Irish Tax Institute

Response to OECD Discussion Draft:

BEPS Action 7

Additional Guidance on the Attribution of Profits to Permanent Establishments

5 September 2016

About the Irish Tax Institute

The Irish Tax Institute is the leading representative and educational body for Ireland's AITI Chartered Tax Advisers (CTA) and is the only professional body exclusively dedicated to tax. Our members provide tax expertise to thousands of businesses and individuals in Ireland and internationally. In addition, many hold senior roles within professional service firms, global companies, Government, Revenue and state bodies.

The Institute is the leading provider of tax qualifications in Ireland, educating the finest minds in tax and business for over thirty years. Our AITI Chartered Tax Adviser (CTA) qualification is the gold standard in tax and the international mark of excellence in tax advice.

A respected body on tax policy and administration, the Institute engages at the most senior levels across Government, business and state organisations. Representing the views and expertise of its members, it plays an important role in the fiscal and tax administrative discussions and decisions in Ireland and in the EU.

Our response

The Irish Tax Institute is writing in response to the Discussion Draft on Action 157 which the OECD released on 4 July 2016. We prepared this submission with consideration and input from our members.

Introduction

Action 7 of the OECD's Base Erosion and Profit Shifting ("**BEPS**") project mandated the development of changes to the definition of "permanent establishment" ("**PE**") to prevent the artificial avoidance of PE status under certain circumstances. In relatively short order, the Action 7 outcome will enable changes to Article 5 of the Model Tax Convention ("**MTC**") to be adopted directly into numerous tax treaties through the Multilateral Instrument initiative.

We have chosen to provide comments of both general nature and specific to examples in the Discussion Draft that together will address issues raised for the consultation. Our response has been to focus on the questions and issues of most significant relevance to our members based on their observations of how these rules may be applied in practice.

The Irish Tax Institute recognise the Discussion Draft is the first step in ultimately developing new guidance to supplement (or modify) the OECD Report on Attribution of Profits to Permanent Establishments (2010). It is important that this consultation, where possible, takes into account the differences across jurisdictions on matters such as PEs, the Authorised OECD Approach (AOA), sourced-based taxation, to name a few. The purpose of Action 7 is to provide governments with new rules allowing them to tax profit on transactions arising from their jurisdictions that were not taxable before under pre-existing laws. It becomes important to balance these rights with mechanisms to avoid greater instances of double taxation.

A. General comments

Exemption of tax filing obligation for "zero profit" PEs

Revisions to Article 5 are due to result in newly created PEs, when businesses are commercially unable to restructure their operations accordingly. As already noted, tax laws often require a foreign entity to file an annual corporate income tax return if the foreign entity operates abroad in such a way to give rise to a PE. The Irish Tax Institute is aware that under the MLI initiative, the OECD is leading a simplification initiative to reduce the burden to file such returns if no profit is attributable to the PE. We strongly support this initiative as a broad simplification measure and recommend the OECD publicises developments in this area along with general updates under Action 15. Pgh 104 briefly remarks on the possible filing obligation of a zero income PE. It would be appropriate for the OECD, in developing guidance on the profit attribution to PEs, to explicitly advocate that no filing obligation is to be required by a government under these circumstances.

Practical guidance required on mix of control functions / significant people functions (SPFs) in both jurisdictions

Most examples cited in the Discussion Draft (Examples 1-3 and Example 5) are useful to illustrate in basic terms the different outcomes on profit attribution analyses. The facts generally state that only one of the two parties is responsible for the control over risk or significant people functions (*except Example 4*). All risks - both strategic and routine - are within scope for analysis under Article 7 whereas in Article 9, only strategic risks are frequently of concern. In practice, most multinational businesses allocate some element of risk management to more than one location while control is centrally allocated. It would be helpful to have examples and guidance on more common scenarios, e.g. when the extension of credit involves both parties while only one party contractually assumes the risk. Later, we provide comments specific to Example 4, which has attempted to cover a mix of control functions.

Requirement to make practical decisions

The Discussion Draft identifies two risk-bearing functions involved in selling product (inventory and credit management). In order to apply the proposed analysis, two assessments are required that would normally be subjective if one were to assess conduct within most multinational organisations. First, one must identify the personnel responsible for **each** individual risk management function. Second, one must benchmark the return associated with risks that require funding by the Head Office. It would be nearly impossible for two experts to agree on the complete spectrum of risks of an enterprise, the relative importance of people performing some control functions and the discrete returns associated with discrete risks. Hence, a pragmatic approach is best suited to deal with this subjectivity, i.e. the arm's length range as applied in the OECD Guidelines.

Tax authorities may deem DAPEs to exist relying on new Article 5(5) ("*habitually plays the principal role….without material modification…*") while the taxpayer disagrees with this basis. In disputed cases of DAPEs, taxpayers may choose to just argue the profit attribution issue rather than contest the existence of the DAPE under the treaty law. Can the analysis look toward a bundle of risks and their control functions? Can there be a de minimis threshold (either objective or relative to the group) that would deem one of the parties to not undertake sufficient control functions to be considered in the Article 7 analysis? Perhaps the OECD can advocate for such a simplification measure without having to quantify it to any extent.

Greater analysis specific to importance of 'financial capacity'

We believe that the relevance of financial capacity was overlooked in the Discussion Draft, in favour of a focus on functional capacity to control risk. The facts of each example largely indicate that one of the two parties has the financial capacity to assume the risks of the commercial transaction. In particular, Example 2 intently notes SellCo has this capacity such to allocate to it the inventory and credit risks and rewards. In addition to the prior request, it would be most helpful to obtain guidance on the relative importance of financial capacity in the context of the Article 7 analysis, which follows the Article 9 analysis on the same issue. Under Chapter I of the Transfer Pricing Guidelines, risk can be fully allocated to an entity if it performs the appropriate control functions and has the financial capacity to assume the risk. Many multinational companies may have established separate entities in the same jurisdiction solely for legal and/or regulatory purposes. This can create circumstances whereby the control functions and financial capacity are in separate entities, yet in the same jurisdiction. The guidance illustrating the AOA should cover such situations, as well as those where the control over risk and financial capacity are not in the same jurisdiction.

Prohibit use for indirect / Source-based taxation

Paragraph 13 of the Discussion Draft suggests that the P&Ls included are for illustrative purposes only, and that no domestic legislation should interpret the P&L for any use other than under the Article 7 PE profit attribution. The final direction from the OECD needs to be more detailed on these principles and stronger on the message. The OECD must make it clear that the PE analysis **cannot** be used by tax authorities for other purposes. A cautionary statement is in our view not adequate to prevent the unintended consequences already foreseen by the OECD.

A number of countries have and are enacting domestic tax laws that effectively tax notional transactions as a withholding tax and/or deny the ability for a PE to deduct arm's length margins applied to head office costs. We believe the concern could be pre-empted to some extent by committing to a peer review of inappropriate use of pro-forma P&Ls by tax authorities.

Further, it is unclear why the Discussion Draft states in pgh 36 that Article 7 attributes sales income and cost of sales to the DAPE when the sole purpose of Article 7 is the attribution of profit or loss from the enterprise. The analysis should solely focus on profit or loss linked to the risks and/or assets which the functional analysis attributes to the PE and avoid, where possible the notional recognition of sales and/or cost of sales not related to the PE itself.

Lack of coherence between Article 9 and Article 7 approaches

The relative operation of the two treaty analyses is fundamental to ensuring they are applied correctly. In conducting the Article 7 analysis, the Discussion Draft clearly relies on the assumed Article 9 analysis that provides the arm's length reward to SellCo. This illustrates that the revised Guidelines vis-à-vis Chapter I must be applied correctly and consistently.

The Article 9 determination of the appropriate reward to a sales activity is easily the most contested transfer pricing issue globally. DAPEs that result from Article 5(5) extend the basis for tax disputes connected to sales activity. We do not believe new mechanisms to ensure appropriate application could result in BEPS risks. Rather, there is a much greater risk of double taxation in absence of stricter rules on the application.

The core distinction between the two analyses is the relevance of contractual allocation of risk that applies in Article 9 but not in Article 7. This element in Article 9 provides a much needed simplification for cases when *some* element of risk management (routine or otherwise) is performed in more than one country. Absent the reliance on contractual risk allocation, the Article 7 analysis loses objectivity and can become unmanageable for businesses with a fact pattern different from the simpler examples in the Draft (see Example 4).

B. Technical comments – Dependent Agent Permanent Establishment (Examples 1-4)

Examples 1-2

- Both examples rely on the correct application of Article 9 to the compensation to SellCo as starting points to the DAPE analysis. In either example, the only potential profit (or loss) attributable to the DAPE is the return for funding investments in assets supporting risk.
- The two examples are good evidence that the Article 7 analysis on the DAPE is outweighed in quantum by the Article 9 analysis. We expect this to be a common theme.
- Example 2 illustrates that Article 7 has negligible impact on the tax base in Country B as the reward is represented as a cost of SellCo. This raises the technical issue of whether tax authorities would allow SellCo a tax deduction for a notional funding return to the DAPE in the same jurisdiction, especially in the event that a DAPE is deemed to exist by Country B's tax authority.

Example 3 – DAPE without local SellCo

- On the irregular assumption that the single employee is responsible for all inventory and credit management functions and control decisions, we agree it is appropriate under the AOA to allocate the full operating expenses to the DAPE.
- Following comments already raised, we suggest the income of the DAPE is shown solely as notional income from Head Office (e.g. commission of 42) rather than an attribution of Sales and COGS to the DAPE. This would more reasonably follow the AOA particularly since we expect DAPEs of this nature are most likely to be asserted by tax authorities and contested by taxpayers based on the merits of the Article 5(5) conditions.
- Example 3 affords the DAPE the same effective reward as provided to SellCo in Example 2 (a 4.5% return on sales). While the Draft notes the figures are illustrative, the link might be incorrectly interpreted to equate the margins for quite different functional profiles.

Examples 2 vs. Example 3

- When comparing the figures of these two examples, we expected there to be similarity between the Opex of SellCo (Example 2) and the Salary of the Employee (Example 3). All other figures were the same, except for these and one would expect that SellCo would in fact have more expenses than the single employee. If the expenses were equated in these two examples, then it would be easier to contrast the outcomes from the perspective of both Country A and Country B.

Example 4

- We acknowledge the intent of Example 4 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. As similar risk sharing transactions do not occur in the market, it would be a challenge to arrive at a definitive Article 9 conclusion on the reward to SellCo.
- First, there is a notional assumption that the return for credit risk management is 5%. In practice, the quantification of empirical risks is challenging, and in this case, the 5% return represents the entire pool of profit under analysis.

- Second, the share of return is measured by relative SPF costs, an approach that appears reasonable on first read. However, for scenarios involving returns more than credit risk, it can be extremely complicated to accurately identify the costs belonging to the right SPFs in more than one country. A SPF is not represented by the entire department but rather those in an active decision-making capacity.
- The example would be best explained if only Prima had contractually assumed the risks yet the risks were jointly controlled and managed.

C. Warehousing – Example 5 (A, B and C)

No economic ownership without SPFs

In our view, the remuneration to the PE should be the same in each of the three Scenarios. In any case, the PE does not undertake any significant functions as all SPFs are undertaken in Country A. The Discussion Draft cites the 2010 PE Report where 'use' defines economic ownership. Noting member states were in disagreement on this issue (see pgh 75 of 2010 PE Report), for the purpose of this guidance the OECD should consistently advocate that SPFs (or KERT functions) are the sole determinant of economic ownership of assets.

In this case, the PE would not be attributed third party income from the warehouse and would be rewarded a same notional intra-group profit from WRU as in 5B and 5C. The Discussion Draft requires more detailed guidance on the determination of this profit, expanding on pgh 97.