KPMG

To Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA

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From KPMG International

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Comments on Discussion Draft: Additional Guidance on Attribution of Profits to Permanent Establishments

Professionals in the member firms of KPMG International ("KPMG") welcome the opportunity to comment on the OECD's Discussion Draft titled *BEPS Action 7: Additional Guidance on Attribution of Profits to Permanent Establishments* (the "Discussion Draft").

The Discussion Draft is a second draft[1] from the OECD addressing additional guidance on the attribution of profits to permanent establishments, in light of changes to Article 5 of the Model Tax Convention ("MTC")[2] and to the OECD Transfer Pricing Guidelines ("Guidelines")[3]. The OECD received numerous comments from the public on the previous draft, and chose in the new draft to pursue a different approach. Specifically the new draft provides only high-level principles to be followed, in place of the detailed examples of the prior draft.

KPMG commends the OECD for its effort on profit attribution guidance, and for its recognition that changes to Article 5 and to the Guidelines create the need for additional guidance. KPMG appreciates the openness of the OECD to comments on the previous draft and recognizes the complexities of the issues. Nonetheless, we still have concerns on several key issues.

KPMG's comments on the Discussion Draft are presented below.

General Comments

The Report on Action 7 explicitly stated that no modifications are required to existing provisions on attribution of profits to permanent establishments. KPMG notes that, at present, tax authorities often take inconsistent approaches to the application of PE profit attribution rules. This condition has persisted for many years despite the publication of the OECD's Reports on the Attribution of Profits to Permanent Establishments in 2008 and 2010, the accompanying revisions in 2008 to the official Commentary on Article 7 as it then stood, and the revision to both Article 7 and the accompanying Commentary in 2010. Some tax authorities avoid the Article 7 analysis altogether and focus on the arm's length return to the intermediary under Article 9. To the extent these jurisdictions are satisfied that the intermediary has reported sufficient profit for the connected enterprise, they generally do not argue for the existence of a

[1] The prior draft bore the same title and was dated 4 July, 2016.

[2] Report on Action 7 of the BEPS Action Plan (Preventing the Artificial Avoidance of Permanent Establishment Status).

[3] Report on Actions 8-10 of the BEPS Action Plan (Aligning Transfer Pricing Outcomes with Value Creation).

PE. The expansion of the PE standard and the changes to the transfer guidelines under Article 9 might make such an approach less viable going forward. Amongst jurisdictions that attempt to apply Article 7 to a PE, the majority have not adopted the Authorized OECD Approach (AOA) to determine the profits attributable to a PE. Either way, tax authorities in these jurisdictions have inconsistent approaches to determining profit attributable to a PE or in applying the AOA to make that determination. For example, in some countries, where the tax rate for foreign companies is higher than the tax rate for domestic companies, the tax authority may take an aggressive view regarding the existence of a PE and the profit attributable to it versus the return to the intermediary. This makes some countries more prone to find a PE and more aggressive attributing profit to it than their treaty partners. We understand from government officials, moreover, that resolution of PE issues at Competent Authority is particularly difficult; both the existence of a PE and the attribution of profit to a PE present challenges greater than a typical transfer pricing double tax case. The situation, in short, is that there is still insufficient predictability surrounding how the PE profit attribution issue will be approached by tax authorities or even by a single tax authority. The revisions to Article 5, which were meant to increase tax certainty for governments and taxpayers, threaten to become one of the greatest sources of tax uncertainty for both. Accordingly, practical guidance is needed.

The objective of the Discussion Draft is to provide additional guidance addressing the impact of changes to Article 5 and to the Guidelines. Taxpayers generally understand that the changes to Article 5 will lead to significant additional PE exposure under common structures such as commissionaire arrangements. However, taxpayers face significant uncertainty regarding the amount of the associated tax exposure – how much profit would be attributed to the PE if current arrangements are left in place? This uncertainty is heightened by the related uncertainty regarding the effect of changes to the Guidelines on profit attributed to the commissionaire (or other related party intermediary) itself under Article 9, particularly around impact of revised Chapter I of the Guidelines on attribution of risk.

The prior discussion draft attempted to address these uncertainties directly by providing a number of examples illustrating how revised Chapter I and the AOA are intended to interact and how Article 7 and Article 9 should be applied to determine the profit attributable to the related party and to the PE respectively.

The new draft abandons the attempt to provide specific numerical examples and restricts itself to stating general principles. Notably the draft accepts that different tax authorities are likely to take different approaches to profit attribution in these cases, for example to the application of the AOA or to the order in which the Article 9 and Article 7 analyses are applied.

The Discussion Draft is helpful by 1) emphasizing that, whatever approach is applied, the source country should not subject profits to double taxation in the PE and in the intermediary; 2) cautioning that the same risks cannot be attributed to both the PE and the intermediary; 3) observing that if all relevant risks are attributed to the intermediary rather than the PE, then the profits attributable to the PE could be minimal or zero; and 4) acknowledging the potential administrative burdens on taxpayers associated with the potential proliferation of PEs with minimal or zero profit and suggesting that tax authorities may adopt measures to relieve that administrative burden for example by collecting taxes attributable to the PE from the local subsidiary.

However the Discussion Draft falls short of reducing taxpayer uncertainty by outlining a clear, consensus based approach to the attribution of profits to a PE. Indeed, the Discussion Draft gives the impression that the OECD is abandoning the effort to achieve consistency and standardization amongst jurisdictions in the application of these rules. Beyond the mandate that the source country should not tax the same profits in both the intermediary and the PE, the

Discussion Draft does not express sufficient concern about the impact of widely varying approaches to the attribution of profits on reducing certainty, increasing administrative burden (for taxpayers and tax administrations) and fostering controversy.

While KPMG acknowledges the complexities of these issues, we encourage the OECD to commit to further efforts to seek greater standardization and provide clearer guidance, especially as between the interaction of the AOA and the Guidelines, with a focus on the following issues:

- Consistent methodology for applying the AOA and the interaction of Article 9 and Article 7;
- The distinction between 'control of risk' functions and 'significant people functions' as currently defined in Chapter 1 of the Guidelines and the 2010 Report respectively;
- Detailed recommendations and explicit guidelines (including a model competent authority agreement) for achieving administrative simplification in connection with the application of Articles 5 and 7.

Specific Comments

Paragraph 9 states that the "separate and independent" enterprise approach applies regardless of whether a tax administration adopts the 2010 AOA "or any other approach used to attribute profits under a previous version of Article 7 of the MTC." However some member states apply domestic law under prior versions of Article 7 in a manner that does not bifurcate income based on a hypothetical separate entity, but rather analyze whether a single item of income recognized by the nonresident enterprise should be attributed to the PE. The OECD guidance should be limited to explaining how the AOA applies after the BEPS changes to Article 5 and the changes to the OECD transfer pricing guidelines.

Paragraph 12 indicates that tax authorities may differ regarding the order of application of Article 7 and Article 9. KPMG applauds the OECD's statement that the order of application should not impact the total amount of profits over which the source country has taxing rights. However, paragraph 18 later provides that "where a risk is found to be assumed by the intermediary under the guidance in Section D.1.2 of Chapter 1 [pursuant to an Article 9 analysis] such risk cannot be considered to be assumed by the non-resident enterprise or the PE for the purpose of Article 7]." This application of Chapter I principles to determine whether the intermediary manages a risk for itself or on behalf of the non-resident is appropriate. To the extent the OECD wishes to avoid dictating an order to the application of these Articles, at the very least it might be useful to clarify further that, without regard to the mechanical order used to attribute profits to a PE, risk control functions associated with risks attributed to the intermediary under Article 9, cannot be deemed to be performed "on behalf" of a non-resident, and thus the associated profit cannot be attributed to the PE of a non-resident for purposes of Article 7. Further, the OECD should recognize the specific issues faced by financial services enterprises in this area and therefore the guidance should reaffirm that Parts II to IV of the 2008 and 2010 Reports continue to apply to the financial services activities they describe, including the treatment of the dependent agent enterprise and the DAPE.

Paragraphs 13-19 address attribution of risks between the PE and the intermediary, where the activities of the intermediary give rise to a PE. While the statement in paragraph 18 that the same risks should not be attributed to both the PE and the intermediary is helpful as a general principal, it is insufficient alone to preventing divergent and inconsistent approaches to applying the AOA in conjunction with the new transfer pricing Guidelines to prevent just such a result. Recognizing in paragraph 17 that the AOA notion of "significant people functions" for

attributing risks, and the risk control functions standard used in Chapter I of the Guidelines may not be aligned, without providing specific guidance on how the concepts should be applied to prevent double taxation is contrary to the OECD's goals of improving ease of tax administration and promoting certainty for taxpayers. KPMG recommends that the OECD commit to further work to reconcile these standards. In this connection, KPMG recommends that the OECD clarify the role of capital in attribution of risk, with due consideration given to the importance of this issue in financial services and other regulated industries, where the intermediary may have neither the capital nor the regulatory authorization to bear the risks and thereby potential losses associated with attribution of risk.

Paragraph 21 of the Discussion Draft is helpful in acknowledging that "the potential burden on a non-resident enterprise 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" and in reinforcing the value of adopting administratively convenient procedures to relieve this burden, including by collecting tax only from the intermediary. Nevertheless, the Discussion Draft does not go far enough in providing the kind of guidance necessary to address this issue. As noted in the comments KPMG submitted to the prior discussion draft on the Attribution of Profits, the OECD should prescribe a pathway for administrative relief for DAPEs with little or no profit attribution. Ideally, this mechanism would have been included as part of the MLI. As that pathway was not chosen, clarity, speed, and certainty can still be achieved through the development of a model competent authority agreement that countries can adopt to agree on and implement the type of administrative relief contemplated. It would be invaluable to the goals of reducing administrative burdens, promoting certainty, and avoiding unnecessary controversy for the OECD to go farther than simply stating the general principle that administrative relief would be permitted and welcome by providing a model for achieving such relief that jurisdictions are encouraged to adopt.

About KPMG

KPMG is a global network of professional services firms providing Audit, Tax and Advisory services. We operate in 152 countries and have 189,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. Each KPMG firm is a legally distinct and separate entity and describes itself as such.

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