation 33 European Taxation No. 5, 154, 156–157 (1993).

23 Perhaps this was the intention of the *Action 7 PDD* in OPTIONS C & D by referring to "contracts . . . which . . . are on the account and risk of the enterprise," but that's unclear because no explanation of the choice of language was given.

relevant provisions in the applicable commercial law, in order to identify *commissionnaire* arrangements which are intended to create PEs.

2. Flaws with OPTIONS A–D as they affect Article 5, ¶ 6, and how they could be corrected

Each of OPTIONS A–D proposes the same change to Article 5, ¶ 6, replacing the existing sentence of this paragraph with two sentences. The first sentence provides for the non-application of ¶ 5 for an "independent agent" acting in the ordinary course of business. This is similar to the existing exception to ¶ 5 for an "agent of independent status . . . acting in the ordinary course of [its] business." The second sentence introduces a new concept, giving a specified exception to the existence of an independent agent:

> Where, however, a person acts exclusively or almost exclusively on behalf of one enterprise or associated enterprises, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to these enterprises.

Paragraph 38.6 of the current OECD Commentary on Article 5 explains that "[a]ll the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge," and that the number of principals represented by an agent is <u>one factor</u> to be considered in determining independent status.

A non-resident enterprise may have no knowledge of the extent to which an agent of the enterprise acts on behalf of other enterprises. The agent may simply refuse to provide information relevant in making this determination. Even if it's provided, the consequences of misinformation could be grave for a principal. It's not uncommon for agents to assign or sub-contract all or parts of contracts to associated [agent] enterprises, and the principal may have no visibility into this. In this case a non-resident enterprise principal may unknowingly end up in contractual privity with an assignee that works exclusively or almost exclusively for it. Moreover, the exclusivity of an agent's actions can change with time, so the determination would have to be continuously updated across possibly (for some businesses) many agents. Some business members of the trade association signatories to this letter have distribution channels encompassing many <u>thousands</u> of unrelated enterprises, each of which may further contract with associated or unassociated enterprises. The impracticability of this bright-line exception to independent status is obvious. The second sentence to the change to Article 5, ¶ 6 proposed by OPTIONS A–D should accordingly be stricken, and the existing concept—that the extent of exclusivity is but a factor to be considered in determining independent status—should be retained.

The deemed non-independent agency of a person acting "exclusively or almost exclusively" on behalf of associated enterprises presupposes a level of coordination among associated enterprises on a par with that found within a single enterprise. In effect OPTIONS A–D assume constructive knowledge of all agents used by members of an multinational enterprise group, and ignore the fact that associated enterprises can often exercise autonomy over regional functions, including third-party service providers. This can be punitive, and again it supports using exclusivity or near-exclusivity as not being dispositive but rather as being a factor to be considered in determining independent status.

B. Options addressing specific activity exemptions

1. OPTIONS E–H

a. No changes to Article 5, ¶ 4 are warranted—in general

No changes to the PE exemptions in Article 5, ¶ 4 are warranted. The *Action 7 PDD* proposes three measures each of which lowers the PE threshold: (1) proposed changes to ¶ 5 to deem dependent-agent PEs in many situations; (2) proposed changes to the exemptions in ¶ 4 making them harder to qualify for; and (3) proposed changes to ¶ 6 making it harder to qualify as an agent of independent status. Proposed changes to the exemptions in ¶ 4 lower the threshold for finding <u>both</u> dependent-agent PEs in ¶ 5 <u>and</u> fixed-place-of-business PEs in ¶ 1. The BEPS Action Plan prefaced its statement of Action 7 by explaining that "MNEs may <u>artificially fragment</u> their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities."[24] Action 7—the nominal goal of which is developing changes to the definition of PE to prevent the "<u>artificial</u> avoidance" of PE status in relation to BEPS—calls out specifically "the use of . . . the specific activity exemptions."

None of the ¶ 4 exemption activities either modified (OPTION E) or deleted (OPTIONS F–H) from ¶ 4 are per se artificial. The *Action 7 PDD* doesn't assert that, nor could it rationally do so given that the activities are common facets of most cross-border commerce, unless the *Action 7 PDD* assumes most cross-border commerce somehow involves artificial activities. The *Action 7 PDD* apparently adopted the recommendation of the Action 1: 2014 Deliverable—*Addressing the Tax Challenges of the Digital Economy*, which recommended that work done on Action 7 consider "whether certain activities . . . previously considered to be preparatory or

[24] Emphasis added.

auxiliary may be increasingly significant components of businesses in the digital economy."[25] But the *Action 7 PDD* also apparently bases justification of proposed ¶ 4 changes on the grounds that "various aspects of Art. 5(4) . . . may potentially give rise to the artificial avoidance of the PE threshold."[26] Under this rationale, for example, reliance by an enterprise on the ¶ 4 exemption for use of facilities solely for the purposes of delivery of its goods constitutes the artificial avoidance of the PE threshold unless such use is preparatory or auxiliary. The *Action 7 PDD* bootstraps itself into its conclusion without ever explaining why such non-preparatory or auxiliary use is "artificial avoidance." Why is the non-existence of a PE under current rules the "artificial avoidance" of a PE under those rules? Businesses that have for 50-plus years built cross-border commerce networks in good faith reliance on the existing ¶ 4 exemptions deserve an explanation why such reliance represents "artificial avoidance" of the PE threshold. No sensible explanation can be given. The *Action 7 PDD* may tacitly base proposed changes to ¶ 4 on the results of its having considered—at the request of the Action 1: 2014 Deliverable—the increasing significance, within the digital economy, of activities previously thought to be preparatory or auxiliary. The nominal justifications given for ¶ 4 changes proposed in OPTIONS E–H, addressed below, don't acknowledge this consideration, however. Moreover the proffered justifications are questionable.

OPTIONS E–H remove some or all of the bright line rules for PE exemptions in ¶ 4 and replace them with facts-and-circumstances determinations of whether the relevant activities are preparatory or auxiliary, with scant guidance on how this determination is made.[27] OPTIONS E–

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25 *Action 7 PDD*, ¶ 4.

26 *Action 7 PDD*, ¶ 13.

27 "It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of

H thus compound existing uncertainty around the determination of what's preparatory or auxiliary. This uncertainty is unhelpful, and is likely to dampen cross-border investment decisions by businesses.

Another important consideration not addressed in OPTIONS E–H is whether the profits likely attributable to PEs created by the proposed changes are outweighed by the administrative costs and burdens associated with such PEs, including costs of country-by-country determinations of what activities are or aren't preparatory or auxiliary. This consideration was intended to inform the determination of what might qualify under the preparatory-or-auxiliary exemption in ¶ 4*e*)[28] but it seems forgotten in the *Action 7 PDD*.

b. OPTION E

The *Action 7 PDD* justifies OPTION E on the grounds of addressing "situations where these [¶¶ 4*a*)–4*d*)] give rise to BEPS concerns." But, again, *Action 7 PDD* gives no explanation of what those BEPS concerns are—do they (again) involve the "artificial avoidance" of the PE threshold?[29]

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business in itself forms an essential and significant part of the activity of the enterprise as a whole." Commentary on Article 5, ¶ 24.

28 "It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question." Commentary on Article 5, ¶ 23.

29 The *Action 7 PDD* mentions—but nominally chooses not to base its OPTION E recommendation on—"the views of some delegates who . . . considered . . . the original purpose of [¶ 4 was] to cover only preparatory or auxiliary activities." These delegates are mistaken. There's no indication of such a purpose in the Commentary on Article 5 of the 1963 *Draft Double Taxation Convention on Income and Capital*. Rather, such Commentary explains (paragraph 10) that the specific-activity exemptions are "forms of business activity which <u>should not be treated as constituting permanent establishments</u> even though the activity is carried on in a fixed place of business . . . ." (Emphasis added).

OPTION E would, if implemented, introduce subjectivity into the current bright-line specific activity exemptions in ¶¶ 4*a*)–*d*). An enterprise conducting any of these specified activities in a Contracting State would qualify for the exemption only if it could convince that State's tax administration (or its courts) the activities are preparatory or auxiliary. To this end, guidance in the Commentary isn't especially helpful in reaching conclusions about whether, in a given context, any of the specific activities in ¶¶ 4*a*)–*d*) is preparatory or auxiliary, and the Commentary acknowledges the difficulty of the task in general.[30] The *Action 7 PDD* includes no discussion of how to determine whether any of the specific activities potentially affected by OPTION E "in itself forms an essential and significant part of the activity of the enterprise as a whole",[31] thereby failing to fulfill the mandate of the Action 1: 2014 Deliverable to determine "whether a reasonable, administrable rule . . . can be developed" to identify "the circumstances under which such activities may be considered core activities."[32] Compounding the difficulty is the further determination that must be made concerning whether the locations at which such activities are conducted are fixed places of business of the foreign enterprise—i.e., typically, whether such locations are "at the disposal" of such enterprise.[33] The OECD acknowledged concerns about the lack of clarity of this phrase, and prior to the BEPS project issued a public discussion draft with proposals addressing this issue.[34]

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[30] "It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not." Commentary on Article 5, ¶ 24. This argument would apply with appropriate changes under OPTIONS F–H, addressed below.

[31] Commentary on Article 5, ¶ 24.

[32] Action 1: 2014 Deliverable—*Addressing the Tax Challenges of the Digital Economy*, p. 15

[33] Commentary on Article 5, ¶¶ 4 & 4.1.

[34] *Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention* (12 October 2011), ¶¶ 10–16.

This exercise of resolving the "preparatory or auxiliary" and "fixed place of business" question would have to be repeated in possibly many other countries.[35] Global objective certainty would have been replaced by country-by-country subjective uncertainty, with no guarantee that an outcome in one country applies in any other. Businesses, tax administrations, Competent Authorities, and courts will have to expend significant resources making these subjective determinations. Harmful results of uncertainties in the precision of proposed changes to ¶ 5 (described above) would also flow if OPTION E were chosen.

c. OPTIONS F–H

OPTIONS F–H are proffered if OPTION E isn't adopted. It may have been the intention of the Focus Group that explicit removal of specific activities in ¶¶ 4*a*), *b*), & *d*) would still allow an enterprise to qualify for an exemption for any such activity under the general exemption in ¶ 4*e*), but the *Action 7 PDD* doesn't say so in so many words, even though the proposed drafting appears to favor that conclusion. To preclude inference of a contrary intention—i.e., a negative inference that explicit removal of an activity meant the general exemption in ¶ 4*e*) wouldn't apply—either OPTIONS F–H could be accompanied by Commentary language signaling possible application of ¶ 4*e*) to exempt a deleted activity, or each of OPTIONS F–H could be modified to make this clear in ¶ 4 itself.[36]

Assuming continuing possible qualification for PE exemption through application of ¶ 4*e*), OPTIONS F–H are marginally preferable to OPTION E in that only some of the specific

[35] Because the ¶ 4 exemptions are relevant both to fixed-place-of-business <u>and</u> dependent-agent PEs, the enterprise would face uncertainty in any Contracting State in which it hires an associated or even an unrelated enterprise to perform any of the specified activities.

[36] Each of the relevant activities would be qualified rather than deleted—e.g., OPTION F could be changed to read recommend ¶ 4*a*) to read "the use of facilities solely for the purpose of storage, display or <u>(if of a preparatory or auxiliary character)</u> delivery of goods or merchandise belonging to the enterprise."

activities in ¶¶ 4*a*)–*d*) would be affected. An enterprise would have to plead application of the general exemption ¶ 4*e*) to affected specific activities, but unaffected specific activities—e.g., use of facilities solely for the purpose of storage of goods or merchandise belonging to the enterprise—would continue to constitute per se PE exemptions. The burdens on taxpayers, tax administrations, Competent Authorities, and courts—while significant—would be less under OPTIONS F–H than under OPTION E.

Each of OPTIONS F–H nonetheless has shortcomings and should be rejected.

i. OPTION F—deletion of "delivery" in ¶¶ *4***a***) &* **b***)*

The *Action 7 PDD* asserts it would be difficult to justify application of the exemptions in ¶¶ 4*a*) & *b*) "where an enterprise maintains a very large warehouse in which a significant number of employees work for the main purpose of delivering goods that the enterprise sells online . . . ."[37] It's axiomatic that maintenance of a stock of goods for delivery constitutes part of the overall process by which many businesses earn profits, but why shouldn't it be exempted from PE status, as it is currently? The proffered example strongly suggests that, for the PE Focus Group, size matters: presumably the combination of a "very large warehouse" in which "a significant number of employees" work in large part motivates asserted non-application of the preparatory-or-auxiliary exemption in ¶ 4*e*).[38] Put differently, the Focus Group believes the preparatory-or-auxiliary exemption shouldn't apply if the enterprise sells lots of goods into a Contracting State (for only then would the enterprise need a very large warehouse with a significant number of employees). But the <u>determination</u> of whether using facilities for the delivery of goods is preparatory or auxiliary shouldn't in principle turn on the <u>quantity</u> of

[37] *Action 7 PDD*, ¶ 18.

[38] We assume continuing availability of this exemption, even if "delivery" is deleted in ¶¶ 4*a*) & *b*).

business conducted—i.e., on the scale of business. Why should use of facilities for delivering a million widgets a year not be preparatory or auxiliary if using facilities for delivering a thousand widgets a year is? No rational explanation can be given.

The "decisive criterion" for determining whether using facilities for the delivery of goods is preparatory or auxiliary is (as noted above) "whether or not the activity of the fixed place of business [i.e., delivery] in itself forms an essential and significant part of the activity of the enterprise as a whole."[39] So OPTION F (and OPTION E, too, as it relates to delivery) rejects the per se exemption for delivery in favor of a case-by-case determination of whether delivery forms "an essential and significant part of the activity" of a cross-border business. As noted above, there's very little guidance on how this determination should be made. Does it, for example, depend in part on customers' (subjective) intentions in making purchases? This determination introduces much unhelpful uncertainty for cross-border businesses involving delivery of goods or merchandise—i.e., essentially any businesses to which a treaty would apply. Protracted, fact-intensive disputes will almost certainly arise. Without further guidance tax authorities might leverage this uncertainty either to cast a very broad PE net, or to target selectively certain businesses. Further guidance—beyond "[e]ach individual case will have to be examined on its own merits"[40]—is needed before this rule could even approach practicability.

The proffered example also suggests the PE Focus Group's conclusion may have been motivated in part by the medium through which the sale was conducted—i.e., online sales versus sales via fax or phone or regular mail. Most enterprises selling cross-border have online-sales

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[39] Commentary on Article 5, ¶ 24.

[40] *Id.*

options for customers,[41] and characterization of use of facilities for delivery of goods as preparatory or auxiliary (or not) shouldn't in principle turn on the medium through which the sales were conducted.

There is also the question of whether using a facility or maintaining a stock of goods in a country for the purpose of delivery of those goods gives rise to any potential base erosion concern in a Contracting State in situations where the goods are being delivered to buyers in a third country, and yet the proposed change would potentially hit those situations as well as ones where the goods in question are being delivered within the Contracting State.

Deletion of "delivery" in ¶¶ 4*a*) & *b*) means the remaining exception for "storage" of goods and merchandise is per se exempted from PE status, but "delivery" of goods or merchandise—including goods or merchandise stored in the same jurisdiction—is (presumably) exempted from PE status only if it's preparatory or auxiliary. But in virtually all commercial situations goods or merchandise are <u>only</u> stored so they can later be <u>delivered</u> (somewhere, to someone)—i.e., storage and delivery purposes almost always coexist. So the different exemption standards will likely create confusion.

ii. OPTION G & H—deletion of exemptions for purchasing goods or merchandise, or for collecting information

OPTION G proposes deleting "purchasing goods or merchandise" from ¶ 4*d*), so the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise for the enterprise would only be exempted from PE status if the preparatory-or-auxiliary exemption in ¶ 4*e*) applied. The *Action 7 PDD* asserts that this exemption "seems to

[41] Presumably the Focus Group isn't tacitly asserting online commerce is conducted for the purpose of "artificial avoidance" of PE status.

have been originally justified by the view that no profits could or should be attributed to such activities," but there's no suggestion of that in the original OECD MTC.[42]

Examples in ¶ 26 of the *Action 7 PDD* apparently motivate OPTION G. In *Example 1*, the concern is profits attributable to purchasing discounts escaping taxation in both the "source" State (if the purchasing office of an enterprise doesn't constitute a PE) and the "residence" State (if "the domestic exemption or territorial system of that country attributes the discount" to the source State). In *Example 2* the concern is profits seemingly attributable to purchasing functions of experienced employees being subject to low-taxation in a residence State if an agricultural buying-and-selling enterprise resident in a low-tax jurisdiction had in a source State a purchasing office that wasn't a PE.

These *Examples* fail to justify OPTION G for three reasons.[43] First, the lesson of *Example 1* follows from an assumption the purchasing office will keep the volume discount, but this is contrary to guidance on BEPS Action 8 indicating a volume discount would typically be shared among the group affiliates for which purchases are made.[44] Second, as explained above, low- or non-taxation of cross-border profits shouldn't in principle inform the question of whether a PE exists in a source State—degree of nexus of operations should be independent of tax rates.

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42 The Commentary on Article 5 of the 1963 *Draft Double Taxation Convention on Income and Capital* is silent about this exemption.

43 *Example 2* also asserts that "it would seem difficult to argue that the purchasing would only constitute a routine function," but this misses the point. The purchasing office employees in the *Example* are described as "well paid," and they'll presumably pay tax in the source country. In a free-market economy with facts as given in the *Example* (e.g., other than employee skill & experience, no specific intangibles driving profits) such employees (who are experienced and whose job functions involve a high degree of skill) could be expected to command (as compensation) virtually all profits properly attributable to the selling function. The source State will get all tax properly attributable to the purchasing function, which seems nonroutine.

44 ¶ 1.101 of BEPS Action 8: 2014 Deliverable—*Guidance on Transfer Pricing Aspects of Intangibles*.

Third, in making the policy argument that a PE should exist in *Examples 1* & *2*, the Policy Group is asserting that the activities in the source State aren't preparatory or auxiliary.[45] But characterization of activities in the source State as preparatory or auxiliary (or not) cannot in principle be justified by tax rates imposed on profits arising in part from those activities.

OPTION G deals with the nexus a foreign enterprise must have in a Contracting State for that State to have the right to tax profits attributable to purchasing activities conducted in that State for the enterprise. It's questionable whether much, if any, profit could be attributable in general to purchasing activities. Further, almost all OECD Member States levy VAT or other consumption taxes, and so tax revenues already arise from in-country purchasing activities.

OPTION H proposes additionally deleting "collecting information" from ¶ 4*d*), so the maintenance of a fixed place of business solely for the purpose of collecting information for the enterprise would only be exempted from PE status if the preparatory-or-auxiliary exemption in ¶ 4*e*) applied. In apparent justification for deleting "collecting information" from ¶ 4*d*), the *Action 7 PDD* explains that "[c]oncerns have been expressed, however, that some enterprises attempt to extend the scope of that exception, e.g. by disguising what is in reality the collection of information for other enterprises by repackaging the information collected into reports prepared for these enterprises."[46]

This explanation fails to justify OPTION H for two reasons. First, if in reality an enterprise is collecting information for other enterprises, the PE exemption in ¶ 4*d*)—applicable only if the information is collected "for the enterprise [itself]"—clearly wouldn't apply. Such

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45 We assume continuing availability of this exemption, even if "purchasing goods or merchandise" is deleted in ¶ 4*d*).

46 *Action 7 PDD*, ¶ 28.

enterprise attempts at "disguising" activities don't rise to the level of "artificial avoidance" of PE status, can be simply addressed by a vigilant tax administration, and certainly don't justify removing the "collecting information" exemption for all enterprises. Second, and more fundamentally, most of the value from selling information to customers is attributable to filtering, analysis, and other functions performed on raw data, which by itself is of relatively low value. It's thus entirely appropriate to per se exempt "collecting information" from PE status in ¶ 4*d*).

2. OPTIONS I–J

In suggesting "anti-fragmentation" rules, OPTIONS I–J would formalize the directive in ¶ 27.1 of the Commentary on Article 5 to cover situations in which an enterprise maintains different places of business in a country, and also extend it to situations in which an associated enterprise either works at the same places of business as the first enterprise, or at a different place within the same country. Both OPTIONS have the requirement that the relevant business operations—whether or not geographically dispersed—must "constitute complementary functions that are part of a cohesive business operation."

Paragraph 27.1 of the Commentary on Article 5 asserts an anti-abuse policy that is reasonable: An enterprise cannot fragment a cohesive operating business into several small operations <u>in order to</u> argue that each is merely engaged in a preparatory and auxiliary activity. By assumption, the enterprise fragmented operations in a country to avoid having a PE—i.e., "artificial avoidance" justifies override of the ¶ 4 PE exemptions.

OPTIONS I–J are troubling, however, for two reasons. First, no "artificial avoidance" intention need be present for the override to work. Second, each OPTION introduces a degree of subjectivity and uncertainty by not defining either what makes functions “complementary” or what makes them “part of a cohesive business operation.” The example in ¶ 27.1 suggests that complementarity must be with respect to the same property or the same services (each separately), so that for example the functions of receiving & storing computer equipment, on the one hand, and distributing that computer equipment on the other hand, are complementary, but the functions of distributing computer equipment and servicing that equipment shouldn’t be complementary. This uncertainty should be eliminated, either with a definition or with examples. Further, it’s unclear when functions are “part of a coherent business operation.” MNEs would face a risk of a tax administration asserting any functions performed by associated enterprises within the same MNE are part of a coherent business operation. This risk should also be eliminated, either with a definition or with examples.

Assuming the risks associated with uncertainty/subjectivity can be eliminated, OPTION I is preferable to OPTION J. OPTION J would deem non-application of the PE exemption in ¶ 4 in situations covered by OPTION I, and further in situations in which the combination of activities at the same place or at the different locations (as applicable) goes beyond what is preparatory or auxiliary. This introduces more uncertainty for taxpayers and for this reason should be discarded. OPTION I, although flawed because it’s unclear and rests on questionable policy concerns, is preferable to OPTION J.

C. Profit attribution to PEs and interaction with actions points on transfer pricing

The *Action 7 PDD* states that “[t]he preliminary work . . . done so far on the issue of attribution of profits has focussed on the determination of additional profits that would be allocated to the State of the PE as a result of the changes that could be made to the definition of

PE as a result of the work on Action 7 compared to the profits that would be allocated under the existing definition of PE."[47] This passage raises issues of attribution of profits or losses to a PE under the AOA. The PE Focus Group was tasked with addressing profit attribution issues relating to Action 7 PE definition changes. The *Action 7 PDD* states the PE Focus Group's preliminary work hasn't identified substantial changes that would be need to be made to the AOA if the proposals included in the *Action 7 PDD* were adopted.[48] The AOA was the culmination of a multi-year effort to revise application of the prior version of Article 7, and to revise Article 7 itself. The AOA establishes a complex theoretical framework for determining profits attributable to a PE,[49] but it remains largely untested in application. Nothing in the *2010 Report* signals a need for modifying the AOA if the underlying PE threshold is changed.[50] We accordingly recommend that no changes be made to broaden the scope of the AOA as part of Action 7.

An effect of the *Action 7 PDD* proposing to lower the threshold for what constitutes a PE is that a group of fewer activities can be deemed a PE. A corollary of PEs arising from small sets of activities is that, under the AOA, one can expect in some cases only a small amount of profits (or even losses) would be attributable to the associated PEs, and the administrative costs and burdens associated with such PEs might well outweigh such profits. As a consequence one can expect a chill on cross-border commerce as MNEs forego necessary, but low-profit, activity because of the overall burden they face. In these cases deeming PE status would thus act as a

[47] *Action 7 PDD*, ¶ 45 (emphasis added).

[48] *Id.*

[49] *2010 Report on the Attribution of Profits to Permanent Establishment* ("**2010 Report**").

[50] Phrases such as "nothing in this [*2010 Report*] shall be considered as altering or lowering the existing PE threshold" suggest the AOA was intended to operate independently from the PE threshold.

barrier to trade, contrary to a central purpose of tax treaties. Consequently it's sensible to use the AOA to inform the determination of PE threshold, recognizing that too low a threshold leads to harmful effects.

As discussed above, we recommend *commissionnaire* structures can be more precisely targeted by changes to Article 5, ¶ 5, without having to make the imprecise and overly expansive changes to ¶ 5 suggested in OPTIONS A–D. It's reasonable to ask that any changes to ¶ 5 lowering the PE threshold be accompanied with a discussion of how the AOA would apply in representative fact patterns. The language cited above signals a presumption that profits would necessarily be attributable to (new) dependent-agent PEs that would exist under a new ¶ 5.[51] This is, however, inconsistent with the AOA, which is explicit that "there is no presumption that a dependent agent PE will have profits attributable to it."[52] The Focus Group should reverse the apparent presumption in ¶ 45 of the *Action 7 PDD*. It would more appropriately be warranted—given the nature of activities performed in typical *commissionnaire* arrangements—that the Focus Group clarify that <u>no presumption</u> should arise that any profits attributable to such a PE are <u>other than</u> routine.

The existence of a dependent-agent PE doesn't justify attribution of profits to the PE under a "force of attraction" principle.[53] In many if not most cases, the persons carrying out the activities described in the new varieties of PEs potentially created by the options set out in the *Action 7 PDD* (e.g., acting as a *commissionnaire*, providing warehouse or purchasing services, etc.) already have a taxable presence of their own in the host State and are paying tax there on

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[51] The same applies to new fixed-place-of-business PEs that would arise by virtue of raising the PE exemption threshold in ¶ 4.

[52] *2010 Report*, Part I, ¶ 228.

[53] *2010 Report*, Part I, ¶ 8.

the arm's length remuneration they receive for the functions they perform. Under these circumstances, no further profits are attributable under the AOA to a dependent-agent PE unless "source" State personnel whose activities give rise to a dependent-agent PE perform significant people functions relevant to the assumption and/or management of risks of the foreign enterprise or to determining economic ownership of assets owned by the foreign enterprise.[54] Whether or not such functions are undertaken can only be determined by functional and factual analyses of a dependent agent enterprise, and can't be presumed. We note that it is difficult to imagine what such functions might be in the context of the various proposed forms of PEs, and we urge the Focus Group to provide guidance on when they believe such functions do and do not exist and what the profit attribution implications are in each case. The Focus Group should also clarify in particular that <u>no presumption</u> should arise that such "source" State personnel necessarily perform and control functions, or control risks, related to the development, enhancement, maintenance, protection, or exploitation—as that phrase is used in the BEPS Action 8: 2014 Deliverable—*Guidance on Transfer Pricing Aspects of Intangibles*[55]—relating to any intangibles involved in PE transactions. This clarification is consistent with guidance in the *2010 Report*.[56]

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[54] *2010 Report*, Part I, ¶¶ 228 & 232.

[55] ¶ 6.32 ff.

[56] "[I]t should be noted that the activities of a mere sales agent may well be unlikely to represent the significant people functions leading to the development of a marketing or trade intangible so that the dependent agent PE would generally not be attributed profit as the "economic owner" of that intangible." *2010 Report*, ¶ 233.

ITI Member Companies

1. Adobe Systems, Inc.
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3. Agilent Technologies, Inc.
4. Akamai Technologies, Inc.
5. Alcatel-Lucent USA, Inc.
6. Altera Corporation
7. AOL, Inc.
8. Apple, Inc.
9. Applied Materials, Inc.
10. Autodesk, Inc.
11. BlackBerry, Ltd.
12. Brother Industries, Ltd.
13. Canon, Inc.
14. CA Technologies, Inc.
15. Cognizant Technology Solutions Corporation
16. Corning Incorporated
17. Dell, Inc.
18. eBay, Inc.
19. EMC Corporation
20. Epson America, Inc.
21. Ericsson, Inc.
22. Facebook, Inc.
23. Fujitsu Ltd.
24. Google, Inc.
25. Hewlett-Packard Company
26. HTC Corporation
27. IBM Corporation
28. Intel Corporation
29. Intuit, Inc.
30. Kodak Americas, Ltd.

31. Lenovo Group Ltd.
32. Lexmark International, Inc.
33. Logitech, Inc.
34. Micron Technology, Inc.
35. Microsoft Corporation
36. Monster Worldwide, Inc.
37. Motorola Solutions, Inc.
38. NCR Corporation
39. Nokia Corporation
40. Oracle Corporation
41. Panasonic Corporation
42. Qualcomm, Inc.
43. Ricoh Corporation
44. Samsung Electronics Co., Ltd.
45. SAP SE
46. Schneider Electric
47. Seagate Technology, PLC
48. Sony Electronics, Inc.
49. Symantec Corporation
50. Synopsys, Inc.
51. Tata Consultancy Services
52. Teradata Corporation
53. Texas Instruments
54. Toshiba Corporation
55. Toyota Motor Corporation
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57. Visa, Inc.
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4. Atmel Corporation
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8. IBM Corporation
9. Intel Corporation
10. Intersil Americas LLC
11. Lansdale Semiconductor, Inc.
12. Linear Technology Corporation
13. LSI Corporation
14. Maxim Integrated Products, Inc.
15. Micron Technology, Inc.
16. ON Semiconductor Corporation
17. PMC-Sierra, Inc.
18. Qualcomm, Inc.
19. Rochester Electronics, Inc.
20. SanDisk Corporation
21. Spansion, Inc.
22. Texas Instruments, Inc.

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4. Acxiom Corporation
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7. Altera Corporation
8. Amazon.com
9. Apple Inc.
10. Applied Materials, Inc.
11. Avago Technologies Ltd.
12. Aviat Networks, Inc.
13. Bio-Rad Laboratories, Inc.
14. BMC Software, Inc.
15. Broadcom Corporation
16. Brocade Communications Systems, Inc.
17. Cadence Design Systems, Inc.
18. Chegg, Inc.
19. Cisco Systems, Inc.
20. Cypress Semiconductor Corporation
21. Dolby Laboratories, Inc.
22. eBay, Inc.
23. Electronic Arts, Inc.
24. Etsy, Inc.
25. Evernote Corporation
26. Expedia, Inc.
27. Facebook, Inc.
28. FireEye, Inc.
29. Flextronics International Ltd.
30. Genentech, Inc.

31. Genesys Telecommunications Laboratories, Inc
32. Genomic Health, Inc.
33. Gilead Sciences, Inc.
34. GLOBALFOUNDRIES, Inc.
35. Google, Inc.
36. Groupon, Inc.
37. Hewlett-Packard Company
38. Ingram Micro, Inc.
39. Intel Corporation
40. Intuit, Inc.
41. Intuitive Surgical, Inc.
42. KLA-Tencor Corporation
43. Lam Research Corporation
44. Marvell Semiconductor, Inc.
45. Maxim Integrated Products, Inc.
46. Mentor Graphics, Inc.
47. Microsoft Corporation
48. Netflix, Inc.
49. NVIDIA Corporation
50. Oracle Corporation
51. Palo Alto Networks, Inc.
52. Pandora Media, Inc.
53. Pivotal Software, Inc.
54. Plantronics, Inc.
55. Power Integrations, Inc.
56. Qualcomm, Inc.
57. Riverbed Technology, Inc.
58. Rovi Corporation
59. salesforce.com
60. SanDisk Corporation
61. SAP

62. Seagate Technology, PLC
63. ServiceNow, Inc.
64. Silicon Image, Inc.
65. Silver Spring Networks
66. SMART Modular Technologies Corp.
67. SunPower Corporation
68. Symantec Corporation
69. Synopsys, Inc.
70. Tesla Motors, Inc.
71. The Walt Disney Company
72. Trimble Navigation Ltd.
73. Twitter, Inc.
74. Uber, Inc.
75. Visa, Inc.
76. VMware Corporation
77. Xilinx, Inc.
78. Yahoo! Inc.
79. Yelp Inc.

1. Apple, Inc.
2. Autodesk, Inc.
3. BMC Software, Inc.
4. Microsoft Corporation
5. Symantec Corporation
6. Synopsys, Inc.

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2. American Standard Development Company
3. Amyris, Inc.
4. Apple, Inc.
5. Arch Venture Partners
6. AT&T, Inc.
7. Blackberry, Ltd.
8. Bloom Energy
9. CA Technologies, Inc.
10. ChargePoint, Inc.
11. Cisco Systems, Inc.
12. ClearStreet, Inc.
13. Comcast Corporation
14. Covington & Burling LLP
15. Craigslist, Inc.
16. Dewey Square Group
17. Direct Energy PLC
18. Discovery Education, Inc.
19. eBay, Inc.
20. ecoATM, Inc.
21. eHealth, Inc.
22. Elance-oDesk, Inc.
23. EMC Corporation
24. Encryptics, Inc.
25. EnerNOC, Inc.
26. Etagen, Inc.
27. F5 Networks, Inc.
28. Facebook, Inc.
29. Gilead Sciences, Inc.

30. Goodwin Procter LLP
31. Google, Inc.
32. Hewlett-Packard Company
33. Intel Corporation
34. Intuit Inc.
35. Kleiner Perkins Caufield & Byers
36. Lee & Hayes, pllc
37. LiveOps, Inc.
38. Lyft, Inc.
39. Madrona Venture Group
40. Marvell Semiconductor, Inc.
41. MHR International, Inc.
42. Microsoft Corporation
43. MIND Research Institute
44. Morgan Stanley
45. Motor Vehicle Software Corporation
46. NASDAQ OMX Group, Inc.
47. OpenDNS, Inc.
48. Oracle Corporation
49. Palantir Technologies, Inc.
50. Perkins Coie LLP
51. Pfizer, Inc.
52. Point Inside, Inc.
53. Qualcomm, Inc.
54. Relevad Corporation
55. Revolution LLC
56. salesforce.com
57. SAP
58. Silicon Valley Bank
59. Silver Spring Networks, Inc.
60. Stanford University

61. SV Angel
62. Symantec Corporation
63. TechNexus
64. Uber, Inc.
65. Visa, Inc.
66. WGBH Boston
67. Wilson Sonsini Goodrich & Rosati
68. Yahoo! Inc.
69. Yelp Inc.