International Tax Conference 2008 – Mumbai
The Attribution of Profits to Permanent Establishments:
The Transfer Pricing Analogy

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Attribution of profits to PEs

- The metaphysical challenge
  - a single legal entity
  - with a single set of transactions, assets and risks
  - and a global financial result
  - intra-entity dealings have no legal existence

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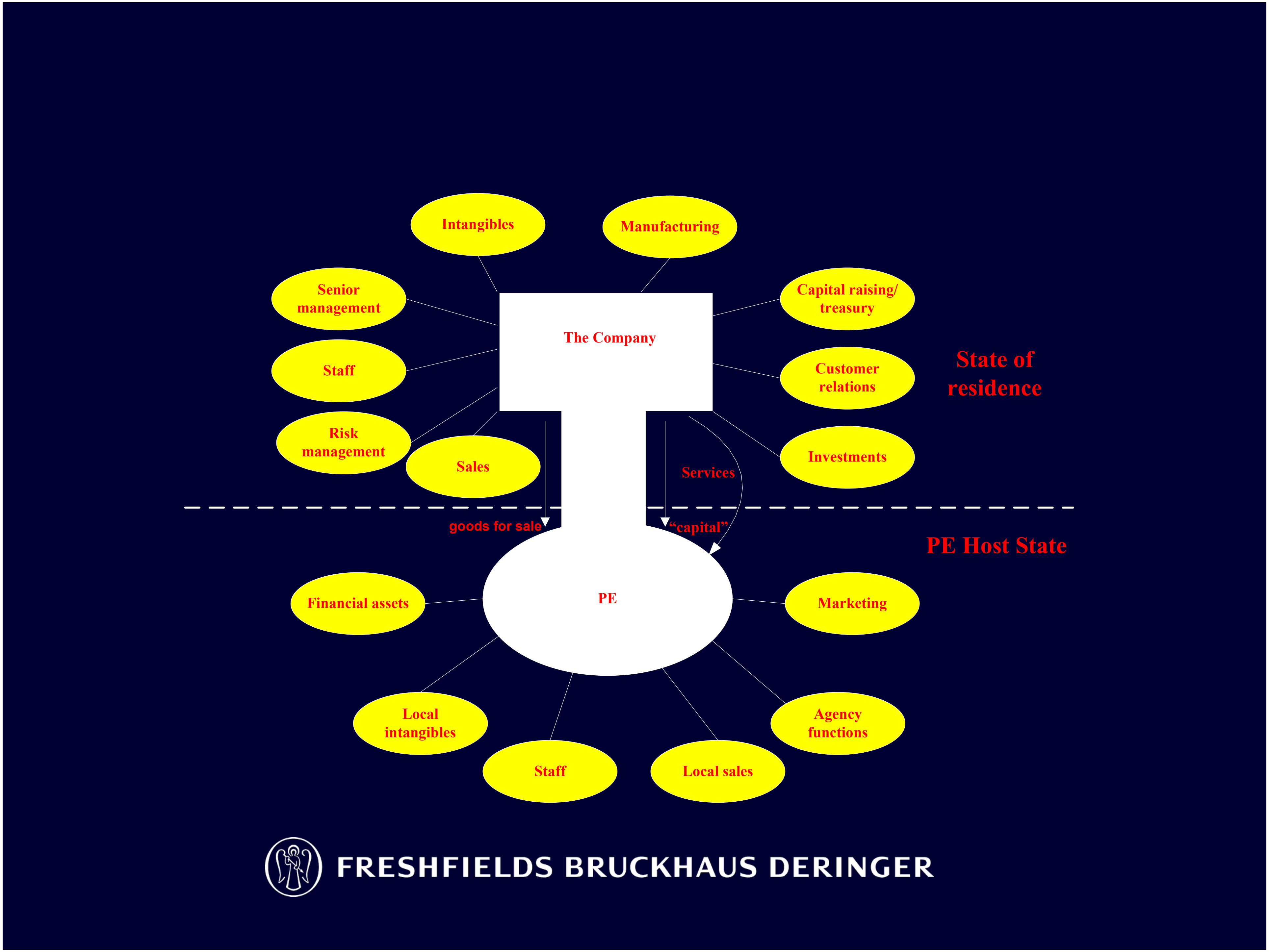
Intangibles
Manufacturing
Senior management
Capital raising/ treasury
The Company
Staff
Customer relations
State of residence
Risk management
Sales
Investments
Services
goods for sale
"capital"
PE Host State
Financial assets
PE
Marketing
Local intangibles
Staff
Local sales
Agency functions
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Article 7 -- OECD Model

- **Art 7(1): residence state tax only on profits, unless PE in host state**
- **Art 7(2): attribute to PE "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 PE"**
- **Art 7(3): allow deductions for expenses incurred (wherever) for the purposes of the PE**
- **Paras (4) – (7)**

The 2008 OECD Report

- **Historic lack of consistent interpretation**
- **Development of the Working Hypothesis: how far does the "distinct and separate enterprise" hypothesis go?**
- **Application by analogy of the OECD TP Guidelines**
- **Draft report constructed in instalments from 2001**
- **WH became "authorised OECD approach" (AOA)**
- **All stages of Report finalised and promulgated July 2008 (2008 Model update also published in July)**
- **NB current DRAFT revised Art 7 and Commentary**

The 2008 OECD Report - Structure

- Part I : General considerations
- Part II : Banks
- Part III : Global trading
- Part IV : Insurance companies

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The 2008 OECD Report – outline of methodology

- “Functionally separate entity” = AOA
- PE’s attributable profits are those it would have earned
  - at arm’s length
  - if legally distinct and separate enterprise
  - performing same or similar functions
  - under same or similar conditions
  - determined by applying arm’s length principle implicit in Art 7(2)
- Art 7(1) reference to “profits” does not go to quantum
- PE profits determined independently of enterprise’s global profits

The 2008 OECD Report – "two step approach"

- Step 1 : hypothesise the PE as a distinct and separate entity
  - functional and factual analysis
  - attribution of assets, risks and capital
  - recognition of "dealings"
- Step 2 : determine profits based on comparability
  - comparability analysis and TP methodologies

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Step 1: hypothesise the PE as a distinct and separate entity

- Functional and factual analysis
  - enables PE to be hypothesised as a distinct and separate entity: no single part of enterprise legally 'owns' its assets, assumes its risks, possesses its capital or contracts with separate enterprises
  - determine which of identified activities of enterprise are associated with the PE and to what extent and in what capacity functions are performed by PE (e.g. as service performed for another part of the enterprise or as a function of the PE on its own)
  - consider significance of 'people functions' of enterprise as whole and PE to generation of profits of the business

Step 1: hypothesise the PE as a distinct and separate entity

- **Attribution of risks**
  - **attribution to part of enterprise performing 'significant people functions' relevant to assumption of risks: 'active' decision making with regard to acceptance and/or management (post transfer) of risks**
  - **attribution of risk carries attendant benefits and burdens: exposure to gains/losses from realisation/non-realisation**
  - **'capital follows risk': creditworthiness of PE is same as enterprise; assumption of risk requires increased capital to maintain creditworthiness**

  relevance to attribution of profit to PE

Step 1: hypothesise the PE as a distinct and separate entity

- **Attribution of assets**
  - **attribution to part of enterprise performing 'significant people functions' relevant to 'economic ownership' of assets**
  - **examine assets economically owned and/or used; extent of use in functions performed by PE; conditions under which used (e.g. joint or sole owner, licensee, member of cost contribution agreement etc.)**
  - **'economic ownership' carries attendant benefits and burdens: income, depreciation, gains/losses from appreciation/depreciation**
  - **relevance to attribution of capital and attribution of profit to PE**
  - **tangible assets: place of use**
  - **financial assets of financial enterprises: the creation and management of such assets (and attendant risks) is the significant people function determining their initial economic ownership**

Step 1: hypothesise the PE as a distinct and separate entity

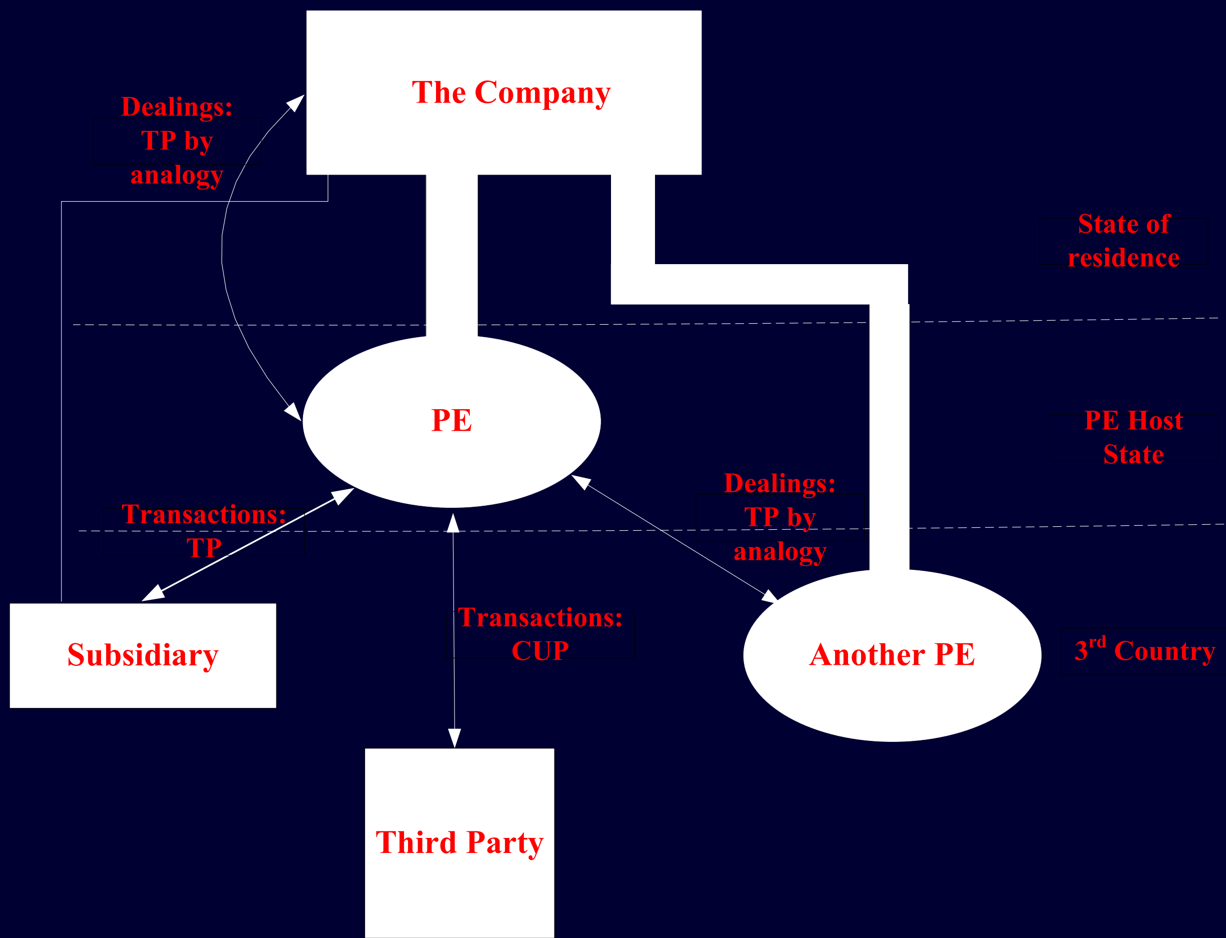
- **Attribution of capital**
  - **arm's length principle requires attribution to PE of sufficient capital ('free' and debt) to support the functions it undertakes, the assets it economically owns and the risks it assumes**
  - **recognition of interest cost on internal movement of funds? scope for recognition of 'treasury function' on such internal movements if supported by functional and factual analysis**
  - ***NatWest* case**

Step 1: hypothesise the PE as a distinct and separate entity

- **Recognition of dealings**
  - **important construct, purely for purpose of Art 7 (equivalent to 'transaction‘ between separate enterprises)**
  - **threshold test: functional and factual analysis to determine whether a 'real and identifiable' event that should be taken into account as a dealing of 'economic significance' between PE and another part of enterprise**
  - **examples of 'real and identifiable' events: physical transfer of stock in trade; provision of services; use of intangible asset; change in part of enterprise using capital asset; transfer of financial asset etc.**

Step 2: determine the profits of the hypothesised PE

- profits/losses from rights/obligations under transactions attributed to PE
  - involving third parties: may be computed directly
  - involving associated enterprises: will be priced in accordance with 1995 OECD Transfer Pricing Guidelines
- arm's length compensation for dealings between PE and rest of enterprise reached through
  - determining comparability of dealings with uncontrolled transactions applying 1995 Guidelines by analogy (contractual terms) and directly (characteristics of property or services, economic circumstances, functional analysis, business strategies); and
  - applying by analogy one of the transfer pricing methodologies in 1995 Guidelines



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Implementation of 2008 OECD Report

- **Stage 1: 2008 update to OECD Model - partial implementation**
  - **'conflicts' rule, but otherwise 2008 OECD Report 'represents internationally agreed principles'**
  - **functionally separate enterprise approach: no 'force of attraction' principle; PE's profits determined independently of enterprise**
  - **endorses 'two step approach' to determining PE's attributable profits**
  - **clarifies Art 7(3): ensures taking into account of certain expenses; does NOT modify Art 7(2) arm's length principle**
  - **maintains (non-financial) ban for interest charges on notional intra-entity**
  - **domestic laws of PE host state to determine 'free' capital attribution where conflicting authorised approaches *and* consistent with arm's length principle**

Implementation of 2008 OECD Report

- **Stage 2: new draft Art 7 and Commentary - full implementation for 2010?**
  - **Art 7(1): clarifies that attribution of profits to PE made in accordance with Art 7(2)**
  - **Art 7(2): full adoption of AOA - attribution to PE of "profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the [PE] and through the other parts of the enterprise"**
  - **Art 7(3): new default rule for capital attribution consistent with 2008 update to Commentary**
  - **Art 7(4): former Art 7(7)**
  - **deletes current paras (3), (4) and (5)**

Application of these principles to dependent agents

- **What are dependent agents?**
  - **Agents who act on behalf of a non-resident enterprise**
  - **Who have and habitually exercise authority to conclude contracts**
  - **Who are not independent agents acting in ordinary course of business**
- **When is this a problem?**
  - **If a non-resident is carrying on business in host state through the activities of its dependent agent**
  - **The activities are not merely preparatory or auxiliary**
- **Examples**
  - **Sales agents (act in name of principal)**
  - **Commissionaires (act as agent on behalf of principal but in own name)**
  - **Global trading (may take various forms)**

Attribution of profits to dependent agents

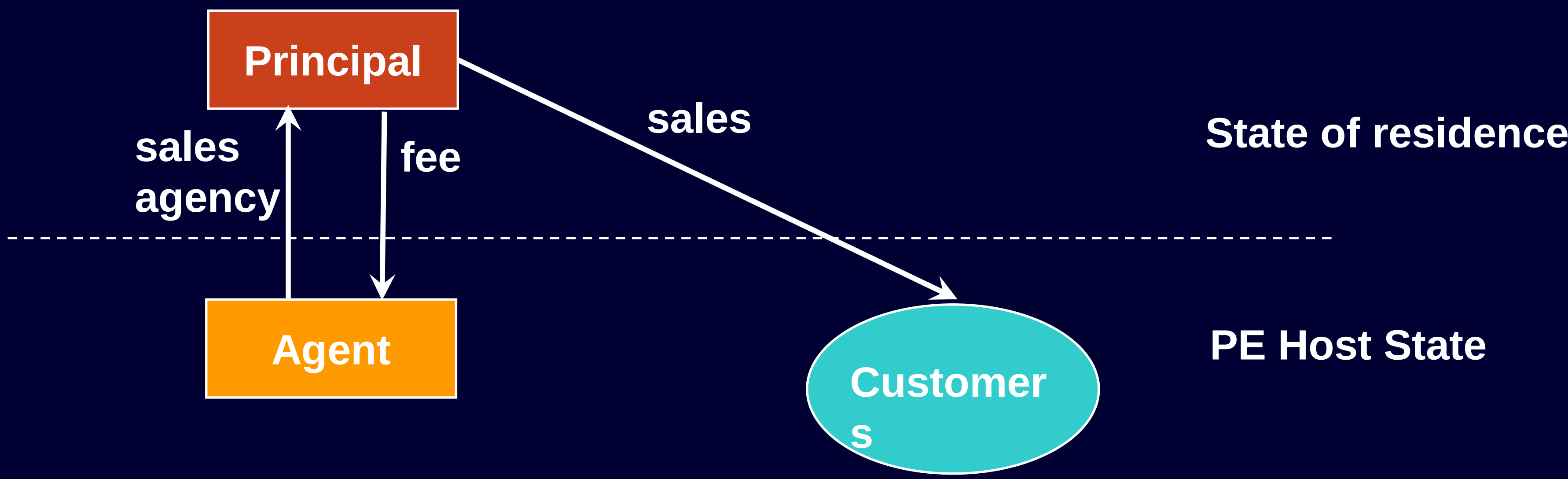
- Assume the non-resident is carrying on business in the host state
- Through a dependent agent
- The agent is paid an arm's length fee
- Is this the end of the story?

- Beware! This may be the potential fallacy of the "single taxpayer" approach
- The interesting Indian cases

Attribution of profits to dependent agents: the AOA

- Remember there are two taxpayers
  - the dependent agent itself
  - the permanent establishment
- An arm's length fee represents the income of the dependent agent
- The profits of the permanent establishment need to be determined by reference to the AOA
  - step 1: functional/factual analysis
  - step 2: determine profits, including a deduction for the arm's length fee
- This may result in additional profits being attributed to the permanent establishment

A simple example: sales agent



Agent

- fee income = 10
- expenses = 8
- profit = 2

Principal

- sales proceeds = 50
- expenses (including fee) = 45
- profit = 5

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