Additional guidance on the attribution of profits to Permanent Establishments released by the OECD on March 22nd, 2018

The Report on Preventing the Artificial Avoidance of Permanent Establishment Status (Action 7 Report, OECD 2015) recommended some changes to the definition of PE in Article 5 of the OECD Model Tax Convention (MTC), as a result of the work on Action 7 of the BEPS Action Plan.

These changes (incorporated into Article 5 as part of the 2017 Update of the MTC) were mainly aimed at preventing the adoption of certain tax avoidance strategies that have been commonly used to circumvent the existing PE definition and, in particular, those arrangements through which a non-resident enterprise makes sales in a jurisdiction through a commissionaire or a dependent agent that does not formally conclude contracts in the jurisdiction, thereby avoiding taxation in the jurisdiction despite having the type of economic nexus that justifies the recognition of a taxable presence. The Report also included changes to prevent the exploitation of the specific exceptions to the PE definition set out in Article 5(4) of the MTC (2014), an issue which is particularly relevant in the case of digitalised businesses.

Though the Report concluded that the changes to the definition of PE in Article 5 of the MTC did not require substantive modifications to the existing rules and guidance on attribution of profits to PEs under Article 7 of the MTC, it did mandate the development of additional guidance on how the existing rules of Article 7 would apply to PEs resulting from such changes (in particular for PEs outside the financial sector), taking into account the revised guidance contained in the Report on Aligning Transfer Pricing Outcomes with Value Creation (Actions 8-10 Report, OECD 2015).

That being said, the guidance at stake – released by the OECD on March 22nd, 2018 – sets out high-level general principles outlined in paragraphs 1-10 and 26-44 for the attribution of profits to permanent establishments in the circumstances addressed by the Report on BEPS Action 7. In particular it:

- covers PEs arising from Article 5(5), including examples of a commissionaire structure for the sale of goods, an online advertising sales structure, and a procurement structure,
- includes additional guidance related to PEs generated as a result of the changes to Article 5(4), and
- provides an example on the attribution of profits to PEs arising from the anti-fragmentation rule included in Article 5(4.1).

(a) Attribution of profits to PEs resulting from changes to Article 5(4)

To prevent the artificial avoidance of PE status through the reliance on the activity exemptions of Article 5(4) of the MTC, the Action 7 Report proposed:

- a new wording of Article 5(4) aimed at ensuring that each of the exemptions included therein is restricted to activities that do not correspond to the core business activities performed in the source country by the enterprise and, therefore, are "otherwise of a 'preparatory or auxiliary' character"
- an anti-fragmentation rule, under the new par. 4.1 of Article 5, according to which if a set of business activities that might be viewed in isolation as preparatory or auxiliary in nature, but if combined "constitute complementary functions that are part of a cohesive business operation", were carried out in the same State by the same enterprise alone or with a "closely" related enterprise, the exception of Article 5(4) would not apply.

As far as the PE arising from the new wording of Article 5(4) is concerned, the guidance simply states that the profits to be attributed to such PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that cause it to be a PE, regardless of whether a tax administration adopts the Authorized OECD Approach (AOA).

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With regards to the anti-fragmentation rule, the guidance points out that, once it is ascertained that the activities in question give rise to one or more PEs, the profits attributed to the PE(s) are those derived from the combined activities constituting complementary functions that are part of a "cohesive business operation" considering the profits each one of them would have derived if they were a separate and independent enterprise performing its corresponding activities, taking into account in particular the potential effect on those profits of the level of integration of these activities.

Thereafter, the guidance includes an example on how attribute profits to a PE arising from the application of the new Article 5(4) to an Online sale company operating in the source country through a warehouse and a merchandising and information office located in different places.

(b) Attribution of profits to permanent establishments resulting from changes to Article 5(5) and 5(6)

The Action 7 Report also targets certain structures and arrangements aimed at circumventing the existing PE definition and, in particular, at positioning below the threshold for the existence of a PE under Article 5(5) of the MTC, such as the use of ***(i)*** commissionaires; ***(ii)*** arrangements whereby sales contracts are substantially negotiated in the source country but are concluded in the principal's State of residence; and ***(iii)*** intermediaries whose activity is tailored to fall under the definition "independent agent".

In this respect, the additional guidance points out that when a PE is deemed to exist under Article 5(5), the circumstance whereby in principle the rights and obligations resulting from the conclusion of the relevant contracts should be properly allocated to such PE does not mean that the entire profits resulting from the performance of such contracts should be attributed to the latter. Indeed, when such PE is deemed to exist due to the activities of the intermediary, those activities are relevant to two taxpayers in the host country: the intermediary (which may be a resident of the source country) and the PE (which is a PE of a non-resident enterprise). Therefore, the arm's length reward to the intermediary for the services it provides to the non-resident enterprise is one of the elements that needs to be determined and deducted in calculating the profits attributable to the PE under Article 7.

The guidance also addresses the specific case where the intermediary and the non-resident enterprise are associated entities and, therefore, both Article 9 and Article 7 of the MTC come into play in determining the total amount of the profits to be taxed in the source country. In this respect, it is clarified that, although the MTC and its Commentary do not explicitly state whether a transfer pricing adjustment on the intermediary should precede the attribution of profits to the non-resident enterprise's PE, the order in which Article 7 and Article 9 are concretely applied should not impact the total amount of profits over which the source country has taxing rights due to the activities carried out therein by the intermediary on behalf of its associated non-resident enterprise. Therefore, any approach to the application of the said articles to the cases at stake must ensure that no double taxation arises by taxing the same profits in the hands of two different taxpayers.

Moreover, when both Article 7 and Article 9 are applicable (because the intermediary and the non-resident enterprise are associated enterprises) and the functions performed by the intermediary can qualify as significant people functions for the attribution of a specific risk to the PE and as risk control functions for the allocation of a risk under Article 9, the risk to which those functions relate should not be simultaneously allocated to the intermediary (according to the Transfer Pricing Guidelines) and attributed to the PE (under Article 7) otherwise double taxation could occur in the source country through taxation of the profits related to the assumption of that risk in the hands of both the PE and the intermediary. In this respect, it has been also clarified that, in principle, the host country's taxing rights are not necessarily exhausted by ensuring an arm's length compensation to the intermediary because, depending on the specific facts and circumstances of a given case, the net amount of profits attributable to the PE may be either positive, nil or negative. Anyway, it must be considered that when the analysis of the transaction under the Transfer Pricing Guidelines indicates that the intermediary is assuming the risks of the transactions of the non-resident enterprise, the profits attributable to the PE could be minimal or even zero.

The guidance also recognises that some States, for reasons of administrative convenience, may – for example – choose to collect taxes only from the intermediary even though they are calculated by reference to the activities of both the intermediary and the PE but clarifies that such approach should not alter both ***(i)*** the taxing rights of the contracting States and ***(ii)*** the ability of the non-resident enterprise to eliminate double taxation under Article 23 of the applicable tax treaty.

Finally, the guidance ends by providing some examples on how attribute profits to a PE – based on the AOA approach – arising from the new wording of Article 5(5) of the MTC, with specific regard to a commissionaire structure, an online advertising sales structure and a procurement structure.

If further information is required, please refer to your LED Taxand contact or to eiascone@led-taxand.it or lgalliani@led-taxand.it

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