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Financial Services Tax Group

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Release of Revised Parts I to III of the OECD Report on the Attribution of Profits to Permanent Establishments

On December 21, 2006, the Organization for Economic Cooperation and Development ("OECD") published the latest versions of Parts I to III of the Report on the Attribution of Profits to Permanent Establishments (Part I: General Considerations; Part II: Banking; Part III: Global Trading). It is intended that a revised version of Part IV (Insurance) will be published as soon as possible.

The revised versions of Parts I to III expressly replace and revoke all previous drafts. No public comment on these revised sections has been sought, and implementation on the conclusions of the Report has already begun.

This edition of Tax News outlines the major changes to Parts I to III of the Report. By way of background, the proposed "authorized OECD approach" for the attribution of profits to a permanent establishment ("PE") is summarized below. (For more detailed discussion of the "authorized OECD approach", please refer to our earlier editions of Tax News Special Issue, dated July 2005.)

Authorized OECD Approach

The authorized OECD approach hypothesizes that the PE is a separate and distinct enterprise, and applies the following two-step process:

- (1) Conduct a full functional and factual analysis of the PE in order to:
 - Attribute economic ownership of the financial assets of the enterprise to the entity performing the key entrepreneurial risk-taking (“**KERT**”) functions (together with risks associated with those functions); and
 - Allocate non-financial assets and associated risks between the PE and its home office on the basis of “significant people functions” (“**SPF**”), rather than KERTs.
- (2) Determine profits of the PE by applying the OECD’s “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” (“**Guidelines**”) to the hypothesized separate and distinct enterprise having the functions and risks determined in Step 1.

Details of specific changes to Parts I to III are provided below.

Changes to Part I: General Considerations

Much of the content of the revised Part I will be familiar from previous versions and from Parts II to IV. However, the following key changes should be noted.

- (a) Distinction in the treatment of tangible and intangible assets (*Part I, paras. 104–128*)
The economic owner of tangible assets should be determined by reference to the “place of use” of the asset. The economic owner of intangible assets should be determined by reference to the location of the SPF related to those assets.
- (b) Relevance of documentation (*Part I, paras. 210–217, 260–262*)
Given the degree of scrutiny that will be required of transactions between a PE and its home office, taxpayers are encouraged to prepare relevant documentation. Each of the revised Parts to the Report states that tax administrations will give effect to such documentation to the extent that:
(i) it is consistent with the economic substance of the activities taking place as determined in the functional and factual analysis; (ii) the documented arrangements do not differ from those that would have been adopted by comparable independent enterprises; and (iii) the dealing described in the documentation is not inconsistent with the authorized OECD approach.

For the purposes of the Report, “documentation” covers both accounting records, ledgers and other internal documents; as well as traditional transfer pricing style documentation.

Other changes contained within Part I are discussed below in relation to either Parts II or III.

Changes to Part II: Banking

Part II of the Report is the least affected by revisions, with only minor changes to the text as discussed below.

- (a) Non-KERT functions (*Part II, paras. 13, 65, 69*)
Emphasis is placed on recognition of functions other than KERT functions. Thus, while the location of KERT functions will determine the location of assets and risks, profits attributable to the PE will also need to reflect the performance of functions that do not attract assets and risks. (This emphasis is reiterated in Part III also.)
- (b) Asset/risk transfer (*Part II, paras. 78, 138~140, 184, etc.*)
Various comments in Part II clarify the position where assets and risks are transferred, and the potential corresponding reduction in capital required to support the relevant business.
- (c) Head office and support costs (*Part II, paras. 188~190*)
One important difference between the new authorized OECD approach and the existing position is noted; namely, where the arm's length principle to be applied in Step 2 (see above) requires the addition of a markup on expenses incurred by head offices, which have historically been allocated to a PE or PEs at cost only.

Changes to Part III: Global Trading

Although there is no change to the fundamental approach for global trading, there are a number of significant changes to Part III of the report, as follows.

- (a) Definition of global trading (*Part III, paras. 8~10*)
Clarification is provided that, to be considered global dealing, the operation need only perform one of the enumerated functions in more than one tax jurisdiction.
- (b) Parameter setting (*Part III, paras. 74~81*)
New commentary on "parameter setting" expressly rejects the idea that such activities generally qualify as KERTs. Thus a distinction must be drawn between the periodic setting of risk parameters and the day to day activities of risk assumption and management.
- (c) Comparability of hedge fund model (*Part III, paras. 161~164*)
The discussion in Part III seems open to the use of hedge fund models for proprietary trading activities, although less so for market making or other customer flow business.
- (d) Treatment of capital in profit splits (*Part III, para. 181*)
It is expressly emphasized that when using a profit split approach to allocate profits to a PE, the reward for capital should only go to the enterprise(s) that have the capital.
- (e) Location of other risks and costs (*Part III, paras. 102~104*)
There are expanded comments on operational risk, which broadly indicate that responsibility for operational risk will typically fall on those that made the error. Thus, the attribution of costs for operational risks will follow the SPF approach.
- (f) Dependent agent PEs (*Part III, paras. 275~286*)
The Report emphasizes heavily that it is not concerned with whether a dependent agent PE exists in respect of a particular global trading activity or not. In particular, it is stated that the Report does not discuss or alter the PE threshold under Article 5(5) of the OECD's Model Tax Convention. Thus, KERT functions are to be used solely in determination of the proper profit or loss to be attributed to a PE, and not in the determination of whether a PE exists or not.

Implementation of Conclusions

As noted above, work has already begun on implementation of the conclusions from Parts I, II and III. This work is proceeding on two tracks:

- (1) Supplementing the existing Commentary to Article 7 of the Model Tax Convention to the extent that such supplementary guidance does not conflict with the existing Article 7; and
- (2) Preparation of a new Article 7 and new Commentary to fully implement the conclusions from 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.

First drafts of both tracks 1 and 2 documents are intended to be released for public comment in 2007.

Questions for Consideration from the Japanese perspective

- Is distinguishing between economic ownership of tangible and intangible assets valid (the former based on “use”, the latter based on SPF)?
- How does the test for determination of economic ownership of intangible assets interplay with recent amendments to the Commissioner’s Directive on the Operation of Transfer Pricing?
- Will the requirement to markup head office cost allocations to a PE be upheld in Japan?
- How applicable is the hedge fund model in Japan?
- How should a capital provider be rewarded in Japan?

Finally, it is worth noting the repeated discussion in each of Parts I, II and III on the importance of documentation to support the substance of a dealing between the home office and its PE, and the profit to be attributed to the PE as a consequence. These comments are consistent with the position taken by PricewaterhouseCoopers’ for transfer pricing purposes, i.e., that good documentation is the key starting point of the transfer pricing process, whether it be for penalty protection, as the first line of defence in a tax audit, or as the initial step in preparing for an Advance Pricing Arrangement (“APA”). The conclusion to be drawn from the revised Report is that similar considerations now make documentation an integral part of a PE profit analysis.

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For a more detailed discussion of the changes to Parts I to III of the Report, please refer to PwC-UK’s Financial Services Tax Bulletin, dated January 2007.

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