



*Financial Services Tax Group*

# **News Letter**

*Special Issue - August 27, 2004*

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## **OECD revised discussion Draft on the Attribution of Income to Permanent Establishments Part I (General Considerations) – A Financial Sector Perspective**

On August 2, 2004 the OECD published a revised version of Part I (General Considerations) of its Discussion Draft on the Attribution of Profits to Permanent Establishments. The new Discussion Draft revises and updates the description of the key building blocks and general principles underlying a three-year effort by the OECD to revise the rules on income attribution applicable under Article 7 of the OECD Model Tax Treaty. While the OECD project to this point has focused primarily on banks and securities dealers, the August 2, 2004 revision of Part I applies well beyond the financial services industry and will be applied to any treaty situation where a national tax authority asserts the existence of a permanent establishment.

### **Importance of the New Discussion Draft**

Revised Part I of the Discussion Draft is an important document. The OECD suggests that the thinking reflected in this document is now sufficiently far advanced that it represents the "authorized OECD approach" to attributing profits to permanent establishments. The implication is that, while the OECD will revise this draft one additional time in January, 2005, and will thereafter make substantial changes to the Model Treaty Commentary to implement the provisions of the Discussion Draft, OECD member country competent authorities will in all likelihood immediately seek to apply the principles contained in the August 2, 2004

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Discussion Draft in resolving cases involving permanent establishments. The OECD suggests that any future changes to this document will be only for the purpose of clarification and should not be expected to change the substance of the tax rules set out in the August 2 draft.

The rules of the Discussion Draft apply principally to companies that operate in branch form in treaty jurisdictions. However, because this document is issued at a time when tax authority assertions of the existence of permanent establishments are proliferating in transfer pricing and other tax audits around the globe, the rules for attributing income to permanent establishments contained in the Discussion Draft may often be relevant to those operating in subsidiary and partnership form. In particular, the analysis in the Discussion Draft of the attribution of income to dependent agent permanent establishments, described in detail below, could apply to many companies that do not operate through branches. Moreover, because the rules are built on the OECD Transfer Pricing Guidelines, the document may well influence the thinking of competent authorities and country tax administrations in transfer pricing situations that do not involve permanent establishments. Thus, while this OECD process has proceeded largely beyond the notice of many taxpayers outside the financial services industry, this version of Part I of the Discussion Draft is likely to have profound tax consequences for taxpayers in many industries in coming years.

For financial sector taxpayers, the chief areas of interest in the newly revised Part I are likely to be the comments on the dependent agent PEs and the deference to host country determinations in relation to the quantum of capital allocated to the PE. Both areas are discussed below, together with certain other points that are also of interest.

### **Basic Approach**

The purpose of the OECD project on attribution of income to permanent establishments is to bring international consistency and consensus to a topic that has been highly confused for many years. The starting point of the OECD analysis is that the income of a permanent establishment should be determined on the basis of an assumption that the permanent establishment should be viewed as a "functionally separate entity." Consistent with the basic methodology set out in earlier versions of the Discussion Draft, income is then attributed to the PE by applying the following steps.

- A detailed functional analysis must be undertaken to identify the location of key

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entrepreneurial risk taking functions in the permanent establishment and its home office;

- Assets and risks of the business are attributed to the permanent establishment and home office based on the situs of the performance of the key functions as identified in the functional analysis;
- Free capital is allocated to the permanent establishment in proportion to the assets and risks allocated to the PE; and
- Income is allocated to the permanent establishment by applying the OECD Transfer Pricing Guidelines to the notional separate legal entity assuming it has the assets, risks and capital determined under the first three steps and deals with its home office on an arm's length basis.

#### **Treatment of Dependent Agent Permanent Establishments**

Revised Part I of the Discussion Draft clearly states an intent to apply its provisions to dependent agent permanent establishments, i.e., permanent establishments created when one entity operates in a country on behalf of a non-resident legal entity by habitually exercising the authority to contract on behalf of that entity. The Discussion Draft states that it does not intend to expand or otherwise modify the existing dependent agent permanent establishment definition, but does make it clear that a related entity acting as a sales agent in a country may give rise to a dependent agent permanent establishment.

Under such circumstances, the question arises as to whether any income in addition to the arm's length fee to the sales agent for its services, determined under normal transfer pricing principles, should be allocated to the permanent establishment so created. In an earlier draft of Part III of the Discussion Draft, relating to global dealing in financial products, the OECD had suggested that compensation in addition to the arm's length fee to the dependent agent should be attributed to such a permanent establishment. This was by far the most intensely debated point at the recent public consultation in Geneva, Switzerland held to discuss the OECD income attribution project with affected financial sector businesses.

Notwithstanding the adverse comments from affected businesses in Geneva, revised Part I

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clearly takes the position that a dependent agent permanent establishment can, under appropriate circumstances, be allocated income over and above the arm's length fee due to the dependent agent that gives rise to the permanent establishment. Such income arises when employees of the dependent agent perform key entrepreneurial risk taking functions and therefore attract to their location assets and risks under methodology summarized above. Such assets and risks belong to the principal, not the agent, but since the functions giving rise to those assets and risks occur in the agent's country, they should properly be allocated to the permanent establishment in that country, not to the home office. The assets and risks so allocated to the permanent establishment in this manner would then attract income when the Transfer Pricing Guidelines are applied to the functionally separate entity that is the permanent establishment.

In a global dealing context this analysis would have the effect of assigning to the dependent agent permanent establishment part of the return attributable to the capital of the enterprise.

#### **Deference to Host Country Determinations**

While it is clear that free capital must be allocated among branches based on functional analysis, it has been impossible for the OECD member countries to finally agree on a single detailed method for making these allocations in a banking context. Instead, tax authorities may take (1) a thin capitalization approach to the determination of the required level of branch capital; or (2) a capital allocation approach based on risk-weighted assets; or (3) apply a quasi-thin capitalization approach, (which involves, broadly, the use of a safe harbor measure). All three methods for the allocation of capital to PEs remain open to OECD member countries, although the revised Part I of the Discussion Draft suggests the quasi-thin capitalization approach is less desirable in comparison to the other two methods. This failure to agree a single approach to capital allocation by OECD members has attracted considerable criticism from the financial services industry. In the Geneva consultation meeting earlier this year representations of the industry suggested a variety of approaches, all of which would have permitted taxpayers to operate a single basis for capital allocation on a global basis. Despite the very high level of support for this expressed by the financial services industry, the OECD member countries have not been able to accept the industry position.

In an effort to mitigate the effects of what is proposed, the OECD has articulated in the revised Part I of the Discussion Draft an interesting canon of treaty interpretation.

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Essentially the position is that where more than one method of attributing income and deductions is "approved" or "appropriate" under the treaty, the host country may apply any of the approved methods. Thereafter, the taxpayer's home country is then obligated to grant relief from double taxation, even though its own domestic tax rules are different and acceptable under the treaty. An unfortunate consequence of this approach is that a global enterprise may find that it needs to undertake allocation exercises in different ways in different countries and its home country may be obliged to provide relief from double taxation for all of them. What remains somewhat unclear is the extent to which foreign tax credit limitation and sourcing rules in the home country's domestic law and preserved under Article 23 of the treaty, may operate to prevent full double tax relief in situations where host countries follow different approved rules.

### **Intangible Property Generally**

The original version of Part I of the Discussion Draft contained confusing discussions of intangible property that were the subject of substantial adverse comment by the business community. In essence, the original draft suggested that it might be appropriate to allocate intangible assets between a permanent establishment and the home office by reference to the place where the intangible was used or intended to be used. The revised version of Part I modifies this analysis significantly, suggesting that the functional analysis approach based on key entrepreneurial risk taking functions should also be applied to determine the economic owner of intangibles.

With respect to internally developed trade intangibles, the revised Discussion Draft takes the position that the key entrepreneurial risk taking functions are those functions related to the development of the intangible. Active decision-making and day-to-day management of R&D programs would, in most instances, be the key factors.

The treatment of marketing intangibles in revised Part I of the Discussion Draft is more open ended. While the authors assert that the same principles should apply in determining the owner of marketing intangibles, they also suggest that as a factual matter it may be more difficult to isolate the location of performance of key development functions. The implication is that marketing intangibles may, in many instances, be appropriately thought of as a global asset jointly owned by home office and permanent establishment. Businesses such as banks and other financial institutions that operate in branch form should be particularly cognizant of the potential impact of this analysis of marketing intangibles.

## **Key Entrepreneurial Risk Taking Functions**

As noted in the discussion above, the entire scheme for allocating income to PEs turns on identifying the geographic location of the performance of key entrepreneurial risk taking functions. The Discussion Draft defines key entrepreneurial functions as "those which require active decision making with regard to the most important profit generators of the business." It is clear that the identification of such factors is a highly fact specific exercise and that the key entrepreneurial risk taking functions will not necessarily be the same in any two analyses, even for enterprises in the same industry, although for banks and investment banks such factors will often relate to the day to day decision-making process relating to the commitment of capital in financial transactions and the risk management of the resulting positions.

What is clear is that the profit attribution exercise outlined in the Discussion Draft will always be extraordinarily fact intensive, that primary weight is placed on the functional analysis, and that as with all fact intensive enterprises, this process will be one open to substantial disagreement and dispute.

## **Free Capital and Financing Costs**

At the heart of the approved OECD approach is the methodology for allocating capital and interest deductions to permanent establishments. This methodology has been elaborated in the context of banks and financial institutions in earlier drafts of Part II and Part III of the Discussion Draft. Revised Part I essentially stays the course, affirming that the previously described approaches to this issue are essentially being adopted without significant change.

Under the OECD methodology, risks and assets are allocated between home office and permanent establishment by reference to the functional analysis. The free or equity capital of the enterprise is then allocated to permanent establishment and home office in proportion to the assets and risks they are deemed to own. Interest deductions of the permanent establishment are limited to the extent the PE's funding requirements are satisfied by the allocated free capital. Location of capital and or assets on the branch or home office books of account is of no importance. What ultimately matters is where the key entrepreneurial risk taking functions are performed.

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While banks and other financial institutions may have grown accustomed to this approach through the various iterations of Parts II and III of the Discussion Draft, an open question had remained regarding the extent these rules would be applied to non-financial institutions. Revised Part I of the Discussion Draft makes it abundantly clear that the same rules regarding capital allocation and attribution of capital that apply in a banking context must also be applied to branch operations in other industries. Hence, even when capital is physically deployed in property, plant and equipment or inventory physically located in one location, it seems to be the OECD intention, at least for the purposes of determining interest deductions, to treat such capital as allocated to where risk taking functions are performed rather than to where the capital is deployed.

### **Documentation**

The Discussion Draft suggests that taxpayers should prepare documentation supporting their application of the Discussion Draft rules in accordance with the Transfer Pricing Guidelines. Such requirements are now commonplace and for businesses operating in branch form will come as no surprise. More interesting questions will arise in dependent agency permanent establishment situations where the very existence of the PE may be open to dispute. Whether tax administrations would seek or are being encouraged to impose penalties or other adverse consequences for failure to prepare documentation in such situations remains very unclear.

### **Conclusion**

Comments may be submitted to the OECD on the revised Discussion Draft until September 28, 2004. The Discussion Draft will then be considered one final time at an OECD meeting in October and finalized in January. Businesses which either operate in branch form or which have exposure to possible assertions that they have dependent agent PEs will want to give careful consideration to the Discussion Draft during the comment period.

As noted above, the OECD suggests that the thinking reflected in this document is now sufficiently far advanced that it represents the "authorized OECD approach" to attributing profits to permanent establishments. Accordingly, the OECD member country competent authorities will in all likelihood immediately seek to apply the principles contained in the August 2, 2004 Discussion Draft in resolving cases involving permanent establishments.

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Furthermore, any new tax legislation and regulations are likely to incorporate the major tenets of Part I. For example, in the U.S., the Internal Revenue Service is currently drafting another set of proposed treasury regulations on global dealing of financial instruments and final treasury regulations on services and related intangibles, both of which are expected to be completed by the end of 2004 or in early 2005.

Finally, on August 17, 2004 the OECD published revised versions of Part II (Banking) and Part III (Global Trading of Financial Instruments) of the Report on the Attribution of Profits to Permanent Establishments. We will provide a summary in a subsequent special News Letter.

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This Financial News Letter provides a general summary of the OECD revised version of Part I published on August 2, 2004, and does not constitute the provision of advice of any kind. Before making any decision or taking any action, you should consult your usual PwC contact with all the pertinent facts relevant to your particular situation.

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