Further down the rabbit hole we go: Additional guidance released by OECD on the attribution of profits to permanent establishments

Tax Update

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Action 7 of the BEPS Action Plan\(^1\) tackles the definition of permanent establishment (PE) in order to prevent the artificial avoidance of a PE status through the use of commissionaire arrangements and the specific activity exemptions. The envisaged changes will be implemented into Article 5 of the OECD Model Tax Convention and its commentary (MTC).

Under the proposed new Article 5 wording and commentary, activities performed by a local subsidiary of a multinational group, while being taxable in their own right, are more likely to create another taxable presence for the multinational group in the form of a permanent establishment. For example, where a local subsidiary’s activities result in the regular conclusion of contracts to be performed by the multinational group, that multinational group could be considered to have a taxable presence in that country (being either a so-called “dependent agent permanent establishment” or “DAPE” or a “dependent agent enterprise” or “DAE”\(^2\)) unless the local subsidiary is performing these activities in the course of an independent business. Furthermore, revision of Article 5, paragraph 4 MTC aims at preventing the avoidance of PE status through reliance on the specific activity exemptions by introducing a “preparatory or auxiliary” condition and a new anti-fragmentation rule.

In light of the above changes, Action 7 has to be expanded to address related profit attribution issues. Preliminary work on profit attribution focussed on the fact whether the existing rules of Article 7 MTC would be appropriate for determining the profits that would be allocated to PEs, taking into account the changes to Article 5 MTC. The final report on Action 7 concluded that no substantive modifications are required to the existing rules and guidance with regard to attribution of profits to a PE. However, additional guidance on the applicability of these rules was required, taking into account the outcomes of BEPS Actions 8-10 (on transfer pricing issues) which clearly would affect the arm’s length remuneration of the local subsidiary that is performing the functions that give rise to the DAPE\(^2\).

Prompted by a diversity of comments received from public commentators that have stressed the need for additional guidance on the issue of attribution of profits to DAPEs arising from these proposed changes to the PE definition, on 4 July 2016 the OECD issued a Public Discussion Draft (the "Discussion Draft") to which interested parties may provide comments\(^3\). The Discussion Draft presents various worked examples, together with specific questions on which input is sought from commentators.

**Key take aways and considerations**
Although the Discussion Draft does not (yet) represent a consensus position, it does provide insight as to the direction the OECD is heading with regard to profit attribution to PEs arising as a result of the changes to the PE definition. The key practical take aways from the Discussion Draft at this stage are, in our view, as follows:

- If the transfer pricing is correct for the local subsidiary and there are no significant people functions performed by the DAPE, then there will be no further profits to be attributed to the DAPE.
- If however the DAPE does perform significant people functions, not only must this be correctly reflected in the transfer pricing of the local subsidiary, this may also result in an allocation of further profits to the DAPE, such as a funding return for the assets for which economic ownership is allocated to the DAPE as a result of the significant people functions performed by the DAPE.
- No suggestions or changes are made in the Discussion Draft with regard to financial activities under the authorised OECD approach (“AoA”). The guidance as provided in the Discussion Draft mainly deals with Part I (General Considerations) of the AoA.

Whilst the first take away may be welcomed by multinationals (although in contradiction with the current guidelines, namely paragraph 26 of the Commentary on Article 7 that are applicable to many of the existing treaties), one important (and concerning) consideration is that, MNEs now face a situation whereby the revised PE definition may result in a DAPE in a country, giving rise to all of the associated compliance and reporting obligations (and potential penalties for non-compliance), despite there being no attributable profits and no taxable income. From a tax policy perspective, this is also a rather unexpected outcome that may not be accepted by tax authorities looking for more tax revenue as a result of Action 7.

As regards the second take away, whilst the Discussion Draft does set out relatively clear worked examples for determining the profits attributable to a DAPE in situations where significant people functions are performed by the DAE, practical implementation of this approach will be extremely complex and time consuming as it requires the dissection of an enterprise’s business into discrete elements for which arm’s length returns must then be determined.

Although the third take away shows that no additional guidance was released by the OECD on Part II, II and IV of the AOA (being considerations for applying the AOA to PEs of banks, enterprises carrying on global trading of financial instruments and insurance companies), the guidance to Part I may be useful for the financial industry understanding the approach set by the OECD on profit attribution to PEs. Hence, the methodology applied under the examples of the Discussion Draft for DAPE’s and fixed place of business PEs may therefore be regarded as (general) guidance with regard to the profit attribution to PEs.

A further consideration that adds an additional layer of complexity to this already complex and controversial area of tax law is the lack of consistency concerning the rules on attribution of profits to permanent establishments as between countries, and as between actual and model tax treaties. Many of the concepts relied upon in the Discussion Draft are dependent on the prior acceptance of the AOA to the attribution of profits to permanent establishments. Despite the AoA being adopted in the MTC in 2010, to date, adoption of the AoA in practice has been limited. So far only a small number of treaties have adopted the revised Article 7, and numerous OECD and non-OECD countries have expressed their intention not to include it in their treaties. Further, the United Nations Committee of Experts on International Cooperation on Tax Matters has specifically rejected its inclusion in the United Nations Model Double Taxation Convention between Developed and Developing Countries.

The examples

Below we summarize the five examples set out in the Discussion Draft. Please refer to the Discussion Draft for a more detailed description of the relevant facts, underlying functional analysis and methodology of profit attribution.

**Example 1**

In Example 1, a non-resident enterprise acting as principal engages an associated enterprise resident in the host jurisdiction to perform activities that give rise to a DAPE under Article 5, paragraph 5 MTC. This example intends to
illustrate the attribution of profits to the DAPE under the AOA in a fact-pattern in which an analysis under Article 9 is also required.

*Outcome:* in this example the Discussion Draft concludes that there are no profits to be attributed to the DAPE since there are no significant people functions performed by the DAE on behalf of principal that are relevant for attributing any of the non-resident enterprises’ assets and risks to its DAPE. Therefore, none of the profits of the principal are attributed to its DAPE but are all profits of the principal’s head office.

**Example 2**

In Example 2, a non-resident enterprise acting as principal engages an associated enterprise resident in the host jurisdiction to perform activities that give rise to a DAPE under Article 5, paragraph 5 MTC. The difference in this example compared to Example 1 is that the functional analysis results in the allocation of risk not to the party contractually assuming the risk, but to the party that has control over risk and has the financial capacity to assume the risk. This example intends to illustrate the impact that such allocation of risk may have for the analysis under the AOA.

*Outcome:* whereas in Example 1 there were no significant people functions performed by the DAE relevant to the attribution of the non resident enterprises’ assets and risks to its DAPE, in Example 2 significant people functions are performed by the DAE. As a result, these functions (and therefore the related assets and risks) must be taken into account in determining the arm’s length remuneration of the DAE. In the example this results in the DAE being remunerated for (and bearing the costs associated with) the inventory and credit risk. As the non-resident is the legal owner of the inventory, it is allocated a funding return in relation thereto. As regards the attribution of profit the DAPE, these significant people functions result in allocation of inventory risk and economic ownership of the inventory, credit risk and economic ownership of the receivables and the necessary capital to the DAPE. As a result, the profits allocation to the DAPE results in its profits comprising of a funding return for holding the assets (as the commercial return for deploying the assets has already been allocated to the DAE through the arm’s length transfer pricing).

**Example 3**

In Example 3, the facts are the same as in Example 2, except that the non-resident enterprise acting as a principal sends an employee to the host country to perform activities that give rise to a DAPE under Article 5, paragraph 5 MTC. This example intends to illustrate the attribution of profits to the DAPE under the AOA in a fact-pattern in which an analysis under Article 9 MTC is not required.

*Outcome:* in this example, there are significant people functions performed by an employee seconded by the principal to perform full-time selling activities. These functions are attributable to the DAPE which result in the attribution to the DAPE of the inventory and receivables risks and the economic ownership of the company vehicle, inventory and receivables, under Article 7 MTC. Accordingly, there are profits attributable to the DAPE (above the salary paid to this employee).

**Example 4**

In Example 4, based on the facts in Example 2, the analysis focuses on the activities related to the provision of credit to customers performed by the dependent agent enterprise and the non-resident enterprise. This example intends to illustrate the consequences for the attribution of profits to the DAPE resulting from the attribution of risk under the AOA and the allocation of risk under Article 9 MTC⁴. Two different scenarios are presented for this example, Scenario A, where the bad debts expense and management costs are less than the return determined for the credit risk (resulting in an overall "profit" for this function), and Scenario B, where the bad debts expense and management costs are greater than the return determined for the credit risk (resulting in an overall "loss" for this function).

*Outcome:* in this example, there are functions performed by the DAE that do not lead to the assumption of risk by the DAE under Article 9 MTC, but which are significant people functions relevant to the attribution of risk to the DAPE of the principal. As a result of these risks being allocated to the DAPE, profits are allocated to the DAPE (under Scenario A) or losses are allocated to the DAPE (under Scenario B).

**Example 5**
The Report on Action 7 introduced modifications to paragraph 4 of Article 5 of the MTC, which contains specific activity exceptions to the PE definition. The revised Article 5, paragraph 4 MTC ensures that that each of the exceptions included in that paragraph is subject to the requirements that the listed activities are of a “preparatory or auxiliary” character. This example is considered based on three different scenarios, Scenario A, where warehousing is the enterprises’ core business, Scenario B, where warehousing is an internal (but important) function of the business, and Scenario C, where warehousing is an internal function of the business carried out by a separate (unrelated) enterprise.

The example provided is that of a fixed PE arising from the use of facilities, a warehouse, solely for the purpose of storage, display or delivery of goods or merchandise belonging to a non-resident enterprise, and not qualifying as preparatory or auxiliary to the overall business activity of the enterprise under paragraph 4 of Article 5 of the MTC. Given the difficulties of identifying profits when the warehousing activity is carried out as a cost centre representing only one aspect of the MNE Group’s activities, this example supposes that the warehousing activities are conducted as a profit centre by an MNE Group specialising in providing warehousing services to third party customers. Profiling the warehouse in this manner provides a basis for developing guidance on the approach for determining the profits arising from the arrangements when carried out as a cost centre as part of the MNE Group’s total activities. This examples is designed to illustrate the application of Article 7 and it is assumed that Article 6 of the MTC has no application.

You may also enjoy our report “OECD BEPS Working Groups issue three discussion drafts.”

3Interested parties are invited to send their comments on the Discussion Draft by 5 September 2016 by email to: [email protected]  
4In particular Section D of Chapter I of the Guidelines

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