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The problem with taxing ghosts: Agency PE’s and spookiness at a distance

Johann Müller (International tax professional) · Thursday, March 23rd, 2017

In quantum physics, nothing is certain, particles are not to be found at one point but within waves of probabilities and connected particles can mirror each other faster than the speed of light because there is no transfer of information. Agency PE’s threaten to become the quantum physics of taxation.

Introduction
But let us get back to the difficulties of taxing ghosts. This is difficult because they are not there, which means they cannot perform any functions, they cannot control any risk and they do not DEMPE on assets. Which brings us to the transfer pricing aspects of BEPS Action 7, specifically with regard agency PE’s. I have already identified this problem at the OECD in the public hearings on Action 7 in 2015 when I said that the Authorised OECD Approach to the allocation of profits to PE’s (the AOA) does not work in relation to agency PE’s.

My prediction first came to fruition when the final BEPS Action 7 report stated that the TP aspects of Action 7 are complicated and needed more consideration. The grapevine then rumoured that the Action 7 TP report would be done before end 2016. However the end of 2016 has come and gone and at a recent TP Minds conference in London, the OECD informed the attendees that new public discussion drafts are expected by mid 2017, with the final papers expected end of 2017, maybe beginning 2018.

I am not gloating, I appreciate that this is complex. I also understand – and can afford to say – that the problem lies in the AOA, which took years of work and was supposed to be a standard reference work for PE’s. Except, it is not; it is rejected by the UN, or as we say “the other 160 countries”.

The problem with the AOA
First, the concept of free capital is an unnecessary disaster which the banks have convinced the OECD would be easy to manage. We now end up in a world where MNE’s can decide the debt to equity ratio of their subsidiaries, but not their PE’s (not business neutral). In addition MNE’s and tax administrations have multiple ways of calculating free capital, which provides fertile grounds for never ending disputes.

Second, the AOA – due to free capital – imposes unrealistic asset allocation rules on PE’s. In short if a PE touches an asset, it owns it. This makes outsourcing of asset and risk management to subsidiaries possible, but not to PE's (there is a killer for the independent enterprise theory). It also leads to absurd results which will never happen in reality. E.g. if a drilling company drills in a foreign company for 8 months, that could create a PE. A drilling rig can cost up to USD 1 billion, depending on the price of oil. No company will ever buy such an expensive asset with such a volatile price for such a short period, if it can lease it instead, but a PE must, in an AOA world (not the real world).

The 2016 Agency PE profit allocation paper

The best solution would be to first fix these AOA problems (and get the AOA accepted by the UN) before building the agency PE profit allocation rules on such loose sand. Just how loose the sand is could be clearly seen from the first agency PE profit allocation papers published by the OECD in July 2016. First the papers created confusion in the given examples through using the concept of COGS in profit allocation calculations instead of just referring to resale minus like many practitioners are used to. The papers went on to display exactly how incomprehensible and random the allocation of assets, and hence free capital, to agency PE's can be. This is why the papers were not finalised by December 2016 and are not expected to be finalised before end 2017, or beyond.

Conclusion and suggestions

To be fair, I do understand the problem. Say country A has a fully-fledged distributor earning an EBIT of 50 for many years. If the distributor is subsequently converted to a commissionaire earning 10, then country A wants to recuperate the 40 it used to tax, somehow, maybe even any how. One possibility is the fiction of an agency PE. The problem is that the agent may already be given an arm's length compensation for all its work AND THEN THERE IS NO ONE LEFT TO DO ANY OTHER WORK, except ghosts. No work, no pay. Therefore, this does not seem to be a path worth pursuing.

So we are waiting for the OECD new papers. I am worried that the OECD may still be looking for ways to tax the ghosts. Please stop this, they are not there and doing more of what does not work, does not work.
Off course he that criticises must also come with alternatives. I will do my best. Again I recognise that this is not easy. However, here are some suggestions:

1. stick to the basics and tax value there where it is created. Ghosts do not create value, because they do not exist;
2. change the AOA and get rid of the obligations it generate to build fiction upon fiction (see the above mentioned July 2016 papers to see how that pans out). Abolish free capital, abolish the compulsive allocation of profits, restore equality with subsidiaries and simultaneously restore the status of the independent enterprise approach;
3. find the missing 40 (see above example) in chapter IX; if there never was a reorg, then maybe there never was a missing 40. Alternatively look for it in the new chapter I.D. If you cannot find there, then it is because it is not there. And please allocate functions to people, where they are. If they are not where you want them, then they are not there and no amount of wishful thinking will put them there.

Let's abolish the ghost tax.

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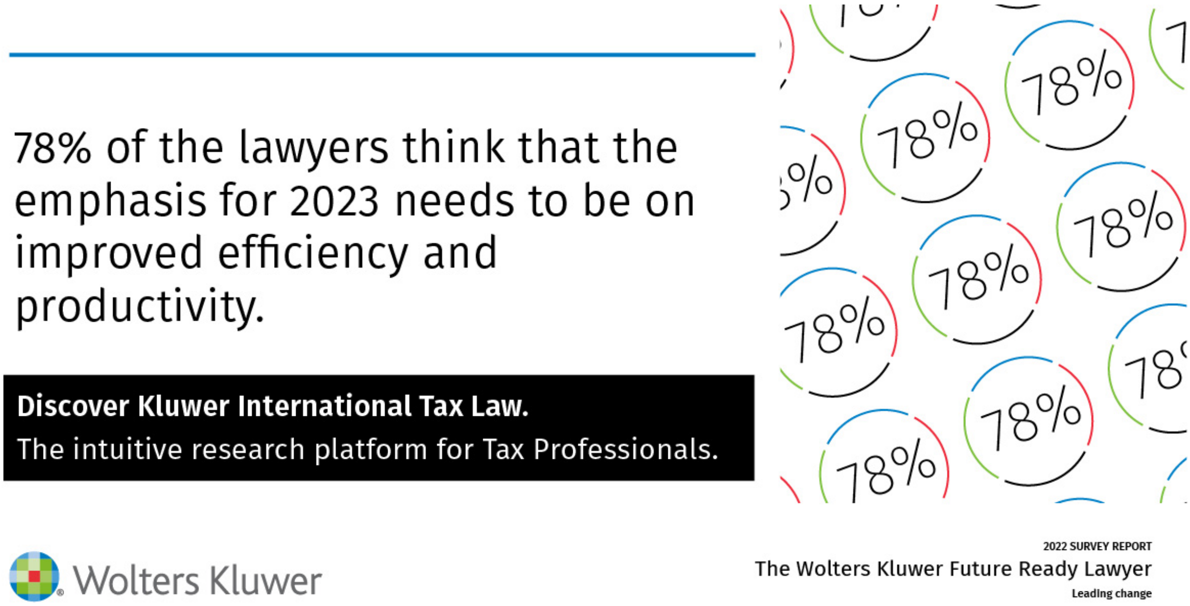

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