Update on OECD Initiatives: Attribution of Profit to a Permanent Establishment

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Outline of Presentation

- Summary of process
- Brief reminder of history and Working Hypothesis (WH)
- Key issues for Parts I-III
- Insurance and Part IV
Summary of process (1)

- Discussion Drafts: 8th February 2001
  - Part I: PE in general
  - Part II: Special Considerations for banks

- April 2002 business consultation

- 4 March 2003 release
  - revised Part II on banks
  - Part III on global trading

- Consultation in Geneva 25/26 March 2003
  - Aim to help finalise Parts II and III
Summary of process (2)

- Release of revised Part I on 3 August 2004
- Release of revised Parts II and III to previous commentators mid-August 2004
- Discussion of comments by WP6 (including day with Parts II and III Commentators) in Paris end of October 2004
- Statement on OECD website on 19 November 2004 revising timetable for completion of project
  - Final decision by CFA in late January
  - Already clear will not finalise Parts I – III in early 2005
Summary of process (3)

- **Likely outcome of CFA meeting in January**
  - No change in final completion date of January 2007 (indeed may be accelerated)
    - Principles settled but need more time to look at implementation issues

- **Completion requires two elements**
  - Final version of Parts I-IV
  - Revised Commentary to Article 7 and Article 23 (and possibly changes to Article 7 itself)

- **Ongoing business dialogue**
  - Feedback on comments already made
  - Focused discussions with commentators
  - Release of draft Part IV for comment in spring/summer 2005
History of project

- **Why work on this topic?**
  - problems with financial sector and e-commerce

- **Current position: lack of consensus**
  - no common interpretation or application of Article 7
  - recent court cases confirm primacy of treaty over domestic law
  - courts however didn’t find guidance in how to apply treaties in OECD Model Commentary
  - Divergent approaches (e.g. separate vs single entity, different capital allocation methods) which lead to double taxation as no agreed international framework for resolving differences

- **Need global solution and agreement**
  - Look to build on consensus found with transfer pricing

- **Development of Working Hypothesis (WH)**
  - step towards achieving a consensus position on the attribution of profit to a PE under Article 7.
Working Hypothesis

- Functionally separate entity approach (not single entity)
- Two step approach to attribute profit
  - (1) Use functional and factual analysis to hypothesise the PE as a distinct and separate enterprise
  - (2) Application of the arm’s length principle to the hypothetical enterprise in accordance with the 1995 Guidelines (by analogy)
- First step is the most problematic
Scope of project

- **Project is NOT about**
  - Changing threshold for existence of PE under Article 5 (based on assumption PE exists under current rules)
  - Changing balance between source and residence
  - Countering tax avoidance via low tax jurisdictions

- **Project is about providing guidance on the attribution of profits to a PE under Article 7**
  - Based on existing tax principles such as transfer pricing
  - In a manner that as far as practicable minimises the incidence of double taxation
Key Issues

1) Importance of People Functions (KERT)
2) Branch v Sub
3) Intangibles
4) Capital attribution
5) Symmetrical approach
6) Reward for Capital – Hedge Fund Model
7) Risk transfers
8) Dependent Agent PEs
(1) Importance of the KERT

- From functional analysis establish
  - where active decision making takes place
  - where ongoing risk management occurs

- What are the key entrepreneurial risk-taking functions (KERT) for this product/business line
  - Risk follow functions
  - Capital follows risk
  - People focus: inability to separate capital and risk

- KERT is tool for attributing profits as provides starting point for attributing assets and risks and for identifying key business drivers (e.g. in profit split)
  - Still need to reward other functions (including by giving a share of residual profit)

- Server PE
  - Limited functionality in absence of personnel
  - Assets and risks related to hardware
(2) Branch v sub

- Equality of treatment (same principles) not equality of outcome if branch and sub are economically different
  - Economies of scale etc

- Differences in legal structure may therefore result in divergence from taxation perspective: sub not equivalent to P.E.
  - Lack of segregation of capital and risks means no separate reward for provision of capital within a single legal enterprise
(3) Intangibles

- Can attribute “ownership” to one part of the enterprise
  - Based on key entrepreneurial risk-taking functions

- Same principles for different types of intangibles
  - but different facts may lead to different results
  - trade and marketing intangibles
  - created and acquired intangibles

- Special issues for pre-existing intangibles
  - “grandfathered”, i.e. follow existing approach?

- How to implement new approach

- Is it that new? Existing Commentary actually allows for allocation of all the return from intangible to one part of enterprise provided do it through price not royalty
  - PE Distributor of branded goods
(4) Capital Attribution

- No single “correct” approach – need for flexibility
- Number of possibilities as long as based on functions, assets, risks
- Approved capital attribution approaches for financial institutions
  - Require measurement of risks
  - Regulatory based capital allocation approaches
  - Thin capitalisation
- Other methods, e.g. quasi-thin capitalisation, book value based methods are OK but only as a safe harbour
  - Article 7 sets ceiling on source country taxing rights
- Similar principles for non-financials but
  - No regulatory approach possible
  - Still measure significant risk
  - Can have internal interest dealing but only if tied to KERT function
(5) Symmetrical approach

- Risk of double taxation from having more than one authorised approach
  - Relieved by symmetry
- Symmetrical approach
  - Home country to follow authorised host country approach to treaty issues when relieving DT (provided result is consistent with arm’s length principle)
  - More than one authorised approach is permitted so flexibility should not lead to DT
  - But are limits for DT relief - based on domestic law differences – e.g. different definition of profits, entertainment expenses, different depreciation rates etc.
  - Also double taxation relief rules (e.g. baskets etc)
(6) Reward for capital

- Very important for financial institutions
- No separate reward for capital in PE situation
  - Inconsistent with principles of authorised OECD approach
- Is possible between separate legal enterprises (where no dependent agent PE created)
- Pricing issues where are associated enterprises
- Hedge fund model as a good comparable?
  - Trader, management fee + 20-25% profit share
  - Capital provider, the residual, 75/80% profit share
- Differences in risks and functions (e.g. marketing)
  - No sharing of losses
  - Better where business model is closer to proprietary trader?
- Asked for more factual information from business
(7) Risk Transfers

- Recognition of internal dealings
  - Subject to a functional threshold
  - Onus is on taxpayer to prove
- Parent/Sub: can have provision of guarantee
- H.O/Branch: no provision of guarantee recognised

Impact on
- use of credit derivatives
- re-insurance in insurance industry
(8) Dependent agent PE

- Dependent agent PEs) - General principle in Part I
- Report based on the assumption that PE has been created by virtue of Article 5(5) under existing interpretation
- OECD may need to consider clarifying Article 5(5) threshold
- Aim is to replace current lack of guidance on attribution
- May be profit over and above reward to agent
  - May be no profit where all agent’s functions are already fully rewarded
- Need to recognise are 2 taxpayers in PE jurisdiction
  - The PE and the agent
- Administratively may collect tax off only one taxpayer
(8) Dependent Agent P.E.s (DAPE)

Impact of D.A.P.E.
- service fee v profit split
- recognition of third party D.A.P.E.s
- two taxpayers – sub + D.A.PE.

Profits/losses from principal positions

Parent

Sub A Booking location

Service fee

Sub B Trader

D.A.P.E. of A in B?
Dependent Sales Agent Example
SubCo sells computer products on behalf of ForCo
Dependent sales example – PE of Forco

- Dependent agent (Subco) doesn’t take title to the goods
  - Inventory risk and reward belongs to Forco
- Question is whether should be attributed to PE of Forco
- Depends on functional and factual analysis
  - Where are key entrepreneurial risk-taking (KERT) functions performed in respect of inventory risk?
  - Only attribute to PE of Forco if agent (Subco) performs the KERT on behalf of Forco
Key Issues for Insurance

- What are key entrepreneurial risk-taking functions?
  - Role of underwriting?
  - Setting limits and authority
- Capital attribution
- Internal reinsurance
- Article 7(4)
- Release of Part IV in spring 2005
Future Dialogue with business

- Recognise importance of dialogue with business
  - Small groups focusing on drafting suggestions
- Discussion of business comments on Parts II and III at March Steering Group
- Feedback to business on that discussion
- Release of draft Part IV on Insurance in spring/summer 2005
- Discussion with insurance industry of comments on Part IV (summer/autumn 2005)
- Release of revised Part I for comment
- Release of draft Commentary changes
- Completion date Jan 2007 (probably earlier)