Taxwize

Attribution of Profits to Permanent Establishments

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How do you Attribute Profits to a Permanent Establishment?

1. Opening

In BEPS Action 7 the OECD has recommended changes to Tax Treaties to prevent Artificial Avoidance of Permanent Establishment (PE) Status. Those changes will be made through Multi-Lateral Instrument (MLI). Among other things, the changes make the criteria for formation of Dependent Agency PE stricter.

So now, Post-BEPS and Post-MLI, we are more likely to be confronted with the formation of PE in Host Country, whereas in earlier times we were able to plan for avoidance of PE. When a PE gets formed it becomes necessary to attribute taxable profits to the PE. How do we attribute profits to a PE? That is the subject matter of this Article.

First, a general discussion on how profits are attributed to a PE, on basis of the Authorized OECD Approach, will be made. And then specific discussion on attributing profits to a Dependent Agency PE (DAPE) will be made to examine whether arm's length payment of remuneration (e.g. commission) to the Dependent Agent (DA) is enough or whether additional profits need to be attributed to DAPE? Whether we should adopt Single Taxpayer (DA remunerated at ALP) approach or Dual Taxpayer (DA remunerated at ALP + DAPE attributed additional profits) approach? We will examine that by looking at a simple numerical example.

In so doing I will share certain practical approaches. Also, we will look at the OECD 2010 Report on Attribution of Profits to PEs as well as the 'Additional Guidance issued by OECD in March 2018 on Attribution of Profits to PEs' in the wake of BEPS Action 7.

2. Attribution of Profits to a PE: Authorized OECD Approach

Under Article 7(2) of Tax Treaties the PE is hypothetically treated as a distinct and separate enterprise dealing independently with the Head Office (HO) or the Parent Enterprise (of which PE is a part). This is a hypothesis because actually a PE is not

legally and economically separate - like a Subsidiary is - and a PE, not being a separate legal entity, actually does not deal independently with the HO.

2.1. Step I: Functional and Factual Analysis

Because the PE is actually not a separate and independent entity, first we need to construct the PE as a hypothetical distinct and separate enterprise dealing independently with its HO. To do that the Authorized OECD Approach ('Step I + Step II' prescribed in OECD 2010 Report on Attribution of Profits to PEs) guides us that in Step I we should undertake a Functional and Factual Analysis (FFA), leading to:

i. The attribution to the PE of the contractual Rights and Obligations arising out of transactions (evidenced by contracts between the enterprise and external parties) between the enterprise of which the PE is a part and separate external enterprises;

ii. The identification of Significant People Functions relevant to the attribution of economic ownership of Assets to the PE;

iii. The identification of Significant People Functions relevant to the assumption of Risks, and the attribution of Risks to the PE;

iv. The identification of other Functions (or Activities) - in addition to the Significant People Functions relevant to the attribution of economic ownership of Assets and Significant People Functions relevant to the assumption of Risks - of the PE;

v. The recognition and determination of internal Dealings between the PE and other parts of the same enterprise (HO and other parts) that can appropriately be recognised; and

vi. The attribution of Capital based on the Assets and Risks attributed to the PE.

2.2. Step II: Determining the Profits of the PE as a Hypothesised Separate and Independent Enterprise based upon a Transfer Pricing Comparability Analysis

After constructing or setting up the PE as a Hypothetical Separate Enterprise we can then move to Step II of the Authorized OECD Approach to determine the Arm's Length Price of Internal Dealings (e.g. purchase of goods from HO for resale, sale of goods to HO, rendering service to HO, etc.) between the PE and the HO or Parent Entity (of which PE is a part).

In Step II the Internal Dealings, between the PE and the HO, recognized in step I, is priced at arm's length, assuming the PE and the HO (or rest of the enterprise of which it the PE is a part) to be independent of one another, as if the PE is an Associated Enterprise (AE) of the HO. The arm's length price of Internal Dealings is determined using Comparability Analysis applying the Most Appropriate Transfer Pricing Method.

We must keep in mind that in addition to the Internal Dealings with HO the PE may have transactions with other unrelated external enterprises as well as transactions with other related enterprises (AEs). In the case of transactions with unrelated enterprises (Arm's Length Parties) the PE's profits (or losses) attributable to its participation in those transactions (Arm's Length Transactions) can be computed directly. And the pricing on an arm's length basis of any transactions with AEs (other than HO), attributed to the PE, can be done separately by performing Transfer Pricing analysis.

The attribution of profits to a PE of an enterprise on an arm's length basis will follow from the calculation of the profits (or losses) from all its activities, including transactions with other unrelated external enterprises, transactions with related enterprises (with separate TP analysis) and internal dealings with other parts (HO) of the enterprise (under Step II of the Authorized OECD Approach). So, profits attributable to the PE from all its activities will be –

- Income and Expense with regard to dealings with third parties;
- Income and Expense with regard to dealings with AEs (other than HO) at ALP determined by making a TP analysis; and
- Income and Expense with regard to Internal Dealings with HO/Parent Entity (at ALP by virtue of Article 7 of Tax Treaties and determined by following Steps I and II of the Authorized OECD Approach).

3. Attribution of Risks to PE in Step I

The Functional and Factual Analysis, under Step I of Authorized OECD Approach, will initially attribute to the PE any risks inherent in, or created by, the PE's own Significant People Functions relevant to the assumption of risks.

The Significant People Functions relevant to the assumption of risks are those which require active decision-making with regard to the assumption and management of those risks – you may also refer to the '6 Step' framework for risk allocation given in OECD BEPS Action 8-10.

4. Attribution of Assets to PE in Step I

We need to determine which assets are "economically owned" and/or used by the PE and in what capacity. The factual position is that no one part (PE or HO) of an enterprise owns assets; they belong to the enterprise as a whole. So, it is necessary to find a means of attributing economic ownership of assets.

Assets generally are attributed to that part (PE or HO) of the enterprise which performs the Significant People Functions relevant to the determination of economic ownership of assets. The Functional and Factual Analysis will examine all the facts and circumstances to determine the extent to which the assets of the enterprise are used in the functions performed by the PE, including the factors to be taken into account to determine which part (PE or HO) of the enterprise is regarded as the economic owner of the assets.

There is broad consensus among the OECD member countries for applying *use as the basis* for attributing economic ownership of tangible assets. This is regarded as a pragmatic solution for attributing economic ownership of tangible assets.

The attribution of economic ownership of assets will have consequences for the attribution of capital and interest-bearing debt as well as the attribution of profit to the PE.

- Where a PE is treated as the economic owner of a tangible asset, it will typically be entitled to deductions for depreciation (in the case of depreciable assets) and interest (in the case where the asset is wholly or partly debt-financed).
- Where a PE is treated as the lessee of a tangible asset, it will typically be entitled to deductions in the nature of lease-rent.

4.1. The Attribution of Intangible Assets

(i) Internally Developed Trade Intangibles

If the PE performs Significant People Functions related to the internally developed intangibles, then the PE will be treated as economic owner of those intangibles.

The Significant People Functions relevant to the determination of the economic ownership of internally created intangibles are those which require active decision-making with regard to the taking on and management of individual risk and portfolios of risks associated with the R & D of intangible property.

(ii) Acquired Trade Intangibles

Just as with internally developed intangible property, the key question in determining economic ownership of acquired intangibles is where within the enterprise (PE or HO) the Significant People Functions related to active decision-making required for taking on and managing risks are undertaken. With regard to acquired intangibles, these functions might include the evaluating the acquired intangible, analyzing the performance of any required follow-on development activity, and evaluating and managing risks associated with deploying the intangible asset.

(iii) Marketing Intangibles

The principles of the Authorized OECD Approach can also be applied to questions regarding the attribution of income with respect to marketing intangibles. The fundamental principles as regards marketing intangibles are the same as for trade intangibles. The Significant People Functions relevant to the determination of economic ownership are likely to be those associated with the initial assumption and subsequent management of risks of the marketing intangibles. These may include, for example,

functions related to the creation of and control over branding strategies, trademark and trade name protection, and maintenance of established marketing intangibles.

5. Attribution of free capital

5.1. Capital Attribution and Funding the Operations of the PE

(1) Introduction: The importance of “free” capital

Enterprises require capital to fund day-to-day business activities, to create or acquire assets (tangible and intangible), and as explained in the previous section to assume the risks associated with an ongoing business (*e.g.* credit or market risk). Broadly, capital comes from three sources: (i) contributions of equity by shareholders; (ii) retained profits (including sometimes reserves, though practices among countries may vary); and (iii) borrowings.

Sources (i) and (ii) are referred to collectively as equity capital and source (iii) is debt capital. Under tax law, deductions are generally not given for payments made to equity holders, whereas deductions are generally available (subject to thin capitalisation rules, etc.) for payments of interest or interest equivalents to the holders of debt capital.

The term “free” capital (sources (i) and (ii)) is defined as an investment which does not give rise to an investment return in the nature of interest that is deductible for tax purposes under the rules of the host country of the PE. Because interest expense is generally deductible for tax purposes, it will be necessary to ensure an appropriate attribution of the enterprise’s “free” capital to a PE in order to ensure an arm’s length attribution of profits to the PE on deduction of interest.

Under the Authorized OECD Approach, the economic ownership of assets is attributed to a PE if the Significant People Functions relevant to the determination of economic ownership are performed in PE’s jurisdiction, and risks are attributed to a PE if the Significant People Functions relevant to the assumption and/or management of the risks are performed in PE’s jurisdiction. Once the Functional and Factual Analysis (of Step I) has attributed the appropriate assets and risks of the enterprise to the PE, the next stage in attributing an arm’s length amount of profits to the PE is to determine how

much of the enterprise's "free" capital is needed to cover those assets and to support the risks assumed. This process involves two stages. The first is to measure the risks and value the assets attributed to the PE. The second is to determine the "free" capital needed to support the risks and assets attributed to the PE.

5.1.1. Stage 1 - Measuring the Risk and valuing the Assets attributed to the PE

Enterprises that are not banks or not non-banking financial institutions (non-financial institutions) are less likely to measure risks and value assets for business purposes on a day-to-day basis and will not be subject to regulatory requirements requiring them to do so.

Where enterprises which are non-financial institutions do not measure risks, one possible approach would be to attribute capital to a PE by reference only to the assets attributed to the PE. This is because, for non-financial enterprises, more so than for financial enterprises where the role of capital is to support risk, the capital would primarily be serving a funding purpose and it is the assets that are being funded. There are a number of possible valuation options for assets.

To value assets the best option is to use the original purchase price or cost of the asset. This approach would appear to offer a number of advantages. Firstly, the borrowed amounts would bear a close relation to the historical value of assets funded by the borrowings. Secondly, the approach facilitates a consistent measurement of assets across jurisdictions (in particular where different accounting rules exist to determine the book value of assets) and thirdly it would be simpler to comply with than an approach requiring the periodical determination of the market value of assets.

5.1.2. Stage 2 - Determining the "free" capital needed to fund the Assets and support the Risks attributed to the PE

While the PE actually may not need to have "free" capital allotted to it (i.e. the PE may actually be funded entirely by debt), still under the Authorized OECD Approach the PE must be allocated an appropriate amount of "free" capital in order to support the functions it performs and the assets and risks attributed to it.

Accordingly, a management decision in the HO to allot a certain amount of capital to the PE, or to record capital on the books of the PE, is not determinative of the risks assumed by the PE and of the amount of "free" capital that is attributed under the Functional and Factual Analysis.

5.2. Attributing an appropriate amount of "free" capital and interest-bearing debt

The next issue is how to attribute an appropriate amount of "free" capital and interest-bearing debt to various parts of the enterprise.

The OECD 2010 Report describes a number of different possible approaches recognising that the attribution of "free" capital and interest-bearing debt to a PE is not an exact science. Following are three relevant approaches.

(1) The capital allocation approach

The capital allocation approach seeks to allocate an enterprise's actual "free" capital to a PE in accordance with the attribution of assets owned and risks assumed. Under this approach, "free" capital is allocated on the basis of the proportion of assets and risks attributed to the PE by the functional analysis. So if the PE has 10% of the enterprise's assets and/or risks the PE will be attributed 10% of the enterprise's "free" capital.

(2) Economic capital allocation approach

In the banking context another approach to allocating "free" capital has been suggested based not on regulatory measures of capital but by reference to economic capital. This approach can conform to the Authorized OECD Approach as it is explicitly based on measuring risks.

(3) Thin capitalisation approach

Another approach (generally followed in practice) would be to require that the PE has the same amount of "free" capital as would an independent enterprise carrying on the same or similar activities under the same or similar conditions in the host country of the PE, by undertaking a comparability analysis of such independent enterprises.

The functional and factual analysis would identify the assets and risks to be attributed to the PE and this would determine the amount of funding *per se* (*i.e.* without distinguishing between debt and "free" capital) that would be required by the PE. The next stage would be to determine the allocation of the funding into interest-bearing debt and "free" capital.

There are a number of factors relevant to the determination of an arm's length amount of debt and "free" capital for PEs. These include:

- The capital structure of the enterprise as a whole
- The range of actual capital structures of independent host country enterprises carrying on the same or similar activities as the PE under the same or similar conditions.

For non-financial enterprises it is useful in practice to focus on capital structure rather than on "free" capital in isolation. This would require us to determine first of all the arm's length amount of funding ("free" capital + interest-bearing debt) that should be attributed to the PE to support its functions, assets and risks. Then comparable Debt-to-Equity ratios in the host country could be used to determine which part of the arm's length funding should be made up of "free" capital and which part should be made up of interest-bearing debt. This approach, in practice, is generally followed because it is based on of Debt-to-Equity ratios of comparable enterprises.

The other methods suggested by the Authorized OECD Approach are (4) Safe harbour approach, (5) Other methods and (6) Attribution of capital to the PE of a thinly capitalised enterprise. But, as stated, in practice the Debt-to-Equity ratios of comparable enterprises generally provide an acceptable measure of "free" capital plus interest-bearing debt.

6. Approaches to Attribute Interest Costs to PEs

PEs generally enjoy the same creditworthiness as the enterprise of which they are a part (the same is not necessarily true of a Subsidiary and its Parent Company). Because the external lenders evaluate creditworthiness of the enterprise (of which the

PE is a part) as a whole, the PE is attributed the creditworthiness of the enterprise as a whole.

Remember that there is no scope for the rest of the enterprise guaranteeing the PE's creditworthiness or for the PE to guarantee the creditworthiness of the rest of the enterprise – they have the same creditworthiness and are not legally separable entities.

6.1. Tracing Approach and Fungibility Approach

There are in principle two approaches under the Authorized OECD Approach for attributing the external interest expense of the enterprise to its PE: (1) a tracing approach, and (2) a fungibility approach. A number of countries currently use some variation of these approaches.

Under a "pure" tracing approach, any internal movements of funds provided to a PE are traced back to the original provision of funds by third parties. The interest rate on the funds provided to the PE are determined to be the same as the actual rate incurred by the enterprise to the third party provider of funds.

Under a "pure" fungibility approach, money borrowed by a PE of an enterprise is regarded as contributing to the whole enterprise's funding needs, and not simply to that particular PE's funding needs. This approach ignores the actual movements of funds within the enterprise and any payments of inter-branch or head office/branch interest. Each PE is allocated a portion of the whole enterprise's actual interest expense paid to third parties on some pre-determined basis.

6.2. Debt-to-Equity ratios of comparable enterprises

In practice, the Debt-to-Equity ratios of enterprises comparable to PEs will give the "free" capital plus interest-bearing debt. Then the tracing approach described above will be applied to determine the actual interest-bearing funds provided to the PE. If those funds are more than interest-bearing debt allocated (on basis of comparable Debt-to-Equity ratio) to the PE then we attribute to the PE proportionate interest cost based on the actual interest paid to external lenders. And if the funds actually provided by HO to the PE are less than the interest-bearing debt allocated to the PE then we attribute to

the PE additional interest cost - in addition to actual interest paid to external lenders - worked out on basis of rate of interest on loan in host country or home country (whichever is cheaper because the Foreign Enterprise has access to both markets) based on credit rating of PE.

7. Attribution of Profit to Dependent Agent PEs

In cases where a PE arises from the activities of a Dependent Agent (DA), the host country will have taxing rights over two different legal entities - the DA enterprise (a resident of the host country) and the DAPE (Dependent Agent PE of a Non-Resident enterprise). If the DA and the Non-Resident enterprise are Associated Enterprises (AEs) then for transactions between the AEs (the DA enterprise and the Non-Resident enterprise), Article 9 will be the relevant article in determining whether the transactions between the AEs - *e.g.* commission paid to the DA based on volume of product sold - are conducted on an arm's length basis.

In respect of the DAPE, the issue to be addressed is one of determining the profits of the Non-Resident enterprise which are attributable to its DAPE in the host country (*i.e.* as a result of activities which have been carried out by the DA enterprise on the Non-Resident enterprise's behalf). In this situation, Article 7 will be the relevant article.

Where a DAPE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. The answer is to follow the same principles as used for other types of PEs, for to do otherwise would be inconsistent with Article 7 and the arm's length principle. Under the first step of the Authorized OECD Approach a Functional and Factual Analysis determines the functions which DA enterprise undertakes both on its own account and on behalf of the Non-Resident enterprise. On the one hand the DA enterprise will be rewarded for the service it provides to the Non-Resident enterprise. On the other hand, the DAPE will be attributed the assets and risks of the Non-Resident enterprise relating to the functions performed by the DA enterprise on behalf of the Non-Resident. DAPE will also be attributed sufficient capital, including "free" capital and interest-bearing debt, to support those assets and risks.

On the basis of those assets, risks and capital the Authorized OECD Approach then attributes profits to the DAPE. The analysis also focuses on the nature of the functions carried out by the DA on behalf of the Non-Resident enterprise and in particular whether the DA undertakes the Significant People Functions relevant to the assuming and/or managing of risks or to determining the economic ownership of assets. In this regard an analysis of the skills and expertise of the employees of the DA enterprise is likely to be instructive, for example in determining whether negotiating or risk management functions are being performed by the DA on behalf of the Non-Resident enterprise.

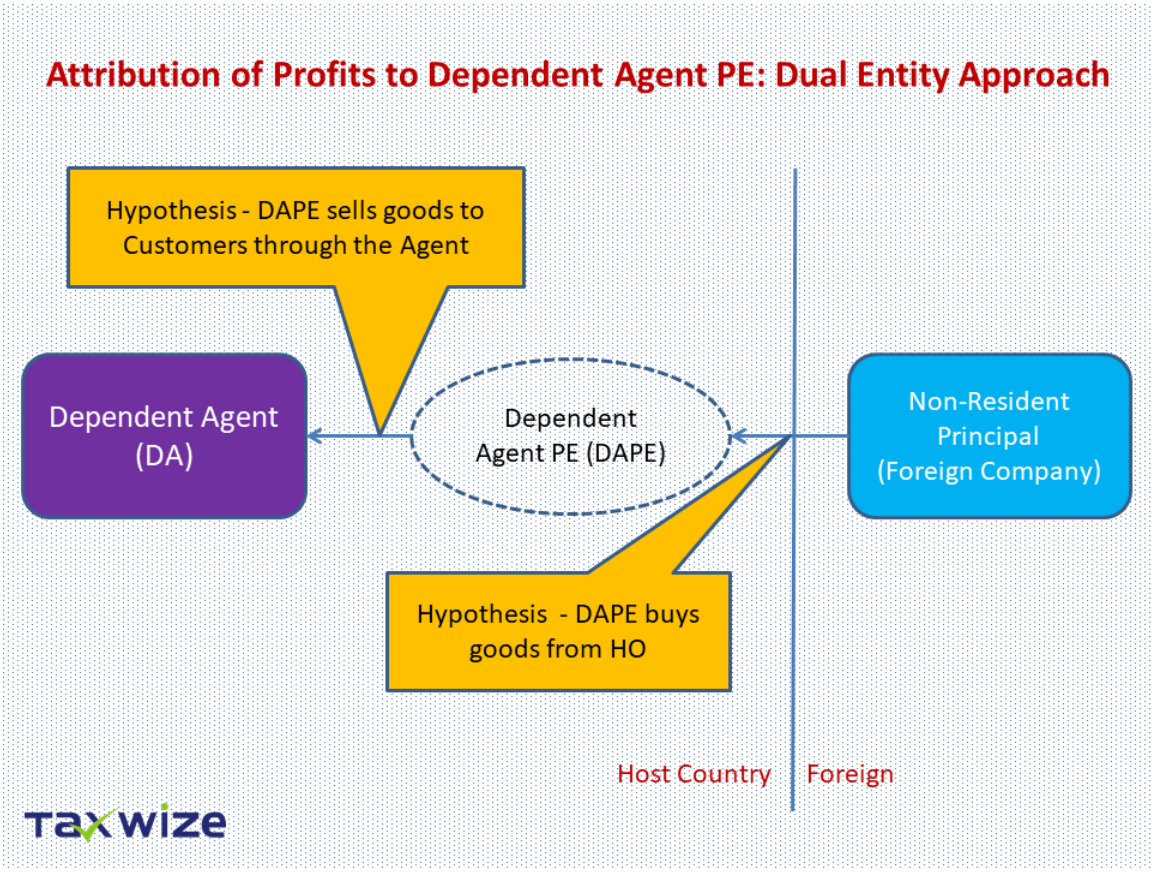
In general, the Functional and Factual Analysis focuses on the nature of the functions carried out and in particular whether the above-mentioned Significant People Functions are carried out by the DA enterprise on behalf of the Non-Resident enterprise, such that the associated assets and risk of the Non-Resident enterprise should be attributed to its DAPE (in which case the profits associated with those assets and risks would be taxable in the host country) rather than to another part of the Non-Resident enterprise (in which case the associated profits would not be taxable in the host country).

It may happen that the DA enterprise does not perform the Significant People Functions relevant to the assumption and/or management of risk or the Significant People Functions relevant to the determination of economic ownership of assets, and if it does not then the attribution of the assets, risks and profits to the DAPE is correspondingly reduced or eliminated.

In calculating the profits attributable to the DAPE it would be necessary to determine and deduct an arm's length reward to the DA enterprise (taking into account its assets and its risks if any) for the services it provides to the Non-Resident enterprise. Issues arise as to whether there would remain any profits to be attributed to the DAPE after an arm's length reward has been paid to the DA enterprise. In accordance with the principles outlined above (and illustrated in the example below) the answer is that it depends on the precise facts and circumstances as revealed by the Functional and Factual Analysis of the DA and the Non-Resident enterprise. However, the Authorized OECD Approach recognises that profits can be attributed to the DAPE in appropriate circumstances.

7.1. Single vs Dual Taxpayer

The difference between the two approaches (Single vs Dual Taxpayer) is that under the "Single Taxpayer" approach certain risks (e.g. inventory risk, credit risk, etc.), which are legally borne by the Non-Resident enterprise, can never be attributed to the Dependent Agent PE of the Non-Resident enterprise, whilst the Authorized OECD Approach would attribute those risks to the Dependent Agent PE for tax purposes but if, and only if, the Dependent Agent performed the Significant People Functions relevant to the assumption and/or subsequent management of those risks.



8. Numerical Example of Attribution of Profits to DAPE

We must understand that the functions of the DA, which lead to creation of DAPE of a Non-Resident Principal in the host jurisdiction under Article 5(5) of the Tax Treaty, namely *inter alia* securing of orders or conclusion of contracts or habitually playing the principal role in concluding contracts on behalf of the Non-Resident Principal, are different from those which might trigger attribution of profits to the DAPE under Article 7.

For attribution of profits, the DA must carry out Significant People Functions, on behalf of the Non-Resident Principal, related to the assumption of risks and economic ownership of assets.

For instance, carrying out of Significant People Functions for inventory and debtors means planning for the level of inventory to be maintained for timely delivery, taking key decisions around credit ratings and credit terms for customers, assuming responsibility for collection of receivables from customers, etc., though the debtors and inventories would always legally belong to the Non-Resident Principal under the agency model unlike in buy-sell distribution model.

Now let us take a case where the DA carries out Significant People Functions, on behalf of the Non-Resident Principal, in the host country around debtors and inventory. So, a need may arise to attribute profits to the DAPE of the Non-Resident Principal over and above the remuneration received by the DA solely for its agency functions, being the profits relating to the assumption of risks with respect to debtors and inventory. For our example let us assume the following facts:

- ForiegnCo, a foreign company, directly sells products worth US$ 100 million to customers in the Host Country;
- All selling activities in the Host Country are undertaken by SubCo (DA), being an agent and subsidiary of ForiegnCo;
- SubCo creates a DAPE of ForiegnCo in the Host Country, through securing of orders/concluding of contracts/playing principal role in concluding contracts;
- Product ordering, delivery, monitoring of inventory, evaluation of creditworthiness of customers, etc. functions are performed by SubCo;
- Inventory and debtors management functions are undertaken by SubCo in the Host Country;
- Inventory and debtors are owned by ForiegnCo under all circumstances, though they are managed by SubCo;
- SubCo is remunerated on a Cost plus Mark-up (12%) model for its agency services including inventory and debtors management functions;

- Total Costs of SubCo are US$ 10 million; thus Sub Co earns Net Profit of US$ 1.20 million; Total Revenue of Sub Co is US$ 11.20 million; and
- Inventory worth US$ 1.50 million becomes obsolete; and debtors worth US$ 2.50 million had to be written off as bad-debt.

Since the DA, namely SubCo, performs Significant People Functions around debtors and inventory, commensurate to that of a Distributor, the Host Country deserves to levy tax on profits, which are commensurate to the entirety of such distribution functions. Those profits are the aggregate of remuneration receivable by SubCo (in the capacity of an agent, from ForeignCo); and the additional profits attributable to the DAPE (of ForeignCo, created through SubCo) for the distribution functions.

The Internal Dealing in this case is purchase of goods (for resale through DA) by DAPE from the HO, and so, DAPE acts as a distributor.

A robust TP analysis results in the following arm's length profits for the DAPE as captured in its functional, asset and risk (FAR) profile, as outlined in the example above:

Profit & Loss A/c for 1 April 2018 to 31 March 2019

Particulars	**US$ million**	**US$ million**
Sales Turnover		100.00
Less : Cost of goods sold (COGS) (Balancing Figure)		82.80
Gross Profit (Balancing Figure)		17.20
Less: Selling and general administrative (SG&A) expenses -		

Fees paid to DA	11.20	
Stock obsolescence	1.50	
Bad debts written off	2.50	15.20
Net Profit (based on TNMM analysis)		2.00

The DAPE will deduct the arm's length remuneration (10 million + 1.2 million) paid to the DA. The DAPE will also bear the inventory risk and the credit risk. Of course, the DA will be remunerated for functions carried out to manage inventory and creditworthiness of customers. But the risk will be borne by DAPE. The Net Profit under TNMM analysis comes to 2%, which is the median of range of PLIs (Operating Profit/Sales) of comparable distributors. The balancing figure of Gross Profit works out to 17.20 million (15.20 + 2.00). The total profit taxed in the host country comes to 1.20 million in DA's hands and 2 million in DAPE's hands.

In the context of the above Example, the Two Steps of the Authorized OECD Approach are highlighted below.

8.1. Step I: Functional and factual Analysis

i. Rights and obligations of sales contract with customers and agency contract with DA are attributed to DAPE.

ii. The economic ownership of inventory and sundry debtors (sales to customers) is attributed to the PE;

iii. The inventory risk and credit risk are attributed to the PE;

iv. The other Functions (dealing with DA for selling goods) are attributed to the PE;

v. The recognition and determination of Internal Dealings of purchase of goods by the PE from the HO is attributed to DAPE; and

vi. The attribution of Capital based on the Assets and Risks attributed to the PE - the DAPE is attributed “free” capital and interest-bearing debt on basis of Debt-to-Equity ratios of comparable distributors.

Assets, that is, inventory in hands of DA and sundry debtors pertaining to goods sold to customers in the Host Country, are attributed to DAPE. Then, on basis of Accounts Payable of comparable distributors and Debt-to-Equity ratios of comparable distributors, “free” capital and interest-bearing debt is attributed to DAPE.

8.2. Step II: Arm’s Length Pricing of Internal Dealing of purchase of goods by the PE from the HO

TNMM is applied to find the PLI (Operating Profit/Sales) of comparable distributors having comparable FAR profile as the DAPE. The Arm’s Length PLI of comparable distributors comes to 2%. And that leads to profit of US$ 2 million attributed to DAPE.

[Note: *If the inventory risk and credit risk in the Host Country are managed by the Non-Resident Principal, and not by the DA, then we need not attribute any profit to the DAPE. In that situation the arm’s length remuneration paid to DA will be enough.****]***

8.3. Interest-Cost

Additionally, interest-cost can be attributed. Tracing approach will not work here, because there is no movement of funds from HO to DAPE, like normally happens in Branch PE or Project Installation PE. So, we will take arm’s length (comparable distributors’) Debt-to-Equity ratios. That will give “free” capital and the interest-bearing debt. Coming to the rate of interest, the Credit Rating of the PE will be same as that of the Non-Resident Enterprises whose part the PE is. This is made clear by the OECD in its 2010 Report. This is so even if otherwise the stand-alone Credit Rating of the PE may be different. Based on the Non-Resident Enterprise’s Credit Rating we can determine the rate of interest (Home or Host Country Loan Market wherever the loan is cheaper) and consequently the interest-cost of the PE.

8.4. Marketing Intangibles

Here we assume that, under the Agency arrangement, which is different from a Buy-Sell Distributorship arrangement, the Marketing intangibles (Brand, Logo, Trademark, etc.) are managed by Non-Resident Principle from Home Country. Generally, the Significant People Functions relevant to the determination of Economic Ownership (PE or HO or Both) of Marketing Intangibles are likely to be those associated with the initial assumption and subsequent management of risks of the Marketing Intangibles. These may include, for example, functions related to the creation of and control over branding strategies, trademark and trade name protection, maintenance of established Marketing Intangibles and promoting the Intangibles. These functions, in our example, are assumed to be performed by the Non-Resident Principle from Home Country. So, the Non-Resident Principle is the Economic Owner and also uses the Marketing Intangibles. No Royalty payments by PE to HO, therefore, arise in the present case.

In other cases the PE might use the Marketing Intangibles either as Economic Owner of those intangibles or on paying Royalty to the HO, the Economic Owner.

8.5. Tangible Assets

If there are tangible assets used by the PE then the PE can claim Depreciation if the PE is found to be the Economic Owner (depending upon Significant People Functions related to management of those assets); or else, the PE can claim Rent for using tangible assets owned by the HO.

9. Conclusion

In a Post-BEPS and Post-MLI world, we are more likely to be confronted with the formation of PE in Host Country, whereas in earlier times we were able to plan for avoidance of PE. When a PE gets formed it becomes necessary to attribute taxable profits to the PE. To do that reference to the OECD 2010 Report on Attribution of Profits to PEs as well as the ‘Additional Guidance issued by OECD in March 2018 on Attribution of Profits to PEs’ in the wake of BEPS Action 7 is necessary.

Because the PE is actually not a separate and independent entity, first we need to construct the PE as a hypothetical distinct and separate enterprise dealing

independently with its HO. To do that the Authorized OECD Approach (Step I + Step II) guides us that in Step I we should undertake a Functional and Factual Analysis (FFA) to *inter alia* determine Internal Dealings between the PE and the HO. Those Internal Dealings are priced at arm's length in Step II using Comparability Analysis applying the Most Appropriate Transfer Pricing Method.

The attribution of profits to a PE of an enterprise on an arm's length basis will follow from the calculation of the profits (or losses) from all its activities, including transactions with other unrelated external enterprises, transactions with related enterprises (with separate TP analysis) and internal dealings with other parts (HO) of the enterprise (under Step II of the Authorized OECD Approach).

Under the Authorized OECD Approach, the economic ownership of assets is attributed to a PE if the Significant People Functions relevant to the determination of economic ownership are performed in PE's jurisdiction, and risks are attributed to a PE if the Significant People Functions relevant to the assumption and/or management of the risks are performed in PE's jurisdiction. Once the Functional and Factual Analysis (of Step I) has attributed the appropriate assets and risks of the enterprise to the PE, the next stage in attributing an arm's length amount of profits to the PE is to determine how much of the enterprise's "free" capital is needed to cover those assets and to support the risks assumed.

To work out the interest-cost we need to determine first of all the arm's length amount of funding ("free" capital + interest-bearing debt) that should be attributed to the PE to support its functions, assets and risks. Then comparable Debt-to-Equity ratios in the host country could be used to determine which part of the arm's length funding should be made up of "free" capital and which part should be made up of interest-bearing debt.

As regards Dependent Agent PE (DAPE), additional profits, over and above arm's length remuneration to DA, can be attributed when the DA performs Significant People Functions around debtors and inventory on behalf of the Non-Resident Principal.

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