The OECD releases discussion draft for additional guidance on the attribution of profits to Permanent Establishment

Background
The final report on Base Erosion and Profit Shifting (BEPS) Action Plan dealing with ‘Preventing the Artificial Avoidance of Permanent Establishment Status’ indicating, inter alia, that there is a need for additional guidance on how the rules of Article 7 would apply to Permanent Establishments (PE) resulting from the changes in the report, in particular for PE outside the financial sector.

Accordingly, the Organisation for Economic Co-operation and Development (OECD) recently issued a discussion draft on Action Plan 7 (AP 7) in relation to additional guidance on the attribution of profits to PE. This discussion draft presents the following fact patterns that would particularly benefit from additional guidance concerning attributions of profits to PE:

- Dependent Agent PE (DAPE), including those created through commissionaire and similar arrangements and
- Warehouses as fixed place of business PE.

In this discussion draft, for each fact-pattern, through the use of examples, a number of questions are identified on which comments are sought from commentators.  

Existing guidance on attribution of profits to PE
For purposes of this discussion draft, the analysis of the different fact patterns is performed by reference to Article 7 in the 2010 version of the Model Tax Convention (MTC), and under the principles set out in the 2010 Commentary to the MTC, and the 2010 Report on the ‘Attribution of Profit to Permanent Establishments’ (the 2010 Attribution of Profits Report), which endorse and attribute profits to the PE under the Authorised OECD Approach (the AOA).

The key highlights of the additional guidance are as follows:

Guidance on particular fact patterns related to DAPE
- Paragraphs 5 and 6 of Article 5 of the MTC set out the circumstances in which an enterprise is treated as having a permanent establishment in respect of activities undertaken for that enterprise, even though the enterprise may not have a fixed place of business.
- Where a DAPE arises from the activities of a dependent agent, the host country may have taxing rights over two different legal entities: the dependent agent, if it is a resident of the PE jurisdiction; and the DAPE, which is a PE of a non-resident enterprise, as per 2010 Attribution of Profits Report.

1 Interested parties are invited to send their comments on this discussion draft by 5 September 2016 by email to TransferPricing@oecd.org in Word format

2 Part I paragraph 230
• For purposes of determining the profits attributable to the DAPE, Article 7 of the MTC is applicable together with the guidance in the 2010 Attribution of Profits Report. According to the 2010 Attribution of Profits Report, ‘in calculating the profits attributable to the dependent agent PE, it would be necessary to determine and deduct an arm’s length reward to the dependent agent for the services it provides to the non-resident enterprise (taking into account its assets and its risks, if any).’

• There are cases where the dependent agent that performs activities that give rise to a DAPE under Article 5(5) is also, for transfer pricing purposes, an associated enterprise of the non-resident enterprise acting as the principal and is resident in the PE jurisdiction. In those cases, in addition to the attribution of profits to the DAPE, it will also be necessary to determine the arm’s length remuneration of the Dependent Agent Enterprise (DAE). These cases have been illustrated by certain examples wherein, the determination of the profits of the DAE and the DAPE have been performed independently, without any direction about the order in which they should be performed. However, in determining the profits of the DAPE under the AOA, it would be logical and efficient first to accurately delineate the actual transaction between the non-resident enterprise and the DAE, and to determine the resulting arm’s length profits. This process would provide the arm’s length fee deductible in the DAPE in respect of the functions performed by the DAE, as required by the 2010 Attribution of Profits Report.

• Commentators are invited to express their views on whether the order in which the analyses are applied under Article 9 of the MTC and Article 7 of the MTC can affect the outcome, and what guidance should be provided on the order of application.

Fact patterns and issues illustrated in the examples

The examples illustrating the attribution of profits to DAPE present the following fact patterns and address the following issues:

• In Example 1, the non-resident enterprise acting as a principal engages an AE resident in the host jurisdiction to perform activities that give rise to a DAPE under Article 5(5). 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.

• In Example 2, the non-resident enterprise acting as a principal engages an AE resident in the host jurisdiction to perform activities that give rise to a DAPE under Article 5(5). The difference in this example compared to Example 1 is that the Article 9 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.

• 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(5). 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 not required.

• 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 (in particular Section D of Chapter I of the Guidelines).

Guidance on the attribution of profits to PE arising from activities not covered by specific exceptions in Article 5(4)

• The BEPS 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(4) ensures 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 modification was needed because, from the introduction of these exceptions, changes in the way business is conducted have been far-reaching, leading to activities previously considered to be merely preparatory or auxiliary in nature becoming core business activities in some circumstances.

- 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 first 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. The examples are designed to illustrate the application of Article 7 and it is assumed that Article 6 of the MTC has no application.

Exploring additional approaches to co-ordinate the application of Article 7 and Article 9 of the MTC

- The simultaneous developments under BEPS Actions 7 and 8-10 have (1) reduced the scope to avoid the PE status, and thus have reinforced taxing rights in the source country, and (2) clarified aspects of the transfer pricing guidance, which may affect the potential profits available to attribute through the PE mechanism under the AOA.

- Suggestions for a co-ordinated application of Article 7 and Article 9 to determine the profits of a PE have been included in this Discussion Draft. For some countries, it may be the case that uncoordinated implementation of Articles 7 and 9 may lead to situations of double taxation between the taxpayers situated in the host country (that is the DAPE of the non-resident enterprise and the associated DAE).

- Furthermore, the analysis of one example in this Discussion Draft seems to identify that there could be situations where the profits attributed to the PE are nil. Nevertheless, the existence of a DAPE for corporation tax purposes may arise even when there are no profits attributable to the DAPE, and notwithstanding this, may create filing requirements and may give rise to other tax liabilities.

- The 2010 Attribution of Profits Report notes that there may be administratively convenient ways of recognising the existence of a DAPE and collecting the appropriate amount of tax resulting from the activity of a DAE. In this regard, the question, therefore, arises whether there are mechanisms that could ensure additional coordination 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 to 10 were designed to reduce.

- Commentators are invited to respond to this question to inform any discussions on this point by the relevant Working Parties, taking into account that the changes made through the work under Actions 7 and 8 to 10 have been agreed and are not open for discussion.

Our comments

The BEPS AP 7 recommends the development of changes to the definition of PE to prevent the artificial avoidance of PE status. It also recommends that it should address related profit attribution issues. Based on many comments received by the OECD that stressed the need for additional guidance on the issue of attribution of profits to PE, the follow-up work was carried out with a view to providing the necessary guidance before the end of 2016. In this process, the OECD has come out with the discussion draft, wherein certain questions are identified on which comments are sought from commentators.

In this discussion draft, the facts of the examples have been created solely for the purposes of illustrating the analysis under Article 7 and Article 9. The facts are necessarily limited and have been supplemented by assumptions so that commentators can follow the illustrated process on which comments are sought. The examples are built on the assumption that a PE exists, under either Article 5(1) or Article 5(5), considering the revisions to the definition of PE introduced by the report on AP 7.

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5 see paragraph 246 of Part I of the 2010 Attribution of Profits Report
6 Please refer to the discussion draft for examples and the questions
The aim of the additional guidance given in this discussion draft is to illustrate how the rules for the attribution of profits to PE apply, taking into account both the changes made in relation to AP 7 and the Transfer Pricing Guidelines. This discussion draft concentrates on DAPE and warehouses as fixed place of business PE scenarios, for which examples are provided together with specific questions on which input is sought from commentators. The comments are requested solely on the application of Article 7 to determine the attribution of profits to PE.
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