Dear Sir, Dear Madam,

In the context of BEPS Action 7, OECD has released on July 4, 2016, a document for public review (the “Discussion Draft”) titled “Additional Guidance on the Attribution of Profits to Permanent Establishments”.

We thank you for the opportunity to provide comments on this document.

With this Discussion Draft, the OECD has produced a document which explores aspects of one of the most subtle concepts in tax, the Permanent Establishment (“PE”) and in particular the Dependent Agent PE (“DAPE”), following from Article 5.5 of the OECD Model Tax Convention (“MTC”). It represents the work on attribution of profits related to Action 7 of the BEPS Action Plan, elaborating the 2015 Final Report.

In spite of the considerable work done, we remain uncertain that the Draft addresses the concerns attached to the question of profit attribution to PEs, in particular in the context of what in the BEPS process is called “the Digital Economy”. Reasons are the following.

- The examples given in the Draft are based on deliberately simplified fact sets. Most of the key assumptions are unexplained. They tend to represent fact sets from the past, and to ignore the challenges attached to dealing with the consequences of business models that companies apply in the Digital Economy. In these models parties, whether or not associated in the sense of Article 9.1 MTC, seamlessly work together in the form of integrated processes in order to jointly create value; the parties involved are often globally dispersed.

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1 These comments represent views of the authors and do not necessarily reflect the views of NERA Economic Consulting.
- The essential mission of the BEPS initiative is to align taxation with value creation. Today’s business models can only be captured on the basis of understanding these value creating processes, and identifying the contribution to that joint value creation by the individual parties involved. The current Draft seems to have overlooked the value dimension nearly completely. The examples are based on static description of activities and operational or financial risks (ignoring strategic and human and intellectual capital risks). Consequently, no relevant insight is offered into how parties involved contribute to joint value creation.

- We think that it is important to note that the current Discussion Draft on profit attribution to permanent establishments may benefit from the insights offered by the Discussion Draft, issued simultaneously, containing Guidance on Profits Splits, and which are applicable integrally to the PE profit attribution. We strongly recommend alignment of the current Discussion Draft with the Draft on profits splits. This is the case in particular where it concerns the importance of Value Chain Analysis, the economic significance of risk and the application of profit split as a method in situations of integrated operations. The comments invited were requested to stay away from the PE definition as such. But given the interaction between the determination in today’s business models of the existence of a PE or not and the attribution of profits, it is doubtful whether this request is justified.

This being said, we may add the following comments to the examples and the Questions asked in the Discussion Draft. Please note that our comments are restricted to the field of economics, and that pure tax concepts (such as the application of the AOA) as such are left untouched.

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2 We may also refer in this respect to our comments on the BEPS Action 7 Discussion Draft of January 9, 2015, and to the article in BNA TP International Journal of December 16, 2008 by Fris, Llinares and Gonnet titled “PEs and transfer pricing: the playing field in international taxation redefined”.

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Detailed responses to the Draft Questions

Guidance on Particular Fact Patterns related to DAPEs (Q1)

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

The 2015 Action 8-10 BEPS report stressed the importance of (i) a first phase of “delineation” of the transactions as well as (ii), possibly, the consideration of a situation distinct from the one reflected in the contractual arrangements, in the context of the DEMPE framework.

Article 9 therefore dictates that a careful analysis of the economic contribution of the legal entities be performed, which may deviate from the legal arrangements.

Consequently, we believe that the order of the analyses may, in certain circumstances, affect the allocation of profit between the DAE and the DAPE, insofar as the true scope of functionality attributable to a legal entity such as the DAE or the NRE will be performed at the level of Article 9.

We think however that the order should not affect the attribution of profit amongst jurisdictions.

Example 1: DAPE – Agent (Q2 – Q5)

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

Most of the functional and factual analysis relies on assumptions. Therefore, we understand that Question 2 primarily relates to the following sentence, in §34:

“the DAPE has not been attributed the economic ownership of any assets (inventory, marketing intangibles, or receivables) of Prima because there are no significant people functions performed by Sellco on behalf of the non-resident enterprise (Prima) in Country B relevant to the attribution of economic ownership of such assets. Accordingly, there are no risks or assets attributable to the DAPE and there is no need to attribute capital to the DAPE.”

Example 2: DAPE - Distributor (Q6 – Q9)

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

Example 2 consists in attributing the return for inventory and receivable risks and assets to the DAPE because the DAE manages such assets.

In the way the example is drafted, it is difficult to know to which extent the “return of 9” attributable to the DAE

3 Including assets and risks
accounts for the inventory and receivable management functions. The only way to assess whether such a return is appropriate would be to have access to the economic analysis to determine how this return was determined, and, possibly, to review the external comparables that may have been used.

We assume that the return of 9 corresponds to the return that independent companies comparable to Sellco –acting as a distributor – , and with the same level of added value, but neither owning nor managing directly the inventory and receivables, would earn.

By the same token, it is not clear how the return of 2 has been determined. We assume it to be a risk-free return on the inventory and receivable, since we would expect the Functional Return to capture all of the return in excess of this risk-free return.

We may conclude that the total return of 7 already accounts for the whole of the functions and services provided by the DAE under Article 9 and reflects a situation where the DAE would manage the inventory and receivable on behalf of its principal, without actually owning those.

In this regard, we do appreciate that the profit of the DAE under Article 9 already accounts for the exploitation of the customer list, which is therefore not taken into account at the level of the analysis Article 7.

As such, we agree that the profit attributed to the DAPE is possibly reasonable.

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

No comment.

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

If Sellco does not have the financial capacity to assume the inventory and credit risks, under Article 9, the return attributable to such risks should be attributed, in whole or in part, to Prima.

Yet, if we assume that these risks are entirely managed by Sellco’s SPFs, then, under the AOA, the return for these risks would be attributable to the DAPE.

**Question 9.** What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE?

Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?

Based on our reading of the 2010 Report, we agree with the Draft that, under Article 7 and the AOA:

- The same functions are likely to be considered simultaneously for risk (or intangible) allocation under Article 9
- The inventory and credit risks are to be allocated to Sellco under Article 9 and the economic ownership of inventory and receivables is to be attributed to the DAPE

**Example 3: DAPE – no DAE (Q10 – Q11)**

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

The main difference between Example 2 and Example 3 is the absence of DAE.

The numerical figures may (surprisingly!) differ between Example 2 and 3, but we understand the overall logic of the P&L to be exactly the same. The Example seems to imply that additional marketing and sales efforts lead only to increased costs, with no impact on sales revenue as such. We fear this may illustrate the unconvincing relevance of the examples.

In that case, Article 7 substitutes indeed to Article 9, as if the Employee had been a DAE.

As reflected in the Example, the legal form of an economic agent does not affect the arm’s length outcome of dealings. In Example 3 the profit of the DAPE under Article 7 would be expected to be at least the same as if the Employee had been a DAE, under Article 9.
Question 11. What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?
No comment.

Example 4: Closely integrated functions (Q12 – Q13)

Question 12. Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?
Example 4 relates to a situation of integrated functions and where in substance, (i) functions performed by the DAE do not lead to the assumption of risk under Article 9, largely as a result of a close or literal reading of 1.95 of the BEPS Report 5 but (ii) these functions include SPFs which drive the allocation of assets and risks to the DAPE.
We do not reach the same conclusion as the Draft.
We believe such approach not to make any sense and the reason for this conclusion to be the too literal reading of §1.95. We believe this article to have been prepared so as to prevent abusive application of the AOA, in case of duplicative risk control. Nevertheless, we believe that it is not intended to be applied when high value adding risk control functions are effectively shared amongst several parties.

Question 13. Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima’s Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of risk within the same enterprise?
See response to question 12

Example 5: Fixed Place PE – Scenario A (Q14)

Question 14. Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?
No we do not agree.
In the example, the Draft uses an unspecified method to determine the fee attributable to WRU’s intangibles. We believe that the application of such a method to be highly complex.
We would rather recommend a TNMM or modified TNMM with a PLI based on the financial return of third parties. In that case, comparables relied upon would be independent companies providing low value-adding warehousing services.

Example 5: Fixed Place PE – Scenario B & C (Q15 – Q20)

Question 15. Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?
In Scenario B:
- We agree that the profit should be identical to that of scenario A as the service provided is identical. By saying that, we assume that the fact that the Draft mentions that the warehouse is run as a profit centre in Scenario A and as a cost centre in Scenario B does not reflect a difference in functionality between the two scenarios. We understand that such difference would be actually reflected at the level of the Head Office.
- We also note that in the above, the terms cost centre and profit centre are used without proper definition; the most pertinent challenges in respect of PEs arise in situations where the (related) party’s profile is that of an expense centre or a revenue centre.

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5 “Furthermore, in some cases, there may be more than one party to the transaction exercising control over a specific risk. Where the associated enterprise assuming risk (as analysed under step 4(ii) controls that risk in accordance with the requirements set out in paragraphs 1.65-1.66, all that remains under step 4(ii) is to consider whether the enterprise has the financial capacity to assume the risk. If so, the fact that other associated enterprises also exercise control over the same risk does not affect the assumption of that risk by the first-mentioned enterprise, and step 5 need not be considered.”

6 We suggest the following set of definitions:
- **Investment Centre**: Profit centre the responsibility of which is linked to the continuity of the business
- **Profit Centre**: Responsible for the bottom line on a given period of time (one to three years in general)
- **Revenue Centre**: Its main objective is sales maximization taking into account costs discipline
- **Cost Centre**: Characterized by a measurable and thus manageable relationship between inputs and outputs
• As previously stated, we do think that third party income should be a valid reference point for the economic analysis.

We do agree with conclusions in scenario C

Question 16. In particular, do you agree that there can be an investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?
Yes, we do agree.
In a bottom-up analysis, such approach may also be relevant in certain circumstances (i.e. total compensation would be the sum of a return on assets plus a profit of the PE’s operating costs, respectively determined by appropriate reference to the dealings of independent parties)

Question 17. Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, i.e. attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?
No, we do not agree with this approach to the extent that the functional analysis in Scenario C in particular, does not show the existence of any investment advice.
In such circumstances, we believe that a risk-free return may be appropriate.

Question 18. Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.
We do agree that the fact that SPF may be performed by other parties (such as Wareco in Scenario C) would not lead to an additional attribution of risk or assets to the PE.
The profit attributable to a Fixed Place of Business PE would be determined based on the tangible assets and functions (including SPF) attributable to such PE.

Question 19. Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits to the PE of WRU?
No, we do not think there would, as long as the interest is not included in the basis for the mark up.

Question 20. What would the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?
No comment.

Additional approaches (Q21)

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