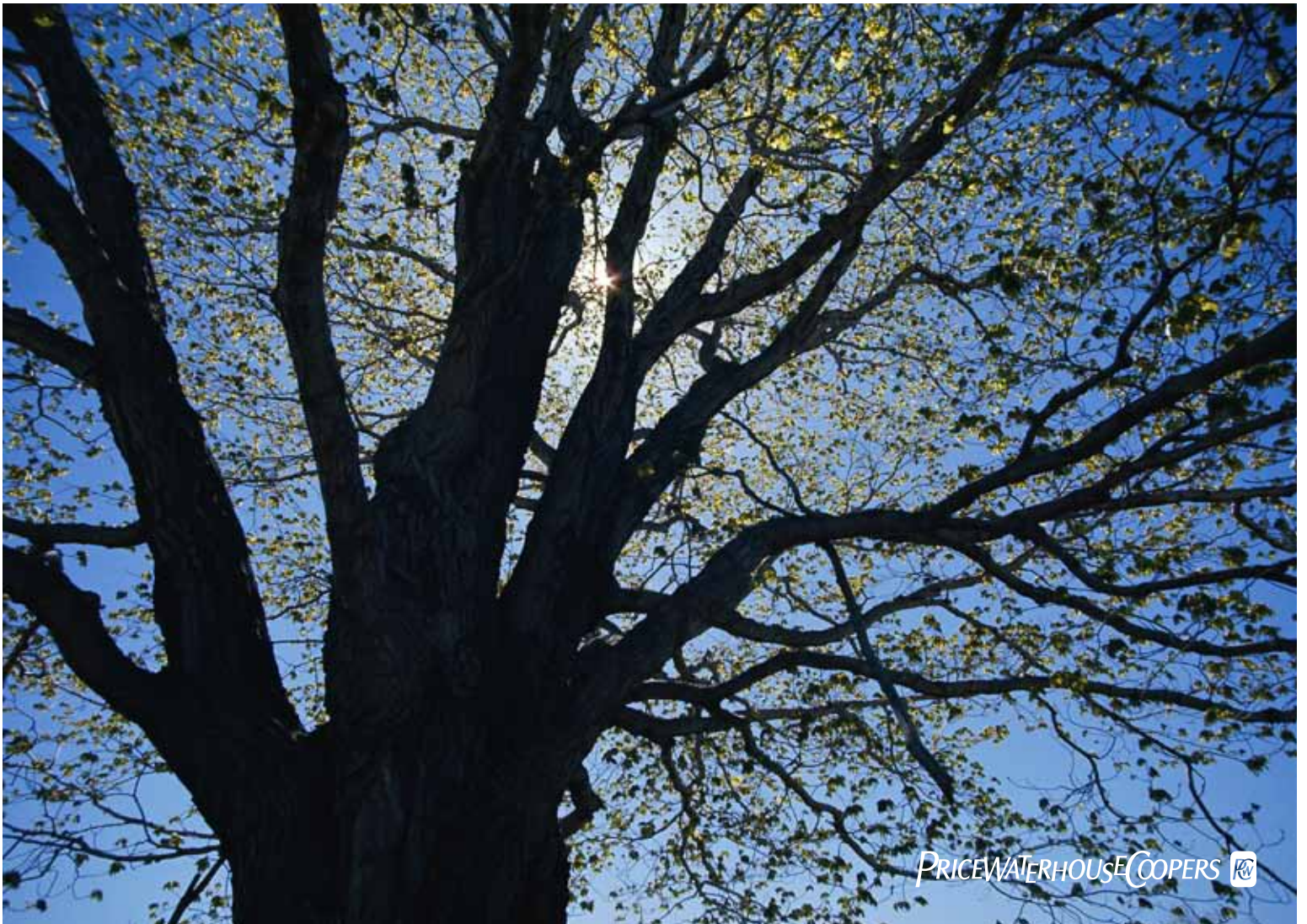


The transfer pricing challenge of the future—  
Managing permanent establishment risk

# Transfer pricing perspectives

Re:solutions  
moving towards certainty



# The transfer pricing challenge of the future— Managing permanent establishment risk

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In trying to predict the future, it is tempting to look to the past for direction. But what happens when tried and true models and assumptions from the past change so dramatically that they make it impossible to envision what the future will hold? What if all of this happens in the current environment, where the global business community is changing rapidly all while the world endures a major financial crisis?

This is the scenario for stakeholders who are tasked with managing permanent establishment (PE) risk following the recent release of new guidelines from the Organisation for Economic Co-operation and Development (OECD) for allocating profit to a PE.

The OECD released its first discussion draft on allocation of profit to a PE in early 2001. The original release was followed by numerous additional reports and revised versions, which, taken together, reflect the OECD's thought process for developing technical guidance regarding profit allocation for PEs. The length and depth of the process also indicate the complexity of an issue that is not subject to any type of 'quick fix'.

Two documents relevant to this discussion were released in 2008. The first document is the final report on allocation of profit to a permanent establishment. The second is a discussion draft of a revised Article 7 and commentary which, if adopted in final form, would fully implement the changes outlined in the report.

The definition of a PE is defined by Article 5 in the Model Tax Treaty. The amended commentary to Article 7 does not intend to change the definition, but the release of the OECD documents will likely increase the focus on PEs for years to come.

A defined PE is associated with a fixed place of business. For example, is a business address available or does the local representatives work from home? Do they have business cards indicating conclusion of sale? Are their activities of a preparatory or auxiliary character?

The traditional allocation of profit to a PE was based upon an 'all or nothing' approach: either there was a taxable presence and therefore an allocation should be made, or the activities did not meet the threshold for a PE and no allocation was made. The allocation was made arbitrarily based upon revenue or profit.

The new commentary language in Article 7, changes the approach to allocate profit

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to a PE by assessing the value chain between the head office and the potential PE in its entirety. As a result of this change, the process for determining a profit allocation has become much more complex, but likely also more accurate. Article 7 reengineers transfer pricing methodology as the tool to identify and qualify the value of the activities undertaken throughout the value chain between the head office and the potential PE and the performance of the proper allocation of profit. This new process may appear to work well in theory, but the reality, it is often much more difficult to describe, especially when it comes to allocation for a PE.

For tax directors, this represents a tremendous challenge. Despite the limited number of examples from case law, some cases in India (Rolls Royce, Morgan Stanley), Italy (Phillip Morris) and France (Zimmer) offer some guidance. The cases are very different in content and nature, but the common denominator was that the PE challenge came as a surprise, that is that documentation to sustain the tax position had to be produced subsequently which always creates a procedural risk to the tax payer.

Obviously, tax directors may have relied on the PE analysis. When a PE did not exist or the activities were deemed to be of a preparatory and auxiliary character, there was no need to start a process of allocating profit.

The Article 7 approach, as reflected in the new commentary and the profit attribution report, looks specifically at the head office and the PE it allocates assets based on where within that single entity functions are performed, and it allocates risks based on the allocation of assets. It then proceeds to allocate income between the home office and the PE based on transfer pricing principles, treating the PE as a notional separate entity.

### **How the new approach differs from traditional TP approach**

As stated earlier, the new approach focuses on the value chain between the head-office and the PE.

The traditional transfer pricing approach is based upon an analysis of the factual and functional arrangement. In addition, the contractual relationship is evaluated to determine the risk and assets deployed. Hence, in ordinary transactions between affiliates, it is possible to segregate functions, risks and ownership to assets by virtue of the contractual relationship. This is the approach deployed by tax authorities and professionals when performing a functional and risk analysis.

The arrangement between a PE and its head office is referred to as a dealing.

### **The first step is to identify whether a dealing could exist**

For multinational companies (MNCs) working cross-border without established legal entities in host countries, the question of whether an arrangement may constitute a dealing can appear. Typical examples are cross-border projects, where people from the head office are on the ground for a longer period of time, or are making decisions that significantly influence the outcome to the project; or if the head office engages in extended maintenance or warranty provisions; or all of the above.

Many progressive companies are introducing virtual management models, where the skill sets and competencies of management rather than the geographic location of a manufacturing site or head office determine how the business is operated. For example, although a company's sales directors are located in US, thought they have responsibility for the sales in Asia. The UK production manager may have a global responsibility, but the head office might be in New York. Management meetings are conducted through virtual technologies (instant messaging, video conferencing, etc.), and may even be conducted from a private residence in order to lower office costs. These types of examples will create a significant challenge, both in identifying whether a dealing is actually taking place between the head office and a potential PE and in allocating the appropriate profit.

When conducting the analysis within this type of model, an organisation's HR department is often a good place to start, since they know where staff is located and usually have determined that they are in compliance with local tax and social laws. Identifying insurance policies taken out on people and projects is another helpful tool.

It should be borne in mind that the accounting records typically will not reflect the transactions corresponding to a dealing until it has actually been identified and treated accordingly.

## **The second step is to identify what is happening**

Under the new process outlined in the commentary on Chapter 7, tax directors should keep in mind that they are properly the only people in the organisation who can speak with authority about PE and PE-related issues. Hence, the tax director needs to have a more sophisticated grasp of the investigation in order to better understand which part of the value chain is undertaken and by whom. The traditional function and risk analysis must be conducted with caution.

If a dealing is found to exist, the allocation of profit is based on a division of function risks and assets between the head office and the PE. But unlike the traditional functional analysis, risk and function cannot be separated by a legal agreement. The analysis further divides assets and liabilities between the head office and the PE using the capital employed for the underlying transactions.

Tax directors will need to build a more intelligent reporting structure to accurately demonstrate whether or not a dealing exists. As always, the devil is in the details. The reporting structure should resemble that of a function and risk analysis, where the tax director seeks to obtain information from both the host and home country of the arrangement in question.

A dealing should be documented similarly to a legal arrangement (i.e. establish the terms and conditions) although, by nature it can not be legally binding on the parties. The documented dealing should also ease the audit process.

In order to complete the analysis, an allocation of capital (PE equity) is made to assert the independence of the PE.

But as in an ordinary transfer pricing study, the price setting will depend on the qualification of the transaction in conjunction with the functional risk analysis and should ultimately be supported by relevant benchmark studies.

### **The third step is the valuation process for establishing an accurate transfer price**

Some may ask, isn't a PE always considered a service provider? As such, it would be appropriate to use the cost plus approach, which would render the economic result insignificant. Why undertake the entire administrative burden of full implementation of the guidance for allocating profit to a PE?

Simply because cost plus may be the right approach. But it will have to be justified based on the actual factual and functional analysis — any TP method must represent a viable solution.

Special care should be observed with respect to the handling of significant people functions. Where undertaken in the PE context, capital follows risk, which follows assets, which follow functions. Hence the execution of significant people functions in the host country may lead to the application of profit split as a more reasonable method for allocation of profit.

But as in an ordinary transfer pricing study, the price setting will depend on the qualification of the transaction in conjunction with the functional risk analysis and should ultimately be supported by relevant benchmark studies.

If a PE is found to exist as part of the exercise, a compliance burden is automatically created and the filing of separate tax returns in the host country may be applicable.

### **The fourth step is documentation**

The allocation of profit to a PE will also be subject to the documentation requirements in Chapter 5 of the OECD guidelines on transfer pricing documentation by analogy.

At the time profit from dealings is determined, taxpayers need to make a reasonable effort to ascertain whether their approach to determining that profit is in accordance with the arm's length principle.

The OECD report highlights elements that can establish the existence of a PE's dealings:

- The documentation is consistent with the economic substance of the activities taking place and supported by the functional and factual analysis.
- The arrangement covered by the dealings does not differ from those adopted between unrelated parties in similar circumstances.
- The arrangement does not seek to separate risks from functions.

However, in addition it will be necessary to produce documentation for the purpose of justifying the application of the arms-length principle for the price setting on the transactions subject to PE's dealings. This documentation may be quite different from the documentation discussed above.

The traditional transfer pricing documentation has not focused on or addressed the PE's dealings, so the requirements presented in the OECD report will add an extra layer to the documentation burden of the taxpayer.

## **Conclusion**

There is no doubt that the updated commentary to Chapter 7 on the allocation of profit to a PE has added additional complexity to a tax director's already busy agenda.

It is possible that tax authorities in local jurisdictions hosting limited-risk distributors or contract manufacturers might be tempted to compensate for declines in sales and idle capacity caused by the current economic downturn by arguing for the presence of a PE in order to maintain a source of revenue, although, if the principal overall is incurring a loss an interesting discussion of loss split may arise.

In fact, there have already been instances where tax authorities have argued for the presence of PE following a challenge to the transfer price or vice versa.

The best way to avoid these types of discussions is by proactively establishing procedures for identifying existing PE dealings and performing the additional detailed analysis and assuring the proper allocation of profit and the presence of proper supporting documentation.

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