OECD releases BEPS discussion drafts on attribution of profits to permanent establishments and transactional profit splits

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In brief

On June 22, 2017, the OECD released two public discussion drafts providing further guidance on the Final Reports on Base Erosion and Profit Shifting (BEPS) published in October 2015, both replacing previous drafts released on July 4, 2016 which were subject to public consultation on October 11-12, 2016.

The first discussion draft provides practical guidance on how to attribute profits to permanent establishments (PE) following the finalisation of the BEPS Action 7 report, while re-emphasising that the principles of the Authorised OECD Approach (AOA) to attributing profits to PE remain unchanged. The paper sets out high-level general principles for the attribution of profits to PE, including no double taxation in the source country as a result of Articles 7 and 9; risk allocation between the intermediary under Article 9 MTC and the non-resident enterprise or the PE under Article 7 MTC; and the possibility of zero profit PE. The discussion draft also addresses administrative approaches to simplifying compliance. The discussion draft includes four examples addressing issues concerning commissionaire structures under the revised Article 5(5) OECD Model Tax Convention (MTC) and the anti-fragmentation rules in the newly added Article 5(4.1) MTC, providing qualitative guidance on the underlying principles of the profit attribution.

The second discussion draft provides revised guidance on profit split methodologies (PSM). This discussion draft links with BEPS Action 10 and serves to clarify and strengthen the guidance in Chapter II of the OECD Transfer Pricing Guidelines (TPG). Focus areas are situations in which a profit split methodology is appropriate on either an anticipated profits base or an actual profits base. The discussion draft further contains guidance on the split factors to use under profit split methodologies, illustrated in 10 practical examples.

Comments on both discussion drafts are invited by September 15, 2017, with public consultations planned in November 2017.

In detail

On June 22, 2017, the OECD released two discussion drafts providing additional guidance on the Final Reports on BEPS published in October 2015: Guidance on the Attribution of Profits to Permanent Establishments and Transactional Profit Splits. This insight covers both reports and provides an overview of the drafts, covering the background and mandate, content, and main takeaways of the respective reports.

Attribution of Profits to Permanent Establishments

Background and mandate

The Final Report on BEPS Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status) mandated the development of additional guidance on how the rules of Article 7 of the OECD Model Tax Convention (MTC) would apply to PE, with a focus on PE outside the financial sector. It should further take into account the results of the work on the Final Reports on BEPS Actions 8-10 (Aligning Transfer Pricing Outcomes with Value Creation), in particular the revisions on intangibles, risk, and capital.

This discussion draft replaces a previous discussion draft published for comments in July 2016. The new discussion draft reconsiders the guidance on the attribution of profits to PE created as a result of the widened definition of a PE following BEPS Action 7. Similar to the previous discussion draft, the new paper does not consider or seek comments on either 'threshold' PE or any points discussed under BEPS Action 7.

Content overview

This new discussion draft sets out high-level general principles outlined in paragraphs 1-21 and 36-42 for the attribution of profits to PE in the circumstances addressed by the Report on BEPS Action 7.

The paper can be summarised as covering two main aspects:

- general guidance for PE profit attribution under the AOA; and
- possible approaches jurisdictions may adopt for administrative simplification.

In addition, the paper includes four qualitative examples of how to apply the attribution of profits to PE in practice.

General principles

The paper reemphasises that there is no change in the principles and application of Article 7 MTC that profits attributable to a PE are those that the PE would have reported if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions. The paper further affirms that this fundamental standard applies regardless of whether the relevant treaty adopts the Authorized OECD Approach (AOA).

The discussion draft clarifies the relationship between Article 9 (transfer pricing) and Article 7 (PE profit attribution), noting that the priority order of analysis between Article 9 and Article 7 MTC should be considered inconsequential. The OECD, however, recommends jurisdictions to apply a consistent priority approach of Article 9 versus Article 7 MTC which could be made public at their discretion to help provide certainty to taxpayers.

The paper further confirms an overlap of "risk control functions" under Article 9 MTC following Final Reports on BEPS Actions 8-10 with the concept of Significant People Functions (SPF) under Article 7 MTC, but stops short of fully reconciling the distinct concepts. The paper further states that risks that have already been attributed under Article 9 MTC cannot also be allocated under Article 7 MTC.

Paragraph 19 concludes that "when the proper delineation of the transaction under the guidance of Chapter 1 of the TPG indicates that the intermediary is assuming the risks of the transactions of the non-resident enterprise, the profits attributable to the PE could be minimal and even zero." This supports the proposition that, if a PE results from the activities of a related party in the source state and the related party has received an arm's-length consideration for its activities, there should be little or no residual profit to attribute to the PE.

PwC comment: The clarification on the propriety order of Articles 9 and 7 MTC is welcome. The absence of a consistent international priority approach, however, raises concerns as taxpayers face multiple local regimes, posing potential for increased international disputes particularly in cases of different tax reliefs (e.g., loss relief) or collateral tax impacts (VAT).

Administrative approaches

The paper stresses that the compliance burden of the event that constitutes a PE cannot be deemed insignificant. Jurisdictions thus are encouraged to adopt local compliance simplification procedures.

Examples

Whereas the previous discussion draft from July 2016 included five quantitative examples, this revised discussion draft includes four qualitative examples without actual calculations of additional PE profits.

The first three examples discuss profit attribution principles for Dependent Agent PE (DAPE) under Article 5(5) MTC. Examples 1 and 2 describe marketing and sales activities of an intermediary that also constitute DAPE in the source state. Example 3 describes a procurement agent intermediary that creates a DAPE via habitually concluding purchase contracts on behalf of a non-resident enterprise.

In all examples, the Article 9 MTC transfer pricing compensation of the intermediary is a percentage commission (on revenues and goods purchased respectively). All expenses for the purposes of the PE, wherever incurred, are deducted from the revenues. This includes expenses that would be recognised as "dealings" between the head office and PE and priced in accordance with Article 9 MTC and the underlying transfer pricing principles (e.g. the amount that would have been paid by the sales PE to acquire the inventory legally owned by the head office, before reselling it locally). Additionally, to ensure that profits are not double taxed, the arm's-length remuneration of the intermediary is deducted in each case.

Example 4 applies the new anti-fragmentation rule in Article 5(4.1) MTC in the context of a Fixed Place of Business (FPOB) PE. The example includes an internet-based sales business, where a warehouse and a geographically separate merchandising office in the source state are deemed to be part of a cohesive business operation that is not preparatory or auxiliary in nature. The example concludes that both the warehouse and the merchandising office would create two separate FPOB PE.

A separate analysis is then provided to attribute revenues and costs (i.e., profits) to the warehouse FPOB PE and the merchandising office FPOB PE based on what unrelated parties would have earned locally if performing the same or similar functions. Costs include local employee costs of the FPOB PE less any other expenses for the purposes of the FPOB PE wherever incurred (such as the warehouse rental costs in the case of the warehouse FPOB PE). As no intermediary exists in this example, no further deductions are needed to account for profits already taxed in the source state.

PwC comment: The examples do not have quantitative information, which was included in previous discussion draft from July 2016, and which would provide additional tax certainty for taxpayers.

In Example 4, the creation of two separate PE allows taking into account possible varying taxation rates in different regions of a jurisdiction. This concept creates the situation where a cohesive business operation needs to be considered collectively in the context of Article 5 MTC, but independently for the purposes of Article 7 MTC. The implications of this have not been explored further in the paper. This concept also is generally inconsistent with the notion of administrative simplification suggested in the guidance.

Transactional Profit Split

Background and mandate

The draft follows a mandate in Action 10 of the BEPS Action Plan, which invited clarification of the application of transfer pricing methods, in particular the transactional profit split method, in the context of global value chains. This discussion draft follows and replaces a previous draft published in July 2016 and takes into account input received.

This revised draft is intended to clarify the application of the transactional profit split method by identifying indicators for its use as the most appropriate transfer pricing method, and provides additional guidance on determining the profits to be split.

Content overview

The revised discussion draft focuses on the following:

- indicators that the profit split method may be the most appropriate method;
- profits to be split, including when anticipated or actual profits should be used; and
- profit splitting factors such as capital or capital employed, headcount of similar employers and cost basis.

The revised draft includes a number of examples illustrating these principles.

Selection of the most appropriate method

This first part of this discussion draft outlines indicators that may lead to the selection of the PSM as the most appropriate method. These are the presence of unique and valuable contributions by each party involved in the transaction, a high degree of integration, or the shared assumption of economically significant risks and the separate assumption of closely related risks. The discussion draft highlights that the absence of comparables does not warrant the use of the PSM.

PwC comment: Focus areas remain the questions of how the "risk control" framework of the revised Chapter I TPG would apply. Of note are that two issues that were included in the previous discussion draft are no longer included/focal to the revised draft:

- **Value chain analysis**, whether to include guidance at all, and if so where (Chapter II - transfer pricing method, or Chapter I - accurate delineation of the actual transaction); and

- **Parallel and sequential integration** as a useful tool for tax administrations and taxpayers in the selection of the TP method.

Profits to be split

One of the key elements of a PSM is the determination of the profits to be split, confirming that the approach should align with the accurately delineated transactions as discussed under Chapter I TPG.

The discussion drafts favors a split of actual profits when parties share the same economically significant risks or separately assume closely related, economically significant risks. In cases where no economically significant risk is shared, a split of anticipated profits is deemed more appropriate.

The discussion draft concludes that that profits generally should be split on a gross basis.

PwC comment: Although the focus on risks assumed is an important factor, the discussion draft does not sufficiently include the remaining elements of the functional analysis — namely, the functions performed and the assets used, in particular intangible assets.

Further, although a gross profit split can be performed in principle, it should be pointed out that accounting differences should not distort the determination of the combined gross profits. The split of gross or net profits should be made under appropriate facts and circumstances.

Profit splitting factors

The discussion draft outlines the profit splitting factors and determines that they should:

- be consistent with the functional analysis (and risk in particular); and
- provide the possibility to be reliably measured.

Further, the profit splitting factors should be documented and consistently used.

Several profit splitting factors are mentioned such as assets or capital employed, costs, incremental sales, employee compensation, or time spent. Examples 9 and 10 are illustrations of splitting factors based upon respectively assets and costs.

PwC comment: In principle any splitting factor could be used as long as it is appropriate and reliable for the case. The discussion draft provides an exhaustive list of acceptable profit split factors.

Examples

The discussion draft contains 10 examples illustrating the revised guidance on PSM. The examples include several industry sectors such as pharmaceutics, electronics, IT, asset management, retail, and automotive.

PwC comment: It is not clear to what extent the industries used in the examples are representative for the issues illustrated in the examples. The approach should not be considered the default position for that industry sector.

Public comments and consultation on the discussion drafts

Both discussion drafts were released as non-consensus documents to the public, and interested parties are invited to send in their comments by September 15. In addition, the OECD intends to hold a public consultation on both drafts in November 2017.

The takeaway

The new discussion drafts begin to address many issues previously left unresolved in the Final Reports on BEPS, as well as respective previous discussion drafts on the Attribution of Profits to PE (Action 7) and the Transactional Profit Split Method (Action 10).

The discussion drafts generally result in simplified guidance compared to the previous drafts released in July 2016, and provide valuable insights into the underlying principles for the application of both the TPG and the AOA. Key issues, however, remain either unresolved or should be clarified further. Examples are the absence of any priority between Article 7 and Article 9 MTC or the emphasis on risks in the determination of whether the PSM is the most appropriate method.

Multinationals should consider how the additional guidance in the discussion drafts could impact their business operations. Responding to the OECD with specific examples is an effective means to highlight the consequences of the implementation guidance should it be adopted. The OECD has invited comments by September 15, 2017.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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