Profit allocation to deemed PEs

Herbert Wehrmann, Tax Manager Heerema Marine Contractors
Antonio Russo
Jurjen Bevers

BAKER & MCKENZIE
>>Ahead of Tax 2010

OECD authorised approach

Attribution of Profits to PEs – OECD authorised approach

Two-step analysis

- **Step 1:** Hypothesize the PE as a distinct and separate enterprise =>Identify the economically significant activities and responsibilities undertaken by the PE
- **Step 2:** Determine the remuneration of any dealings between the hypothesized enterprises applying Article 9 by analogy

Very similar to work carried out in transfer pricing

Attribution of Profits to PEs

– Step 1: Hypothesizing the PE as a distinct and separate enterprise
  – Functional and factual analysis
  – Attribution of risks
  – Attribution of assets
  – Attribution of free capital
  – Recognition of dealings

Attribution of Profits to PEs

– Step 1: Hypothesizing the PE as a distinct and separate enterprise (cont'd)

  – Functional and factual analysis

    – Identify the functions/ activities performed by the enterprise as a whole including the PE

    – Assess what significance they have in generating the profits of the business.

Attribution of Profits to PEs

– Step 1: Hypothesizing the PE as a distinct and separate enterprise (cont'd)

  – Attribution of risks

    – Risks follow functions => significant people functions

    – Issues regarding transfer of the management of the risk and transfer of the risk itself

Attribution of Profits to PEs

– Step 1: Hypothesizing the PE as a distinct and separate enterprise (cont’d)

– Attribution of assets

- “tax balance sheet” for the PE
- Attributing assets may not always result in the attribution of income produced by using the asset
- Tangible Assets: generally attributed to the “place of use”
- Intangible Assets: active decision-making regarding the taking on and management of the risks related to the intangible
  - Trade intangibles (internally developed or acquired)
  - Marketing intangibles

Attribution of Profits to PEs

– Step 1: Hypothesizing the PE as a distinct and separate enterprise (cont'd)

  – Attribution of free capital

    – Attributing creditworthiness to the PE

      – OECD approach: the PE generally enjoys the same creditworthiness attributable to the enterprise of which it is a part

      – Capital attribution and funding the operations of the PE

      – Stage 1 – Measuring the risk and valuing the assets attributed to the PE

      – Stage 2 - Attribute "free" capital

Attribution of Profits to PEs

– Step 1: Hypothesizing the PE as a distinct and separate enterprise (cont'd)

  – Recognition of dealings

    – Identify and determine the nature of the "internal dealings" between the PE and the rest of the enterprise of which the PE is a part

    – Issues related to the recognition of dealings

    – OECD: Greater scrutiny of documentation – a threshold needs to be passed before the dealing is accepted

Attribution of Profits to PEs

– Step 2: Determining the profits of the PE based upon a comparability analysis

  – Applying transfer pricing methods to attribute profits

  – Comparability analysis

    – OECD Guidelines (Chapter 1)

Deemed PEs

Deemed PEs

- Building site or construction or installation site
  - Duration test (not the place of business but rather the activity itself)
  - Threshold can be 3 to 12 month depending on tax treaty.
- Continental shelf activities
  - Activities in question are carried on in source for a period or periods in the aggregate of 30 days or more in any twelve month period.
- Leasing substantial equipment
  - Leased and used within one contracting state for more than12 months

Deemed PEs

- Differences between ‘normal’ and deemed PEs
  - Limited existence
  - No real fixed place of business
  - No separate commercial accounts
  - Focus on contract with third party
  - Consolidated project results

Deemed PEs

<u>Revised commentary on article 7 (published 10 april 2007)</u>

In paragraph 2 under 14 it is stated that:

"The paragraph incorporates the view that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with the rest of the enterprise, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle" discussed in the Commentary on Article 9. ***Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy".***

For the above described separate entity approach one can properly allocate the profits to the permanent establishment using the trading accounts of the permanent establishment as explained in paragraph 2 under 15:

*"**In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used to ascertain the profit properly attributable to that establishment"***

Deemed PEs

– Is it realistic to use the separate entity approach in relation to Deemed PEs?

– Can profits be attributed to a deemed PE using the Authorized OECD approach?

– Documentation requirements (commentary paragraph 2. under 24.)

– Alternatives

Deemed PEs

- Case Law (ATO ID 2009/21)
- Conclusion