OECD Launches Consultation on Attributing Profits for Tax Purposes to Permanent Establishments

Attributing profits to a permanent establishment ("PE") is one of the most conceptually difficult and practically complex issues in international business taxation and the subject of wide variations in individual OECD countries’ approaches. In an effort to establish a consensus on this issue, the OECD has launched a consultation process involving governments and businesses.

The main use of the concept of a permanent establishment in international tax is to determine the right of a country, under tax treaties, to tax the profits of an enterprise of the other Contracting State. Under the OECD Model Tax Convention, a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein. The definition of the term "permanent establishment" found in the Convention brings out its essential characteristic, i.e. a distinct "situs", a "fixed place of business". The work of the OECD on attributing profits to a PE seeks to clarify what profits are taxable when such a permanent establishment exists.

As a first step in its consultation process, the OECD has developed a working hypothesis as to the preferred approach for attributing profits to a PE. In doing so, the OECD examined the feasibility of treating a PE as a hypothetical distinct and separate enterprise and reviewed ways in which the principles of the 1995 OECD Transfer Pricing Guidelines could be applied by analogy in order to attribute profits to a PE in accordance with the "arm’s length principle". It tested the working hypothesis by considering how it applies in practice to the attribution of profits to PEs in general and in particular to PEs of banking enterprises.

The preliminary results of this testing are contained in a "Discussion draft" that has been released for public comment and which can be found on the OECD website (http://www.oecd.org/daf/ctp2a/tp) along with responses received so far from the business community, banking associations and other representative bodies, reflecting a diversity of interest and views. The draft was the basis for discussions at a meeting bringing together more than 60 senior officials from OECD countries and some 60 representatives of the global business community in Paris on 11-12 April 2002.

Discussions at the Paris meeting focused mainly on banking issues, especially issues related to capital allocation, funding and the booking of loans. Three case studies were examined in relation to the practical implications of functional analysis, recognition of dealings and characterisation of dealings. The case studies and the agenda of the meeting are also available on the OECD website.

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• Case A discussed how to recognise and to characterise dealings between the head office and the PE in the case where a PE is engaged in Research and Development activities leading to the development of intangible property rights.

• Case B related to the importance of the sales/trading function when attributing financial assets.

• Case C addressed the issue of risk management and risk transfer among the various parts of the enterprise.

Business representatives at the Paris meeting welcomed the opportunity to comment constructively on the drafts and encouraged OECD governments to reach a consensus on these difficult issues. They universally endorsed the prospect of working with the OECD to reach this goal. The Chair of the Fiscal Committee of the Business and Industry Advisory Committee to the OECD, Richard Hammer, said "It is essential in resolving difficult conceptual and technical international taxation issues such as the ones discussed at the consultation, that the international business community join with the representatives of governments to produce well reasoned solutions. They must be practicable and administrable for tax payers and tax administrators alike and fulfil the paramount goal of international tax policy - the elimination of double taxation."

Closing the consultation, David Grecian, the Chair of the OECD Working Party that is dealing with this issue, stressed that dialogue with business is an essential element in the search for a consensus amongst governments on the interpretation and practical application of tax rules that take account of modern-day multinational operations and trade.

For further information, journalists are invited to contact John Neighbour in the OECD’s Centre for Tax Policy and Administration (tel. [33] 1 45 24 96 37 or john.neighbour@oecd.org).