Tax Insights from Transfer Pricing
Tax Policy Bulletin

OECD guidance on attribution of profits to PEs leaves unanswered questions

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In brief

The OECD on March 22 released a final report containing additional guidance on attribution of profits to permanent establishments (the Report). The Report sets forth high-level principles for attributing profits to permanent establishments (PEs), following the two discussion drafts published in July 2016 and June 2017 and public discussions held in November 2016 and November 2017. The Report provides further guidance on the Final Reports on Base Erosion and Profit Shifting (BEPS) published in October 2015.

The new additional guidance indicates that the high-level principles should apply regardless of whether the countries involved have adopted the principles of the Authorised OECD Approach (AOA) to attributing profits to PEs. It addresses issues surrounding commissionaire structures and the anti-fragmentation rules covered in the report on BEPS Action 7 issued on October 5, 2015 and under the Multilateral Instrument (MLI).

The Report contains examples on fragmentation of activities, commissionaire structures, sales of advertising on a website, and procurements of goods. All four examples seek to illustrate the underlying principles of profit attribution, without providing details on the actual calculations of these profits. The starting point of the examples is the AOA, recognizing that its use is not required by many treaties and the method for attributing profit therefore may differ significantly from the AOA.

In detail

This Insight provides an overview of the March 22 OECD Report, covering the background and mandate, content, and main takeaways.

Background and mandate

The report on Action 7 of the BEPS Action Plan (Preventing the Artificial Avoidance of Permanent Establishment Status) discussed broadening the definitions of PEs in Article 5 of the OECD Model Tax Convention (MTC), in particular with regard to commissionaire structures and fragmentation of activities. At the same time, it mandated the development of additional guidance on how the rules of Article 7 of the MTC would apply to PEs resulting from the changes in the report on BEPS Action 7, in particular for PEs outside the financial sector. It takes into account the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk, and capital.

Content overview

The new paper can be summarized as covering the following broad aspects:

- General guidance for PE profit attribution, related to fragmentation of activities and commissionaire structures;
- Possible approaches that jurisdictions may adopt for administrative simplification.

In addition, the paper includes four high-level working examples of how, in practice, attribution of profits to PEs should be applied. The examples are discussed below.

General principles

The Report reemphasizes at several points that under Article 7 MTC profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions. The Report confirms that this fundamental standard applies regardless of whether the relevant treaty adopts the AOA.

The Report discusses the relationship between Article 9 (transfer pricing) and Article 7 (PE profit attribution). The Report recognizes that while many countries find it logical and efficient to perform an Article 9 analysis before an Article 7 analysis, other countries prefer to conduct the Article 7 analysis before the Article 9 analysis. Whereas the discussion draft released in June 2017 indicated that the order of analysis between Article 9 and Article 7 generally is inconsequential, the Report now indicates that the order in which Article 7 and 9 are applied should not impact the amount of profits over which the country in which the PE is situated (the host country) has taxing rights.

The OECD, however, recommends that jurisdictions should apply a consistent priority approach of Article 9 versus Article 7, which could be made public at their discretion to help provide certainty to taxpayers.

In that context, the Report also calls upon countries to ensure that double taxation does not occur in the host country.

As under the previous discussion draft, the Report confirms an overlap of 'risk control functions' under Article 9 following BEPS Action 8-10 (Aligning Transfer Pricing Outcomes with Value Creation) with the concept of Significant People Functions (SPFs) for the attribution of risk under Article 7, but stops short of fully reconciling the similarities and distinctions between the concepts. The guidance in the Report is limited to stating that the two concepts are not aligned or cannot be used interchangeably. The paper further states that risks that already have been attributed under Article 9 (transfer pricing) cannot also be allocated again under Article 7 (PE profit attribution). Doing otherwise may lead to double taxation.

Finally, the paper reemphasizes that although the taxing rights of the country where the PE is situated may not be exhausted by the arm's-length payment to the intermediary (the commissionaire or dependent agent), the net profits attributable to the PE could be positive, nil, or even negative (i.e., a loss).

Observations: The limited guidance on the order of Articles 9 and 7 MTC has not changed compared to the discussion draft of June 2017, even though numerous comments during the public consultation favored the priority order of Article 9 followed by Article 7 MTC for providing clarity and certainty. The absence of a consistent international priority approach continues to raise concerns as taxpayers face multiple local regimes, posing potential increased international disputes, particularly in cases of different tax reliefs (e.g., loss relief) or collateral tax impacts (VAT). Therefore, the call for ensuring there is no double taxation in the host country is welcomed.

The statement that the net profits attributable to a PE could be minimal or even zero is welcomed and may be helpful in resolving double taxation.

The high-level guidance on the non-alignment of the risk control functions under Article 9 and the SPFs relevant to the assumption of risk under the AOA is not conclusive and may lead to increased controversy between the countries involved. The guidance that the risk assumption should be considered only once therefore is helpful.

Administrative approaches

The Report addresses administrative approaches to enhance simplification noting that the compliance burden, in the event a PE exists due to an intermediary, 'cannot be dismissed as inconsequential.' Jurisdictions thus are encouraged to adopt local compliance simplification procedures. The Report does not contain specific suggestions with regard to simplification other than tax collection only through the intermediary, even though the amount of tax is calculated by reference to activities of both intermediary and PE. Such simplification measures, of course, depend on the domestic law of the country where the intermediary/PE is situated.

Observation: The call for simplification is welcomed. Unfortunately, the proposed simplification only comes into play when the complex analyses under both Article 9 (transfer pricing) and

Article 7 (profit attribution to PEs) have been finalized. For the actual determination of profits, no simplification measures are proposed.

Examples

Whereas the discussion draft from July 2016 included five quantitative examples, the revised discussion draft of June 2017 included four more or less qualitative examples without actual calculations of additional PE profits. The Report builds on the examples in the June 2017 discussion draft. The Report indicates that the proposed approach based on the AOA is not the only possible approach and that other different outcomes based on a different appropriate approach for attributing profits are possible.

Example 1 applies the new anti-fragmentation rules in Articles 5(4) and 5(4.1) in the context of a Fixed Place of Business (FPOB) PE. (Article 5(4) MTC lists the activities not constituting a PE; Article 5(4.1) MTC contains the actual fragmentation rule. These articles disallow the fragmentation of a cohesive business operation into several small operations.) The example considers an internet-based sales business, where a warehouse and geographically separate merchandising and information gathering office in the host country are deemed to be part of a cohesive business operation that is not considered preparatory or auxiliary in nature. The example applies the two-step AOA approach.

With regard to the warehouse, the example concludes that the PE is the economic owner under step 1 (hypothesizing the PE as a separate and independent enterprise) of the AOA, providing warehouse services to the sales business. The SPFs related to operating the warehouse are performed by personnel of the PE. Under step 2 (determining arm's-length pricing to the internal dealing), the price would equal the amount that the sales business would have had to pay if it had received the warehouse services from an independent enterprise in the host country.

With regard to the merchandising and collection of information services, the example concludes that under step 1 AOA, the PE bears the responsibility and hence is hypothesized to have the sales business rights and obligations arising from transactions with unrelated parties in merchandising and collection of services. The SPF relevant to the merchandising and information gathering office are performed by personnel of the office, and hence the PE is considered to be the economic owner of the office. Under step 2, the internal dealing pricing would equal the amount that the sales business would have had to pay if it had obtained the merchandising and information gathering services from an independent enterprise in the host country.

Examples 2–4 discuss profit attribution principles for Dependent Agent PEs (DAPEs) under Article 5(5) MTC.

Examples 2 and 3 describe marketing and sales activities of an intermediary that also create DAPEs in the host country.

Example 4 describes a procurement agent intermediary that creates a DAPE via habitually concluding purchase contracts on behalf of a non-resident enterprise.

Under step 1 an internal dealing between the PE and the head office is recognized. Under step 2, that dealing is priced at arm's length equaling the amount that the head office would have received from an unrelated party. This amount is a deductible expense for the intermediary/PE.

In all examples, the Article 9 transfer pricing compensation of the intermediary is assumed to be at arm's length. All expenses for the purposes of the PE (including the dealing), wherever incurred, are deducted from the revenues. To ensure that profits are not taxed twice, the arm's-length remuneration of the intermediary is deducted in each case when determining the profit attribution to the PE.

Example 2 contains an alternative version: instead of concluding the sales as a commissionaire, the activities in the host country are performed under a services agreement where the intermediary plays the principal role in the conclusion of the sales. The Report concludes that in this case the same analysis as under alternative 1 would apply.

Observations

Although the Report states that the use of the AOA is not required by all tax treaties, the analysis in all examples indicates applying the AOA in line with the 2010 version of Article 7 (which links in with the 2010 OECD Report on the attribution of profits to PEs). The Report thus does not contain approaches outside the 2010 AOA Report or how the AOA and other approaches would co-exist and how double tax could be resolved. The Report does not indicate which countries shall follow the AOA and which countries take the position to rely on another appropriate approach. The absence of country positions is unfortunate, in particular as one of the three BEPS pillars is transparency.

While upholding the application of the AOA to a PE under the widened definition of a PE following BEPS Action 7, the Report provides only limited general guidance on the application of the complex principles of the AOA in such cases.

Further, the creation of a PE and the additional attribution of profits to a PE where there is a service agreement providing sales services may continue to give rise to concerns.

This is further evident in the lack of factual and quantitative information in the examples provided. Such general guidance and high-level examples ultimately can lead to significant uncertainties for taxpayers.

Also the examples use attributing rights and obligations as one of the elements to derive the subsequent dealing. This contrasts with the limited discussion on rights and obligations in the 2010 AOA Report.

Finally, the examples assume clear segregation of activities between the head office and the PE, which does not reflect the reality of how multinational enterprises operate. Usually roles and responsibilities in functions overlap, but the head office or a regional office maintains a significant decision-making role. The examples set out general principles in a simplified setting that does not reflect the complexities that enterprises and tax authorities encounter.

The takeaway

In general, while offering some helpful and welcome views, the Report is limited to providing high-level guidance. PwC thus recognizes there are issues left unresolved or that would benefit from clarification. The Report does not contain a decisive tie-breaker on the priority between Article 7 and Article 9 MTC, or conclusive guidance on the SPFs relevant to the assumption of risk and the risk control functions.

The absence of guidance on which countries apply the AOA or which countries rely on another appropriate approach under Article 7 MTC for attributing profits to a PE (or on the co-existence of such approach) can contribute to significant uncertainty and controversy. For reasons of transparency, countries should indicate (for example, through the OECD) whether they would use the AOA or specify which other method they assume appropriate.

The publication of the Report is an indication that issues related to profit allocation to PE will be under greater scrutiny by tax authorities.

During the development of BEPS Action 6 (preventing the artificial avoidance of PE status), there was considerable debate and disagreement over when activities such as warehousing or procurement cross the line from being preparatory or auxiliary in nature to complementary functions that are part of a cohesive business operation. Similarly, the collection of information should not be viewed as *per se a* value-added function. The Report, however, could be viewed as creating a presumption that these activities add significant value, which in turn will lead to more uncertainty and controversy.

The Report recognizes that the net profits attributable to the PE could be positive, nil, or even negative (i.e., a loss). This is a welcome approach and recognition for administrative convenience.

Multinationals also should be aware of other approaches related to PE issues and allocation of profits that are rapidly evolving. In particular reference can be made to evolutions on the digitalization of the economy. These include the EU Commission directive proposals in its digital tax package presented on March 21, or unilateral measures countries have introduced or might introduce such as diverted profit tax regimes, equalization levies, or withholding taxes.

Let's Talk

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

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