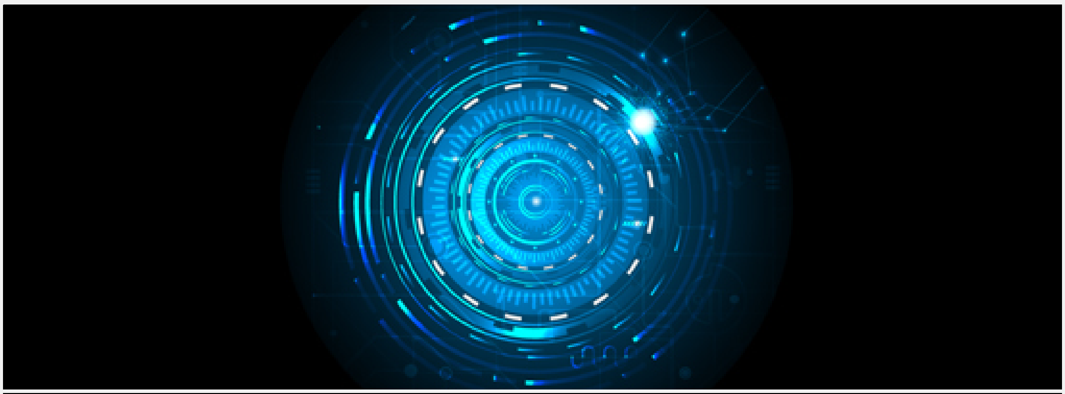
Global Transfer Pricing | 1 May 2018



OECD releases additional guidance on attribution of profits to permanent establishments

Global Transfer Pricing Alert 2018-012

The Organisation for Economic Co-operation and Development (OECD) on 22 March released additional guidance on the attribution of profits to a permanent establishment (PE) under action 7 of the base erosion and profit shifting (BEPS) project. This latest guidance was preceded by two discussion drafts, one issued in July 2016 and the other in June 2017. The 2018 guidance sets out high-level general principles in light of the comments received on the earlier drafts, but doesn't address the most challenging issue – rationalizing the application of articles 7 and 9 to the same legal structure.

Background

Action 7 of the BEPS action plan mandated the development of additional guidance on the issue of attribution of profits to PEs, in particular for PEs outside the financial sector. The final report on action 7, which was released in 2015, focused on whether the existing rules would be appropriate for determining the profits allocated to PEs. The final report concluded that, even though substantive modifications to Article 7 of the OECD Model Tax Convention (MTC) were not necessary, additional guidance was needed on how the rules would apply to the new definitions of a PE contained in Article 5 of the MTC.

The 2016 discussion draft presented two types of fact patterns the OECD felt would particularly benefit from additional guidance on attributions of profits to a PE. Those fact patterns were: (i) dependent agent PEs (DAPEs), including those created through commissionaire and similar arrangements;

and (ii) warehouses as fixed place of business PEs. The 2016 discussion draft explored through a series of numerical examples potential differences that may result from attributing profits to these new PEs under the Authorized OECD Approach (AOA) versus under Article 9 of the MTC, which deals with transactions between associated enterprises.

The 2017 discussion draft moved away from the numerical examples and instead set out high-level general principles. Some commentators viewed this new approach as not being as useful, because it failed to help taxpayers and tax administrators deal with the fundamental issues relating to the application of the AOA outside the financial services context – the core task that Working Party 6 (WP6) had set out to resolve.

Most problematic was the lack of clarity on how to apply Articles 7 and 9 of the MTC together. The AOA relies on the concept of significant people functions (SPFs) to allocate assets and risks to the PE hypothesized in step one of the AOA, whereas Article 9 relies on the risk control framework of Chapter I of the OECD 2017 Transfer Pricing Guidelines (2017 TPGs). The 2017 discussion draft did not provide any additional guidance on how these differences between the AOA and Article 9 would translate into profit attribution to a PE, and for that reason many observers found it wanting.

Nevertheless, the 2017 discussion draft did provide some helpful guidelines affirming that: (i) there should be no double taxation as a result of attributing profits to a PE; (ii) through the accurate delineation of the transaction, the net amount of profits attributable to the PE might be positive, zero, or even negative; and (iii) source countries may continue to adopt administratively convenient ways of recognizing the existence of a PE and collecting the appropriate amount of tax resulting from the activity in the host country. The 2017 discussion draft also provided four examples that were intended to illustrate how the attribution of profits analysis should be applied. Some commentators, however, felt those examples were too general to be useful.

2018 guidance

The 2018 guidance maintains the same approach as the 2017 discussion draft. In particular, it continues to affirm that there should be no double taxation when attributing profits to a PE, either through the double counting of risks or in the combined application of Articles 7 and 9 of the MTC. It also reaffirms that the net profit attributable to a PE may be positive, negative, or a loss. Finally, the 2018 guidance continues to provide that countries may keep implementing administratively convenient procedures for recognizing the existence of a PE and collecting the tax in the host country, regardless of whether they have adopted the AOA. However, there is no recommendation or requirement that they do so.

The 2018 guidance also includes the four examples from the 2017 discussion draft but revises them to provide a more robust analysis of how the profits would be attributed to the PEs. The revised examples now go step-by-step through the

AOA, detailing the SPFs hypothesized as being performed by personnel of the PE and the internal dealings between the PE and head office in the home country.

As discussed in more detail below, the first example illustrates the specific activities exemption and the anti-fragmentation rule under Articles 5(4) and 5(4.1) with respect to a warehouse and office PE. The remaining three examples involve fact patterns whereby Articles 7 and 9 of the MTC would be applied in combination to an Article 5(5) DAPE.

Observations

Despite the additional analysis in the examples, many of the most important questions remain unanswered. For instance, it is still unclear how the 2018 guidance fits into the overall framework of the current OECD guidance relating to the attribution of profits to a PE, and therefore the degree to which member jurisdictions are committed to following the guidance.[1] The executive summary states that the 2018 guidance is designed to provide high-level general principles, but left unspecified is whether the new guidance is designed to supplement the current AOA rules or act as commentary to them.

The 2018 guidance also fails to address the lack of a common set of concepts and language between the AOA, which is applicable in Article 7 cases, and an analysis under Article 9. In the absence of such harmonization of the two approaches, the result in any particular case may differ depending on which analysis is performed first – the Article 7 or the Article 9 analysis. The revised examples, though providing more details on how the AOA would apply, do not provide any additional clarity on this crucial issue.

Example 1: The warehouse example

Example 1 of the 2018 guidance applies the steps of the AOA to a situation in which the home country enterprise maintains a warehouse in the host country. Importantly, the 2018 guidance concludes that there is an internal dealing between the warehouse PE and the head office of the foreign parent company, OnlineCo, such that the PE should be analogized to an entity that provides internal storage and delivery services to the head office. Of particular note, however, is what the functional and factual analysis does *not* assert – that the warehouse PE has the function, asset, and risk profile of a distribution company.

Under step two of the AOA, therefore, the arm’s length pricing of the internal dealing would equal the amount that the parent company, OnlineCo, would have had to pay if it had obtained the storage and delivery services from an independent enterprise in the host country.

Examples 2 through 4: Articles 7 and 9 of the MTC applied to an Article 5(5) DAPE

[1] See the 2010 Report on the Attribution of Profits to Permanent Establishments (22 July 2010).

Examples 2 through 4 all deal with variations on the same theme – the interaction of Articles 7 and 9 applied to an Article 5(5) DAPE. In each example, there is both a local enterprise (called the related intermediary in the guidance) and a PE of the home office in the host country. The 2018 guidance asserts that it should not matter in which order Articles 7 and 9 are applied, because either way double tax is to be avoided. Nevertheless, none of the examples resolves the fundamental question of how to apply both articles to the same legal structure. Instead, each example summarily applies Article 9 first and then just notes that the remuneration is found to be at arm's length taking into account the functions, assets, and risks of the related intermediary.

Thus, while not expressly stated in the examples, under the Article 9 risk control framework, the conclusion that the local intermediary is being compensated at arm's length must mean that the local intermediary has: (i) accurately identified its functions, assets, and risks; and (ii) priced the transaction in accordance with the arm's length standard. Arguably, in such a fact pattern, there should be no additional profits to attribute to the PE. None of the examples discusses this point, however, nor do they provide any additional guidance on how to apply Articles 7 and 9 together or how to reconcile the different concepts and language between the two approaches.

Conclusion

Without affirmatively reaching consensus that the Article 9 analysis precedes the Article 7 analysis (or *vice versa*), and without to harmonizing the SPF analysis under Article 7 with the risk control framework under Article 9, the 2018 guidance leaves unresolved the fundamental issue that WP6 set out to address post-BEPS.

[Back to top]

Contacts

Philippe Penelle (Washington DC)
ppenelle@deloitte.com

Bob Stack (Washington DC)
bstack@deloitte.com

Paul Epstein (Washington DC)
pepstein@deloitte.com

[Back to top]

Useful links

Resources

- 2016 Global Transfer Pricing Country Guide
- Arm's length standard
- Transfer pricing alerts

Get Connected

- Deloitte tax@hand
- Join Dbriefs
- Follow @Deloitte Tax
- www.deloitte.com/tax

Back to top

Get in touch

30 Rockefeller Plaza
New York, NY 10112-0015
United States