



## **Global Business Tax Alert** Sharp Insights

**OECD releases additional guidance on attribution of profits to permanent establishments pursuant to BEPS action 7**

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## Backdrop

India has been an active participant in the G20 and OECD's Base Erosion and Profit Shifting [BEPS] project, and has implemented key BEPS actions requiring amendment to its domestic tax law. India has also signed the multilateral instrument [MLI], for implementation of the BEPS actions requiring amendment to tax treaties.

One of the key aspects covered by BEPS relates to artificial avoidance of permanent establishment [PE] status, which is a big area of dispute between taxpayers and Revenue authorities. Existence of a PE is crucial in determining whether a non-resident enterprise must pay income tax on its business profits in India.

To prevent the use of certain common tax avoidance strategies used to circumvent the existing PE definition, the BEPS action 7 (Preventing the Artificial Avoidance of PE Status) recommended changes to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties. BEPS action 7 *inter alia* provides changes to the rules on PE created by dependent agents. Essentially, an agency PE will exist pursuant to any business activities carried through an agent who habitually concludes contracts or habitually plays the principal role leading to conclusion of contracts by the non-resident. Changes are also proposed in the specific activity exemptions for a PE. These are to be implemented through the MLI.

Recently India has also proposed to widen the term 'business connection' (akin to PE concept under the tax treaties) to align the agency PE definition with BEPS action 7 and MLI.

## Additional guidance on attribution of profits to PE

In terms of Article 7 of the OECD Model Tax Convention, the profits to be attributed to a PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that cause it to be a PE.

Guidance on the attribution of profits to PEs has been provided in the OECD's 2010 profits attribution report. The key features of the 2010 report are:

- Step one: hypothesising the PE as a separate and independent enterprise based on functional and factual analysis, attribution of assets, risks and free capital, and recognition of dealings between the PE and the rest of the enterprise;
- Step two: determining the profits of the hypothesized separate and independent enterprise based upon a comparability analysis.

The 2010 report also provides that same principles are to be applied in the case of an agency PE.

The BEPS action 7 report concluded that the changes to the PE definition did not require substantive modifications to the existing rules and guidance on attribution of profits to PEs under Article 7 of the OECD Model Tax Convention. It however did mandate the development of additional guidance on how the existing rules of Article 7 would apply to PEs resulting from the changes in the report, taking into account the revised guidance contained in the BEPS actions 8-10 report (Aligning Transfer Pricing Outcomes with Value Creation). In this backdrop, the OECD released two public discussion drafts on the attribution of profits to PE in July 2016 and June 2017.

After considering the comments received, the OCED has now issued the report providing additional guidance on attribution of profits to PE, which sets out high-level general principles for the attribution of profits to PE in the circumstances addressed by the BEPS action 7 report. The additional guidance covers specific examples dealing with:

- Warehousing, delivery, merchandising and information collection activities
- Commissionaire structure (related intermediary)
- Sale of advertising on a website (related intermediary)
- Procurement of goods (related intermediary)

In the context of an agency PE, the report states that when an agency PE is deemed to exist due to the activities of an intermediary, those activities are relevant to two taxpayers in the host country: the intermediary (which may be a resident of the host country) and the PE (which is a PE of a non-resident enterprise). The arm's length reward to the intermediary for the services it provides to the non-resident enterprise is one of the elements that needs to be determined and deducted in calculating the profits attributable to the PE under Article 7.

In the examples dealing with agency PE, broadly speaking the profits attributable to the PE are determined by deducting from the sale consideration charged to the customer, the following amounts: (i) arm's length pricing of internal dealing of 'purchase' by the PE from the head office; (ii) remuneration paid to intermediary; and (iii) other expenses for the purpose of the PE.

The report also 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. As noted earlier, one of the elements to determine and deduct in calculating the profits attributable to the PE is an arm's length reward to the intermediary. 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).

## **Conclusion**

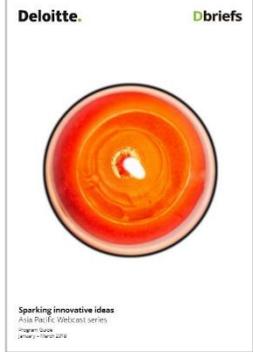
The amendment to the Indian tax law and the MLI (which will enter into force from 1 July 2018) significantly widen the definition of an agency PE. It is important for multinational enterprises to undertake a risk assessment exercise to evaluate how the proposed expansion of the PE definition could lead to creation of a PE of the overseas group entity in India, including the attribution of profits to the PE.

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