Attribution of Profits to Permanent Establishments

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Article 7(2) of OECD Model Treaty

- "Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

Article 7(3) of OECD Model Treaty

- "In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere."

Background on Project

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- Begun in 1998 to seek consensus on how to determine profits attributable to PEs
- Draft Reports have been published in four inter-related Parts:
  - Part I – General Principles
  - Part II – Banking
  - Part III – Global Trading
  - Part IV – Insurance
- All follow “functionally separate entity” approach
- Builds on previous work (1994 update to Article 7 Commentary)

Background on Project (cont'd)

Why this project?

- First reason for the project was the lack of a common interpretation and of consistent application of Article 7
- Risks of double, or less than single, taxation
- Need to ensure an appropriate allocation of tax base between home and host countries

Background on Project (cont'd)

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Why this project?

- Second reason was the need to update the guidance:
  - The current Model Commentary to Article 7 is largely based on the view of the arm's length principle found in the 1979 Transfer Pricing Report
  - Thinking on the application of the arm's length principle has evolved as reflected in the 1995 OECD Transfer Pricing Guidelines
  - And considerable experience has been gained since 1995

Step one:

- Hypothesise the PE as a "distinct and separate enterprise" engaged in "the same or similar activities" under "the same or similar conditions" and "dealing wholly independently" with the enterprise of which it is a part

How to do Step one:

- By applying the principles of the OECD's 1995 Transfer Pricing Guidelines *by analogy* to perform a factual and functional analysis:
  - to identify functions performed, assets used, and risks assumed by the PE,
  - to attribute adequate free capital to the PE in light of its risks, and
  - to identify any "dealings" between PE and rest of enterprise

Basic principle – Step two

- Determine the profits of the hypothesised separate enterprise by applying the OECD's 1995 Transfer Pricing Guidelines *by analogy* to "dealings" between PE and other parts of the enterprise

First Step

- **Hypothesizing the PE as a separate enterprise:**
  - Functions and risks: what are the activities of PE?
  - Attributing economic ownership of assets (tangible and intangible): drawing up a "tax balance sheet" for the PE under the authorised OECD approach
  - Capital: attributing "free capital" and interest-bearing capital

First Step

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Risks follow functions:

- Under the OECD approach, risks cannot be segregated from associated functions within a single legal entity
- I.e. risks inherent in, or created by, the functions performed by the PE are attributed to the PE

First Step

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Attribution of assets:

- Necessary in order to hypothesise the PE as a functionally distinct enterprise
- But: legally, assets belong to the whole enterprise
- So how can "economic ownership" of assets be attributed to one part of the enterprise?
  - Generally by reference to significant people functions relevant for this purpose (in financial sector, KERT functions)

Attribution of assets:

- The attribution of assets and their classification will have consequences for both:
  - the attribution of free capital and interest-bearing debt to the PE (step one, delineating the PE)
  - the attribution of profit (recognition of intra-entity dealings and arm's length remuneration of those dealings)

First Step

Intangible assets:

- Paragraph 17.4 of the current Commentary does not recognise intra-entity royalties or mark-up for the use of intangible property by one part of the enterprise
- Under the OECD approach, there is a clear implication that arm's length notional payments between different parts of the enterprise may be allowed under certain conditions

First Step

Tangible assets:

- Broad consensus to attribute based on place of use, unless circumstances warrant different conclusion
- Viewed as a pragmatic solution

First Step

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Capital follows functions, assets and risks:

- Under the arm's length principle, a PE should have sufficient capital ("free capital" + debt) to support the functions it undertakes, the assets it uses, and the risks it assumes
- The functional and factual analysis will attribute "free capital" (i.e. funding that does not give rise to a tax deductible return) to the PE for tax purposes

First Step

3 approaches to attributing "free capital" to the PE are examined in the draft Report:

- The Capital Allocation Approach
- The Thin Capitalisation Approach
- The Safe Harbour Approach – quasi thin capitalisation / regulatory minimum capital approach

First Step

Determining the Funding Costs of the PE:

- Under the OECD approach, attribution of capital can imply, in appropriate circumstances, the recognition of internal "interest" dealings
- By contrast, in the current Commentary to paragraph 3 of Article 7 there is a ban on deductions for internal debts generally (subject to special problems for financial activities)

First Step

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Attributing Creditworthiness to the PE:

- Under the approach, generally, the same creditworthiness is attributed to a PE as is enjoyed by the enterprise as a whole
- Consequence: no scope for the rest of the enterprise guaranteeing the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise (no intra-entity guarantee fee)

Second Step

- Once hypothesised as a functionally separate enterprise,
- the PE must be attributed profits that it would have earned at arm’s length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions

Second Step

- This determination will be done by applying the Guidelines *by analogy*
- The Report provides guidance on:
  - when to recognise and how to characterize intra-entity "dealings" between the PE and other parts of the enterprise of which it is a part and
  - how to price those internal "dealings" by applying the arm's length principle

Dependent Agent PE

- Potentially two taxpayers in host country:
  - Dependent agent enterprise
  - Dependent agent PE
- Issue – does dependent agent perform functions on behalf of foreign principal that cause attribution of risks or assets of foreign principal to host country?

Dependent Agent PE

- If so, DAPE will be attributed capital to support those assets and risks
- Profits (or losses) may be attributed to DAPE by host country based on those assets, risks and capital
- DAPE entitled to deduction in host country for arm’s length compensation to dependent agent enterprise

Current Status

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- Parts I – III:
  - Revised versions now approved by WP6
  - Will be published during December 2006
  - Old Discussion Drafts to be superseded
- Part IV:
  - Consultation held March 31, 2006
  - Discussions ongoing at OECD, but hope is to republish during 2007

Some developments since 2005

- Attribution of tangible assets – broad consensus to attribute based on place of use, unless circumstances warrant different conclusion
- “KERT” terminology – to be limited to financial sector; Part I to use “significant people functions” for attributing assets and risks

Some developments since 2005

- Symmetry (regarding residence State obligation to respect PE State's domestic law capital attribution method) – discussion to be removed from Article 7 reports, but policy to be addressed through implementation package
- Better differentiation of steps 1 and 2
- Text reviewed to ensure it creates no implication of lowering of PE threshold

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Way forward

- Publish new versions of Parts I-III during Q4 of 2006
- Publish new version of Part IV as soon as possible thereafter
- Publish draft implementation package (Model/Commentary changes) during 2007 – comments will be sought

Implementation

Implementation package to reflect a two-track approach:

- Implement full AOA through new text for Model Article 7, with new Commentary
- Also prepare new Commentary for *existing* Model Article 7, importing as much as possible of AOA as does not conflict with existing Commentary

Implementation

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- **Goal of implementation approach:**
  - To provide improved certainty for interpretation of existing treaties using current text of Article 7
  - To provide maximum certainty for how to apply Article 7 under new treaties and protocols