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OECD Discussion Draft on Permanent Establishment Profit Attribution: Back to the Future

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The attribution of profits to a permanent establishment is already a complex issue with at least three separate regimes in the tax treaty context- the OECD Authorised Approach under the 2010 OECD version of Article 7 of the OECD Model, the AOA subject to limitations required by the pre-2010 version and that permitted by Article 7 of the UN Model Treaty.

Action 7 of the BEPS Action plan proposes an amended definition of agency PE, the exclusion of certain functions from automatically qualifying as preparatory or auxiliary and a rule to prevent complimentary functions from being fragmented so as to each qualify as preparatory or auxiliary. Although these proposals are to be included in the Action 15 Multilateral Instrument, contracting states will not be required to accept them in becoming a party to it. The purpose of these proposals is to shift taxing rights towards source countries and will result in an increase in the number of PEs.

The Final Report on Action 7 called for additional work on attribution of profit issues focussed on whether the existing rules of Article 7 of the OECD Model Tax Convention would be appropriate for determining the profits that would be allocated to PEs resulting from the changes included in this report. The OECD Public Discussion Draft BEPS ACTION 7 Additional Guidance on the Attribution of Profits to Permanent Establishments published on 4 July 2016 (the Discussion Draft) aims to resolve these issues by the end of 2016.

Dependence on transfer pricing principles

Since the OECD approaches to PE profit attribution are dependent on transfer pricing principles, both in hypothesising the PE as a functionally separate enterprise and, then, by analogy, attributing profit based on applying the transfer pricing guidelines to dealings between the PE and other parts of the enterprise. As a result, the changes to the Guidelines in BEPS Actions 8-10 will automatically impact on PE profit attribution. The Discussion Draft does not deal directly with the transfer pricing changes but it is clear that both the Action 7 and Actions 8-10 reforms will make traditional problems more common.

Agency Permanent Establishments

The issue itself is of considerable antiquity. In *Pommery and Greno v Aptthorpe* (1886) 2 TC 182, the UK House of Lords noted the difficulty in determining profit where a French champagne

producer sold its product in the UK through a local agent but left the question for "the consideration of persons skilled in dealing with such matters as assessing profits of trade." (See *Schwarz on Tax Treaties* (CCH) 4th Edition Chapter 9, paragraph 17-275).

Although the OECD project on Attribution of Profits to Permanent Establishments, which culminated in the 2010 Commentary to Article 7, took 12 years to complete, no specific guidance on profit attribution to agency PEs was included in the commentary itself but is addressed in part I of the OECD 2010 Report on the Attribution of Profits to Permanent Establishments . A short discussion is found in the OECD Report on the Attribution of Profits to Permanent Establishments. The fundamental question remains whether the arm's length remuneration of the agent is the profit attributable to an agency PE, or, whether the profit of the enterprise as principal from the activities of the agent is the profit attributable to an agency PE. In the latter case, the agent's remuneration is a deduction in calculating the PE profits. In the former case, the agent's remuneration (less its expenses) is the PE profit.

The OECD view is that the host country's taxing rights are not necessarily exhausted by ensuring an arm's length compensation to the dependent agent enterprise under Article 9. In so doing they recognise complexity and difficulty in attributing profit in agency PE cases.

Fact-patterns examined in the Discussion Draft on dependent agent PEs, including those resulting from commissionnaire and similar arrangements as a result of the BEPS Action 7 proposals. The approach adopted in the discussion paper follows that in the OECD 2010 Attribution of Profits Report. That is, attribution is determined by the functional and factual analysis of whether risks of the enterprise related to inventory, marketing intangibles or receivables are attributed to the PE because significant people functions are performed by the PE on behalf of the non-resident enterprise. This approach is will result in a range of outcomes from no profit, to the bulk of the trading profit attributable to the agency PE.

In the context of an agent in the normal legal sense, the logical outcome is some profit beyond the agent's remuneration because the agent's authority to conclude contracts inherently involves performance of the agency function of concluding contracts. Exactly how this might differ under the extended definition of agency PE where different functions are involved, is not considered in the Discussion Draft.

The Discussion Draft however observes that there are situations where the profits attributed to the PE are still nil. The draft acknowledges the problem that has long concerned companies and advisors that, the existence of a PE even when there are no profits attributable to it, may give rise to filing and other requirements.

The 2010 report rejected the "single taxpayer" theory by which profit allocation is fully addressed by Article 9 and the Transfer Pricing Guidelines, that is, the agent embodies the PE. Many taxpayers have long favoured this as administratively convenient. In recognition that this issue is to become commonplace, the OECD now asks "whether there are mechanisms that could ensure additional co-ordination of the application of Article 7 and Article 9 to determine the profits of a PE without providing opportunities for the re-emergence of BEPS risks that the changes under Actions 7 and 8-10 were designed to reduce."

The 2010 Attribution of Profits Report notes that there may be administratively convenient ways of recognising the existence of an agency PE and collecting the appropriate amount of tax resulting

from the activity of the agent. In this regard, the Discussion asks, arises whether there are mechanisms that could ensure additional co-ordination of the application of Article 7 and Article 9 to determine the profits of a PE without providing opportunities for the re-emergence of BEPS risks that the changes under Actions 7 and 8-10 were designed to reduce. No tentative solutions are offered.

Warehouses

A similar problem is raised by the proposals in Action 7 relating to the deemed exclusion from PE status of warehouses. The policy behind the exclusions in article 5(4) is that the activity is concerned, are likely to give rise to either no or insufficient profit to justify compliance obligations and represent a convenient dividing line in allocating taxing rights between the contracting states. This discussion draft set out fact patterns involving warehouses as fixed place of business PEs where the warehousing is the core business, where it is an internal function of the business and where it is an internal function of the business carried out by a separate enterprise. The examples, however, illustrate cases where profit attribution is justified rather than any conceptual difficulty.

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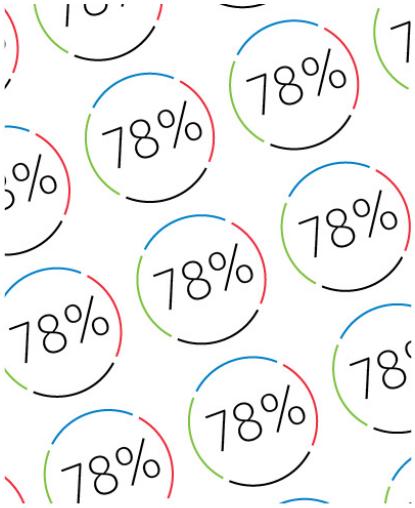

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