Still busting ghosts: imaginary people do not function very well: Thoughts on the second OECD draft guidance on BEPS Action 7

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In March I blogged about the first OECD draft guidance on the allocation of profits to commissionaire and other PE's. Looking at the June OECD draft, further ideas have come up as to why the allocation of profits to absentees is not a good transfer pricing idea.
I have great respect for the OECD's work and realise that the draft is the result of many people spending many days in drafting, discussing and redrafting; do not see my comments hereafter as not appreciating that process. My comments are focussed on my wish for the TP Guidelines to be internally consistent, practically applicable, and not more complicated than necessary.

Taxing ghosts

1. Example 1. If fully-fledged distributor X earns 100 in taxable income in country X and is then converted into a commissionaire earning 10 in country X, country X may want to recuperate the other 90 somehow. If the 100 was an arm's length compensation based on X's functions, assets and risks in country X before conversion, and if the same functions are still performed in country X after conversion, I agree.Example 2. Likewise, if

YCo in country Y sets up a commissionaire X in country X and the same functions are performed in country X as those which fully fledged distributor X performed in example 1, under the same comparability factors, then the arm's length compensation in country X should be 100. This is what Chapters I.D and VI of the TP Guidelines tell us.

But those functions must be performed in country X. And there must be people in country X performing those functions in country X. To do otherwise would be for country X to:

– do what chapters I.D and VI combat (the allocation of profits and risks away from functions); and
– open a wide new world of transfer pricing planning opportunities.

2. Even in this second draft, the effort to recuperate "the other 90" is done with a disregard for chapters I.D and VI and for the actual places where actual functions (including risk control) are performed by actual people. To add insult to injury the deemed PE's of the draft not only fail all the substance requirements of chapters I.D and VI of the OECD Transfer Pricing Guidelines ("TPG"), but they even implicitly receive the residual profits from the local sales. Afterall, in the new draft the PE profits equal the total sales proceeds, less local costs, less an arm's length compensation for the head office costs. Typically, one deducts routine compensation for a residual compensation; one does not deduct a residual compensation from a routine compensationI assume that this method of calculating the PE profits were chosen, because the authors realised the practical impossibility of treating the PE as the tested party on which a proper functional analysis can be performed. How would you properly analyse the functions performed by the PE, if there is no one in the PE actually performing the functions. Going through the exercise of allocating deemed functions to deemed people based on a deemed allocation of assets, which then triggers deemed risks, which then requires risk control to be performed by the same or other deemed people, does stretch the imagination.

<u>Taxing ghosts under the **A**uthorised **O**ECD **A**pproach and the parallel universes of articles 7 and 9</u>

3. The draft also makes reference to the differences between articles 7 (with or without the AOA) and 9. Remember, the AOA was rejected by the UN committee of tax experts. Whilst I think these differences are exaggerated (especially since 2008) and unnecessarily complicating transfer pricing under the arm's length principle, they do not influence the arguments made here above. An article 7 analysis still requires the presence of significant people and the ability of a proper functional analysis of the appropriate tested party. An exercise which remains difficult to perform if there is no one in the tested party at the tested location.

Collecting ghost's taxes from real people

4. The draft suggests that the PE state may collect the PE tax from the local taxpayer (e.g. the commissionair) instead of from the deemed PE which may have no local people and no local office. While this certainly is practical solution to the problem of collecting money from people that are not there, it does bring its own issues with it. For instance, would this rule also apply to third party local entities acting as commissionaires or are related party PE's to be treated different from unrelated party PE's going forward? I foresee an unwillingness of taxpayers to share their financial information with third party service providers. I also foresee practical difficulties for e.g. the group principal in finding out which rules to apply in which (deemed) PE countries, because one would need to know which PE countries apply which tax collection system, to which particular type of PE.

Activating ghosts under MLI

5. Which naturally brings one to last issue: the MLI and the fact that until now many countries have chosen not to activate BEPS action 7 under the MLI for their tax treaties. Even if they do, one would still need the necessary local legislation to accomplish the same as well. Whilst one can research that local legislation, e.g. through Kluwer's PE+ tool, the whole taxation of commissionaire PE's and the like is becoming a very complicated exercise, for what cannot be (or at least should not be) a huge amount of taxable income.

A proposed practical solution

6. Criticism is easy, constructive criticism not always. I sympathise with

countries going after part of “the other 90”. I also accept that now that Action 7 has defined commissionaires as PE’s, we have to do something with that. However, we should not use a quasi scientific approach by arguing that there is a deemed presence, deemed functions and deemed risks, when in reality there are none. Better would be a safe harbour based on a comparison to reality. My proposal is this: treat the deemed PE as the difference between a commissionaire and a limited risk distributor selling under flash title under the same comparability factors. In addition, make the PE file the same documentation an LRD would file (i.e. show the inventory movements in the PE accounts). That way tax authorities can see the goods streams they are currently missing from commissionaires, and they get the same money as they get for LRD’s (which they accepted under BEPS action 7 by not arguing for LRD PEs).

7. To do otherwise would leave Example 1 hereabove with the absurd result that country X’s taxable income and compliance procedures will be vastly different when turning X into an LRD instead of into a commissionaire.

Can we please stay real.