Executive summary

On 22 March 2018, the Organisation for Economic Co-operation and Development (OECD) released the final Additional Guidance on the Attribution of Profits to a Permanent Establishment (the Report), under the Base Erosion and Profit Shifting (BEPS) Action 7 report (Preventing the Artificial Avoidance of Permanent Establishment Status).

The Report provides additional guidance on the attribution of profits to permanent establishments (PEs) resulting from the changes to Article 5 of the OECD Model Tax Convention (MTC), as outlined in the final report on BEPS Action 7. The Report sets out general principles for the attribution of profits to PEs in light of the changes to Article 5 of the OECD MTC. The proposed analysis of the examples included in the Report is governed by the authorized OECD approach (AOA) contained in the 2010 version of Article 7. However, the Report is not intended to extend the application of the AOA to countries that have not adopted that approach in their treaties or domestic legislation. It includes examples dealing with the attribution of profits to a PE relating to warehousing activities, commissionaire arrangements, an online advertising sales structure, and procurement activities.
The key principle across the examples is that the profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise. This principle, the Report says, applies regardless of whether a tax administration adopts the AOA or any other approach used to attribute profits.

The Report was agreed by all members of the Inclusive Framework (IF) on BEPS,\(^1\) and thus these principles are relevant and applicable in attributing profits to PEs to all members of the IF and not only to OECD member countries.

**Detailed discussion**

**Background**

On 5 October 2015, the OECD released its final report on preventing the artificial avoidance of permanent establishment status (Final Report) under its Action Plan (Action 7) on BEPS.\(^2\) The Final Report noted that the work on Action 7 focused on whether the existing rules of Article 7 of the OECD MTC would be appropriate for determining the profits that would be allocated to PEs resulting from the changes to the definition of PEs included in the Final Report. The conclusion was that these changes do not require substantive modifications to the existing guidance concerning the attribution of profits to PEs under Article 7 of the OECD MTC, but that there is a need for additional guidance on how the Article 7 rules would apply to PEs resulting from these changes, in particular for PEs outside the financial sector.

The Final Report stated that work on attribution of profit issues related to Article 7 of the OECD MTC could not be done before the work on Action 7 focused on whether the existing rules of Article 7 of the OECD MTC would be appropriate for determining the profits that would be allocated to PEs resulting from the changes to the definition of PEs included in the Final Report. Therefore, the Final Report indicated that follow-up work on attribution of profits issues related to Action 7 would be carried on after September 2015.

Under this mandate, the OECD issued two public discussion drafts providing additional guidance on the attribution of profits to PEs (in July 2016\(^3\) and June 2017\(^4\)). Interested parties were invited to comment on the proposed additional guidance regarding the application of the rules in Article 7 of the OECD MTC to PEs resulting from the changes to Article 5. Based on the comments received, the OECD held a public consultation on 6–7 November 2017 with respect to the discussion draft of June 2017.\(^5\)

**Report overview**

The Report sets out general principles for the attribution of profits to PEs in light of the changes to Article 5 of the OECD MTC. The Report provides examples on the attribution of profits to certain types of PEs arising from the changes to Article 5(4) and Article 5(5) under BEPS Action 7. However, the Report states that the guidance therein is not intended to extend the application of the AOA to countries that have not adopted that approach in their treaties or domestic legislation.

Broadly, the guidance in the Report follows the text of the 2017 discussion draft. A notable difference is the inclusion of a more detailed analysis of the examples, with a step-by-step explanation of the AOA in the 2010 Report on the Attribution of Profits to Permanent Establishments (2010 Report). However, the Report has left out the use of numerical examples as seen in the 2016 discussion draft.

**Attribution of profits to PEs resulting from changes to Article 5(4) of the OECD MTC and the Commentary**

With regards to profit attribution to PEs resulting from changes to Article 5(4) of the OECD MTC and the Commentary, the Report states that under Article 7 of the MTC, the profits to be attributed to a 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. The Report clarifies that after it has been established that a PE exists due to activities specified in Article 5(4) of the OECD MTC that are not preparatory or auxiliary in nature, the attribution of profits to the PE should be determined under an analysis of the amounts of revenue and expense that the PE would have recognized if it were a separate and independent enterprise. The Report explains that the above principle applies regardless of whether a tax administration has adopted the AOA.

Regarding the anti-fragmentation rule in Article 5(4.1), the Report states that it applies in two types of cases:

*Where there is an existing PE in the country*

(i) The nonresident enterprise or a closely related enterprise already has a PE in the source country, and the activities in question constitute complementary functions that are part of a cohesive business operation. In such situation, the profits attributed to the PEs and subject to source taxation are the profits 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.

Where there is no existing PE in the country
(ii) There is no pre-existing PE but the combination of activities in the source country by the nonresident enterprise and closely related nonresident enterprises results in a cohesive business operation that is not merely preparatory or auxiliary in nature. The profits attributable to each PE so arising are those that would have been derived from the profits made by each activity of the cohesive business operation as carried on by the PE if it were a separate and independent enterprise performing the corresponding activities, taking into account in particular the potential effect on those profits of the level of integration of these activities.

The Report provides guidance on the application of the AOA in this context using an example which demonstrates the amount of profits which should be attributed to a PE that is recognized as a result of the anti-fragmentation rule. The example describes a warehouse PE providing storage and delivery services and an office PE providing merchandising and collection of information services. For both the warehouse PE and the office PE, the profits attributable to them are those that each of them would have derived if they were separate and independent enterprises performing the same storage and delivery activities or the merchandising and collection of information activities respectively. It is clear from the Report that the application of the anti-fragmentation clause does not lead always to a single PE, but it can create more than one.

Attribution of profits to PEs resulting from changes to Article 5(5) and 5(6) of the MTC and the Commentary
The Report commences by clarifying that while the changes made to Article 5(5) and 5(6) of the OECD MTC by the Final Report have modified the threshold for the existence of a deemed PE under Article 5(5), they have not modified the nature of the deemed PE. Therefore, any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5(5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5(5).

The Report states that the profits to be attributed to a PE are to be determined in accordance with Article 7 of the relevant tax treaty, i.e., profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions. It mentions again that this principle applies regardless of whether a tax administration adopts the AOA contained in Article 7 in the 2010 version of the OECD MTC, or any other approach used to attribute profits under a previous version of Article 7 of the MTC. Notwithstanding this, the Report also makes it clear that this guidance is not intended to extend the application of the AOA to countries that have not adopted that approach in their treaties or domestic legislation.

The Report highlights that once a PE exists under Article 5(5) of the OECD MTC, one of the effects will typically be that the rights and obligations resulting from the contracts to which Article 5(5) refers will be properly allocated to the PE. This does not necessarily mean however that the profits resulting from the performance of these contracts should be attributed to the PE. Depending on the facts and circumstances of a given case, the net amount of profits attributable to the PE may be either positive, nil or negative (i.e., a loss). In this context, the Report indicates that there may be functions that would be considered both significant people functions relevant for the attribution of risks and assets under Article 7 and risk control functions for the purpose of Article 9, the conclusion cannot be drawn that these two concepts are aligned or can be used interchangeably.

Three examples are included in this section of the Report, which illustrate the attribution of profits to PEs resulting from changes to the definition of a Dependent Agent PE (DAPE). The examples deal with the attribution of profits to a PE relating to commissionaire arrangements, an online advertising sales structure, and procurement activities. Of particular interest is the latter example of procurement activities, which confirms that the new definition would not only cover sales activities, but a wide range of activities, including procurement activities. Additionally, an important element in the examples is the characterization of the dealings. As a result of the characterization, the activities of a DAPE could effectively be remunerated with the residual profit, leaving a routine profit for the service dealing by the head office. Notably, the inventory risk is allocated to the PE, even though the agent was sufficiently rewarded.
Interaction between Article 7 and Article 9 expected to avoid double taxation in the source country

It is also stated in the Report that the OECD MTC and its Commentary do not explicitly prioritize the application of either Article 9 or Article 7. The order in which these articles are applied should not influence the taxing rights of the source country, however the approach adopted by a jurisdiction should be applied consistently. The OECD reiterates that any approach in the application of Articles 7 and 9 to cases of deemed PEs under Article 5(5) must ensure that there is no double taxation in the source country. Therefore, jurisdictions are expected to have in place within their domestic legal and/or administrative systems the necessary principles, doctrines, or other mechanisms to eliminate double taxation in the source country.

Administrative approaches to simplify tax collection

It is stipulated that countries may adopt mechanisms aimed at simplifying a taxpayer’s compliance in relation to the existence of a PE in their country, and reference is made to countries that collect tax only from an intermediary even though the amount of tax is calculated by reference to the activities of both the intermediary and the Article 5(5) PE. The Report recognizes that the administrative burden on a nonresident enterprise resulting from the recognition of an Article 5(5) PE cannot be dismissed as being inconsequential.

Implications

Companies with a global operating model with activities such as procurement, warehousing, sales and distribution are all affected by the changes to PE thresholds and should review their operating models for PE risk in light of the Report and evaluate the need for measures to address the risk. They should also stay informed about PE developments in the countries where they operate or invest, in particular the implementation by jurisdictions of the changes to Article 5 provided in the Final Report through the multilateral instrument (MLI).

The Report is relevant not only to OECD member countries, but to all members of the IF on BEPS (currently 113 jurisdictions). However, as the Report states, it should be noted that the proposed analysis under the AOA approach should not be understood as representing the only appropriate approach to attributing profits to a PE. Many tax treaties contain a version of Article 7 that does not require the use of the AOA. In cases governed by those treaties, the method of attributing profits to a PE for the purpose of Article 7 of the applicable treaty might be a function of the interrelation between the treaty and the domestic law of the jurisdiction where the PE is located. Thus, a case-by-case analysis is required.

Lastly, the Report states that changes to the definition of PE in Article 5 of the OECD MTC did not require substantive modifications to the existing rules and guidance on attribution of profits to PEs under Article 7 of the OECD MTC. Hence, the guidance set forth in the Report is of relevance also to pre-BEPS cases.

Endnotes

2. See EY Global Tax Alert, OECD releases final report on preventing the artificial avoidance of permanent establishment status under Action 7, dated 19 October 2015.
3. See EY Global Tax Alert, OECD releases discussion drafts on profit splits, attribution of profits to permanent establishments and conforming amendments to OECD Chapter IX on business restructurings, dated 14 July 2016.
4. See EY Global Tax Alert, OECD releases revised discussion drafts on profits splits and attribution of profits to permanent establishments, dated 26 June 2017.
5. See EY Global Tax Alert, OECD holds second public consultation on attribution of profits to PEs and profit splits, dated 8 November 2017.
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