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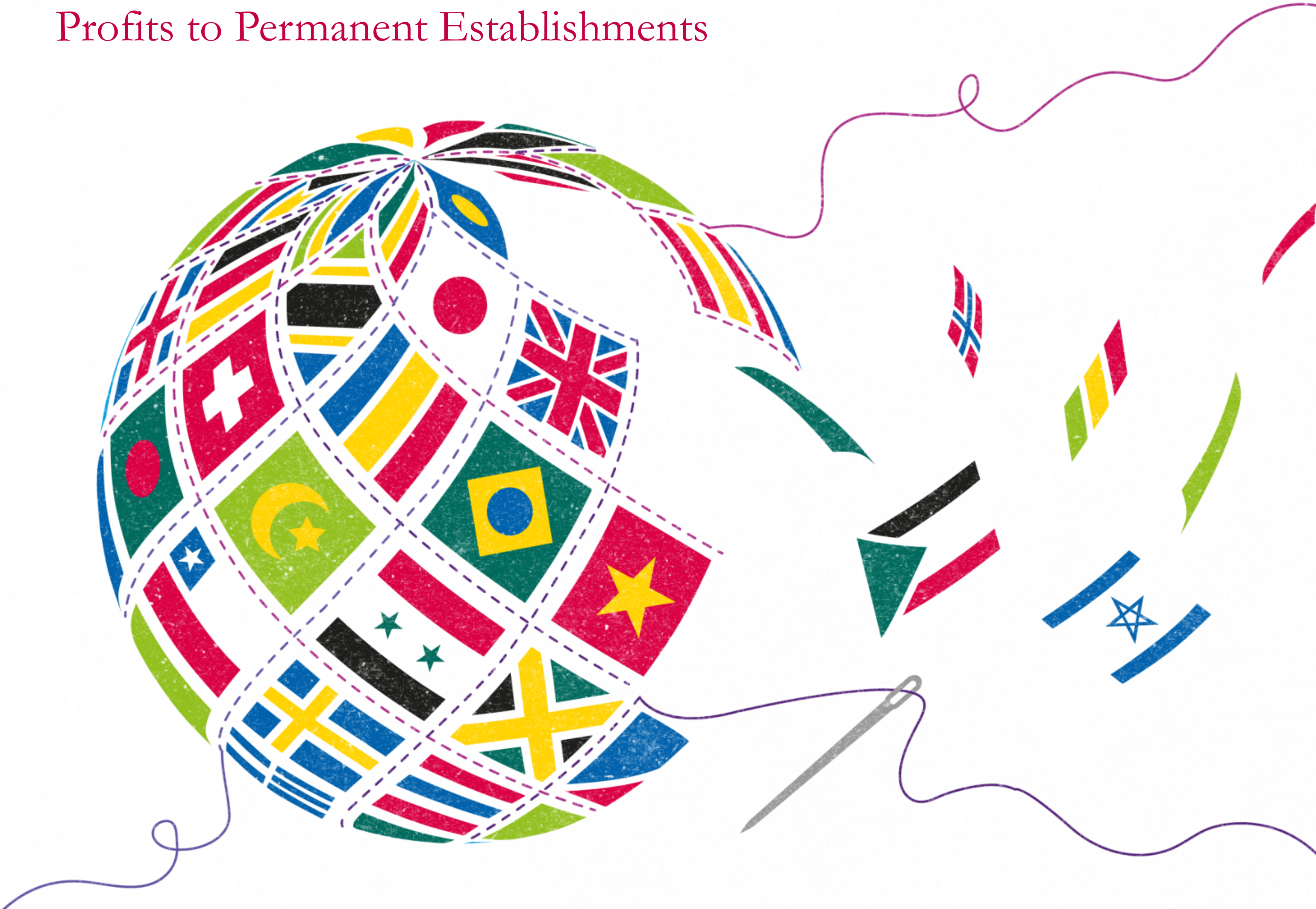
Grant Thornton discussion draft response

BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments



Grant Thornton International Ltd welcomes the opportunity to comment on the OECD public discussion draft entitled BEPS Action 7: Additional Guidance on the Attribution of Profits to Permanent Establishments, issued on 4 July 2016.

We appreciate the work that the OECD has undertaken in the area of permanent establishments. We have provided general comments in Appendix A and specific comments in Appendix B.

Appendix A

Order of application

Example 1 illustrates the overlap between Article 9 and Article 7 and sets out a process to establish profits attributable to the Dependent Agent Permanent Establishment (DAPE). The analysis initially focuses on the importance of functions to control 'Economically Significant Risks' in Article 9, followed by the analysis of relevant Significant People Functions (SPFs) in Article 7.

We note that Example 1 appears to be very simplistic and hence not necessarily reflective of practical issues surrounding multinational enterprises' business and pricing arrangements. For example, it is common in practice for a commissionaire agreement to provide for performance-related remuneration. If Sellco performed strongly in the relevant territory, the commission in Example 1 might be 15 instead of 10. This would turn the profit attributable to the DAPE of Prima in Country B into a loss of five.

Some territories may permit the DAPE and the commissionaire to form a tax group or consolidation so that the loss in the DAPE could be offset against the profits of the commissionaire. However, in territories where domestic laws do not allow this, double taxation could arise within that territory if relief for the losses of the DAPE is not available. In addition, some territories may restrict the carry-forward or carry-back of losses of the DAPE.

This problem would be exacerbated by the fact that the profits attributed to Country A would remain the same and the tax rules in Country A may not permit the offset of the Country B DAPE loss against other Country A profits.

A further example of a potential practical problem would be a situation where the sales commission paid Prima to Sellco is subject to a transfer pricing adjustment (increase) in Sellco's jurisdiction. If the amount of the transfer pricing adjustment was five, the sales commission would now again be 15, resulting in a loss of five for the DAPE of Prima. Again, double taxation and/or timing permanent differences could arise as already identified above. In both of the examples above, it can be seen that the OECD's suggested approach leads to additional complexities, particularly in Country B, without altering the overall profit attributable to that territory. There may therefore be instances in which it would be appropriate for the OECD to permit Contracting States to take a practical approach and not require an attribution of profits or losses to a DAPE of Prima where this results in the practical problems identified above.

Splitting of contracts as a way to avoid PE status

Broadly the report proposes that the principal purpose test (PPT) is applied when it is reasonable to conclude that one of the principal purposes of splitting up the contract is to obtain the benefit of the 12 months rule in terms of article 5(3). However the OECD does not provide clear guidance for the application of the PPT and in our opinion this may lead to uncertainty and an increase in conflict of interpretation between treaty parties.

Furthermore, the wording of the report raises our concern since a transaction motivated by commercial purposes may still not pass the PPT if gaining a tax advantage from the transaction was also a secondary principal purpose. This is clearly contrary to the freedom of establishment as defined by the European Court of Justice (ECJ). Indeed ECJ case law on freedom of establishment allows residents to establish in other EU states and to benefit from tax provisions provided that the company has a genuine economic activity. Hence, a subsidiary set up and having a genuine economic activity and economic substance in a jurisdiction which has a more efficient or competitive tax regime may fall foul of the said PPT inhibiting the freedom of establishment sanctioned by EU law.

Appendix B

Example 1

Do you agree with the functional and factual analysis performed in Example 1 under the AOA?

Under the Authorised OECD Approach (the AOA), risks of a non-resident enterprise relating to inventory, marketing, intangibles or receivables should only be attributed to the DAPE in circumstances where relevant SPFs are performed by the DAPE on behalf of the non-resident enterprise. In this example there are no risks or assets attributable to Sellco as there are no relevant SPFs performed by Sellco on behalf of Prima.

Based on the facts in Example 1, we agree with the analysis. However, we would welcome further guidance on the identification of SPFs, as we consider the existing draft guidance to be very limited.

We also note that depending on how each case is interpreted, there potentially could be a range of outcomes based on the functional and factual analysis. This may lead to inconsistency across multinational enterprises. Clear guidance and detailed, comprehensive examples are therefore required.

Do you agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA?

Broadly we agree with the construction of the profits or losses of the DAPE in Example 1 under the AOA.

We note, however, that Example 1 is simplified as compared to most business arrangements, and may not reflect the complexities most businesses may face when determining how much profit is attributable to the DAPE, as explained by our comments above.

What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

With respect to Example 1, we are of the view that if an approach other than the AOA was to apply, the conclusion would unlikely be different. This is due to the simplistic nature of the facts as outlined in Example 1. However, for multinational enterprises whose commercial arrangements are more complex, the conclusion may be significantly different, as our comments on Example 1 illustrate.

For example, the wording of Article 7(6) of the UK/India double tax treaty in conjunction with Indian domestic laws means that the attribution of head office company costs is very limited in calculating the profits attributable to an Indian PE of a UK enterprise.

Therefore, in Example 1, the amount of the cost of goods sold (COGS) of 190 that could be deducted against Country B sales income could be heavily restricted. This would result in the potential for significant double taxation where the head office territory operates an exemption system of taxation for foreign permanent establishments or where credit relief for foreign tax is limited to the head office country tax on the same profits that are subject to foreign tax.

In addition, Article 7(3) of the UK/India treaty contains a distinct and separate rule which states that where a PE takes an active part in negotiating, concluding or fulfilling contracts entered into by the enterprise, then, notwithstanding that other parts of the enterprise have also participated in those transactions, that proportion of profits of the enterprise arising out of those contracts which the contribution of the PE to those transactions bears to that of the enterprise as a whole shall be treated as being the profits indirectly attributable to that PE.

While we note that India is not a full OECD member country, it has a strong working relationship with the OECD. In addition, India is part of the ad hoc group addressing the double tax treaty related measures to be implemented by BEPS Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties.

We would therefore encourage one approach to the attribution of profits across all relevant double tax treaties. This will mitigate uncertainty and risk of double taxation where, for example, one tax authority argues for an attribution of profit based on the AOA whilst another tax authority may not wish to adopt the AOA. This is the current situation in countries which have chosen not to adopt the AOA in practice, leading to a lack of consistency between countries and the actual/model treaties.

Many double tax treaties contain a provision in Article 7 that the same method of attributing profits to a PE should be used year-on-year unless there is good and sufficient reason to the contrary (eg UK/France treaty). The new proposals could affect existing PEs as well as clarify the position for new PEs. On this basis, we could seek the OECD's confirmation that the new proposals are sufficient for this purpose.

In the types of cases illustrated by Example 1, is it appropriate to conclude that, where under the functional and factual analysis under Article 7, the dependent agent enterprise does not perform significant people functions on behalf of the non-resident enterprise, there will be no profits attributable to the DAPE after the payment of an appropriate fee to the DAE under Article 9?

In principle, we agree with the conclusion of Example 1. Particularly, if the transfer pricing is correct for a non-resident entity and there are no relevant SPFs performed by the DAPE on behalf of the non-resident entity, no further profits should be attributed to the DAPE. As noted above, however, in practice multinational enterprises' business arrangements are often more complex than the facts of Example 1. Therefore, we do not believe that Example 1 will completely alleviate taxpayers' concerns that the process of attributing profits to new PEs which come into existence as result of BEPS Action 7 will be a complex and potentially subjective process.

We consider that multinational enterprises will generally welcome the clarification that some DAPEs arising due to BEPS Action 7 should not give rise to additional tax. However, it would still appear that the revised definition of a PE will give rise to all of the associated reporting and compliance obligations (and potential penalties) even in a situation where there are no attributable profits or further tax.

Therefore, we consider that the relevant OECD commentary should be amended to provide that contracting states should have the option to pursue the existence of a PE and exempt the enterprise of the other contracting state from tax filings and other compliance requirements associated with having a PE in circumstances where no additional overall attribution of profits arises to the contracting state. This would also cover the situations which we have identified above.

Example 2

Do commentators agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA?

In principle, we agree with the construction of the profits or losses of the DAPE in Example 2 under the AOA.

What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

With respect to Example 2, we are of the view that if an approach other than the AOA was to apply, the conclusion would unlikely be different. This is due to the simplistic nature of the facts as outlined in this Example. However, for multinational enterprises whose commercial arrangements are more complex, the conclusion may be significantly different.

In your opinion, what would be the consequences if, in the example, Sellco does not have the financial capacity to assume the inventory and credit risks? In that case, to which party would you allocate those risks? How would it affect the fee payable to Sellco and the profits to be attributed to the DAPE?

If SellCo would not have the capacity to take over the risks in the first stage, the remuneration for the legal contract between SellCo and Prima needs to be adopted. Therefore, there would be a shift in the profit calculation towards Prima. In the second stage, Prima would then need to allocate the calculated profits between Prima in Country A and the permanent establishment in Country B. The criteria therefore would be the AOA.

What are your views on the fact that in Example 2 the same functions that are considered under the Article 9 analysis to allocate risks to Sellco, are also taken into account, under Article 7, as the SPF that result in the attribution of economic ownership of assets to the DAPE? What is your opinion about the fact that, in this example, the inventory and credit risks are allocated to Sellco under Article 9 and the economic ownership of inventory and receivables are attributed to the DAPE? Does your reading of the current guidance of the 2010 Attribution of Profits Report, and in particular with paragraphs 230 to 245, support the conclusions of the Example?

We do not feel that the current guidance sufficiently supports the conclusions drawn in this Example. The example highlights the increased compliance burden that is likely to be faced for many of our clients with complex operating models. This simplistic example indicates a minimal tax increase of two in Country B.

Example 3

Do commentators agree with the construction of the profits or losses of the DAPE in Example 3 under the AOA?

With respect to Example 3, DAPE is created by the employee and no associated entity is created. Therefore, we consider that Article 9 of OECD Model does not apply. The example should be analysed only by the application of AOA. The inventories, the credit risk, the ownership of company vehicle and capital are attributed to the DAPE.

The first step should be to perform a functional analysis to identify and compare significant activities and responsibilities undertaken; assets used, such as plant and equipment, the use of valuable intangibles, financial assets, etc. The nature of the assets used, such as the age, market value, location, property right protections available, etc.

Functions

According to the OECD Guidelines, 'remuneration in independent transactions' typically reflects the functions performed by each entity. The functions carried out (taking into account the assets used and the risks assumed) will determine to some extent the allocation of risks between the parties, and therefore the remuneration each party would expect to receive in arm's length transactions. In relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction.

Risks

Risks usually refers to possible events that may arise while performing the activities, or inherent to them, which can be on detriment or benefit of the business. In general, it is to be expected that the entity bearing the greatest risk should be entitled to a relatively larger share of the profit earned on the business transaction. Therefore, the focus is to analyse which risks affect the different entities and whether those risks are significant. The main types of risks to consider include market risks, such as input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by currency exchange rate and interest rate variability; credit risks; and so forth.

Finally, we note that there are many risks, such as general business cycle risks, over which typically neither entity has significant control and, which at arm's length, could therefore be allocated to one or the other entity to a transaction. Analysis is required to determine to what extent each party bears such risks in practice.

Therefore, for a correct attribution of profits (or losses) in Example 3, it is essential that a proper analysis of the SPF is carried out, which can be rather simple if applied to certain assets on the one hand, but complicated if related to other assets (ie intangible assets) on the other hand.

Furthermore, an employee can be appointed by the company not only to manage a sale activity but also other administrative activities that are not connected to the country where they perform the main activity (ie sale of goods). That situation can influence the SPF analysis and result in a change of profit attribution over the principal company.

Therefore, we agree with the construction of the profits (and losses) under AOA, but we note that such an approach can be largely impacted by a more complex situation where an employee develops different activities and manages more complex assets. Under such circumstances, a deeper functional and risks analysis is required (as well as interaction with other Action plans as Actions 8-10).

What would be the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

On the basis of our above response, the attribution of profits may be influenced by other components that are not considered in Example 3, such as royalty flows or administrative functions developed by the employees, which may reduce the profits over the employee and shift the profits over the principal company. In addition, the determination of Capital to be attributed to the DAPE can be affected by this analysis, because DAPE has been attributed a lower level of risk.

Moreover, the OECD Commentary to paragraph 2 of Article 7 of the OECD Model highlights that the AOA determines the profits that are attributable to a permanent establishment. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2, it is necessary to determine whether and how such profits should be taxed, considering the domestic law of each Country. Therefore, the profits individuated in Example 3 would be subject to the taxation provided by the Country where the employee develops his activity, leaving less room for the application of international approaches.

Reference needs to be made to paragraph 15 and 16 of the document. The new text of Article 7 (and the 2010) report is contained in a limited number of treaties and, while some Countries have declared to use the AOA in 'full' regardless of which version of Article 7 is present in their treaties, others have expressly declared their reluctance to adopt the new text of article 7. This raises the question of whether the conclusions reached can be considered accurate with respect to Article 7 of the previous year (compared to 2010) and that of the 2010 report. In our view, all the documents referred to in the Discussion Paper would need to be re-analysed. Although it is most likely that the conclusions reached would be the same, there is an inherent risk of double taxation in a situation where a country (eg head office) follows one interpretation, while the other Country (PE) follows another. In this situation, there should be a mandatory MAP in place but given the conclusions of Action 14 it is unlikely that the OECD intend to implement this.

Example 4

Do commentators agree with the construction of the profits or losses of the DAPE in Example 4 under the AOA?

The intent of Example 4 is to highlight scenarios where SPFs are performed in two jurisdictions and to illustrate a comparison of profit and loss scenarios. Despite the intent, the facts demonstrate the complexity and assumptions required to conduct this analysis, partly because the contractual arrangement allocates risks to SellCo.

The allocation of the profits/losses in the DAPE is being apportioned via the basis of the respective contributions to credit management costs (ie SPF) for Country B customers, which equates to 25% for the DAPE, which represents the costs incurred by Sellco.

However, Sellco is compensated for such costs already under Art 9 as reflected in the workings on paragraph 74, by way of a cost plus Service Fee and Incentive Fee. Consequently, under this example, Country B is being compensated twice for the credit management activities carried out in Sellco – partly in Sellco under Art 9 and partly in DAPE under Art 7.

In total, Country A shows profit of 967 and Country B shows profit of 1,632 (1,210 + 422.5) on the transaction, which does not reflect either the contractual risk basis or the SPF activity in either country.

We would suggest that the appropriate result should be that Sellco is remunerated as per Para 74 based on TP principles, and no additional income is attributed to the DAPE on the basis that adequate income has been reflected in Country B in Sellco.

Alternatively, if it is still necessary to reflect income in the DAPE under Art 7, then this income should be proportionally taken from the Income of Primco and Sellco, in order to avoid Country B being over compensated on the entirety of the transaction, in conflict with the contractual risk arrangements and SPF.

Consequently, we do not agree that the profits are being allocated on a reasonable basis in the examples given.

Do commentators agree that the profits or losses in the DAPE over and above the fee payable to Sellco arise because the contractual allocation of risk to Prima is respected under Article 9, and is not shared with Sellco, whereas under Article 7 the risk is partly attributed to Prima's Head Office and partly to the DAPE of Prima? In other words, the difference arises from differences between allocation of risk between two separate enterprises and attribution of the risk within the same enterprise?

Yes, as noted above, we agree that the profits or losses arise from differences between the allocation of risk between two separate enterprises and attribution of risk within the same enterprise, and this leads to the inevitable over attribution of profits to Country B in the examples provided.

It should be noted however, that it is difficult to analyse the real world commercial effects of such a scenario. Other factors may have to be considered in the construction of the profits to the DAPE.

Example 5

Do commentators agree with the construction of the profits or losses of the PE in Scenario A of Example 5 under the AOA?

Whilst we agree with the proposed P&L elements to calculate the service remuneration of WRU's PE in Scenario A, the calculation of the said elements, particularly the 'Cost of workforce' should not be limited to a direct recharge of 'costs' but should also include the value created by the workforce as an asset, taking into consideration training and other qualities which WRU could have benefitted from had the workforce not been assigned to the PE.

Broadly, the notion is that employees are merely costs, and add no overall value to the PE as they are not 'assets' and as such, no taxable profit is attributed. However, our view is that in an increasingly service dominated economy, employees could also be considered an 'asset' for which an appropriate reward needs to be reflected.

In the case of scenario A, where third party revenue is received, this is reflective of both the location of the warehouse, and its service element to deliver appropriate parts/inventory in a timely manner. Hence, the arm's length pricing of the reward by the PE to WRU 'for the economic ownership of the asset and the routine function performed at the warehouse' should include the overall value to the PE or correlated 'loss' to the non-resident enterprise. Furthermore, in line with paragraph 68 of the 2010 Report on the Attribution of Profits to Permanent Establishments, the reward for the 'Cost of workforce' should also include a discounting factor by way of remuneration for the risk taken over by the PE from negligence of employees engaged in the function performed by the PE.

Do commentators agree with the conclusion reached in Scenarios B and C of Example 5 under the AOA?

We broadly agree with the conclusions reached, however, in applying the AOA the conclusions drawn are not clear on what constitutes the 'asset' base. As noted in our comments above, the reward for the employees should go beyond the mere cost since people are intrinsically an asset to the operation. Hence, as the main distinction between Scenarios B and C is the outsourcing of the employees to a third party, arguably if the employees are maintained in-house, the reward for maintaining such employees should be equivalent to the third party scenario.

In addition, comparing scenario A to scenarios B & C, although the PE is respectively being compensated for operating the warehouse in the former whilst being rewarded as a cost centre in the latter scenarios, in our opinion, the risk borne by the PE goes beyond the warehouse asset and should include business continuity risk emanating from the maintaining of inventory, employee service and other business functions the failure or rewards from which should be adequately compensated to the PE.

The other area of potential discussion is the difference between third party inventories versus owned inventory. Should there be any taxable profit attributed to the jurisdiction holding the owned inventory? Perhaps there should on the basis that higher revenues are earned by virtue of having these inventory available at short notice. Currently the examples suggest that an investment return is only attributable based on the capital cost of the warehouse, not necessarily the stock on the basis of its working capital.

Under all scenarios, interest costs and free capital in connection with the warehousing facility (including depreciation of asset) should be equal to those allocated to WRU in Scenario A.

In particular, do you agree that there can be investment return on the asset or assets creating or being part of the PE when there are no personnel of the non-resident enterprise operating in the PE?

We agree that there can be, and should be, an investment return on the asset or assets when there are no personnel. However, in line with our comment to question 15 the elements constituting the asset base should be clarified (ie building only, inclusive of parts/inventory or not?, how to price employees as assets?).

Do you agree with the streamlined approach proposed in this example for cases where there are no functions performed in the PE apart from the economic ownership of the asset, ie attribute profits to the PE commensurate with investment in that asset (taking into account appropriate funding costs and the compensation payable for investment advice)? How would you identify the investment return?

Subject to our remarks in the foregoing comments, we agree with the approach. The investment return should take into consideration the WACC of the tax payer and comparable yield for identical investments.

Do you agree that if the non-resident enterprise has no personnel operating at the fixed place of business PE, then significant people functions performed by other parties on their own account in the jurisdiction of the PE do not lead to the attribution of risks or assets to the PE, and no profits would be attributable to the PE? If not, please explain the reasons for taking a different view.

Subject to our remarks in the foregoing comments, we agree that the proposed scenario should not lead to the attribution to the PE of risks or assets, nor profits, emanating from the significant people functions performed by third parties on account of the non-resident enterprise.

Under Scenario C, if Wareco were a related enterprise, and if it is assumed that the arm's length fee is 110% of its costs, would there be any difference to the outcome of the attribution of profits of the WRU?

In our view, the proper application of the AOA should lead to the same outcome.

What would the conclusion if, because of the wording of Article 7 in the applicable tax treaty, an approach other than the AOA applied? If the conclusion is different, what would be the differences?

In theory, whatever the methodology applied, the same conclusion should be achieved for the purposes of allocating the taxable base between the respective jurisdictions. Hence, the AOA and any other methodology, should include an equivalent approach or formula which takes into consideration functions performed, risks incurred and assets employed, applying the right weighting for each element as is commensurate and akin to the market and economic dynamics of the sphere of operation of the enterprise.

If you would like to discuss any of these points in more detail then please speak to one of the contacts below:

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