



*Financial Services Tax Group*

# **News Letter**

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## **OECD Discussion Draft on the Attribution of Income to Permanent Establishments – Surprise Deferral of the Package**

Further consultations with representatives of the financial services industry were held in Paris on 28 October 2004 and with representatives of non-financial industries on 25 October 2004. This followed the release in August 2004 of further revised drafts of Part I (general considerations), Part II (Banks carrying on traditional banking activities) and part III (Global Trading of Financial Instruments). PwC representatives participated in each of these consultations. This News Letter surveys the major points emerging from these consultations and the revised texts that were released in August.

### **Timing of the Package**

The OECD had expressed a clear intention to release a final version of Part I, II and III by early 2005 and it was expected that the recent meeting in Paris would represent the final opportunity for discussion prior to the finalised texts being produced. These plans have now been dropped and it seems likely that it may be at least 2007 before a final version of the OECD Discussion Draft on the Attribution of Profits to Permanent Establishments is available. As well as changing significantly the timing arrangements, it is also possible that the manner in which the package is enacted may also be altered. Previously, it seemed likely that the finalised OECD Permanent Establishment document would become another section of the OECD's 1995 Transfer Pricing Guidelines. Whilst that is still possible, there appears now to be more active consideration given to changing the Commentary to the OECD Model Double Tax Treaty on Article 7 (on the Attribution of Profits to Permanent

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Establishments) to bring it into line with the discussions and conclusions from this project, the aim of this amended approach clearly being to ensure the impact on the OECD Model Double Tax Treaty is kept in focus. Final decision on the way forward will be made in January 2005, when a report back on Parts I, II and III is made by the OECD's Working Party 6 (which has so far been responsible for the Permanent Establishment project) to the Committee on Fiscal Affairs. Ultimate decisions on approach and timing will rest with the Committee on Fiscal Affairs.

If the above route is followed and further work is carried out on the Commentary to Article 7, it is expected that this will lead to the creation of a joint working group, comprised of Working Group 6 and Working Group 1 (whose main focus is on the OECD Treaty, including the Commentary).

These developments were strongly welcomed by financial sector representatives attending the Paris consultation on 28 October, reflecting industry reservations on various aspects of the OECD Permanent Establishment package. However, it seems likely this change of plan by the OECD is not so much a consequence of the comments and representations by the financial sector on Parts II and III but rather a response to the situation on Part I. Whereas Parts II and III are exclusively focused on specific segments of the financial services sector, Part I has a much wider application to taxpayers in all sectors. Further whilst the first draft of Part I was released in 2001, it was only in August of this year that a further revised draft was released. Much of the public comment on that revised draft has called for more time to discuss the draft and this would have been very difficult under the original OECD proposals for finalisation by early 2005.

The additional time for discussion on Parts II and III is certainly welcomed, particularly as there are some areas where further work by financial sector representatives would be very useful. However, there remains a concern that tax authorities may seek to use or apply parts of the draft text as if it represented the finalised OECD position.

With regard to Part IV of the Permanent Establishment document (on the Insurance Sector), it is reported that a first draft may be released in March 2005.

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

The dependent agent issue has been one of the major issues discussed. Both revised

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Parts II and III of the Discussion Draft apply expressly to dependent agent permanent establishments within the meaning of Article 5 (5), (i.e. permanent establishments created when one entity operates in a country on behalf of a different and non-resident entity by habitually exercising the authority to contract on behalf of that non-resident entity).

The issue is of particular importance to enterprises carrying on global trading of financial instruments.

The OECD therefore addresses this issue in more detail in both the revised Part I and the revised Part III of the Discussion Draft. The Draft states that the dependent agent entity will be regarded as receiving a ‘reward’ (typically a fee) for the services it provided to the non resident enterprise, whereas the dependent agent PE will be regarded as having attributed to it assets and risks by reference to the functions performed on behalf of the non resident entity, together with sufficient free capital to support those assets and risks. It follows that profits will have to be allocated to the dependent agent PE on the basis of those assets, risks and free capital. In calculating these profits, the arm’s length reward paid to the dependent agent entity are deducted: The formal recognition of the existence of a dependent agent PE results in the host country having taxing rights over the two legal forms of entities – the dependent agent entity and the dependent agent PE. In most (though apparently not all) cases, the determination that a dependent agent PE exists would give rise to the taxation in the host country of income in excess of an arm’s length fee for the services of the dependent agent.

This issue was much discussed at the Paris consultation on 28 October. A major concern expressed by taxpayer representatives was that the discussion in the OECD papers on the key Entrepreneurial Risk Taking Functions (“KERT” – see below) suggested a different approach was being taken to the question of whether a dependent agent PE existed, in effect usurping the usual rule in Article 5(5) of the OECD Model Double Tax Treaty. During the Consultation it was emphasised this was not the intention: the work of working Party 6 is devoted to the (Article 7) topic of the proper measure of profits to be attributed to a permanent establishment – it is not concerned with the (Article 5) circumstances in which a dependent agent may exist.

### **Key Entrepreneurial Risk Taking (“KERT”) Functions**

The authorised OECD approach is designed to allocate income to the PE by reference to

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the location where key entrepreneurial risk taking functions are performed, since it is these functions that reflect the key economic value that is added. It is also the location of the KERT functions that dictate the location of assets, risks and capital for tax purposes.

The topic of KERT was also keenly discussed at the Paris consultation. The conclusion of the discussion was that it is not possible to define the relevant KERT functions in all cases or eventualities. Thus, whilst it would be helpful for the OECD document to include a discussion of KERT and typical KERT functions in various situations, that discussion should clarify the fact that KERT functions in any particular situation would also be driven by the relevant facts and circumstances.

In consequence, the discussion of KERT should not be prescriptive. Currently, for example, the OECD text denies that what it regards as “strategic” risk management – such as the setting of dealing limits – can be part of the KERT functions, a view disputed by industry representatives.

#### **Allocation of Capital – Deference to Host Country Determinations**

Under the authorised OECD approach, there is no single method of allocation of free capital among PEs but rather a choice of three possible methods (being a thin capitalisation approach; a quasi thin capitalisation or safe harbour approach; and an approach based on the allocation of capital by reference to risk weighted assets). Thus, countries will be able to incorporate different authorised approaches in their domestic regimes. The absence of a single approach to the allocation of capital has continued to attract considerable criticism from the industry, particularly since the initial proposals of the OECD contemplated a single methodology, involving capital allocation by reference to risk weighted assets. The OECD has recently sought to react to this situation by proposing (in the revised Part I document released in August 2004) a new approach to ensuring no double or multiple taxation arises. Under this proposed mechanism, the home country is required by Article 23 of the OECD Model Tax Treaty, when giving double tax relief, to accept the tax imposed by the host country where the permanent establishment is located provided that the host country has applied an authorised capital attribution approach and the result is consistent with the arm’s length principle. Under this approach, it seems to be the case that even where the home country has a domestic rule which attributes capital in accordance with an authorised method which differs to the host country’s approach, the home country is still bound to give relief for the tax on the profits calculated under the host country basis. A number of

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detailed question were raised in connection with these proposals – and their operation in practice – at the Paris consultation. For example, it was noted that even if the host country were to agree in principle, there may still be differences between the host country method and rules and the credit allowed in the home country.

The overall sentiment by industry representatives was that the proposed approach leaves a number of open questions relating to its practical impact and also puts too much pressure on Article 23, dealing with Methods for the Elimination of Double Taxation, and is therefore unlikely to prove acceptable in practice. The issue remains a hotly contested area under the OECD proposals.

### **Hedge Fund Comparables**

The revised Part III document released in August recognises that an appropriate transfer price will need to be arrived at in the situation involving one entity which provides services – such as dealing in the market - to another separate entity, the risk taker, located in another country. However, the existing OECD text is dismissive of the ability to use hedge fund model comparables, indicating that they are of little or no utility in allocating income between participants in the sort of global dealing business that is the subject of Part III. However, following a useful discussion at the Paris consultation, it was recognised that the hedge fund industry may, in appropriate circumstances, provide useful comparables for the purposes of that transfer pricing exercise. It would therefore seem likely that the existing comments in Part III on the hedge fund comparables will be removed or toned down when the paper is finalised.

### **Marketing Intangibles**

Part I contains a new and somewhat confusing discussion of the situs of marketing intangibles applicable to all industries. At the 25 October 2004 consultation, both business representatives and certain key governments including the United States expressed misgivings about the current draft. It is anticipated that this topic will be revisited during further considerations of the Discussion Draft.

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This Financial News Letter provides a measure points of the OECD revised version of Part I, II and III published on August 2, 2004, and does not constitute the provision of advice of any

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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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