

**TRANSFER PRICING AND
RECHARACTERIZATION OF
SUBSIDIARIES INTO
PERMANENT
ESTABLISHMENTS**

PROFESSOR JEAN-PIERRE LEGALL

**PARTNER – SULLIVAN &
CROMWELL, FRANCE**

SECTION I

PURPOSE

- **ADDRESS ISSUES DUE TO RECHARACTERISATION OF SUBSIDIARIES INTO PERMANENT ESTABLISHMENTS IN RELATION TO TRANSFER PRICING**
- **ARE THEY TWO DIFFERENT WAYS TO APPROACH THE SAME ISSUE?**
- **SHOULD ONE OF THE WAYS BE PREFERRED?**

SECTION II

HISTORICAL ANALYSIS

SOME EXAMPLES

- **OECD – ARTICLE 5 PARA.7 AND ITS COMMENTARY**
- **ITALY : 2002 AND 2004 SUPREME COURT DECISIONS**
- **FRANCE : 2003 STATE COUNCIL DECISION (INTERHOME)**
- **MEXICO : US PARENT COMPANIES OF MAQUILADORAS SUBSIDIARIES**
- **STATEMENT OF AUSTRALIAN TAX AUTHORITIES**
- **DEVELOPMENT OF CONVERSION SCHEMES (DISTRIBUTOR TO COMMISSIONAIRE; MANUFACTURER INTO TOLLERS)**
- **CONDITIONS :**
 - **DEPENDENCE OF SUBSIDIARY**
 - **BUSINESS OF PARENT CARRIED ON THROUGH SUBSIDIARY**

SECTION III

QUESTIONS RAISED BY

RECHARACTERIZATION

- ONE : GROUNDS FOR RECHARACTERIZATION
- TWO : SCOPE OF RECHARACTERIZATION

THREE : RESULT OF A RECHARACTERIZATION

QUESTION ONE

GROUND FOR

RECHARACTERIZATION ?

**LEGAL ANALYSIS : A DEPENDENT
SUBSIDIARY LOSES ITS STATUS AS
A LEGAL ENTITY AND BECOMES A
BRANCH OR P.E.**

**ECONOMIC ANALYSIS : THE
SUBSIDIARY CARRIES ON THE
BUSINESS PROPER OF THE FOREIGN
DEPENDENT COMPANY**

QUESTION TWO

SCOPE OF

RECHARACTERIZATION

- **DEPENDENT AGENT P.E. (ARTICLE 5 (5))**
- **FIXED PLACE OF BUSINESS
P.E. (ARTICLE 5 (1))**
- **THE OECD POSITION**

QUESTION THREE CONSEQUENCES OF A RECHARACTERIZATION

DEPENDS ON P.E. DEFINITION

TWO APPROACHES :

**"THE SUBSIDIARY IS A
P.E."**

**"THE SUBSIDIARY WITH A
P.E."**

CONSEQUENCES

SUMMING UP

- COMMONLY ACCEPTED CONCEPT –
RECHARACTERIZATION OF THE SUBSIDIARY AS A
P.E. WHERE THE SUBSIDIARY IS A DEPENDENT
AGENT (DEPENDENT AGENT P.E.)
- DIVERGENCES IN CONCEPTS –

RECHARACTERIZATION OF THE SUBSIDIARY AS A
P.E. WHERE THE SUBSIDIARY IS DEPENDENT ON
THE PARENT AND CARRIES ON A BUSINESS
ACTIVITY (FIXED PLACE OF BUSINESS P.E.)

SUBSIDIARY IS THE PERMANENT ESTABLISHMENT
OR SUBSIDIARY COEXISTS WITH THE P.E. OF
THE PARENT

SECTION IV

A COMPARISON BETWEEN THE
RECHARACTERIZATION OF A
SUBSIDIARY AS A PE OF ITS PARENT
AND ADJUSTMENT OF THE TRANSFER
PRICES BETWEEN THE SUBSIDIARY
AND ITS FOREIGN PARENT

COMPARISON BETWEEN THE TWO TECHNIQUES

- **COMMON FEATURES**

CONDITIONS

CONSEQUENCES

- **DIFFERENCES**

CONCEPT OF DEPENDENCE

SCOPE

**TAXPAYERS (SUBSIDIARY IS WITH THE
P.E.)**

SECTION FIVE

PROS AND CONS OF

- RECHARACTERIZATION OF A SUBSIDIARY AS A PE OF ITS FOREIGN PARENT

AND

- ADJUSTING THE TRANSFER PRICES BETWEEN THE SUBSIDIARY AND ITS FOREIGN PARENT (FOCUSING ON THE OECD'S POSITION)

DRAWBACKS OF **RECHARACTERIZATION OF A** **SUBSIDIARY AS A P.E. OF ITS** **FOREIGN PARENT**

- **DIFFICULTY IN ESTABLISHING THE DEPENDENCE UNDER ARTICLE 5.5.**
- **DIFFICULTY IN IMPLEMENTING THE CHARACTERISATION PROCESS**
- **DIFFICULTY IN DETERMINING THE TAXABLE PROFIT OF THE P.E.**
- **RISK OF DOUBLE TAXATION BETWEEN THE SUBSIDIARY AND THE PARENT**

COMMENTS

- DIFFICULTIES IN IMPLEMENTATION
 - INJUNCTION TO THE PARENT TO FILE A TAX RETURN
 - SANCTIONS (ADMINISTRATIVE AND CRIMINAL)
- DIFFICULTIES IN DETERMINING TAXABLE PROFIT OF P.E.
 - EXISTENCE OF P.E.'S BOOKS
 - ATTRIBUTION OF PROFITS TO THE P.E.
- RISK OF DOUBLE TAXATION BETWEEN SUBSIDIARY AND PARENT

THESE DRAWBACKS DO NOT EXIST IN CASE OF TRANSFER PRICING READJUSTMENT BETWEEN THE SUBSIDIARY AND ITS FOREIGN PARENT

(SINGLE TAXPAYER) APPROACH

MERITS OF **RECHARACTERIZATION OF** **SUBSIDIARY AS A PE OF ITS** **FOREIGN PARENT**

- **OECD POSITION (AUGUST 2004 DRAFT) : ENTREPRENEURIAL RISKS BELONG TO THE NONRESIDENT PARENT AND CAN ONLY BE TAXED IN THE PARENT'S P.E. IN THE COUNTRY OF THE SUBSIDIARY**
- **OECD DISCUSSION : SINGLE TAXPAYER APPROACH IS PREFERABLE WHERE THE PROFITS OF THE SUBSIDIARY ARE ADJUSTED FOR THE ENTREPRENEURIAL FUNCTIONS, ASSETS EMPLOYED AND RISKS ASSUMED – THE TRANSFER PRICING METHOD**

VI. CONCLUSION

- **SUBSIDIARY IS INDEPENDENT FROM THE PARENT (UNDER ARTICLE 5(5) OR POSSIBLY 5(1) – ARTICLE 9(1) APPLIES**
- **SUBSIDIARY IS DEPENDENT**
 - **ARTICLE 9(1) APPLIES (ARM'S LENGTH PROFIT BASED ON FUNCTIONS, RISKS AND ASSETS)**
 - **ARTICLE 7 APPLIES (SUBSIDIARY RECHARACTERISED AS P.E. OF PARENT UNDER SINGLE TAXPAYER APPROACH WITH ARM'S LENGTH PROFIT ALLOCATED FOR FUNCTIONS, RISKS AND ASSETS)**

IN EACH CASE THE RESULT IS THE SAME BASED ON THE ARM'S LENGTH PRINCIPLE

PROPOSAL:

- **APPLY SINGLE TAXPAYER CONCEPT IF P.E. IS ALLEGED TO EXIST**
- **DO NOT APPLY THE OECD APPROACH WHICH RESULTS IN UNJUSTIFIED AND SERIOUS DRAWBACKS**

THANK YOU

MUMBAI – INDIA

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