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VIA ELECTRONIC TRANSMISSION

Tax Treaties
Transfer Pricing and Financial Transactions Division
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Re: Comments on June 22, 2017 OECD Public Discussion Draft on BEPS Action 7
Additional Guidance on the Attribution of Profits to Permanent Establishments

Dear Sirs or Madams,

The Silicon Valley Tax Directors Group ("***SVTDG***") hereby submits these comments on the above-referenced Public Discussion Draft ("***PDD***"). SVTDG members are listed in the Appendix of this letter.

Sincerely,

Robert F. Johnson

Robert F. Johnson
Co-Chair, Silicon Valley Tax Directors Group

I. INTRODUCTION AND SUMMARY

A. Background on the Silicon Valley Tax Directors Group

The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley, that are dependent on R&D and worldwide sales to remain competitive. The 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.

B. Summary of recommendations

The PDD in places makes reference to the 2010 authorized OECD approach ("***AOA***"). We do the same. To ensure the final guidance will be considered relevant to the many treaties that don't incorporate the 2010 version of Article 7, we think it important for the guidance to confirm that the analysis provided will also apply under treaties with the pre-2010 version of Article 7, or to explain any differences in outcome, as appropriate.

The PDD explains that if activities performed by an associated enterprise intermediary give rise to an Article 5(5) dependent agent PE ("***DAPE***"), and if functions performed by the intermediary are both (i) significant people functions for attributing a specific risk to the PE under the AOA, and (ii) risk control functions for allocating the risk to the intermediary under Article 9, no double taxation should arise in the source/host country by virtue of twice taxing profits related to assumption of that risk—i.e., profits related to the assumption of that risk shouldn't be taxed in the hands of both the PE and the intermediary. The SVTDG agrees such double taxation should be avoided, and commends the OECD for clarifying any confusion on this point that might have arisen from the *2016 Discussion Draft*. The SVTDG notes, however, that the PDD seems in places confused on how such double taxation is avoided, especially in the sense of which entity—the intermediary or the PE—assumes the risk. For instance, each of *Examples 1–3* determines profits attributable to the PE by first hypothesizing it earns revenue consistent with it assuming particular risks, but then deducting from such hypothetical revenue a payment to the intermediary as if the intermediary assumed such risks. Such an approach may yield the correct profits attributable to the PE, but it violates a directive in the PDD that a risk assumed by an intermediary under the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* ("**TPG**") can't be considered assumed by the PE for purposes of Article 7. We point out the inconsistencies and recommend the PDD be clarified to remove them.

The SVTDG recommends the AOA should, in the context of PEs arising from activities of associated enterprise intermediaries, be revised to better align with the current (2017) *TPG,* especially regarding risk attribution. The *2010 Profit Attribution Report on the Attribution of Profits to Permanent Establishments* (the "**2010 Profit Attribution Report**") by its terms must comport with the post-BEPS version of the *TPG*. If the AOA under the *2010 Profit Attribution*

Report takes into account discussion of risk control in the current *TPG*, a strong argument can be made that the attribution of risks to an associated enterprise DAPE under the AOA should, in cases in which the associated enterprise intermediary has the financial capacity to assume the risks, be materially the same as the allocation of risks between a nonresident enterprise ("***NRE***") and the intermediary under Article 9. As a consequence, in the context of attributing profits to an associated enterprise DAPE as a result of risk attribution, we believe the host country's taxing rights in many cases will be exhausted by taxing the intermediary on income from arm's length compensation it gets for risk it bears.

We recommend the OECD adopt a new paragraph in Article 5[1] allowing an NRE that would otherwise be treated as having a PE as a result of host country activities of a closely related person to avoid such treatment if the NRE and the resident enterprise (i) make a binding election pursuant to which the latter agrees to recognize profits equal to the sum of those profits otherwise attributable to the PE and any arm's length profits the resident enterprise would have based on functions performed on its own account; and (ii) execute intercompany arrangements pursuant to which the resident enterprise charges the NRE, and the NRE pays, an amount such that the total profits recognized by the resident enterprise are described in (i). This provision, if availed of, would ensure the host country collects from the resident enterprise the same total tax it would if the PE existed, yet result in the NRE having no PE, no filing obligation, and no tax liability in the host country arising from activities conducted on the NRE's account by the resident enterprise or at its premises.

II. Specific concerns with, and comments on, the *PDD*

A. The clarification in paragraph 18 on non-double taxation of profits from risk assumption is welcome, but the discussion needs refinement

Paragraph 18 of the PDD discusses situations in which the NRE and the intermediary (whose activities give rise to a DAPE) are associated enterprises, so that Articles 7 and 9 both apply. In particular, it addresses the situation in which the functions performed by the intermediary are <u>both</u> (i) "significant people functions" ("***SPFs***") for attribution of a specific risk to the PE under the AOA; and (ii) risk control functions for allocation of the risk to the intermediary under Article 9.[2] Paragraph 18 correctly points out that <u>no double taxation should arise</u> in the source country by virtue of twice taxing profits related to assumption of that risk—

1 An alternative route to achieve the same goal could be for the competent authorities of two Contracting States to enter into a mutual agreement under Article 25(3) to provide the same approach, and we recommend that the OECD endorse this alternative route as well.

2 Tacit in paragraph 18 is the assumption that the intermediary has the financial capacity to assume the risk. This point should be clarified.

i.e., by virtue of taxing such profits in the hands of both the PE and the intermediary. Paragraph 18 states that if conditions (i) and (ii) are met, such double taxation can be avoided as follows:

> it is important to ensure that the risk to which those functions relate is not simultaneously allocated to the intermediary . . . and attributed to the PE . . . . Accordingly, where a risk is found to be assumed by the intermediary under [the *TPG*], such risk cannot be considered to be assumed by the [NRE] or the PE for the purposes of Article 7.

The SVTDG agrees that such double taxation should be avoided, and commends the OECD for clarifying any confusion on this point that may have arisen from the *2016 Discussion Draft*.

The SVTDG notes, however, that the PDD is in places confused on how—i.e., the mechanism by which—such double taxation is avoided. The SVTDG agrees that, provided conditions (i) & (ii) are met, if a risk is assumed by an associated enterprise intermediary under Article 9, it can't also be considered assumed by the NRE or the PE. So if Article 9 analysis is done first the risk is allocated to the intermediary, and such risk can't be assumed by the PE (or the NRE).

If, however, Article 7 (AOA) analysis is done first, one way of proceeding is to initially attribute the risk to the PE for purposes of determining a hypothetical revenue amount earned by the PE, but subsequently—when determining the nominally deductible payment the PE should make to the intermediary[3]—allocate risks to the intermediary for purposes of determining such nominal payment. This is the approach the PDD takes in *Examples 1–3*.[4] In theory both

[3] PDD ¶ 10 ("The arm's length reward to the intermediary for the services it provides to the non-resident enterprise is one of the elements that needs to be determined and deducted in calculating the profits attributable to the PE under Article 7.")

[4] In *Example 1* the hypothetical revenue used as a starting point for determining profits attributable to the PE is "the amount of [the NRE's] revenue from sales of goods to customers in [the source country]," equivalent to "attributing to the PE the sales revenue resulting directly or indirectly from the contracts to which Article 5(5) refers;" (PDD ¶ 25); in *Example 2* such hypothetical revenue is "the amount of [the NRE's] revenue from sales to customers in [the source country]," likewise equivalent to "attributing to the PE the sales revenue resulting directly or indirectly from the contracts to which Article 5(5) refers;" (PDD ¶ 30); and in *Example 3* such hypothetical revenue is "the amount that [the NRE] would have had to pay if had purchased the widgets from an unrelated supplier performing the same functions in [the source country] that [the intermediary] performs on behalf of [the NRE] (attributing to such supplier ownership of the assets of [the NRE] related to such functions, and assumption of the risks related to such functions);" equivalent to "attributing to the PE the rights and obligations associated with the procurement of widgets resulting directly or indirectly from the contracts to which Article 5(5) refers." (PDD ¶ 34). In all three *Examples* the attribution of risk to the PE to derive a hypothetical (starting) revenue is either directly or indirectly apparent.

approaches should yield the same profits attributable to the PE:[5] under an Article-7-first approach as described, hypothetical revenue earned by the PE reflects an amount for the risk initially attributed to the PE, but the nominally deductible payment from the PE to the intermediary (based on the risk allocated to the intermediary under Article 9) gives an equal offset. Under an Article-9-first approach, because the PE doesn't assume the risk, hypothetical revenue earned by the PE wouldn't reflect an amount for such risk, which is allocated solely to the intermediary, and so there's no nominally deductible payment from the PE to the intermediary. This contradicts the statement in the PDD that "[t]he arm's length reward to the intermediary for the services it provides to the non-resident enterprise is one of the elements that needs to be determined and deducted in calculating the profits attributable to the PE under Article 7."[6]

On the other hand, the Article-7-first approach as described (and as applied in *Examples 1–3*) strictly contradicts the directive in the quoted passage above that a risk assumed by the intermediary shouldn't be considered assumed by the PE. An Article-7-first approach that hewed to the directive in the passage <u>wouldn't</u> begin with hypothetical revenue earned by the PE that reflects the relevant risk. Rather, such hypothetical revenue would be a lesser amount. But with this approach there <u>wouldn't</u> be a nominal deductible payment to the intermediary for its assuming the risk.

The SVTDG recommends that these points be clarified.

The Article-7-first approach carries with it the possibility the tax administration of the host country might—in determining profits attributable to a PE—impose withholding on deemed payments made by the PE. The AOA suggests the host country shouldn't withhold on such notional payments.[7] Nonetheless, for the above reasons, the SVTDG recommends the PDD be revised to recommend the Article-9-first approach is preferable.

The discussion in paragraph 18 <u>assumes</u> conditions (i) & (ii) are met—i.e., functions performed by the intermediary are both SPFs resulting in attribution of a particular risk to the PE (Article 7) <u>and</u> risk control functions resulting in allocation of the risk to the intermediary (Article 9). Certainly in this situation double taxation of profits associated with the risk shouldn't arise (regardless of whether Article 9 or Article 7 is applied first). The SVTDG asserts further that activities giving rise to risk control functions under Article 9 should automatically

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5 This assumes, for any particular risk, that the profit attributed to a PE for such risk bearing (because of SPFs) under Article 7 equals the arm's length amount allocable to the intermediary under Article 9 for such risk bearing. The SVTDG recommends the OECD clarify this point.

6 *Id.*

7 AOA, ¶ 203 ("The recognition of the notional royalty is relevant only to the attribution of profits to the PE under Article 7 and should not be understood to carry wider implications as regards withholding taxes, which are outside the scope of this Report.")

constitute risk attribution functions under Article 7. Accordingly, assumption (ii) in paragraph 18 should automatically be satisfied if assumption (i) is. We discuss this point next.

B. The AOA should be revised to make attribution of risks consistent with guidance in the *TPG*

The PDD states in paragraph 17:

> While there may be functions that would be considered both [SPFs] for the attribution of risk for the purposes of the AOA and risk control functions for the purposes of Article 9, the conclusion cannot be drawn that these two concepts are aligned or can be used interchangeably for purposes of Article 7 and Article 9.

The SVTDG respectfully disagrees with this statement, and believes these two concepts <u>are</u> and <u>should be</u> aligned—with appropriate assumptions, Article 7 attribution of risks arising from SPFs should follow Article 9 allocation of risks arising from risk control functions. For three reasons (outlined below), the SVTDG recommends the PDD be revised to explain this conceptual alignment.

At the outset we note a potential consequence of non-alignment in the context of an NRE and an associated enterprise intermediary whose activities give rise to a PE. <u>If</u> functions performed by the intermediary constitute SPFs for purposes of attributing a particular risk to the PE under Article 7 (the AOA), but <u>not</u> control functions for purposes of allocating the risk to the intermediary under Article 9, profit related to the risk will be attributed to the PE, and in determining aggregate profits attributable to the PE there'll be <u>no deduction</u> for a nominal payment by the PE to the intermediary in connection with such risk. The arm's length payment from the NRE to the intermediary under Article 9 wouldn't include any component for assumption of this risk by the intermediary, but the profit attributable to the PE would include such a component. More tax would likely be owing in the source country than from just the intermediary because the PE—but not the intermediary— would be subject to tax on income from this risk-related component. A source country tax administration would thus collect more tax by asserting a lower threshold for SPF attribution of risk under Article 7 than for control function allocation of risk under Article 9. The SVTDG believes the threshold under Article 7 shouldn't be lower than it is under Article 9.

1. The AOA should, in the context of PEs arising from activities of associated enterprise intermediaries, be revised to better align with the *TPG* regarding attribution of risks

The *2010 Profit Attribution Report* relies critically on the *TPG* in an ambulatory way[8]—i.e., in particular, changes made in § I.D ("Guidance for applying the arm's length standard") of the *TPG* must be reflected in how the AOA is applied. Changes to the *TPG* as a result of BEPS Actions 8–10 *Final Reports* reflected a mammoth multi-year, multi-country effort receiving careful public scrutiny and comment at several stages. When changes to § I.D of the *TPG* are taken into consideration in applying the AOA, a strong argument can be made that—in the context of associated enterprise DAPEs[9]—attribution of risks to a DAPE under the AOA should, in cases in which the host country intermediary has the financial capacity to assume the risks, be <u>materially the same</u> as the allocation of risks between an NRE and the associated enterprise intermediary under Article 9.

We note also the further complexity introduced by the form of compensation chosen for the arm's length pricing under Article 9 (regardless of which transfer pricing method is most appropriate). Contingent pricing forms can have the effect of shifting risks between associated enterprises.[10] Any such shifted risks should in principle also be taken into account under the AOA.

The *2010 Profit Attribution Report* states that a requisite functional and factual analysis is the foundation of a two-stage attribution of risks to a PE under the AOA:

> The functional and factual analysis will [1] <u>initially attribute</u> to the PE any risks inherent in, or created by, the <u>PE's own [SPFs]</u> relevant to the assumption of risks and [2] take into account any subsequent <u>dealings</u> or transactions related to the <u>subsequent transfer of risks</u> or to the <u>transfer of</u>

8 *2010 Profit Attribution Report*, Preface ¶ 10 ("[This *2010 Profit Attribution Report*] has been based upon the principle of applying by analogy the guidance found in the [*2010 TPG*] for purposes of determining the profits attributable to a PE. To the extent the [*2010 TPG*] are modified in the future, this [*2010 Profit Attribution Report*] should be applied by taking into account the guidance in the [*TPG*] as so modified from time to time.")

9 That is, a DAPE arising under Article 5(5) because of host-country activities performed by an associated enterprise intermediary.

10 The payor of a contingent amount is insulated against the downside of possible underperformance or nonmaterialization of the item or event(s) to which the contingency is attached; the payee is insulated against the downside of possible over-performance or excess materialization of that item. This commonsense notion was observe in the 2016 OECD Public Discussion Draft on BEPS Actions 8–10 *Revised Guidance on Profit Splits*, ¶ 6.

> the management of those risks to different parts of the enterprise or to other enterprises.[11]

That is, [1] there's an initial attribution to the PE of risks based on the PE's own SPFs; the relevant SPFs will be those performed by the intermediary on behalf of the NRE.[12] This is followed possibly by [2] the subsequent shifting of risks, or of management of risks, either within the enterprise or to other enterprises.

Under the AOA, SPFs relevant to [1] initial attribution to a PE of risks are those requiring "active decision-making with regard to the acceptance and/or management" of the risks.[13] By comparison, under the *TPG*, delineation of the actual transaction involves determining which party or parties bear each economically significant risk, meaning determining which party controls the risk and has the financial capacity to assume the risk.[14] Under the *TPG*, control over risk also involves active decision-making with regard to acceptance and management of risks.[15] Active decisionmaking functions triggering risk assumption under the *TPG* should thus also result in risk attribution under the AOA.

Regarding [2] the subsequent shifting of risks, or the management of risks, within the enterprise, the *2010 Profit Attribution Report* states—

> Being attributed risks in the Article 7 context means the equivalent of bearing risks for income tax purposes by a separate enterprise, with the attendant benefits and burdens, in particular the potential exposure to gains or losses from the realisation or non-realisation of said risks. This raises the question of whether, and if so, in what circumstances, dealings resulting in the transfers of risks should be recognised within a single entity so that risks initially assumed by one part of the enterprise will be treated as subsequently borne by another part of the enterprise. The circumstances in which it is possible to recognise such a transfer are discussed in Section D-2(vi) ["Recognition of 'dealings'"].[16]

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11 *2010 Profit Attribution Report*, ¶ 21 (emphasis added).

12 *2010 Profit Attribution Report*, ¶ 47.

13 *2010 Profit Attribution Report*, ¶ 22. *See also*, ¶ 25, which, in the context of a sales PE example outlined in ¶ 23, reiterates the "the [SPFs] relevant to the assumption of risks are those which involve active decisionmaking."

14 *See, e.g.*, *TPG*, ¶ 1.86.

15 Control over risk involves "(i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function." *TPG*, ¶ 1.65.

16 *2010 Profit Attribution Report*, ¶ 21 (emphasis added).

The referenced § D-2(vi) of the *2010 Profit Attribution Report* discusses how to adapt the *TPG* to the PE context, and concludes the functional and factual analysis "will require the determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the dealing."[17] The discussion of intra-enterprise dealings is relevant—

> A dealing takes place within a single legal entity and so there are no "contractual terms" to analyse. However, the [AOA] treats "dealings" as analogous to transactions between associated enterprises and so the guidance in [¶¶ 1.52–1.54 of the *2010 TPG*—entitled "Contractual terms"] can be applied in the PE context by analogy. . . . Further, [¶ 1.48 of the *2010 TPG*] notes that "in line with the discussion below in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties' conduct should generally be taken as the best evidence concerning the true allocation of risk." Paragraph 1.49 [of the *2010 TPG*] goes on to note that "an additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm's length transactions. <u>In arm's length dealings it generally makes sense for parties to be allocated a greater share of risks over which they have relatively more control</u>.[18]

In addressing intra-enterprise dealings that might shift risk, the *2010 Profit Attribution Report* thus references segments of the *2010 TPG*, dealing with risks, that were extensively overhauled in the current *TPG*.[19] Significantly, risk shifting [2] under the AOA should also align with allocation of risks (under the *TPG*) that flows from risk control activities.

The *2010 Profit Attribution Report*'s guidance on the AOA's [1] initial attribution of risks, and [2] possible subsequent shifting of risks, or risk management, overlaps with guidance in the current *TPG* on control of risk. Control of a risk under the current *TPG* means having—

> (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decisionmaking function.[20]

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17 *2010 Profit Attribution Report*, ¶ 178.

18 *Id.*, ¶ 179 (emphasis added).

19 *See also*, *Id.*, ¶ 182, ("Once the above threshold has been passed and a dealing recognised as existing, the [AOA] applies, by analogy, the guidance at [¶¶ 1.48–1.54 and 1.64–1.69 *2010 TPG*].")

20 *2016 TPG*, ¶ 1.65.

These requirements for control of risk under the *TPG* are materially the same as the "active decision-making" required for initial attribution of risks, and the control required for subsequent shifting of risks (or risk management), under the AOA. The SVTDG recommends that risk attribution as a consequence of SPFs under the AOA thus should comport with risk allocation under the current *TPG*.

For an associated enterprise to bear risk under the *TPG*, the bearer must—in addition to controlling the risk—have the financial capacity to assume it. A consequence of risk attribution under the AOA is that the part of the enterprise performing SPFs relevant to risk assumption are attributed sufficient capital to support the risks—i.e., that part of the enterprise is deemed to have the financial capacity to assume the risk.[21] Accordingly, under Article 7 (AOA) initial attribution, and possible intra-enterprise shifting, of risks to a DAPE should be consistent with the Article 9 allocation of risks to the associated enterprise intermediary <u>if</u> the intermediary has the financial capacity to assume the risk. As noted above in § II.A, under an Article-9-first approach, risks allocated from an NRE to an associated enterprise intermediary under Article 9 should not then be attributed to the NRE's PE under Article 7.

2. Practicability supports aligning the AOA with the *TPG*, to decrease the likelihood of double taxation

The SVTDG believes risk attribution under Article 7 should be aligned with risk allocation under Article 9 (assuming the requisite financial capacity to assume the risk). Many tax administrations have much experience applying transfer pricing principles to associated enterprise transactions. The recent addition of detailed guidance in the *TPG* on risk allocation—as a result of the BEPS Actions 8–10 *Final Reports*—fits within a well understood framework of the arm's length principle. By contrast, tax administrations generally have much less experience applying Article 7 (and even less experience applying the AOA) to attribute risk to a PE. The concept of risk attribution under the AOA is also relatively complex and somewhat subjective.

The SVTDG believes that—without further guidance signaling alignment of the Article 7 risk attribution concept with that of the Article 9 risk allocation concept—tax administrations will face significant difficulties applying these concepts. As noted above in § II.B, a perverse incentive potentially exists to collect more tax by asserting a lower activity threshold for risk attribution to a PE under Article 7 than for risk allocation to an associated enterprise intermediary under Article 9. At a minimum, we think it unlikely in practice that a tax authority could, in an unbiased way, suitably parse and apply the two standards to reach materially different outcomes. We believe application of the Article 7 risk attribution and Article 9 risk allocation concepts is unlikely to be uniform across taxing jurisdictions. Similarly, we think it unlikely in practice that two Competent Authorities applying the two standards would

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[21] *2010 Profit Attribution Report*, ¶ 47.

necessarily converge on materially the same outcome. This will almost certainly lead to more competent authority disputes, with a high probability of resulting double taxation. This can be mitigated if the OECD modifies risk attribution under the AOA to comport with risk allocation under the *TPG*.

3. Policy supports aligning attribution under the AOA with guidance in the *TPG*

Ideally, tax outcomes shouldn't drive business decisions. But non-alignment of Article 7 risk attribution with Article 9 risk allocation will almost certainly result in business decisions taken to mitigate the uncertainty in application of the two provisions. In particular, NREs would—other things being equal—generally prefer the relative certainty of application of Article 9 in the context of an associated enterprise buy-sell model to the relative uncertainty of application of Article 7 in the context of an associated enterprise *commissionaire* model. It's rational to expect that the economic value of risk-related functions should lead to equivalent outcomes under either model. Yet non-alignment of Article 7 risk attribution with Article 9 risk allocation confounds that expectation, and it's likely to force taxpayers to choose a buy-sell distributor model, the tax outcomes of which can be determined with greater certainty. This is a bad policy outcome, and can be remedied by the recommended alignment of Article 7 risk attribution concepts with *TPG* risk allocation concepts.

The SVTDG further recommends, in conjunction with its recommendation on alignment, that the OECD signal that the tax outcome—i.e., total tax collected in a source country—under a *commissionaire* structure giving rise to a PE should in many situations be the same as the tax outcome under a buy-sell structure.

C. Going beyond administrative approaches to enhance simplification in cases in which MTC Articles 7 & 9 are both applicable

The PDD acknowledges the important point that "the potential burden on a [NRE] of having to comply with host country tax and reporting obligations in the event it is determined to have an Article 5(5) PE cannot be dismissed as inconsequential."[22]

The PDD points to the *2010 Profit Attribution Report* as noting there may be "administratively convenient ways recognising the existence of a PE under Article 5(5) and collecting the appropriate amount of tax resulting from the activity of the intermediary."[23] The PDD also explains that countries not adopting the AOA "may also adopt mechanisms aimed at simplifying taxpayer's compliance with tax obligations related to the existence of a PE in the

[22] PDD ¶ 21.

[23] PDD ¶ 20.

source country."[24] The PDD explains that a number of countries actually collect tax only from the intermediary even though the amount of tax is calculated by reference to activities of both the intermediary and the Article 5(5) DAPE.[25]

Consistent with these general observations, the *Analysis* sections of *Examples 1–3*, each of which involve a DAPE, and an intermediary and NRE that are associated enterprises, each explain that "[f]or reasons of administrative convenience, the tax administration in [the host/source country] may choose to collect tax only from [the intermediary] even though the amount of tax is separately calculated by reference to the activities of both [the intermediary] and the PE.[26]

The SVTDG appreciates the PDD's acknowledgement of the not inconsequential host-country tax and reporting obligations imposed on an NRE with a PE, and the PDD's observation of ad hoc approaches by countries to collect (only) from the intermediary any aggregate tax owing. The SVTDG believes, however, that more could be done to alleviate burdens imposed on an NRE in situations in which an Article 5(5) DAPE exists. The SVTDG respectfully suggests that no valid policy grounds are furthered, and cross-border commerce is actually hampered, by asserting the existence of a PE for the sake of primarily imposing compliance burdens (and perhaps penalties) on NREs. This situation would arise if little or no profits are attributable to a DAPE, and would also arise in situations in which tax imposable on a PE could be collected from an intermediary.

The SVTDG accordingly recommends Article 5 of the MTC be changed[27] to include a new paragraph 8, allowing an NRE and a closely related person in a source country to make a binding election, and maintain their intercompany arrangements, so as to ensure the host country collects the same tax it would <u>if</u> the closely related person gave rise to a PE, yet resulting in <u>no</u> PE being deemed to exist.[28] This simplification would reduce compliance burdens for the NRE, and also lower burdens on tax administration resources in the host country.

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24 *Id*. The PDD further explains that adoption of such administratively convenient procedures in the host [i.e., source] country wouldn't alter taxing rights of the home country or host country.

25 PDD ¶ 21.

26 *See* PDD ¶¶ 26 (*Example 1*), 31 (*Example 2*), & 35 (*Example 3*).

27 An alternative route to achieve the same goal could be for the competent authorities of two Contracting States to enter into a mutual agreement under Article 25(3) to provide the same approach, and we recommend that the OECD endorse this alternative route as well.

28 We made this recommendation in our *2016 SVTDG Comment Letter*.

To this end, we recommend the OECD consider adopting in Article 5[29] the following new paragraph:

> 8. Notwithstanding the preceding provisions of this Article, activities conducted in a Contracting State by a person that is closely related to an enterprise or through a fixed place of business of any such person shall not cause such enterprise to have a permanent establishment in that State if the enterprise and the person jointly make a binding election pursuant to which the profits of such person which may be taxed in that State shall be equal to the sum of the profits such person would have and the profits that would be attributable to any such permanent establishment of the enterprise in the absence of such election. It is understood that the enterprise and person that make the binding election provided under this paragraph shall ensure that the conditions established between them produce a result that is consistent with the effect of the election, and it is further understood that such conditions shall be considered to be consistent with conditions that are made or imposed between independent enterprises for purposes of the provisions of the domestic law of each Contracting State and Article 9 of this Convention.

This provision would allow an NRE that would otherwise be treated as having a PE in a host country to <u>avoid</u> being treated as having such a PE (and thus avoid the need to comply with host country tax and reporting obligations) in certain circumstances and provided certain conditions are met. The provision would potentially apply only for Article 5(5) DAPEs (i.e., PEs arising from activities of a person closely related to the NRE and resident in the host country) or from activities conducted at the premises of such a person (e.g., a so-called "fixed place of business PE" under Article 5(1)).

To achieve such "no PE" treatment, the provision requires the resident enterprise and the NRE to enter into:

[i] a <u>binding election</u> that provides the resident enterprise agrees to recognize profits, if any, equal to the sum of the profits attributable to the PE of the NRE that would exist in the absence of the binding election, based on functions undertaken on that NRE's account (taking into account assets and risks attributed to the PE, and necessary "free" capital to support them), plus arm's length profits, if any, the resident enterprise would have in the absence of the binding election, based on functions undertaken by that resident enterprise on its own account (taking into account its own assets and risks) and

29 An alternative route to achieve the same goal could be for the competent authorities of two Contracting States to enter into a mutual agreement under Article 25(3) to provide the same approach, and we recommend that the OECD endorse this alternative route as well.

[ii] intercompany arrangements providing that where the binding election is made, the resident enterprise shall charge the NRE, and the NRE shall pay, an amount such that the total profits recognized by the resident enterprise are equal to the arm's length profits, if any, the resident enterprise would recognize in the absence of the election, plus the profits, if any, attributable to the PE the NRE would have in the absence of the election. While the latter amount depends under the AOA on assets, risks, and capital deemed owned, assumed, or contributed, respectively, to the PE, such intercompany arrangement would not need to delineate such deemed assets, risk, or capital.

If, for example, a resident enterprise (intermediary) performs services in a host country on behalf of a closely related NRE, those services could cause the NRE to have a PE in the host country under normal operation of Article 5(5) if they fall within the activities covered by that provision. Suppose the profits attributable to that PE under the AOA would be 100, before any deduction for the arm's length service charge payable to the resident enterprise. Suppose further the arm's length charge for those services under Article 9 would be 88, and the arm's length profit recognized by the resident enterprise from receipt of that payment would be 8, after deduction for its own costs of 80. That would leave 12 of profit attributable to the NRE's PE, and a total profit of 20 taxable by the host country (i.e., 8 in the hands of the resident enterprise and 12 in the hands of the NRE). If, however, the enterprises were to make the binding election authorized by proposed Article 5(8), the NRE would agree to increase its payment to the resident enterprise from 88 to 100, and the resident enterprise would agree to be taxable in the host country on a total amount of 20. The host country would be entitled to collect tax on the profit of 20 from the resident enterprise, and the NRE's country of residence would agree to allow the NRE a deduction for the full payment of 100 to the host country's resident enterprise.

This provision would, if availed of, result in the NRE having no PE, no filing obligation, and no tax liability in the host country arising from activities conducted on the NRE's account by the resident enterprise or at its premises. The NRE would be entitled to deduct amounts accrued under the intercompany arrangement with the resident, discussed above. This provision wouldn't eliminate a PE, filing obligation, or tax liability in a host country arising from a NRE's own activities or operations in that country unrelated to a PE arising from a resident enterprise's activities or premises.

D. The explanation in *Example 4* of how profits attributable are determined should be corrected or clarified

The Analysis in *Example 4* shows the NRE has (with the given assumption) two PEs in the host country (Country S) by application of Article 5(4.1). That is, the preparatory or auxiliary exception to PE status in Article 5(4) doesn't apply to either the warehouse or the office—each of which is a fixed place of business through which the business activities of OnlineCo is (partly) carried on—because the overall activity resulting from the combination of activities at the warehouse and office isn't of a preparatory or auxiliary character.[30] The Analysis conditions this result on the assumption that the business activities carried on by OnlineCo at the warehouse and the office "constitute complementary functions that are part of a cohesive business operation."[31]

In determining profits attributable to the warehouse PE, the PDD begins with "the amount . . . OnlineCo would have had to pay if it had obtained the storage and delivery services from an independent enterprise in Country S (attributing to such service provider ownership of the assets of OnlineCo related to such functions, and assumption of the risks of OnlineCo related to such functions)."[32] The PDD footnotes that "[t]his is equivalent to attributing to the PE the rights and obligations associated with the purchase of storage and delivery services resulting directly or indirectly from the contracts to which Article 5(5) refers."[33] The footnote reference to "the contracts to which Article 5(5) refers" is puzzling inasmuch as the Facts and Analysis of *Example 4* point to the existence of a fixed-place-of-business PE under Article 5(1) (in tandem with Article 5(4) and the anti-fragmentation rule in Article 5(4.1) rather than a dependent-agent PE under Article 5(5). The footnote reference to "the contracts to which Article 5(5) refers" may refer to contracts relevant to activities performed by employees staffing the warehouse—i.e., to shipment receipt, and order delivery, although such contracts aren't referred to in the Facts. If so, the SVTDG recommends the footnote clarify this. Alternatively, the footnote reference may have been an inadvertent carryover of language from *Examples 1*, *2*, and *3*, which did involve Article 5(5) PEs. If so, the SVTDG asks that this reference be corrected. A corresponding change should likewise be made to footnote 15, relevant to determination of profits attributable to the office PE.

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30 PDD ¶ 47.

31 *Id*.

32 PDD ¶ 48.

33 *Id*., n. 13.

Accenture
Activision Blizzard
Acxiom
Adobe
Agilent
Amazon
Apple
Applied Materials
Atlassian
Autodesk
Bio-Rad Laboratories
BMC Software
Broadcom Limited
Brocade
Cadence
Chegg, Inc.
Cisco Systems Inc.
Dell Inc.
Delphi
Dolby Laboratories, Inc.
Dropbox Inc.
eBay
Electronic Arts
Expedia, Inc.
Facebook
Fitbit, Inc.
Flex
Fortinet
GE Digital
Genentech
Genesys
Genomic Health
Gigamon
Gilead Sciences, Inc.
GitHub
GLOBALFOUNDRIES
GlobalLogic
Google Inc.
GoPro
Hewlett-Packard Enterprise
HP Inc.
Indeed.com
Informatica
Ingram Micro, Inc.
Integrated Device Technology
Intel
Intuit Inc.
Intuitive Surgical
Keysight Technologies
KLA-Tencor Corporation
Lam Research
Marvell
Maxim Integrated
MaxLinear
Mentor Graphics
Microsemi
Microsoft
NetApp, Inc.
Netflix
NVIDIA
Oracle Corporation
Palo Alto Networks
PayPal
Pivotal Software, Inc.
Plantronics
Pure Storage
Qualcomm
Qualys, Inc.
salesforce.com
Sanmina-SCI Corporation
Seagate Technology
ServiceNow
ShoreTel
Snapchat, Inc.
SurveyMonkey
Symantec Corporation
Synopsys, Inc.
Tesla Motors, Inc.
The Cooper Companies
The Walt Disney Company
Theravance Biopharma
TiVo Corporation
Trimble, Inc.
Twitter
Uber Technologies
Veeva Systems
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VMware
Western Digital
Xilinx, Inc.
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