B.E.P.S. ACTION 7 – O.E.C.D. CALLS FOR IMPROVED INTERNATIONAL COORDINATION ON THE ALLOCATION OF BRANCH PROFIT

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INTRODUCTION

One of three July 4 releases, the O.E.C.D.'s *Additional Guidance on the Attribution of Profits to Permanent Establishments* is the sequel to the B.E.P.S. (Base Erosion and Profit Shifting) Project's consideration of how to prevent artificial avoidance of a permanent establishment ("P.E."). Now that the conditions for the existence of a P.E. have been reviewed and updated, the July 4 draft asks the critical questions of how much profit should be attributed to a P.E. and how this determination should be made.

THE JULY 4 DRAFT

The draft is a discussion draft in the truest sense, and it is clearly set out to elicit comments from stakeholders. Like other discussion drafts issued throughout the B.E.P.S. Project, it does not represent consensus between Member States and other participants. This means more consultation and drafting is needed to arrive at workable guidance.

If the draft asks more questions than it answers, this should really come as no surprise. Branch or P.E. profit is a slippery topic, chiefly because there is no consensus on which article of the O.E.C.D. Model Tax Convention should be referenced when determining the amount of branch profit, if any at all. To a great extent, the question of P.E. profit attribution is answered by the 2015 B.E.P.S. Action 7 Final Report, *Preventing the Artificial Avoidance of Permanent Establishment Status*, which clarifies the conditions for the existence of a P.E., and the O.E.C.D.'s 2010 *Report on the Attribution of Profits to Permanent Establishments*. The latter document establishes that O.E.C.D. transfer pricing guidance should be used to price inter-branch dealings and thereby attribute profit to a P.E. Not all countries follow this approach.

The discussion draft appears to highlight the potential for double taxation that may arise when countries (i) do not support the current version of Article 7 (as is the case for many countries that follow the U.N. Model Double Taxation Convention, such as India and China), (ii) have not concluded income tax treaties with current Article 7 language, or (iii) either reject or do not fully apply the 2010 Authorized O.E.C.D. Approach ("A.O.A.") of attributing profit to a P.E. The discussion draft calls for a more coordinated approach to the application of Article 7 and Article 9 of the O.E.C.D. Model Tax Convention, and does so by reference to five examples.

EXAMPLES

Example 1 involves a manufacturer with an associated sales agent constituting independent agent enterprise in a second country. The manufacturer has a dependent

agent P.E. in the second country, where its customers are located. Critically, the manufacturer alone determines when to extend credit to customers, and it stores inventory until it ships the product to its customer in the second country. Under Article 9, the sales agent earns a sales commission and profit after deducting expenses other than advertising costs reimbursed by the manufacturer. All other profit accrues to the manufacturer. Under Article 7, the manufacturer's dependent agent P.E. has no risk, no assets, no capital, no people functions, and therefore no profit in the second country. The dependent agent P.E. recognizes all sales revenue from customers in the second country and has expenses of (i) compensation to head office for its functions and (ii) compensation to the dependent agent enterprise [in this example, the sales agent] for its sales function. This leaves the manufacturer's dependent agent P.E. with zero profit. The key question here is how and whether the finding of zero profit for the manufacturer's P.E. depends on the appropriate profit of the associated sales agent. Article 9 seems able to answer this critical question, while Article 7 and the A.O.A. are silent.

In a typical inbound case that we see in North America, a local subsidiary conducts the sales activity. Assuming that the activity causes the subsidiary to be a P.E. – the subsidiary is a dependent agent having the power to bind the foreign manufacturer – Example 1 suggests that the only profit that is taxable in North America is the profit of the subsidiary for acting as a sales agent. Even if the activity constitutes a P.E. for the foreign manufacturer, provided the manufacturer conducts no activity in North America, its manufacturing income is allocated to profits that are taxable in the home country. The sales profit is the arm's length commission of the dependent agent.

Example 2 shifts the responsibility for the credit risk management and collections function, as well as the warehousing and inventory management function, to the sales agent company. Inventory title remains with the manufacturer until the product is shipped to the customer. Under Article 9, these changes in facts give rise to a return to the manufacturer for its funding of the inventory held by the sales agent, and further increases the income and profit of the sales agent. The sales agent's commission goes up by an increase in its operating profit and an amount required to cover actual expenses taken on as a result of the shift in functions. The Article 7 analysis relies on the significant people functions concept to attribute the manufacturer's funding return to the assets physically held in the second country. The net profit result of the change in facts under the Article 7 analysis depends entirely on the funding return to the manufacturer.

Again, the North American inbound experience suggests that the calculation of a return to the P.E. might start from a distributor's return and be adjusted for different levels of receivables risk and inventory risk, leaving the residual to the manufacturer. The discussion draft's approach involves several more moving parts and analyses than North American experience might suggest, generally making for a more complicated and expensive policy to manage.

Example 3 substitutes an employee of the manufacturer for the affiliated sales agent in the second country. Article 9 does not apply to the relation between the manufacturer and its employee. Here, Article 7 deems the manufacturer's dependent agent P.E. to report a distributor's operating profit in the second country. The profit of the dependent agent P.E. in this example is roughly equivalent to the Article 9 result in Example 2.

This example is the beach-head scenario that many companies use as a second step to enter a market. After having over-extended a manufacturer's representative or other independent agent, an employee is sent to further develop the market. Usually it is the employer taxes that arise initially as a concern, as well as the employee's personal tax affairs for the time he or she spends earning income in the second country. This Article 7 result is an extreme outcome for one employee but is more practically problematic for companies that are used to having employees work remotely and/or independently across the globe.

Example 4 takes the same fact pattern but divides the credit analysis and receivables management functions between the manufacturer and the sales agent. This example illustrates the contrast between the results of an analysis of return to risk under Article 9 and Article 7. While Article 9 allocates the return to the credit and receivables risk using a contingent approach, Article 9 apportions returns by relative contributions from those people performing the risk management function. This example illustrates the difference between the current O.E.C.D. transfer pricing approach and an older approach that is geared more toward attaching returns to functions.

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Example 5 contrasts the results of an Article 7 analysis referencing the O.E.C.D. A.O.A., using a company that specializes in providing spare parts, warehousing, and inventory management services to customers in a second country and that uses a building owned by the company in the "home" country. Three variations of this fact pattern are presented: (i) the company provides warehousing services as its core business, (ii) the company performs warehousing functions but purchases spare parts for resale to aeronautical industry customers, and (iii) the company uses a third-party contractor to operate the warehouse, rather than its own people as in (ii).

The approach posited by the discussion draft in the first of these scenarios is an arm's length return for warehousing services, less expense allocations or charges for workforce cost, know-how and operation software use, warehouse operations and investment advice, property depreciation, and acquisition funding expense. The pricing solution in the other two scenarios is suggested to be an arm's length return on the capital asset, less the cost of investment advice and acquisition funding. This example will test the limits and conditions for the reliance on returns on assets and risks as compared to the returns on assets connected to significant people functions prescribed by the O.E.C.D. A.O.A.

CONCLUSION

Though it should be expected that Action 7 guidance, like other B.E.P.S. transfer pricing outputs, will proceed swiftly to conclusion, this discussion draft is one of the most tentative of all the B.E.P.S. outputs, suggesting that significant work is required to arrive at consensus guidance. If implementation of treaty amendments is recommended to better coordinate the application of P.E. and A.O.A. guidance, the proposed O.E.C.D. Multilateral Instrument mechanism and its attendant sovereignty issues will need to be considered.

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