
OECD seeks comments on new permanent establishment profit attribution guidance

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In brief

After the finalisation of Base Erosion and Profit Shifting (BEPS) Action 7 concerning the Permanent Establishment (PE) threshold, the OECD undertook to examine whether its 2010 rules on attribution of profits to PEs, or the Authorized OECD Approach (AOA), require updating. The OECD issued a Public Discussion Draft (the paper) on 4 July 2016 soliciting comments by 5 September 2016, to be followed by a public consultation on 11-12 October 2016.

As widely expected, the OECD did not conclude that wholesale changes are needed to the AOA, but instead focused on providing additional guidance to Part I (General Considerations) of the AOA. It is acknowledged that since the AOA is not applied by all states, this guidance may not be applicable in a number of cases. The OECD has not directly provided any additional guidance on Parts II, III, and IV concerning the application of the AOA to certain Financial Services businesses; however, the additional guidance to Part I likely will be helpful for many Financial Services businesses looking to understand how as a practical matter the OECD expects profit attribution to be carried out.

The paper considers five examples — four relating to Dependent Agent PEs (DAPE), and one relating to Fixed Place of Business PEs in the context of warehousing (FPOB PE). For each of these examples, it provides suggested guidance and asks for comments.

In detail

Introduction

This paper only considers the attribution of profits to PEs and does not consider either 'threshold' PE or any points discussed under Action 7 of BEPS (Preventing the Artificial Avoidance of Permanent Establishment Status). The paper focuses on how Article 9 transfer pricing, taking account of the guidance from BEPS Actions 8-10, should interact

with Article 7 attribution of profits. The paper provides numerical examples of how, in practice, to carry out the attribution of profits to PEs.

Observations: Unlike most BEPS discussion drafts, this paper does not introduce any new rules, nor does it purport to do so. Rather, it seeks to apply principles already established for the attribution of profits to a PE in the context of the lower thresholds for determining the

existence of a PE by way of examples. The paper declares that the changes to significantly lower the PE threshold under BEPS Action 7 did only that — lower the PE threshold, and did not modify the nature of the deemed PE. The paper then states that there is no difference in attributing profits to a PE under the pre-BEPS PE rules versus attributing profits to a PE under the post-BEPS PE rules.

As a result, it concludes no additional guidance is required in relation to the attribution of profits.

Working examples

The paper focuses on scenarios where a PE is likely to be created under the post-BEPS PE guidance. Five specific examples are reviewed: four relating to DAPE, and one relating to FPOB PE. Of the four DAPE examples, three (Examples 1, 2 and 4) focus on scenarios where a DAPE is created by an associated enterprise undertaking sales activity. The other (Example 3) considers the implications of a DAPE being created by a non-resident enterprise's employee visiting the source state to carry out sales activity. There are three iterations of the FPOB PE example — all three iterations concern the attribution of profits to warehouses.

Below is a summary of the relevant DAPE and FPOB examples and our views on the insights that can be gained from these descriptions.

DAPE

Example 1 describes a commonly seen structure in which a non-resident enterprise (Prima) engages an associated enterprise resident in the source state to act as sales agent, and in which the sales agent (SellCo) does not hold title to goods and is rewarded through a commission (i.e., a commissionaire type arrangement). SellCo's functions, assets, and risks are limited to the function of acting as sales agent and SellCo only controls operational risk relating to its business as a sales agent.

The allocation of risk under the sales agency agreement is respected, resulting in a routine profit for the sales agent under the Article 9 analysis. Similarly the AOA (applying the significant people function or 'SPF' doctrine) identifies the same result as the application of Article 9 —

no further assets, risks, or capital are attributable to the sales agent. Example 1 concludes that the application of the AOA does not result in any further attribution of profit to the DAPE created by SellCo under the new Article 5.

Example 2 varies the facts as set out in Example 1, in that SellCo is undertaking additional warehousing, inventory management, and credit control functions. An application of the new Chapter 1 of the OECD Guidelines leads to an allocation of certain risks to SellCo (versus that which is contractually allocated), and the Article 9 outcome takes into account these functions and risks as well as a funding return for the inventory.

The AOA then is applied to identify how the arrangements should be treated under the AOA. The application of these two doctrines results in one practical difference — a risk-free return on funding the inventory that was allocable to Prima under the new Chapter 1 becomes allocable to the DAPE of Prima by virtue of the DAPE being deemed to have economic ownership of the asset under the AOA.

Example 3 concerns the same facts as Example 2, except that Prima sends an employee to SellCo's country to originate business. In this case, as the DAPE is created by an employee, rather than an associated enterprise, only the application of the AOA is relevant. Here the AOA attributes to the DAPE created by the employee: inventory; credit risk and receivables; economic ownership of a company vehicle (through the following: 'place of use' rather than SPF doctrine); and capital. This fact pattern results in sales being attributed to the DAPE with Cost of Goods Sold paid by the DAPE to Prima's Head Office to leave the DAPE with an appropriate margin.

Example 4 (the last of the associated enterprise sales agent examples) varies the facts in Example 2 with specific reference to credit risk. In this case, both Prima and SellCo are involved in making decisions regarding granting credit. Under the new Chapter 1 guidance, it is determined that Prima bears the greater level of bad debt risk due to the economic significance of its role relative to SellCo. That said, given SellCo's involvement in the credit risk, the paper provides that SellCo also should share, to a lesser extent, in the upside and downside of credit risk. On this basis, it is determined that SellCo should receive from Prima a cost-plus of 10% for receivables management services and a fee of 40% of the difference between the value of receivables and bad debt write-off.

Applying the AOA to the assumed DAPE of Prima created by SellCo's activity results in a different allocation of risk and assets. Given SellCo's and Prima's roles in accepting credit risk, it is determined that the SPF is split between the two. This split then is applied across a deemed risk return (i.e., a factoring-like return on receivables managed), fees to SellCo, and proportion of bad debts borne. Again, through this method, the OECD illustrates the different outcomes from the application of Article 7 and Article 9 to the same facts through the SPFs allocating more than a routine return for functions and risks between the jurisdictions (i.e., Article 7 resulting in the allocation of assets and capital).

Observations: The OECD has tackled a difficult area in this paper — one that, in our experience, is seen as highly complex by both tax authorities and taxpayers.

The examples included by the OECD illustrate the increasing overlap between Article 7 and Article 9 — i.e.,

the importance of functions to control Economically Significant Risks in Article 9 analysis and Significant People Functions in Article 7. There is guidance (e.g., in Example 2) on what constitutes a discrepancy between contractual allocation of risk and control over economically significant risks. That said, there is limited specific guidance on identification of SPF; instead, the OECD seems to rely largely on the new Chapter 1 analysis of the functions to control economically significant risks and in the examples given this is assumed to align with what constitutes an SPF.

In Example 4, however, the OECD has set out a scenario where there is a difference between the allocation of control of credit risk and the location of SPFs relating to economic ownership of the credit risk, demonstrating that there are differences between the two. However, this example covers one of the few instances where there is specific guidance on what constitutes an SPF; therefore, there will be many instances where it will be difficult for taxpayers to determine whether a difference should arise between functions to control risk and SPFs.

The OECD helpfully has provided examples of how the income statement of the DAPE should be constructed. This makes clear that, where there is a sales agent, the Cost of Goods Sold may be a dealing that is treated as a 'balancing figure' to ensure an appropriate level of reward is earned by the DAPE, which is treated as the tested party in these examples (effectively treating the relationship as that of principal for the manufacturer and IP owner, and agent for the distributor). Further, Example 2 shows that the creation of a DAPE may only affect below the operating profit line (e.g., funding costs) in accordance with the AOA altering the allocation of the economic ownership of assets — highlighting the

importance of carrying out an AOA analysis even where the SPF and control over risk functions are aligned.

As a general matter, the examples shown are simplified as compared to most business arrangements. Where there is some complexity reflective of most businesses (e.g., Example 4, where both parties are involved in the management of certain risks or assets, which is a common fact pattern), the allocation of profit becomes very complex.

Notably, the paper has re-introduced the concept of split SPFs seemingly without consideration of the complexity of applying this to the balance sheet. While, in theory, split SPFs may be an accurate representation of the functions undertaken across a group and sometimes can be useful in splitting certain asset returns at a high level, practical experience has made it clear that split SPFs also can lead to significant complexity. In particular, the application of split SPFs in the financial sector (with specific allocation of the SPFs to certain assets) has been shown to be onerous. Therefore, the paper as it stands, while helpful in setting parameters, does not alleviate taxpayer concerns that the process of attribution of profit will continue to be complex and subjective.

Lastly, at the end of the paper, the OECD provides that readers should consider whether, as in Example 1, tax authorities should not require tax returns for the DAPes where no additional profit is attributable. For many taxpayers, this is a key area of focus given the associated compliance burden.

Fixed Place of Business PE

The paper also considers how FPOB PEs arising from the restricted availability of the specific activity exemptions should be addressed in

the profit attribution guidance. The paper considers three iterations of an example (Example 5) and how this should be treated under the AOA.

- In the first iteration, the parent entity WRU (a warehousing company) creates a new warehouse in another state (W) — the analysis identifies that there are no SPFs in W and that economic ownership of the warehouse should be attributed to the PE in W.
- In the second iteration, warehousing is considered as an internal function of the business rather than a service offered to clients. Here it is considered that the profit attributable to the PE is materially the same as the function of the PE in W (i.e., reward for economic ownership of assets and provision of warehousing services). That said, it is acknowledged that it is likely that, in the absence of third party revenue for warehousing services, the profit attributable would need to be arrived at through an alternative method (e.g., return on investment in assets, etc.).
- In the third iteration, the facts are the same except that WRU appoints a third party to run the warehouse in W. Here the profit attribution is considered to be the same as would arise in the second iteration of the example, but with the addition of the deduction of the fee to the third party for the provision of warehouse operating services.

Observations: Example 5 helpfully shows that although the AOA may attribute the economic ownership of an asset to a PE, this will not necessarily result in significant additional profit being attributed to the PE. The example demonstrates

that it is necessary to consider how that 'asset PE' receives benefit from elsewhere in the group, for example, for services and intangibles provided from elsewhere, and ensuring that those other group entities are rewarded at arm's length for those activities.

The takeaway

This OECD paper provides taxpayers with additional guidance that can be used to evaluate existing intercompany arrangements in light of BEPS Actions 8-10 and to understand what additional profit, if any, would be allocated to PEs arising following the lowering of the PE threshold.

A number of questions remain to be answered through the consultation process, and a number of areas of subjectivity within the AOA are not addressed in this guidance. The OECD also notes that the AOA is not universally accepted; given the lowering of the PE threshold, this fact is likely to lead to an increased number of disputes.

Let's talk

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

Transfer Pricing

Adam M. Katz, *New York*
+1 646 471 3215
adam.katz@us.pwc.com

David Ernick, *Washington DC*
+1 202 414 1491
david.ernick@us.pwc.com

Kathryn O'Brien, *Washington DC*
+1 202 414 4402
kathryn.obrien@us.pwc.com

Aamer Rafiq, *London*
+44 (0) 20 721 28830
aamer.rafiq@uk.pwc.com

Sonia Watson, *London*
+44 (0) 20 780 42253
sonia.watson@uk.pwc.com

Nick Palazzo, *London*
+44 (0) 20 780 41371
niccolo.m.palazzo-corner@uk.pwc.com

Andrew Casley, *London*
+44 (0) 20 7583 5000
andrew.casley@uk.pwc.com

Gregory J. Ossi, *Washington DC*
+1 202 414 1409
greg.ossi@us.pwc.com

Rita Tavares de Pina, *New York*
+1 646 471 3066
rita.tavares.de.pina@us.pwc.com

Blanca Kovari, *New York*
+1 646 471 6817
blanca.v.kovari@us.pwc.com

Transfer Pricing Global and US Leaders

Isabel Verlinden, *Brussels*
Global Transfer Pricing Leader
+32 2 710 44 22
isabel.verlinden@be.pwc.com

Horacio Pena, *New York*
US Transfer Pricing Leader
+ 1 646 471 1957
horacio.pena@us.pwc.com

Tax Policy

Philip Greenfield, *London*
+44 (0) 20 721 26047
philip.greenfield@uk.pwc.com

International Tax Services

Steve Nauheim, *Washington DC*
+ 202 414 1524
stephen.a.nauheim@us.pwc.com

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