Financial Services Tax Bulletin

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New Versions of Parts I, II and III of the OECD Report on the Attribution of Profits to Permanent Establishment

The Organisation for Economic Co-operation and Development (OECD) Committee on Fiscal Affairs has published new versions of Parts I, II and III of its Report on the Attribution of Profits to Permanent Establishments[1]. The project, which has been underway for several years, is aimed at achieving a greater consensus on the manner of attributing profits to permanent establishments under Article 7 (Business Profits) of the OECD Model Tax Convention, with a primary goal of avoiding double taxation.

The new versions of Parts I (General Considerations), II (Banks) and III (Global Trading) reflect the broad consensus of OECD member countries around an approach to attributing profits to permanent establishments which is based upon the arm's length principle as described in the 1995 OECD Transfer Pricing Guidelines. It has also been announced that work on Part IV (Insurance), which was published in discussion draft form in 2005 is ongoing and that the intention is to publish a new version of part IV as soon as possible.

It is emphasised that the new versions of Parts I, II and III are intended to replace all previous drafts, which it is said should no longer be considered to reflect the views of the OECD. (This express revocation of previous drafts seems to be in response to some taxpayer experience of previous drafts being cited by tax authorities in the context of transfer pricing and attribution disputes).

No public comment is requested by the OECD in relation to the new versions of Parts I, II and III. It is not intended that further versions of these papers will be released and, given that work on the implementation is already underway (see page 8) it is not surprising that it is stated that the revised Report is being released primarily for informational purposes.

This Bulletin discusses the new versions of Parts I, II and III. Particular focus is given to the changes that have been made as compared to earlier versions of these documents. Although a summary of the OECD approach to the attribution of profits to PEs is set out below, readers wanting a fuller discussion should refer to our earlier Bulletins on this topic.

The revised version of Part I on General Considerations

Part I of the Report is intended to set out the principles which are of general application in attributing profits to a permanent establishment ("PE"). These are summarised below in a financial sector context.

There are two key steps in the authorised OECD approach. Both are applied on the basis that the PE is hypothesised as a distinct and separate enterprise.
Step one involves a full functional and factual analysis. The economic ownership of financial assets is attributed to the part of the enterprise which performs the key entrepreneurial risk-taking ("KERT") functions (referred to as significant people functions in Part I – see below), and the PE should be considered as assuming any related risks created by, or inherent in, those functions performed by the PE. KERT functions are, broadly, those which require active decision making with regard to the assumption or management of risks, whether on an individual or portfolio basis. This will give the location performing those KERT functions (the "economic owner") the income and expenses associated with holding the financial instruments or lending them out or selling them to third parties.

Non-financial assets and risks are to be allocated between PE and home office on the basis of "significant people functions" rather than KERTs. Tangible assets will be attributed to the place of use unless circumstances warrant a different view – see further below – while intangible assets are always to be allocated on the basis of significant people functions. The Report

[1] Released on 21 December 2006, and available for download at http://www.oecd.org/dataoecd/55/14/37861293.pdf

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emphasizes that in the PE context, it is not possible to separate business risks from the people functions associated with incurring and managing those risks. Step one also involves the recognition and determination of the nature of any dealings between the PE and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test (see below). "Free" capital is attributed to the PE to support the various risks assumed and the assets allocated to the PE. All functions have to receive an arm's length remuneration, even if they are not key entrepreneurial risk-taking functions or significant people functions which attract financial or non-financial assets, respectively.

Under the second step, the profits of the PE are determined by applying the OECD Transfer Pricing Guidelines to the PE as a distinct separate enterprise possessing the assets and risks and engaging in the dealings identified in step one[2]. Comparability factors relevant under the Guidelines are to be applied directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the PE. It is also necessary to apply by analogy one of the Guidelines' traditional transaction methods or, where such methods cannot be applied reliably, one of the transactional profit methods to arrive at an arm's length compensation for the dealings between the PE and the rest of the enterprise, taking into account the functions performed by and the assets and risks attributed to the PE.

From a financial sector perspective, most of the material in the revised Part I will be familiar both from previous versions of the document and from the more detailed and applied discussions in Part II (on traditional banking activities) and III (on global trading).

However, there are various points relating to Part I which are of interest as follows:-

Relevance to the financial sector of Part I: First, and most important, it is not correct to see the more general discussion in Part I as relevant only to non-financial sector businesses. Part I will be of general relevance to financial sector taxpayers as regards the approach to attribution to a PE apart from where the relatively specific situations discussed in Parts II and III apply instead.

Tangible assets: In the case of tangible assets, the approach to identifying which part of the enterprise should be considered the economic owner is determined solely by Part I. This now provides a revised approach to the matter. The general rule is that the place of use of the tangible asset will determine its economic ownership absent circumstances that warrant a different view. Thus, economic ownership of tangible assets may be located at a place different from the place of performance of significant people functions related to the acquisition and management of those assets. It also follows that a change in place of use of a tangible asset may well trigger a change in the economic ownership of that asset. This approach seems potentially problematic for a variety of reasons (the OECD does not seem to have secured a complete consensus amongst its members on the approach; ownership is a legal concept arguably ill-suited to the test of "use"; "use" seems in any event a vague and uncertain concept that can refer to ownership or alternatively use akin to a leasing arrangement; such vagaries, impossible to distinguish from factual analysis, may well affect the situs of deemed depreciation allowances or deemed lease payments) However, it would seem likely that the more acute issues here will fall outside the financial sector.

Intangible assets: The Report proposes to focus on the relevant significant people activities in determining the situs of intangible property as between PE and home office. However, the OECD do not wish to be overly prescriptive given the variety of ways in which intangible property can be exploited. It is noted that the Guidelines do provide guidance on the treatment of intangible property, which distinguishes between marketing intangibles and other commercial (i.e. "trade") intangibles and could be applied by analogy in the PE context. This would mean the concept of functional and factual analysis would be applied in order to determine what intangible property the PE uses and under what conditions, i.e. does it "own" the intangible

[2] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators (1995)

either solely or jointly with another part of the enterprise?

Although logically consistent with the overall OECD approach, it seems inescapable that the breadth of types of intangible property and the potential subjectivity of the analysis will, in practice, take tax payers and tax authorities into unchartered waters. This is a complex area, made more so by the growth in commercial importance of intangible property and the fact such property is typically used by more than one part of an enterprise. Particular difficulties may arise in connection with the status of notional payments in relation to matters such as deductibility and withholding and whether a common view is taken by tax authorities when they are on different ends of the same notional transaction. There is also a significant risk that the generality of the discussion in the Report will lead to highly results oriented allocations of intangible assets between PE and home office and to potentially serious controversy.

Documentation: There is an important discussion on documentation which is reproduced in each of the three revised Parts of the Report. It is noted that dealings between a PE and the rest of enterprise of which it is a part normally have no legal consequences for the enterprise as a whole. In consequence, the OECD considers that a greater degree of scrutiny of such dealings is required than of transactions between associated enterprises. This means that a threshold needs to be passed before a dealing is accepted for tax purposes. Tax payers are therefore encouraged in the report to prepare relevant documentation - for example an accounting record and contemporaneous documentation - as a 'useful starting point' for the purposes of attributing profit. It is stated the tax administrations will give effect to such documentation, notwithstanding its lack of legal effect, to the extent that (1) the documentation is consistent with the economic substance of the activities taking place within the enterprise as supported by the functional and factual analysis; (2) the arrangements documented in relation to the dealing, viewed as a whole, do not differ from those which would have been adopted by comparable independent enterprises; and (3) the dealing presented in the tax payers documentation does not violate the principles of the authorised OECD approach by, for example, purporting to transfer risks in a way that segregates them from functions.

The Report does not distinguish clearly between two uses of the term documentation. It seems to discuss the need for accounting records, ledgers, and internal file documents to be prepared as part of the prerequisite for recognizing a "dealing" between PE and home office. It also uses the term documentation in the traditional transfer pricing sense of identifying and providing economic support for appropriate transfer pricing methods. As a practical matter, it appears that the OECD intends both of these requirements to be satisfied, heralding an approach at least as onerous (and perhaps a more onerous) to documentation for intra-entity transactions as typically now exists for inter entity transactions.

SPFs/KERTS: The use of the "KERT" to describe the most critical people functions has been avoided in Part I with the substitution of the phrase "significant people functions" (SPFs) relevant to the economic ownership of assets and the assumption/management of risks. This is explained on the basis that those people functions in the financial sector relating to both the ownership of assets and the assumption/management of risks are very likely to be the same (hence the "KERT" terminology is retained in Parts II-IV). The extent of the overlap outside the financial sector is, however, expected to vary from business to business. In any event, there is little practical difference in what is denoted by the "KERT" or "SPF" label.

The revised version of Part II – Traditional Banking Activities

Other than the encouragement to tax payers to prepare documentation relating to branch dealing discussed above, Part II of the PE Paper is the least affected by revisions with only relatively minor changes to the text as discussed below.

Non KERT functions: The revised text does place some emphasis on functions other than KERT functions. It is stated such other functions are not necessarily low value

functions and could involve a whole spectrum of levels of reward, depending upon the circumstances. This clarification seems intended to redress the focus on KERT functions alone, the point being that whilst the location of KERT functions determines the location of assets and risks, the profits attributable to a PE will also need to reflect all functions of the PE, not just those profits attributable to its assets and risks. This emphasis is also reflected in the revised Part III.

Asset/Risk transfer: There are various comments that clarify the effect where assets and risks are transferred, accepting that the required capital to support the business in such a situation will in consequence be reduced. These comments will be of relevance not merely to asset transfers but also where risk has been shifted through the use of, for example, derivatives.

Head Office and support costs: Finally, it is noted that an important difference between the new OECD approach and the existing position is that under the new approach the arm's length principle is applied to determine the reward for performing services, for example as provided by a head office to a PE of the same entity. This means that merely allocating costs will not conform to the new OECD approach. Instead an uplift will typically need to be applied. However, it is noted that services provided by head office to a PE may be different from those provided by a parent or the centralised service provider in a multi national group and, accordingly, Comparable Uncontrolled Prices may well be unavailable so the cost plus methods are more likely to be relevant as a practical matter. It remains to be seen whether head office costs, charged out on an uplifted basis, are accepted by host country taxation authorities.

The revised version of Part III – Global Trading of Financial Instruments

Although there is no fundamental change in the approach set out in Part III on global trading, a number of significant changes have been made as compared to the pre-existing draft.

Somewhat curiously (given the subject matter of the OECD Project) Part III retains a relatively lengthy section on global trading conducted by separate but associated entities.

Scope of Part III: With regard to the scope of the Paper, emphasis is added to the fact that although "global trading" of financial instruments refers primarily to entities that engage in market making on a global or 24 hour basis, it also includes situations where some part of the business takes place in more than one jurisdiction. Emphasising this relatively low threshold, it is noted that the term "global trading" may refer to the dealing or brokering of financial instruments in customer transactions where some part of the business takes place in more than one jurisdiction. This is consistent with the US Proposed Global Dealing Regs. Proposed Reg $1.482-8(a)(2) states that the global dealing operation need not be conducted around the world or on a 24 hour basis. To be considered global dealing, the operation need only perform one of the enumerated functions in more than one tax jurisdiction.

Parameter setting: There is a new commentary on "parameter setting" arrangements which rejects the idea that such activities can qualify as KERTs. This is on the basis that the setting of such overall limits is changed infrequently; limits do not need to be utilised; and regulators do not view capital as being placed at risk until the enterprise is contractually committed to particular transactions. Further, it is stated that where senior management activity is confined merely to setting the parameters which define the potential for the assumption of risk, there is likely to be a separate trading function which does lead to the actual assumption and subsequent management of risk. The discussion goes on to consider whether the parameter setting function should be rewarded at all and refers to the 1995 Transfer Pricing Guidelines to determine whether a chargeable service has been provided.

The OECD has previously emphasised that in the financial sector KERTs are typically the day to day activities of risk assumption and management. Therefore, the above comments on parameter setting should perhaps come as no surprise. However,

they are somewhat disappointing for two reasons. First, during the consultative process business has clearly expressed concerns on the OECD's insistence on focusing on the day to day risk management functions. Whilst this may be appropriate to some – probably the majority of – financial sector businesses, in others it will be more appropriate to focus on periodic (and more strategic) risk management activities (for example, compare highly structured credit trading business with commoditised government bond flow trading). Second, whilst the revised version of Part III has gone to some lengths to emphasise the need for flexibility in construing sales and trading activities to take account of the spectrum of value from situation to situation, the same level of flexibility is not applied in the insistence that KERT functions are to be restricted to functions exercised on a day to day basis. The concern is therefore that the discussion of KERTs in this context remains too prescriptive.

Dependent agent PEs: On the highly controversial topic of dependent agent PEs, and the rule of Art 5(5), the Report emphasises heavily that it is neither concerned with nor addresses the point whether a PE exists in respect of a particular global trading activity through a dependent agent. In particular, it is stated that the Paper does not discuss the PE threshold under Art 5(5) and so nothing in the Paper should be construed as altering or lowering the existing PE threshold. There is a separate section in the Paper on dependent agent PEs but this, it is made clear, is concerned with providing guidance on how to attribute profits where a PE is found to exist under the existing rules and interpretations of Art 5(5) and (6) (and the answer here is that the approach is just the same as for an ordinary PE). Thus, the KERT functions are to be used solely in the determination of the proper profit or loss to be attributed to a PE and not in the determination of whether a PE exists. As well as indicating that KERT functions play no role whatsoever in the dependent agent analysis under Art 5, it is similarly emphasised that they are irrelevant for attributing capital or the reward for capital in situations where capital exists in a separate legal entity from the one performing the people functions and no PE is found to exist (in other words, generally in Art 9 situations).

Non recognition of dependent agent PE and use of transfer pricing: The Paper had previously recognised that countries may adopt "administratively convenient ways" of recognising the existence of a dependent agent PE by collecting the relevant tax relating to the non-resident from the dependent agent enterprise itself rather than from the dependent agent PE. It is now clarified that this would mean taxing the dependent agent enterprise not only on the profits attributable to the people functions it performs on behalf of the non-resident enterprise (and its own assets and risks assumed), but also on the reward for the free capital which is properly attributable to the PE of the non-resident enterprise. The paper comments that such administrative matters related to the taxation of dependent agent PEs are for the domestic rules of the host country and not for the OECD to address. However, the OECD comments that the fiscal authority in the home country of the entity with a PE in a host country that operated such an administratively convenient procedure would not be obliged to give relief or be entitled to tax on the basis that there was no dependent agent PE and that the taxing rights of the home country are not altered by administratively convenient procedures of the host country. The implication is clearly that this is no easy solution to the inadvertent dependent agent PE issue.

Hedge fund model as comparable: There is a new and relatively lengthy section of the Paper given over to considering whether a "hedge fund" model could provide an appropriate comparable for the purposes of determining a reward to capital. The suggestion is that the traders employed by a bank to manage the bank's risks are in a position similar to the manager of a hedge fund, which has found investors who are willing to delegate management of their capital to the manager in return for what they believe will be a higher overall return. The discussion notes some of the difficulties, such as whether it is possible to make reasonably reliable adjustments to account for any material differences between the potential hedge fund comparable and the controlled transaction. In general, the

discussion seems more open to the use of hedge fund comparables in appropriate circumstances, although it seems to indicate that use of hedge fund models is more appropriate for proprietary trading activities than for market making activities.

It should be emphasised that the discussion in the Paper addresses the issue only of whether the hedge fund model provides appropriate comparables for transfer pricing purposes. The "hedge fund model" has, however, been central to previous discussions between the OECD and business on whether a dependent agent PE exists where a related party service arrangement is in place, the argument being that such an arrangement is akin to a hedge fund model and therefore there ought to be no finding of a dependent agent PE under Art 5(5). The comments in the OECD paper do not address that issue at all and it would seem unduly optimistic to conclude that the dependent agent issues under Art 5(5) have been resolved by the OECD's greater openness to the use of hedge fund models as potential comparables.

The Treatment of capital in profit splits: it is expressly emphasised that in profit splits involving associated enterprises the reward for capital, only goes to the enterprise(s) that have the capital. At a logical or technical level it is hard to argue with this. However, the issue is a practical one, but one with potentially far-reaching effects. Taking an example to illustrate the point, assume X Co and Y Co, associated companies operating in different states are carrying on fully integrated dealing activities but booking transactions in X Co's balance sheet. How should capital be dealt with in this situation? Part III tells us the reward for capital goes to X Co. However, if X Co's capital is supporting Y Co's part of the business (as may well be the case) then the capital (at least in part) may be seen by the tax authorities in Y Co's jurisdiction as in the wrong location. The key practical point of difficulty arises from the fact that (1) there is a markedly different treatment of capital as between inter-entity and intra-entity situations and (2) there is a general expectation of no dependent agent PE in profit split arrangements. However, applying the logic of the OECD approach may well lead – at a technical level – to multiple dependent agent PEs being created and the OECD's comments on capital may give tax authorities an incentive to take the point. It would surely be a highly impractical, if not absurd, outcome if multiple dependent agent PEs were to be found in profit splitting arrangements. There are various practical possibilities to avoid such an outcome but Part III makes no comment on the point.

The location of other risks and costs: Finally, there are some expanded comments on operational risk which broadly indicate that in a PE context responsibility for operational risk will typically fall on those that made any error and so the approach of attributing costs from operational risk will follow the people functions approach. A number of other risks which might similarly lead to losses are also considered and a similar conclusion is drawn.

Work in Progress – implementing the conclusions of the Report

The implementation work is proceeding on the basis of the new versions of Parts I, II and III. That implementation work is to be conducted by a working group which is adopting a two track strategy. It is stated that the OECD considers that many (but clearly not all) of the conclusions reflected in Parts I, II and III do not conflict with the existing Commentary to Article 7. Therefore, the OECD intends, first, to supplement the existing Commentary to Article 7 dealing with attribution of profits to permanent establishments with additional guidance reflected in Parts I, II and III but only to the extent that such additional guidance does not conflict with the existing Article 7 (track 1). It will also prepare a new version of Article 7 and a new Commentary in order to fully implement the conclusions reflected in Parts I, II and III in a way that removes any uncertainty as to what is the correct interpretation of the provisions of the Article (track 2). It is intended that a first draft of the proposed additions to the existing Commentary and of the new Article and its Commentary will be released for public comment in 2007.

There is also one particular technical point which is to be addressed as part of the implementation process (and in respect of which the discussion in earlier versions of Parts I, II and III has now been taken out in

the reviewed versions). This relates to double tax relief. Given that it has not been possible to develop a single internationally accepted approach for attributing the necessary “free” capital to a PE, there have been significant concerns that problems might arise where the host (PE) country’s domestic rules prescribe one of the authorised approaches for attributing capital and the domestic rules of the home country (Head Office) prescribe another approach. The main concern is that where the domestic rules of home and host countries require different authorised approaches for attributing an arm’s length amount of capital to the permanent establishment, the home country may not give relief for tax on profits calculated under the host country approach.

It is noted in the OECD document that a large majority of OECD member countries agree on how to give double taxation relief in this situation. However, the withdrawal from the Report of the general proposition that home countries are usually required to follow host country determinations provided they are based on an approved method seems to reflect some erosion of support for such a rule among member countries. It will be interesting to see if the OECD is able to resurrect the prior consensus on this point as the implementation process continues.

What high-level conclusions may be drawn?

- The OECD is clearly determined to draw the long running work on this project to a close a soon as possible.

- Having regard to (1) the various issues on which complete consensus of OECD member countries has not been achieved (2) the open issues relating to implementation and (3) how the package will be applied in practice, it is not self evident that the goal of the project to achieve a greater consensus with a view to reducing the incidence of double taxation will be achieved.

- The key issues now relate to the two track implementation approach – including for example how the various issues are allocated and dealt with under either track one or track two.

- It remains to be seen to what extent the full package of all measures which follow logically from the hypothesising of the PE as a separate and distinct enterprise (and which are to be encapsulated in the revised Article 7 and Commentary - ie the track two approach) will be adopted in tax treaties by states, whether OECD members or not.

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