



## **OECD/United States Tax Alert**

### **OECD releases new discussion draft on attribution of profits to PEs**

The Organisation for Economic Co-operation and Development (OECD) on June 22 released two non-consensus discussion draft documents concerning the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (TPG).<sup>1</sup> These documents are part of the base erosion and profit shifting (BEPS) project, which began in 2013. The first discussion draft, which deals with work in relation to BEPS Action 7, contains additional guidance on the attribution of profits to permanent establishments (PEs). The second discussion draft, which deals with BEPS Actions 8-10, provides proposed revised guidance on the application of the transactional profit split method. This alert will focus on the discussion draft concerning attribution of profits to PEs. A separate alert will focus on the discussion draft concerning profit splits.

Action 7 of the BEPS Action Plan (Preventing the Artificial Avoidance of Permanent Establishment Status) mandated the development of additional guidance on the issue of attribution of profits to PEs, in particular for PEs outside the financial sector. Under this mandate, the OECD released in July 2016 a discussion draft for public comment and held a hearing in October 2016. After considering the comments received and the positions of countries, the OECD released this new discussion draft, which replaces the discussion draft issued in 2016.

The new discussion draft sets out high-level general principles for the attribution of profits to PEs in the circumstances addressed by Action 7 of the BEPS Action Plan. According to the OECD, countries agree that these principles are relevant and applicable in attributing profits to PEs.

In particular, the new discussion draft provides guidance with respect to the following:

- PEs arising from article 5, paragraph 5 of the OECD model treaty, including examples of a *commissionnaire* structure for the sale of goods, an online advertising sales structure, and a procurement structure.
- PEs created as a result of the changes to article 5, paragraph 4, including an example on the attribution of profits to PEs arising from the anti-fragmentation rule included in new paragraph 4.1 of article 5.

It is noteworthy that, unlike the discussion draft issued in 2016, this discussion draft does not contain numerical examples. The OECD indicated that this is to avoid drawing conclusions from this guidance on the level of profitability of the intermediary or the PE. The profits of the intermediary and the PEs should be determined under the relevant articles in the applicable tax treaty (i.e. Article 7 and, when applicable, Article 9) based on the specific facts and circumstances of the case.

The new discussion draft encourages administrative simplification for taxing profits of a dependent agent PE (DAPE) through combined allocation to the dependent agent enterprise that creates the DAPE. This encouragement does not repeal the OECD's original analysis of the "single taxpayer approach" in the 2008/2010 Authorized OECD Approach (AOA) Report or alter its conclusions that such approach is fundamentally incorrect under the OECD treaty. It also does not require host-PE countries to ignore their taxing rights over two separate enterprises, nor does it change the taxing rights of the home country where the host-PE country provides administrative accommodation permitting allocation solely to a dependent agency enterprise. However, the nod provided to administrative convenience is intended to address practical application of a host-PE country's tax base and encourage mutual accommodation when segregating ownership and service-based profits makes little economic difference.

The attribution of profits illustrations in the discussion draft address more common conditions of non-financial enterprises where a residual reward to capital risk may more often be substantially reduced in relation to the service-based profit remuneration owed to the dependent agent. However, the discussion draft does not amend or provide any additional guidance for the "role of capital" in the context of residual rewards to a financial enterprise's capital at risk over that already provided in the 2008/2010 AOA Report in Part III, Section C-2(iv). Accordingly, at this time, there may remain a divergence between the quantum of profits that should be expected to be available for attribution to a DAPE in non-financial enterprise fact patterns compared to financial enterprise cases where rewards to capital may commonly be materially higher. The OECD announced at their annual Washington, D.C. conference on June 6, 2017 that additional guidance on the transfer pricing treatment of financial transactions is planned for release later this summer.

Interested parties are invited to send comments solely on the proposed guidance in this discussion draft on the attribution of profits to PEs by September 15, 2017. Comments are expressly not invited on the 2016 discussion draft and on the PE definitions agreed in Action 7 that were published in the 2015 Final Report, "Preventing the Artificial Avoidance of Permanent Establishment Status."

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<sup>1</sup> All references herein to the OECD TPG are references to the 2010 version of the TPG, as modified by the BEPS Final Reports on Actions 8-10 and Action 15 published October 5, 2015 and adopted into the TPG in May 2016.

## Contacts

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