



Tax Insights

BEPS Action 7: Discussion draft on attribution of profits to PEs

Snapshot

On 4 July 2016, the OECD released a discussion draft on the attribution of profits to permanent establishments (PEs). The draft follows the work previously undertaken by the G20/OECD in relation to preventing the artificial avoidance of PE status (action 7 of the G20/OECD BEPS action plan). It does not reflect, at this stage, a consensus position, but is designed to provide substantive proposals for public review and comment.

Introduction

As expected, the discussion draft draws on the existing guidance set out in the OECD's 2010 *Report on the Attribution of Profits to Permanent Establishments*. The key building blocks of the 2010 report are that:

- A PE should be treated as if it were distinct and separate from its overseas head office; and
- Assets and risks should be attributed to the PE or the head office in line with the location of "significant people functions."

This approach is based on the adoption of the 2010 version of the business profits article (article 7) of the OECD model tax treaty, being the "Authorised OECD Approach" (AOA) to attributing profits, as set out in the OECD's 2010 *Report on the Attribution of Profits to Permanent Establishments*. However, many countries including Australia have not adopted the principles of the new version of article 7 and the associated 2010 report. Particular concerns relate to the recognition of "dealings" for the use or transfer of intangibles, or rights in intangibles, between a head office and a PE that would require a country to take account of "notional" payments. Since countries are not starting from a common approach to the attribution of profits to PEs, the discussion draft requests comments on other approaches that may be applied to each of the scenarios set out in the draft.

The AOA, also referred to as the functionally separate entity (FSE) approach is not presently adopted by Australia. Instead, "Australian tax law currently allocates actual income and expenses of the taxpayer to a PE using functional analysis and applying the arm's length principle by analogy ... Tax treaties continue to be negotiated on the basis of the former OECD Model Article 7, pending final decisions on the FSE approach" (refer para 1.6 of the Board of Taxation report on "Review of tax arrangements applying to permanent establishments", April 2013). The Australian approach is known as the relevant business activity (RBA) approach. The Board made 14 observations commenting on the advantages and disadvantages of Australia adopting the FSE approach, including the more targeted option of adopting the FSE approach for financial institutions.

The draft includes factual examples and focuses on the changes to the threshold for PEs concerning **dependent agents** and **warehouses**. The examples illustrate the effect of changes in the facts of each case, particularly in relation to the location of significant people functions. The examples are helpfully supported by numerical calculations proposing the profits attributable to the PEs, the head offices and other group companies. However, the examples are limited to a small number of fact patterns and it would be helpful if these were expanded. Useful additions would include examples involving toll manufacturing, ownership of stock by a non-resident stored in a third party's or other group company's warehouse and multi-year scenarios where significant people functions vary between the head office and PE.

One example that is provided illustrates a case where there is **no additional profit** to be taxed in a newly-created PE. It is important that

participating countries consider simplification measures to minimize the compliance burden that would arise from separate filing of a nil PE tax return.

In addition, it will be necessary to eliminate any double taxation. Double taxation could arise not only where the tax authorities in different countries do not share the same view of the profits attributable to a PE, but also within a country if the same profits are taxed in the dependent agent and in the PE (e.g. if transfer pricing rules and attribution of profits to PEs are not aligned).

Background

The final report on action 7 of the BEPS project (*Preventing the Artificial Avoidance of Permanent Establishment Status*) was published on 5 October 2015 and included the following:

- Changes to the rules on **deemed PEs** created by dependent agents, addressing *commissionnaire* and other undisclosed agent arrangements;
- Changes to the **exceptions** from creating a fixed place of business PE for specific activities (such as maintenance of stocks of goods for storage, display, delivery or processing, purchasing or the collection of information) so that these will apply only where the activity in question is preparatory or auxiliary in relation to the business as a whole; and
- An **anti-fragmentation** rule that removes exceptions (including those for preparatory or auxiliary activities) in circumstances where activities in a country are carried out by different group companies, where the activities are part of a “cohesive business operation” and not, in the aggregate, preparatory or auxiliary.

These changes will be made to article 5 of the OECD model treaty concerning the threshold for creation of a PE, and subsequently will be incorporated into the BEPS multilateral instrument and bilateral tax treaties. The final report on action 7 mandates follow-up work to develop additional guidance to:

- Apply the rules for the attribution of profit to PEs (under the business profits article (article 7) of the OECD model treaty) to PEs resulting from the threshold changes under BEPS; and
- Take account of the results of the work on other parts of the BEPS action plan dealing with transfer pricing, in particular, with respect to intangibles, risk and capital.

Australia is supportive of the proposed BEPS expansion to the definition of PE, as is evident in Australia’s participation in the negotiation of the multilateral instrument, recent treaty practice and the enactment of the multinational anti-avoidance law (MAAL).

Australia and Germany signed a new double tax agreement in 2015 that adopted most of the treaty related BEPS recommendations and in particular, adopted the expanded concept of PE in relation to dependent agents. The new treaty, when it comes into effect will deem a PE to exist where, inter alia, “a person is acting in a Contracting State on behalf of an

enterprise and ... in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise”.

Australia has also legislated the MAAL from 1 January 2016 which targets multinationals that “avoid a taxable presence by undertaking significant work in Australia in direct connection to Australian sales but [book] their revenue offshore”.

Overview of discussion draft

The discussion draft sets out proposed guidance concerning the attribution of profits to PEs in two areas:

- Dependent agent PEs, including those created through *commissionnaire* and similar arrangements; and
- Warehouse operations that are no longer exempted from being fixed place of business PEs by virtue of their specific activities.

The discussion draft sets out a number of proposals and, in particular, numerical examples, for public comment, although it stresses that these cannot be relied upon until the G20/OECD and other participating countries’ work is finalized.

Although the BEPS changes lower the threshold for when a PE arises, the discussion draft notes that the nature of the PE (or deemed PE) has not changed and, therefore, any guidance on how to attribute profits should be applicable to a PE both before and after the BEPS recommendations have been implemented.

Dependent agent PEs

The discussion draft sets out four similar examples and an analysis of how profits should be allocated by considering article 5 (PEs), article 7 (business profits) and article 9 (associated enterprises) of the OECD model tax treaty. The varying factor in the examples is the extent to which there is a significant people function in the country with the PE. Profits are attributed to the location of functions, and assets and risks attributed to the significant people functions that perform significant functions in respect of assets and control the risks. It is recognized that the additional profit allocated to a PE created under the revised threshold may be very small or nil (illustrated in Example 1).

The discussion draft notes that, in some circumstances, the source country may have taxing rights over two different legal entities: the dependent agent, if it is a resident of the PE jurisdiction, and the PE of a non-resident company created by the presence of the dependent agent. The examples provide illustrations of such cases, and the determination of the profits of the dependent agent and the PE. The discussion draft proposes that it would be most efficient to apply transfer pricing rules (if applicable) to transactions between the non-resident company and the resident dependent agent first, before moving to an analysis of the profit to be attributed to the PE of the non-resident.

Example 1: The non-resident company acting as a principal engages an associated company resident in the source country to perform activities that give rise to a dependent agent PE. This example sets out the attribution of profits to the PE under the principles of the AOA alongside the transfer pricing analysis. There are no profits to be attributed to the PE since there are no significant people functions performed in the country of the dependent agent.

Example 2: The transfer pricing analysis results in the allocation of risk to the party that has control over risk and the financial capacity to assume the risk (rather than the party contractually assuming the risk). The impact of this on the profit attribution to the PE is explored. Significant people functions are performed by the dependent agent that result in the attribution of risks and economic ownership of assets to the PE, in line with the assumption of risk under transfer pricing.

Example 3: A non-resident company sends an employee to the source country to perform activities that give rise to a dependent agent PE. There are significant people functions performed by the employee and attributable to the PE that result in the attribution to it of the inventory and receivables risks and the economic ownership of assets. Accordingly, there are profits attributable to the PE over and above the salary paid to the employee.

Example 4: Activities related to the provision of credit to customers are performed by both the dependent agent and the non-resident company. This illustrates the consequences for the attribution of profits to the PE resulting from the attribution of risk for the PE and the allocation of risk under transfer pricing principles.

The MAAL sits within Part IVA, and so operates on the basis that an alternative postulate is to be identified (as compared to the actual arrangement) and that the tax effects of that alternative postulate need to be determined, so as to ascertain the "tax benefit", if any. As noted in the Explanatory Memorandum, this "will typically require the profits attributable to the notional Australian permanent establishment to be worked out". The EM goes on to say that the approach of attributing profits to a PE is to be determined in accordance with the arm's length principle as contained in the business profits article of Australia's tax treaties and Section 815-225 of the ITAA 1997.

This highlights the uncertainties associated with the MAAL of variously:

- Identifying the relevant scheme;
- Identifying a relevant alternative postulate (deemed or notional PE);
- Identifying a tax benefit, if any, in connection with the scheme and as compared to the alternative. This step involves the hypothetical computation of assessable income and allowable deductions attributable to the deemed or notional PE; and
- Ascertaining whether there is a relevant principal purpose .

As is evident from the OECD's current work, there is as yet no consensus position on the attribution of profits to the proposed expanded category of PE, under the BEPS recommendations.

Warehouses as fixed place of business PEs

Examples are provided where the level of significant people functions in the country of the PE increases along with the level of profit attributed. The profits in the PE also reflect the reward for economic ownership of assets. The examples cover A) warehousing as a core business (i.e. providing warehouse capacity and associated services to third parties); B) the use of warehouses by a non-resident company on its own behalf; and C) where the warehouse owned by the non-resident is managed by a separate resident group company.

Example 5A: The profits in the PE reflect the reward for the economic ownership of the warehouse and the routine functions performed at the warehouse, since all the significant people functions and related risk are performed by the head office.

Example 5B: The profits in the PE reflect the reward for the economic ownership of the warehouse and the routine functions performed at the warehouse, since all the significant people functions in relation to the business and related risks are performed by the head office. The example attributes to the PE profits commensurate with investment in the asset, taking into account costs of funding and investment advice, as well as the performance of the warehouse functions.

Example 5C: Based on the facts, only the reward for economic ownership of the warehouse is attributable to the PE. Additional functions and the assumption of risk by the separate warehouse company do not affect the profits attributed to the PE.

Mechanisms for coordination and avoidance of double taxation

Comments are invited as to whether there are mechanisms that could ensure additional coordination of the application of transfer pricing and the rules for PEs without providing opportunities for the re-emergence of BEPS risks that the changes were designed to reduce.

The discussion draft notes that this is important where (i) countries do not coordinate the changes to transfer pricing with rules on PEs that may lead to double taxation; and (ii) where the existence of a dependent agent PE may arise even when there are no attributable profits (with resulting filing requirements and potentially other tax liabilities).

Next steps

Comments are invited by 5 September 2016 and a public consultation will be held on 11-12 October 2016 at the OECD in Paris

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