

We welcome the opportunity to express these comments which we shall be pleased to present and discuss during the next public consultation.

Yours sincerely,



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5. Last but not least, let us observe that the issue of profit attribution to permanent establishments may in the future raise fundamental and broader policy challenges beyond BEPS Action 7, notably in the field of the digital economy. As mentioned in our cover letter our comments will not engage into this broader discussion. Yet, we would for the future welcome a stronger coordination between the tax treaty aspects (lowering or rethinking the permanent establishment definition), on the one hand and the transfer pricing issues (attribution of profits to permanent establishments), on the other hand. It is indeed known that a number of jurisdictions have not adopted the changes recommended by BEPS Action 7, in particular because of concerns regarding how profit attribution should take place under this revised definition of the permanent establishment concept¹

1. Attribution of profits to a PE – Different principles

6. Art. 7(2) of the OECD Model (2010 version), which provides for the separate entity principle², states that the profits attributable to the PE are those that the PE would have earned acting on an arm's length basis³. A two-step approach, also known as the authorized OECD Approach (AOA), is provided to determine the profits attributable to a PE⁴. The first step involves carrying out a functional and factual analysis to hypothesize the PE, that is, to understand the activities carried out by the PE (considering but not limited to its significant people functions, assets and risks) and its dealings with associated enterprises, including the head office⁵. The second step involves pricing the dealing with the associated enterprise/s by reference to the transfer pricing principles⁶.

7. On the other hand, even though Article 7(2) of the OECD Model (2008 version) in its

¹ See in particular thereupon Christians Allison/Shay Stephen, Assessing BEPS: Origins, Standards, and Responses, General Report, in: IFA (International Fiscal Association), Cahiers de droit fiscal international, Vol. 120A, The Hague 2017, pp. 45-46; Danon Robert / Salomé Hugues, The BEPS Multilateral Instrument, 2017, in press, p. 20

² OECD (2014), Model Convention with Respect to Taxes on Income and on Capital and its commentary (quoted OECD Commentary). See OECD Commentary, Art. 7, Para. 15.

³ OECD (2010), Attribution of Profits to a Permanent Establishment (quoted OECD, Attribution Report) OECD, Attribution Report, Part I: General Considerations, Para. 8.

⁴ OECD Commentary, Art. 7, Para. 20; OECD, Attribution Report, Part I: General Considerations, Para. 10.

⁵ OECD, Attribution Report, Part I: General Considerations, Para. 4.

⁶ OECD Commentary, Article 7, Para. 21; For a detailed analysis of this step see OECD, Attribution Report, Part I: General Considerations, Paras. 183-223.

commentaries endorsed the AOA approach, differences did exist between both versions. The major difference related to recognition of intra-enterprise dealings i.e. deduction of dealings between the head office and PE. Also, the 2008 version included provisions that were considered not to be consistent with the arm's length principle viz., Art. 7(3)⁷, Art. 7(4)⁸ and Art. 7(5)⁹.

8. Provisions similar to Art. 7 of the 2008 OECD Model are also contained in Art. 7 of the 2011 UN Model (with certain exceptions). However, the Committee of experts on international taxation has rejected the application of AOA approach to interpret the business profits provision of the UN Model¹⁰.

9. States conclude tax treaties with each other either by using the OECD Model (various versions) or the UN Model. Accordingly, the attribution of profits to a PE depends on the exact wording contained in tax treaties. In other words, States can follow AOA or non-AOA approaches. The examples in the discussion draft focus on the attributing profits in accordance with the AOA. Therefore, we would find it desirable to have detailed numerical examples with respect to tax treaties that follow and do not follow the AOA.

2. Fundamental clarification with respect to the AOA

10. The discussion draft leaves open the question as to whether the concepts of “*significant people functions*”¹¹ (or “*key entrepreneurial risk taking*”¹²) functions for the purpose of allocating risks

⁷ The provision provided for deduction of expenses for purposes of the PE, whether incurred in the PE State or elsewhere. This provision was deleted as it could have been argued that the rule is an exception to the arm's length principle in the sense of limiting the deductibility of certain charges.

⁸ The provision allowed States to allocate profits to a PE using an apportionment method based upon various formulae up to the extent it was customary in that State.

⁹ The provision provided that profits cannot be attributed to a PE that performed purchasing functions for the head office.

¹⁰ UN (2011), Model Double Tax Convention Between and its commentary (quoted UN Commentary). See UN Commentary, Art. 7, Para. 1.

¹¹ OECD, Attribution Report, Part I: General Considerations, Para. 22.

¹² OECD, Attribution Report, Part II: Special Considerations for Banks, Para. 8.

enterprise”¹⁷ (see section 3.3)

3.2. Situations where the intermediary (DA) is an associated enterprise¹⁸

3.2.1. Substantive issues that require further consideration

3.2.1.1. Article 9 vs Article 7 – What should be given priority?

12. The discussion draft does not take a position to establish the relationship between Art. 9 and Art. 7 when the DA falls within the scope of Art 9. The discussion draft simply states, “*The MTC and its Commentary do not explicitly state whether a profit adjustment under Article 9 should precede the attribution of profits under Article 7. However, many jurisdictions find it logical and efficient first to accurately delineate the actual transaction between the non-resident enterprise and the intermediary and to determine the resulting arm’s length profits while others may decide to undertake an Article 7 analysis first and then to apply Article 9 to adjust the profits of the associated enterprises (i.e. the non-resident enterprise and the intermediary)*”¹⁹.

13. As we have demonstrated, in the below mentioned examples (see section 3.2.2), an Art. 9 analysis will lead to the conclusion that the DAPE will not be attributed any income or expenses and hence no profits or losses. Accordingly, we believe that an Art. 9 analysis should be applied first²⁰ (in such situations) and that future work should take a firm position on this issue. In fact, as we already have a taxpayer i.e. the DA, the creation of a hypothetical separate entity i.e. the DAPE is an unnecessary administrative burden both for taxpayer’s and tax administrations.

14. However, if one goes ahead and applies the analysis as suggested in the discussion draft (Para.

¹⁷ See Philip Baker, Richard Collier, General Report on Attribution of Profits to a Permanent Establishment, IFA Cahiers, Vol- 91B, p. 33; For a contrary opinion, see discussion by Dziurdz in Kasper Dziurdz, Attribution of Profits to a Dependent Agent PE: Different Arm’s Length Principles under Articles 7(2) and 9?, World Tax Journal, June 2014, pp. 135-167. 2) and 9?, World Tax Journal, June 2014, pp.152-153 (references in footnote 83).

¹⁸ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 11.

¹⁹ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 12.

²⁰ Several parts of the Attribution Report also make references to this position. See OECD, Attribution Report, Part I, Para. 234; OECD, Attribution Report, Part III, Para. 281.

25, 30 and 34), the DAPE will be attributed a loss. Therefore, the statements “*In any case, the order in which Article 7 and Article 9 are applied should not impact the amount of profits over which the source country has taxing rights as a result of the activities of the intermediary on behalf of its associated non-resident enterprise in the source country*”²¹ may need to be revisited. Moreover, if this approach is kept, further clarification would then be required as how to interpret and calculate the information in the following paragraphs of the discussion draft:

Para. No	Discussion draft information
25	“ <i>the amount that TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S (attributing to such party ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)</i> ”
30	“ <i>the amount that SiteCo would have received if it had sold the advertising space to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of SiteCo in Country S (attributing to such party ownership of the assets of SiteCo related to such functions, and assumption of the risks related to such functions)</i> ”
34	“ <i>the amount that TradeCo would have had to pay if it had purchased the widgets from an unrelated supplier performing the same functions in Country S that BuyCo performs on behalf of TradeCo (attributing to such supplier ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)</i> ”

3.2.1.2. The impact of the new risk allocation framework under Art. 9 on Art. 7

15. The discussion draft notes that the risk allocation framework (added as a result of BEPS Actions 8-10) contained in chapter I impacts the arm’s length remuneration of the DA²². If an accurate delineation indicates that the “*contractual assumption of risks*” and the “*actual conduct*” do not coincide, in the sense that the DA performs and “*controls*” substantial risks rather than the NRE, then the DA should be attributed those risks and the corresponding returns. For example, reference is

²¹ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 12.

²² OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 13.

made to the facts of Example 2 of the previous discussion draft²³. In that example, Sellco was attributed the inventory and credit risk under an Art. 9 analysis. Consequently, the delineated facts under Art. 9 would indicate that i) Prima sells goods to Sellco (it is the buyer since it was attributed the inventory risk) and ii) Sellco sells the goods to the clients. In other words, from an economic perspective, Sellco sells in its own name and on its own behalf as opposed to selling goods in the name of Prima. If this is the case, the question may arise as to whether Prima has a DAPE in Country B under Art. 5?

16. If a position is taken that such re-characterized arrangement under Art. 9 should be the starting point to do an Art. 5 analysis then that position will save the NRE (taxpayer) from the unnecessary burden of recognizing a DAPE²⁴. However, the discussion draft takes the position that the risk allocation framework under Art. 9 *“is solely for the purpose of determining the taxable profits of the associated enterprises and therefore does not involve any non-recognition of their transaction or the legal relationships created by their transactions with others”*. In other words, the revised transfer pricing guidance *“does not change the facts on which the application of Article 5(5) is predicated”*. We believe that it may be appropriate to reconsider this issue and, if appropriate, to substantiate it further.

17. Moreover, if a risk is allocated to the DA under Art. 9 can that risk be allocated to the NRE or DAPE under Art. 7? The discussion draft correctly states *“where a risk is found to be assumed by the intermediary... such risk cannot be considered to be assumed by the non-resident enterprise or the PE for the purposes of Article 7. Otherwise, double taxation could occur in the source country through taxation of the profits related to the assumption of that risk twice, i.e. in the hands of both the PE and the intermediary”*²⁵. On the other hand, if an accurate delineation of the transaction under Art. 9 indicates that the NRE performs and *“controls”* economically significant risks and has the *“financial capacity”* to assume them rather than the DA, then those risks and its corresponding

²³ OECD (2016), BEPS Action 7, Additional Guidance on the Attribution of Profits to Permanent Establishments (quoted OECD, Discussion Draft on Attribution of Profits to a PE (2016)). See OECD, Discussion Draft on Attribution of Profits to a PE (2016), Example 2, Paras. 40-45.

²⁴ In fact, the OECD in its work on Action 7 has clarified that distributors (in particular, limited risk distributors) fall outside the scope of the revised Article 5(5) and 5(6). See OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 – 2015 Final Report, Para. 9 (commentary in Para. 32.12).

²⁵ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 18.

returns should be attributed to the NRE. However, the discussion draft does not discuss whether a risk, which has been attributed to the NRE (head office) under Art. 9 (NRE-DA relations), can be allocated to the DAPE under Art. 7 (NRE-DAPE relations)?

18. In our opinion, if the functional analysis shows that personnel in the head office perform and “control” the risks (under an Art. 7 analysis), then those risks cannot be attributed to the DAPE²⁶. In fact, the DAPE does not have its own personnel and hence no significant people functions are performed by it. This is because the activities of the DA’s personnel, which will be compensated under Art. 9, lead to the creation of the DAPE. The OECD needs to clarify this point explicitly in its next discussion paper.

3.2.1.3. Does arm’s length compensation to the intermediary extinguish the taxing rights of the host State?

19. The discussion draft states that it “*should be noted that the host country's taxing rights are not necessarily exhausted by ensuring an arm's length compensation to the intermediary*”²⁷. Moreover, it is stated that depending “*on the facts and circumstances of a given case, the net amount of profits attributable to the PE may be either positive, nil or negative (i.e., a loss)*”. In light of the numerical facts presented in the examples (*see section 3.2.2*), it seems to us that in situations where the transactions with the DA fall under the scope of Art. 9, an arm’s length remuneration to the DA (in light of its actual functions) does indeed exhaust the taxing rights of the source State over the NRE²⁸. Accordingly, the profits attributable to the DAPE will be nil. Moreover, if one applies the analysis of the discussion draft (Para. 25, 30 and 34), the DAPE could be attributed a loss. Therefore, future work should clarify the circumstances (if any) in which a DAPE could be attributed a profit.

²⁶ OECD, Attribution Report, Part I: General Considerations, Para. 244.

²⁷ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 19.

²⁸ Refer to the following Court judgments: Set Satellite (Singapore) PTE Limited v. DDIT (2008) 218 CTR 452 (Bombay High Court); BBC Worldwide Ltd v. DIT (2011), 203 Taxmann 554 (Delhi High Court); TS-714-ITAT-2015 (Mumbai Tribunal). All these decisions deal with sale of advertising airtime space in India of foreign television channels through local associated enterprises. Also, see the position put forward by Philip Baker and Richard Collier in Baker, Collier, Profit Attribution, p. 33. Moreover, refer to the discussion in the following articles: Mary C Bennett, Carol A Dunahoo, The Attribution of Profits to a Permanent Establishment, Intertax, 2005, pp. 51-67; Hans Pijl, The Zero Sum Game, European Taxation, 2006, pp. 29-35.

Country S on behalf of TradeCo amount to USD 1,000. As SellCo is compensated on a fixed percentage on sales basis (5% on sales), its compensation amounts to USD 50. Moreover, assume that the total operating expenses incurred by SellCo (*including the salaries of the employees engaged in the sales activities*) amount to USD 40. Consequently, as shown in Table 1A, SellCo operates on a 25% return on its total operating costs³⁵. Furthermore, a comparability analysis indicates that unrelated parties in Country S that provide sales agency services also operate on a 25% return on their total operating costs. Accordingly, the remuneration derived by SellCo, by applying the transactional net margin method³⁶ (on the assumption that the transaction is accurately delineated and that the TNMM is the most appropriate method), can be at arm's length.

Table 1A: Profit and loss statement of SellCo	
Particulars	Amount
Sales service fee received from TradeCo*	50*
Total operating expenses	40
Profit**	10**
*represents remuneration of 5% on sales	
**represents a return of 25% on total operating costs which can be considered to be at arm's length	

24. On the other hand, as discussed previously, the two-step approach provided by Article 7(2) will apply to determine the profits attributable to the DAPE³⁷. In our opinion, under the first step, the DAPE does not perform any significant people functions relevant to the assumption of risks. The significant people functions relevant to economically significant risks (such as risks related to sales, marketing & advertising, inventory management and credit and collection activities), as accurately delineated under Art. 9, are performed and controlled by personnel working in Country R for TradeCo. Thus, as the DAPE does not carry out any significant people functions, it should not be attributed any risks and consequently no profits³⁸. Accordingly, once the intermediary has been compensated on an arm's length basis then there would not be further income attribution to the

³⁵ A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. OECD Transfer Pricing Guidelines, Para. 2.93 and Paras. 2.98-2.102.

³⁶ OECD Transfer Pricing Guidelines, Paras. 2.64-2.105.

³⁷ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 11.

³⁸ OECD, Discussion Draft on Attribution of Profits to a PE (2016), Example 1, Paras. 33-34; OECD, Attribution Report, Part I: General Considerations, Paras. 233-244.

DAPE.

25. However, if one applies the approach followed by the discussion draft, a different result could arise. The discussion draft³⁹ states that the profits attributable to the DAPE are equal to sales to third party customers⁴⁰ as reduced by (1) the amount that TradeCo would have received from the DAPE for selling the goods (2) the amount that TradeCo would have received for other activities carried out for the purpose of the DAPE⁴¹ and (3) arm’s length remuneration of SellCo. As discussed previously, the information with respect to the sales to third parties and arm’s length remuneration of SellCo is already available. Moreover, let’s assume that the other expenses incurred by the head office on behalf of the PE amount to USD 100 (see Table 1B).

S.No	Table 1B: Profit and loss statement of the DAPE under the OECD approach	
Particulars	(Amount)	
(A) Sales to third party customers (minus)	1,000	
(1)	Purchase of goods from Head office (balancing figure)	??
(2)	Other expenses incurred by Head office for the PE	100
(3)	Arm’s length remuneration of SellCo	50
(B) Total operating expenses	??	
(C) Profit (loss)	??	

26. The question arises as to how to interpret and calculate (1)? The discussion draft provides that this represents the amount that “TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S (attributing to such party ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)”. The footnote states, “This is conceptually equivalent to the amount paid by the PE for the inventory

³⁹ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 25.

⁴⁰ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 25 (footnote 5).

⁴¹ This represents the expenses to be incurred by the DAPE for the "activities undertaken by TradeCo (as home office) on behalf of the PE, this would include an arm’s length allocation of expenses associated with these activities, or, under the AOA, a ‘dealing’ between the PE and TradeCo (as home office) associated with TradeCo’s activity on behalf of the PE”. OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 25 (footnote 7).

‘purchased’ from TradeCo. This would correspond to a “dealing” under the AOA”⁴². Although the framing of these sentences seems to be rather confusing, we believe that the DAPE, as an unrelated party, would pay USD 1,000 to purchase the inventory (the amount at which it is sold to the third party) as it does not perform any additional functions (than the functions for which SellCo has already been remunerated on an arm’s length basis). If one follows the approach of the discussion draft, we believe that the attribution exercise leads to the conclusion that the DAPE will be attributed a loss (see **Table 1C**).

S.No	Table 1C: Profit and loss statement of the DAPE	
Particulars		(Amount)
(A) Sales to third party customers as reduced by		1,000
(1)	Purchase of goods from the head office (balancing figure)	1,000
(2)	Other expenses incurred by head office for the PE	100
(3)	Arm’s length remuneration of SellCo	50
(B) Total operating expenses		1,150
Profit (loss)		(150)

27. Even if an accurate delineation of the transaction through a proper functional analysis indicates that the “*contractual assumption of risks*” and the “*actual conduct*” do not coincide⁴³, in the sense that SellCo performs and “*controls*” substantial risks (such as risks associated to inventory and credit and collection activities⁴⁴) rather than TradeCo, then SellCo cannot be characterized as a sales agent. Accordingly, pursuant to Art. 9, SellCo will need to be remunerated on an arm’s length basis for its additional functions, risks and assets that it employs. The question then arises as to whether the DAPE needs to be remunerated for the additional functions, risks and assets for which SellCo has already been remunerated? In our opinion, this should not be the case. The discussion draft correctly confirms this position⁴⁵.

⁴² OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 30 (footnote 9).

⁴³ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 13.

⁴⁴ OECD, Discussion Draft on Attribution of Profits to a PE (2016), Example 2, Paras. 40-42.

⁴⁵ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 18.

3.2.2.2. Example 2: Online advertiser

28. Under this example, the marketing related activities of a related intermediary viz., SellCo creates a dependent agent PE (DAPE) for SiteCo (NRE) in Country S⁴⁶.

29. Article 9 would apply to test whether or not the conditions/prices between SiteCo and SellCo are at arm's length. If an accurate delineation of the transaction through a proper functional analysis⁴⁷ indicates that the “*contractual assumption of risks*” and the “*actual conduct*” coincide⁴⁸, in the sense that SiteCo performs and “*controls*” economically significant risks and has the “*financial capacity*” to assume them⁴⁹ (such as risks associated to sales, marketing & advertising and credit and collection) whereas SellCo bears limited operational risks, then SellCo will be characterized as a taxpayer that provides routine marketing services. Consequently, it will be treated as the tested party for undertaking a transfer pricing analysis given its least complex profile⁵⁰.

30. Assume the following numerical facts into the case study. The total sales generated by SiteCo in Country S on behalf of SellCo amount to USD 1,000. As SellCo is compensated on a fixed percentage on sales basis (5% on sales), its compensation amounts to USD 50. Moreover, assume that the total operating expenses incurred by SellCo (*including the salaries of the employees engaged in the marketing activities*) amount to USD 40. Consequently, **as shown in Table 2A**, SellCo operates on a 25% return on its total operating costs⁵¹. Furthermore, a comparability analysis indicates that independent marketing service providers in Country S also operate on 25% return on their total operating costs. Accordingly, the remuneration derived by SellCo, by reference to the transactional net margin method⁵² (on the assumption that the transaction is accurately delineated and the TNMM is the most appropriate), can be considered to be at arm's length.

⁴⁶ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Paras. 28-29.

⁴⁷ OECD Transfer Pricing Guidelines, Para. 1.51-1.55.

⁴⁸ OECD, Discussion Draft on Attribution of Profits to a PE, (2017) Para. 13.

⁴⁹ OECD, Transfer Pricing Guidelines, Paras. 1.60-1.109.

⁵⁰ OECD, Transfer Pricing Guidelines, Paras. 3.18-3.19.

⁵¹ A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. See OECD Transfer Pricing Guidelines, Para. 2.93 and Paras. 2.98-2.102.

⁵² OECD, Discussion Draft on Attribution of Profits to a PE (2017), Paras. 2.64-2.105.

Table 2A: Profit and loss statement of SellCo	
Particulars	Amount
Marketing service fee received from SiteCo*	50*
Total operating expenses	40
Profit**	10**
*represents remuneration of 5% on sales	
**represents a return of 25% on operating costs which can be considered to be at arm's length	

31. On the other hand, as discussed previously, the two-step approach provided by Article 7(2) will apply to determine the profits attributable to the DAPE⁵³. In our opinion, under the first step, the DAPE does not perform any significant people functions relevant to the assumption of risks. The significant people functions relevant to economically significant risks (such as risks associated to sales, marketing & advertising and credit and collection activities), as accurately delineated under Art. 9, are performed and controlled by personnel working in Country R for SiteCo. Therefore, as the DAPE does not carry out any significant people functions, it should not be attributed any risks and consequently no profits⁵⁴. Accordingly, once the intermediary has been compensated on an arm's length basis then there would not be further income attribution to the DAPE.

32. However, if one applies the approach followed by the discussion draft, a different result could arise. The discussion draft⁵⁵ states that the profits attributable to the DAPE are equal to sales to third party customers⁵⁶ as reduced by (1) the amount that SiteCo would have received from the DAPE for the advertising space (2) the amount that SiteCo would have received for other activities carried out for the purpose of the DAPE⁵⁷ and (3) arm's length remuneration of SellCo. As discussed previously, the information with respect to the sales to third parties and arm's length remuneration of SellCo is already available. Moreover, let's assume that the other expenses incurred by the HO on behalf of the PE amount to USD 100 (see Table 2B).

⁵³ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 11.

⁵⁴ See OECD, Attribution Report, Part I: General Considerations, Paras. 233-244.

⁵⁵ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 30.

⁵⁶ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 30 (footnote 8).

⁵⁷ This represents the expenses to be incurred by the DAPE for the "activities undertaken by SiteCo (as home office) on behalf of the PE, this would include an arm's length allocation of expenses associated with these activities, or, under the AOA, a 'dealing' between the PE and SiteCo (as home office) associated with SiteCo's activity on behalf of the PE". OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 30 (footnote 10).

S.No	Table 2B: Profit and loss statement of the DAPE	
Particulars	(Amount)	
(A) Sales to third party customers as reduced by	1,000	
(1)	Purchase of services from head office (balancing figure)	??
(2)	Other expenses incurred by Head office for the PE	100
(3)	Arm's length remuneration of SellCo	50
(B) Total operating expenses	??	
(C) Profit (loss)	??	

33. The question arises as to how do we interpret and calculate (1) which represents the amount that Site Co would have received if it had sold the advertising space to an “unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of SiteCo in Country S (attributing to such party ownership of the assets of SiteCo related to such functions, and assumption of the risks related to such functions)”. The footnote states that this “is conceptually equivalent to the amount paid by the PE for the rights to the advertising space from SiteCo. This would correspond to a ‘dealing’ under the AOA”⁵⁸. Although the framing of these sentences seem to be rather confusing, we believe that the DAPE, as an unrelated party, would pay USD 1,000 to purchase the advertising space (the amount at which it is sold to the third party), as it does not perform any additional functions (than the functions for which SellCo has already been remunerated). If one follows the approach of the discussion draft, we believe that the attribution exercise leads to the conclusion that the DAPE will be attributed a loss (see Table 2C).

S.No	Table 2C: Profit and loss statement of the DAPE	
Particulars	(Amount)	
(A) Sales to third party customers as reduced by	1,000	
(1)	Purchase of services from Head Office (balancing figure)	1,000
(2)	Other expenses incurred by HO for the PE	100
(3)	Arm's length remuneration of SellCo	50
(B) Total operating expenses	1,150	
Profit (loss)	(150)	

⁵⁸ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 30 (footnote 9).

34. Even if an accurate delineation of the transaction through a proper functional analysis indicates that the “*contractual assumption of risks*” and the “*actual conduct*” do not coincide⁵⁹, in the sense that SellCo performs and “*controls*” substantial risks (such as risks associated to marketing and credit and collection activities) rather than SiteCo, then SellCo cannot be characterized as a routine marketing services provider. Accordingly, pursuant to Art. 9, SellCo needs to be remunerated on an arm’s length basis for its additional functions, risks and assets that it employs. The question then arises as to whether the DAPE needs to be remunerated for the additional functions, risks and assets for which SellCo has already been remunerated? In our opinion, this should not be the case. The discussion draft correctly confirms this position⁶⁰.

35. We would like to highlight that, even though a DAPE arises, income should not be attributed to the DAPE in the absence of significant people functions. The OECD should clarify this point in its next discussion paper. Moreover, we believe that changing the PE definition is not an adept solution to tackle the tax challenges raised by digital economy as profit attribution issues will always persist, especially, when the NRE operates on a remote basis in the market jurisdiction.

3.2.2.3. Example 3: Procurement entity

36. Under this example, the procurement activities of a related intermediary viz., BuyCo (DA) creates a dependent agent PE (DAPE) for TradeCo (NRE) in Country S⁶¹.

37. Article 9 would apply to test whether or not the conditions/prices between TradeCo and BuyCo are at arm’s length. If an accurate delineation of the transaction through a proper functional analysis⁶² indicates that the “*contractual assumption of risks*” and the “*actual conduct*” coincide, in the sense that TradeCo performs and “*controls*” economically significant risks and has the “*financial capacity*” to assume them⁶³ (such as risks associated to purchase, inventory management and credit management activities) whereas BuyCo bears limited operational risks, then BuyCo will be characterized as a purchase agent. Consequently, it will be treated as the tested party for undertaking

⁵⁹ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 13.

⁶⁰ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 18.

⁶¹ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Paras. 32-33.

⁶² OECD Transfer Pricing Guidelines, Para. 1.51-1.55.

⁶³ OECD, Transfer Pricing Guidelines, Paras. 1.60-1.109.

a transfer pricing analysis given its least complex profile⁶⁴.

38. Assume the following numerical facts into the case study. The total purchase made by BuyCo in Country S on behalf of TradeCo amount to USD 1,000. As BuyCo is compensated on a fixed percentage on purchase basis (5% on purchases), its compensation amounts to USD 50. Moreover, assume that the total operating expenses incurred by BuyCo (*including the salaries of the employees engaged in the purchasing activities*) amount to USD 40. Consequently, **as shown in Table 3A**, BuyCo operates on a 25% return on its total operating costs⁶⁵. Furthermore, a comparability analysis indicates that unrelated parties in Country S that provide purchase agent services also operate on a 25% return on their total operating costs. Accordingly, the remuneration derived by BuyCo, by applying the transactional net margin method⁶⁶ (on the assumption that the other TP methods will not be applicable), can be considered to be at arm's length.

Table 3A: Profit and loss statement of BuyCo	
Particulars	Amount
Purchasing service fee received from TradeCo*	50*
Total operating expenses	40
Profit**	10**
*represents remuneration of 5% on purchase	
**represents a return of 25% on total operating costs which can be considered to be at arm's length	

39. On the other hand, as discussed previously, the two-step approach provided by Article 7(2) will apply to determine the profits attributable to the DAPE⁶⁷. In our opinion, under the first step, the DAPE does not perform any significant people functions relevant to the assumption of risks. The significant people functions associated to such risks (such as risks associated to purchasing, inventory management and credit management activities), as accurately delineated under Art. 9, are performed and controlled by personnel working in Country R for TradeCo. Therefore, as the DAPE does not carry out any significant people functions, it should not be attributed any risks and

⁶⁴ OECD, Transfer Pricing Guidelines, Paras. 3.18-3.19.

⁶⁵ A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. OECD Transfer Pricing Guidelines, Para. 2.93 and Paras. 2.98-2.102.

⁶⁶ OECD Transfer Pricing Guidelines, Paras. 2.64-2.105.

⁶⁷ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 11

consequently no profits⁶⁸. Accordingly, once the intermediary has been compensated on an arm's length basis then there would not be further income attribution to the DAPE.

40. However, if one applies the approach followed by the discussion draft, a different result could arise. The discussion draft⁶⁹ states that the profits attributable to the DAPE are equal to:

- a. the “*amount that TradeCo would have had to pay if it had purchased the widgets from an unrelated supplier performing the same functions in Country S that BuyCo performs on behalf of TradeCo (attributing to such supplier ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions)*”. The footnote states that this “*This is 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*”⁷⁰. The question arises as to how do we interpret and calculate this amount. We believe that the DAPE, as an unrelated party, would receive USD 1,000 to sell the goods to the head office (the amount at which it is purchased from third party suppliers), as it does not perform any additional functions (than the functions for which BuyCo has already been remunerated).
- b. The aforementioned amount is to be reduced by (1) the amount that TradeCo would have paid to unrelated suppliers for purchasing the goods (2) the amount that TradeCo would have received for other activities carried out for the purpose of the DAPE⁷¹ and (3) arm's length remuneration of BuyCo. As discussed previously, the information with respect to the purchase from unrelated suppliers and arm's length remuneration of BuyCo is already available. Moreover, let's assume that the other expenses incurred by the HO on behalf of the PE amount to USD 100. If one follows the approach of the discussion draft, we believe that the attribution exercise leads to the conclusion that the DAPE will be attributed a loss (**see Table 3B**).

⁶⁸ OECD, Attribution Report, Part I: General Considerations, Paras. 233-244

⁶⁹ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 34.

⁷⁰ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 34 (footnote 11).

⁷¹ This represents the expenses to be incurred by the DAPE for the "*activities undertaken by TradeCo (as home office) on behalf of the PE, this would include an arm's length allocation of expenses associated with these activities, or, under the AOA, a 'dealing' between the PE and TradeCo (as home office) associated with TradeCo's activity on behalf of the PE*". OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 34 (footnote 12).

S.No	Table 3B: Profit and loss statement of the DAPE	
Particulars	(Amount)	
(A) Sales to the head office (Balancing figure)	1,000	
(1)	Purchase of goods from unrelated suppliers	1,000
(2)	Other expenses incurred by Head office for the PE	100
(3)	Arm’s length remuneration of BuyCo	50
(B) Total operating expenses	1,150	
(C) Profit (loss)	(150)	

41. Even if an accurate delineation of the transaction through a proper functional analysis indicates that the “*contractual assumption of risks*” and the “*actual conduct*” do not coincide⁷², in the sense that BuyCo performs and “*controls*” substantial risks (such as risks associated to inventory activities) rather than TradeCo, then BuyCo cannot be characterized as a purchasing agent. Accordingly, pursuant to Art. 9, BuyCo will need to be remunerated on an arm’s length basis for its additional functions, risks and assets that it employs. The question then arises as to whether the DAPE needs to be remunerated for the additional functions, risks and assets for which BuyCo Co has already been remunerated? In our opinion, this should not be the case. The discussion draft correctly confirms this position⁷³.

3.3. Situations where the intermediary does not qualify as an associated enterprise for the purpose of Article 9

42. We would like to highlight that profits can indeed be attributed to the DAPE when the intermediary does not fall within the scope of Art. 9. This would typically be the case when the intermediary is the employee of the NRE⁷⁴. For example, reference is made to the facts of Example 3 of the previous discussion draft⁷⁵. In that example, remuneration (salary) to the employee did not exhaust the taxing rights of the source State over the NRE. We agree with the numerical analysis of that example (with the exception that depreciation/rent of the company vehicle needed to be added to the costs). Thus, we recommend the OECD to reproduce this example in its next discussion paper.

⁷² OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 13

⁷³ OECD, Discussion Draft on Attribution of Profits to a PE (2017), Para. 18

⁷⁴ Baker, Collier, Profit Attribution, p. 33; See discussion in Dziurdz, Attribution, pp. 152-153.

⁷⁵ OECD, Discussion Draft on Attribution of Profits to a PE (2016), Example 3, Paras. 58-68.

3.4. Single vs dual taxpayer approach – Policy suggestion

43. The OECD favors the application of a dual taxpayer approach as opposed to a single taxpayer approach⁷⁶. We would like to submit that in situations where the intermediary falls under the scope of Art. 9, the single taxpayer approach should prevail, especially in light of the new (strengthened) chapter I of the OECD TP guidelines. On the other hand, we would like to submit that in situations wherein the intermediary falls outside the scope of Art. 9, the dual taxpayer approach should continue to apply (albeit, the DA is the employee of the NRE). Accordingly, it may be desirable to reconsider the dual taxpayer approach in these circumstances.

4. Changes to Article 5(4)

4.1. Preliminary remarks

44. Several signatory countries to the MLI have adopted either Option A or Option B. Moreover, the anti fragmentation rule has been adopted by States that have chosen to apply either option or none of the options⁷⁷. With respect discussing profit attribution to such PEs, the discussion draft contains example 4. The facts⁷⁸ indicate that warehousing activities and the merchandising activities of the Online Co creates two separate PE for the NRE⁷⁹.

4.2. Example 4: Online retailer – Analysis of this case study considering numerical facts

4.2.1. Profit attribution for the warehousing activities⁸⁰

45. Applying the two-step profit attribution approach to the case at hand will lead to the conclusion that i) under the first step, the PE of the online retailer will be hypothesized (characterized) as a taxpayer which is carrying out warehousing activities that entail providing storage and delivery

⁷⁶ OECD, Attribution Report, Part I: General Considerations, Paras. 239-235.

⁷⁷ See for instance the Covered Tax Agreement between Chile and United Kingdom.

⁷⁸ Action 7, Revised Profit Attribution Report, Paras. 44-46.

⁷⁹ Action 7, Revised Profit Attribution Report, Para. 47.

⁸⁰ Action 7, Revised Profit Attribution Report, Para. 48.

services to the head office and; ii) under the second step, the PE needs to be remunerated on an arm's length basis for its storage and delivery activity by reference to transfer pricing principles. Assume that the following expenses are incurred in State S for the storage and delivery activity:

- the salary of the employees engaged in the warehousing activity (storage and delivery) amount to USD 20;
- the cost for delivering the products through independent service providers (through courier or post) is USD 5; and
- the warehouse is rented for USD 20;
- other operating costs related to the warehouse amount to USD 5.

46. Furthermore, a comparability analysis indicates that independent storage and delivery service providers in Country S operate on a total operating cost-plus basis of 10%⁸¹. Taking into consideration the foregoing facts, the profits attributable to the PE (see **Table 4A**) are as follows:

Table 4A: Attribution of profits to the warehouse PE that performs storage and delivery activity	
Particulars	Profit and loss account of the PE
(1) Income* (Balancing figure)	55*
(2) Rent	20
(3) Salary	20
(4) Delivery costs	5
(5) Other operating expenses	5
Expenses	50
Profit**	5**
*represents the amount that R Co would have paid to an independent enterprise performing similar storage and delivery activities	
**represents a return of 10% on total operating costs which can be considered to be at arm's length in light of operating margins earned by independent comparable service providers (on the assumption that the transaction is accurately delineated and that the TNMM is the most appropriate method)	

⁸¹ A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. See OECD Transfer Pricing Guidelines, Para. 2.93 and Paras. 2.98-2.102.

4.2.2. Profit attribution for the merchandising and information collection services⁸²

47. Applying the two-step profit attribution approach to the case at hand will lead to the conclusion that i) under the first step, the PE of the online retailer will be hypothesized (characterized) as a taxpayer which is providing merchandising and information collection services to the head office and; ii) under the second step, the PE needs to be remunerated on an arm's length basis for its activity by reference to transfer pricing principles. Assume that the following expenses are incurred in State S for the merchandising and information collection services:

- the salary of the employees engaged in the merchandising and information collection services amount to USD 20;
- other operating costs related to the merchandising and information collection services amount to USD 5; and
- the office is rented for USD 20;

48. Furthermore, a comparability analysis indicates that independent service providers in Country S operate on a total operating cost-plus basis of 10%⁸³. Taking into consideration the foregoing facts, the profits attributable to the PE (see **Table 4B**) are as follows:

Table 4B: Attribution of profits to the PE that performs merchandising and information collection activity		
Particulars		Profit and loss account of the PE
(1)	Income* (Balancing figure)	55*
(2)	Salary	20
(3)	Other operating expenses	5
(4)	Rent of the office	25
Expenses		50
Profit**		5**
*represents the amount that R Co would have paid to an independent enterprise performing similar merchandising and information collection activities		
**represents a return of 10% on total operating costs which can be considered to be at arm's length		

⁸² Action 7, Revised Profit Attribution Report, Para. 49.

⁸³ A return on total operating costs can be considered to be an appropriate profit level indicator for service-oriented transactions. See OECD Transfer Pricing Guidelines, Para. 2.93 and Paras. 2.98-2.102.

in light of operating margins earned by independent comparable service providers (on the assumption that the transaction is accurately delineated and that the TNMM is the most appropriate method)

4.2.3. Profits attributable to the market jurisdiction

49. In light of the profit attribution exercise, we would like to highlight that, even though a PE arises and profits are attributed to the PE by reference to the separate entity principle, the market jurisdiction will not be able to tax a significant portion of the sales revenue derived by the online retailer. This is because the profits attributed to the PE will be limited to the activities carried out by the PE, i.e. functions relevant to storage and delivery activities or merchandising and information collection activities. Future work should clarify this point.