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Latest OECD Draft on Branch Profit Attribution Sows Confusion

BNA Snapshot

- New guidance indicates no consensus on sticky issues for branch profits
- Whether taxable presence triggered, and how to allocate income to it, important for online giants such as Amazon, Google

By **Alex M. Parker**

New guidance from the OECD reveals it is no closer to figuring out sticky questions for how authorities should tax foreign branches, potentially causing more confusion in an already fraught area of international tax.

"There's not really much here that's going to be useful as a practical matter when the tax authority is doing the tax allocation," said David Ernick, a principal in transfer pricing controversy at PricewaterhouseCoopers LLP in Washington. "If this is the level of generality at which they're able to get consensus, I don't know that it's useful to even have this discussion draft, or a final report like this," he told Bloomberg BNA July 13.

The draft, issued June 22, was prepared by the Organization for Economic Cooperation and Development's Working Party No. 6, which covers transfer pricing matters. Like all working parties, it consists of representatives from the OECD member countries—in this case, expanded to include those from countries participating in the OECD's Action Plan on Base Erosion and Profit Shifting.

A Vexing Online Issue

The June 22 draft represents a loose end from one of the most controversial aspects of the OECD's 15-point BEPS plan, on which most of the work wrapped up in October 2015.

The October 2015 report under Action 7 of the plan resulted in new language to the OECD's model treaty, expanding the definition for a permanent establishment—a branch of a corporate entity with a taxable presence in a country other than where it's headquartered. The 2015 language narrowed exemptions for once non-exempt activities such as warehousing or distribution—no longer seen as auxiliary functions in the age of Amazon.com Inc.—and broadened the definition of a "dependent

agent" that creates or finishes sales.

In today's digital world where sales can happen in the cloud at the click of a button, permanent establishments can be one of the most high-profile areas of international tax law. Tech giants such as Amazon.com Inc. and Google Inc. have come under fire for using elaborate online structures to skirt permanent establishment triggers in jurisdictions where having a taxable presence would generate huge revenue. On June 12, a Paris administrative court ruled in Google's favor in a $1.3 billion tax case, finding that its employees in France didn't have enough autonomy to be considered a permanent establishment.

The issue is also often a point of contention between richer developed nations and developing nations, which are more likely to be the location of a branch than a headquarters.

The 2015 language defines a dependent agent as one who "habitually plays the principal role leading to the conclusion of contracts," in contrast to previous definitions that emphasized whether the agent had the authority to conclude contracts. The new wording was seen as aiming at "commissionaire" structures, in which a seller acts on behalf of a company but doesn't legally have the ability to guarantee a contract, as well as similar intermediaries.

The Action 7 language also tweaked the prior exemption for activities such as warehousing and distribution, saying they should be exempted only if they are auxiliary—rather than being considered auxiliary automatically.

But the OECD left a persistently troubling issue unresolved—once a permanent establishment is determined, then what? In many cases, the warehousing or dependent agent function is carried out by a subsidiary that already exists, and a transfer pricing analysis may already have been performed to determine its taxable income.

Once that function is also determined to trigger a permanent establishment, it's not clear whether that would mean the subsidiary's taxable income increases—especially as the authorized OECD approach to profit attribution, first published in 2010, instructs the tax authority to tax the permanent establishment as if it were a separate entity, using the same transfer pricing principles.

An Admission?

How to imagine the borders of a declared permanent establishment in a seamless, complex, and potentially online or digital operation—and how it would differ from a legally defined subsidiary—is flummoxing many taxpayers and tax authorities as they pore over the new wording.

The June 22 draft states that the branch should be allocated "only those" profits "that the permanent establishment would have derived if it were a separate and independent enterprise performing the activities that the dependent agent performs on behalf of the non-resident enterprise."

The latest discussion draft follows up from an earlier draft released in 2016, which relied mostly on examples to illustrate how the key principle would work in practice. Practitioners praised it for expanding on the principle that the profit attribution should be based on presuming that a permanent establishment is equivalent to a separate entity and clarifying that the new standards shouldn't create double taxation.

But they also noted it pulls back from some of the detailed examples in the earlier draft, and still doesn't come to a clear conclusion about the central question.

"What this draft is, it's really setting parameters, it doesn't really have anything more to say than that," John Warner with Buchanan Ingersoll & Rooney PC in Washington told Bloomberg BNA July 11. "It doesn't tell you what the ultimate answer is. It says, here are some principles that the OECD is going to take into account in its deliberations in determining what, if any, additional profits of the parent can be attributed to this deemed permanent establishment, over and above the profits that the subsidiary is already reporting."

Many companies have been wondering if the ultimate result of this work will be to force them to accept new permanent establishments, including the administrative hassles of filing new returns, without the

balance of taxable income shifting much.

“They're really fairly cautionary principles,” Warner said, speaking of the new draft language. “They really set up a signal, ‘don't get too excited, developing countries. There may not be a ton of additional revenue that's going to be flowing into your coffers.’”

But while it's meant to draw a consistent global standard for profit attribution, to many, the draft reads more as an admission that countries will enforce the new rules differently.

For instance, it states no opinion on whether a transfer pricing analysis of the legally defined subsidiary should come before or after an analysis of the permanent establishment. Rather, it states that countries may find either approach logical and that it ultimately shouldn't affect how much profit is allocated.

Furthermore, it warns against assuming that the “significant people functions” used to determine risk under the newly revised transfer pricing standards are interchangeable with the “risk control functions” used to determine whether a permanent establishment should be allocated a return on risk. The assertion seemed puzzling to some practitioners, as fine-tuning the rules on how to allocate risk was another important aspect of the BEPS project.

“You can't ignore what the left hand of BEPS is doing,” Warner said. “It's supposed to be a unitary document.”

To some, creating a more aggressive permanent establishment standard while admitting the possibilities for disparate treatment of them seems like a recipe for disaster.

“That's really fundamentally troubling to a lot of us about this draft, that rather than saying our mission is to provide clear guidance to do our best to reconcile and get consistent approaches across jurisdictions, based on the comments from the last draft, we're going to acknowledge that different countries are going to do this differently,” Stephen Blough, a principal in the Washington National Tax practice of KPMG LLP, told Bloomberg BNA July 13. “And let's just hope they don't end up coming up with something that's logically inconsistent.”

Recognizing Losses

Many taxpayers could likely live with more permanent establishments, but would hope they could be used to allocate losses as well as profits. Should they be considered robust, risk-taking enterprises on behalf of a global organization, then losses would presumably be as likely as gains, especially if the economy sours.

But the draft spends little time on the possibility of recognizing losses, only acknowledging in one paragraph that it might be possible.

That's not enough, said David Bowen, the transfer pricing practice leader for Grant Thornton in Washington, because allocating losses won't just be as easy as recognizing profits in red ink.

“It's a different toolbox when you get into a loss situation,” Bowen told Bloomberg BNA July 12.

For instance, an independent company experiencing losses would likely be cutting staff, while a profitable one would be hiring.

“If we are truly embracing the arm's-length standard for all times, it's a financial, economic, and business reality that arm's-length results include losses,” he said.

The OECD is accepting comments on the revised draft until Sept. 15, and will hold a public consultation in November in Paris.

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