Day 5, Session 4

Attribution of Profits to Permanent Establishments Workshop

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Dr. Raphael Holzinger

*Partner and Head of Tax, **Grant Thornton Austria***

*Post-Doctoral Research and Teaching Fellow, Institute for Austrian and International Tax Law, **WU***

Grant Thornton

Agenda

I. Introduction on the Levels of Applicability and Application of the Principles of Profit Attribution
II. Case Study 1 – The Relevance of Significant People Functions for the Attribution of Profits to PEs
III. Case Study 2 – Applying the Profit Split Method in a PE Setting
IV. Case Study 3 – Profit Attribution to Dependent Agency PEs
V. Case Study 4 – Sourcing Activities

Section I

Introduction on the levels of applicability and application of the principles of profit attribution

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Introduction on the levels of <u>applicability</u> and <u>application</u> of the principles of profit attribution

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Art 7 World

1 Is there a PE in light of Art 5 and Art 3 OECD Model 2017?

(Pre-step: "hypothesizing the PE as a separate and independent enterprise")

2 Is there a priceable dealing between HQ and PE in light of Art 7 OECD Model 2017?

3 How to price the dealing between HQ and PE in light of Art 7 OECD Model 2017?

Level of **Applicability** of Principles of Profit Attribution

(1)

Level of **Application** of Principles of Profit Attribution

(2), (3)

Art 9 World

1 Are there associated enterprises in light of Art 9 and Art 3 OECD Model 2017?

2 Is there a priceable transaction between associated enterprises in light of Art 9 OECD Model 2017?

3 How to price the transaction between associated enterprises in light of Art 9 OECD Model 2017?

Section II

Case Study 1 – The relevance of significant people functions for the attribution of profits to PEs

WU WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Case Study 1
The relevance of significant people functions for the attribution of profits to PEs

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Facts of the case

- **ACo**, a corporate entity resident in Country A, is a well-known online retailer of different household products.
- In order to market its products in Country B, ACo **owns a server** located in Country B. The server is located at a big server farm of an external server provider.
- In addition to that, ACo has a **country-specific app** for Country B in order to safeguard optimized sales in that region. This app is hosted via the server located at the said server farm in country B.
- In **Country A, ACo runs a big warehouse**. Once the sales via the country-specific app for Country B are made, the products are **directly transported from the warehouse in Country A to the customers in Country B** by third party logistic providers.
- **ACo has a huge workforce in Country A** consisting of warehouse workers, administration employees, management, programmers etc. **In Country B, ACo does not have any employees**.
- Based upon the facts of the case ACo contemplates whether the sales in Country B should be generated:
  - either directly by ACo or
  - by a subsidiary of ACo that should be set-up in Country B (ie BCo).
- ACo's considerations are purely business driven and are not meant to result in BEPS: However, ACo's management wants to know the tax implications of the two possibilities mentioned above.

Other considerations

Consolidated Turnover	EUR 100.000.000,00
Consolidated COGS	EUR 50.000.000,00
Consolidated OPEX	EUR 30.000.000,00
Consolidated EBIT	**EUR 20.000.000,00**

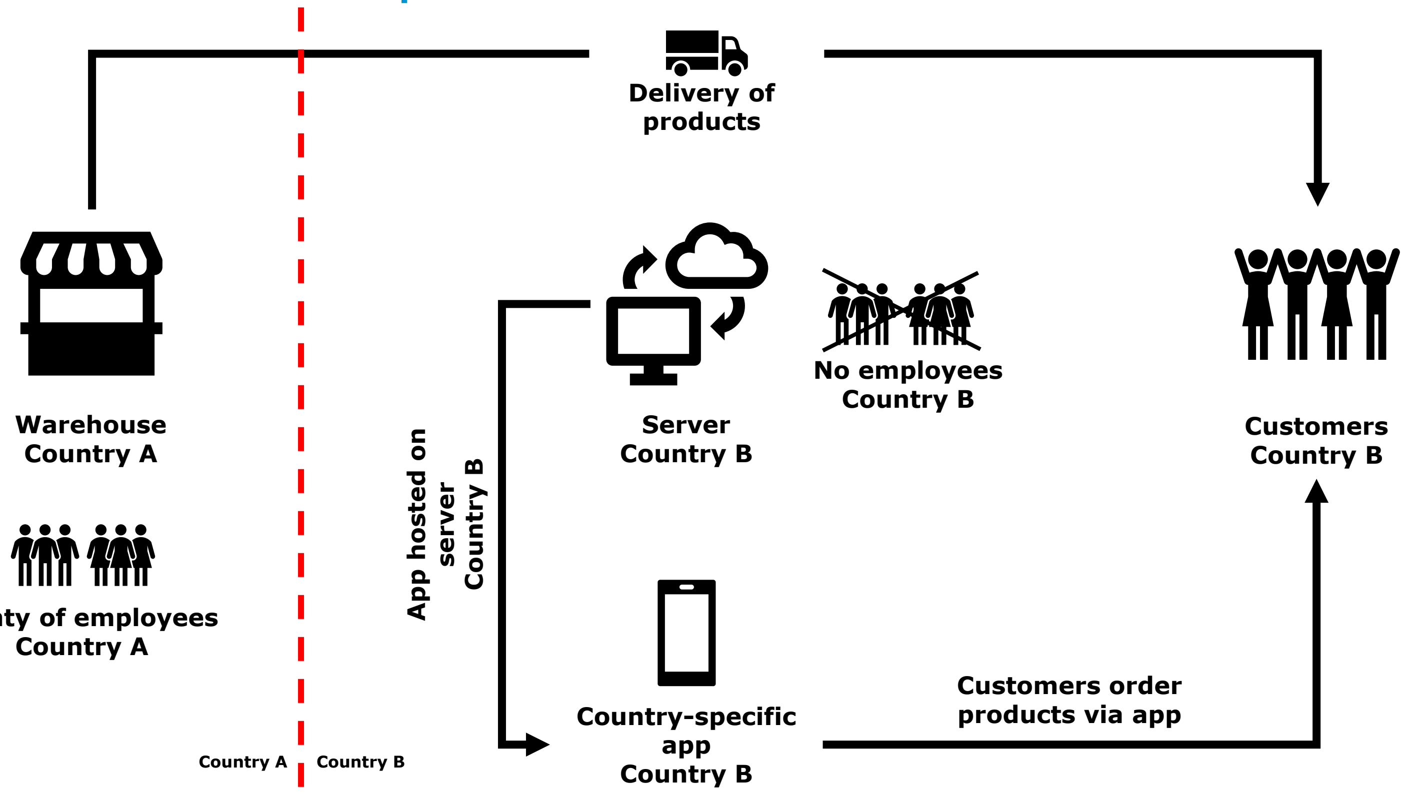
- Turnover split amongst Country A and Country B (80 mln to 20 mln)
- Costs for the server in Country B sum up to EUR 1 mln per year
- Costs for the country-specific app sum up to EUR 1 mln per year
- According to a benchmarking study carried out by ACo, the FCMU for an IT service provider would be 10 %.

Case Study 1

The relevance of significant people functions for the attribution of profits to PEs

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Graphical illustration of fact pattern



EQUIS ACCREDITED AACSB ACCREDITED AMBA ACCREDITED

Case Study 1
The relevance of significant people functions for the attribution of profits to PEs

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Questions

1. Assuming that **ACo directly markets Country B on its own** ➔ which state has the taxing right among the profits resulting from the activities carried out in Country B?
2. Assuming that the **server located in Country B** results in the creation of a **Permanent Establishment** in that Country ➔ which profits may be attributed to the PE in light of Art 7 OECD Model 2017 (AOA)?
   - **Option A**: A profit resulting from a <u>service</u> (ie operating a server) ➔ eg a certain (net) cost plus mark-up
   - **Option B**: A profit resulting from a <u>distribution activity</u>? ➔ eg a certain operating margin based on the sales in Country B
   - **Option C**: <u>No profit</u> at all
3. Assuming that **ACo** does not rent a server in Country B, but rather **uses a server located in Country A** ➔ does Country B still (theoretically) have a taxing right resulting from the country-specific app?
4. Assuming that **ACo sets-up a subsidiary in Country B (ie BCo)** ➔ which Country has the taxing rights among the profits resulting form the activities carried out in Country B (certain exit taxation issues can be neglected)?
5. Assuming that ACo **sets-up a subsidiary in Country B (ie BCo)** ➔ which profits may be attributed to BCo in light of Art 9 OECD Model 2017?
   - **Option A**: A profit resulting from a <u>service</u> (ie operating a server) ➔ eg a certain (net) cost plus mark-up
   - **Option B**: A profit resulting from a <u>distribution activity</u>? ➔ eg a certain operating margin based on the sales in Country B
   - **Option C**: <u>No profit</u> at all
6. Is there a **neutrality of legal forms** on the **level of <u>application</u>** of the principles of profit attribution on the merits?

Case Study 1
The relevance of significant people functions for the attribution of profits to PEs

Question 1

Assuming that ACo directly markets Country B on its own ➔ which state has the taxing right among the profits resulting from the activities carried out in Country B?

Suggested Solution Question 1

- The server located in Country B is to be qualified as a fixed place of business in light of Article 5(1) OECD Model 2017, since
  - it is **fixed**
  - it is **permanent**
  - ACo **carries out its business via the server** in Country B (through which the country-specific app is hosted and through which the sales in Country B are generated)
  - the rented server is **at the disposal** of ACo.

- Therefore, **Country B has the taxing right** concerning the business profits attributable to the PE in light of Article 7 OECD Model 2017.

The relevance of significant people functions for the attribution of profits to PEs

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Question 2

Assuming that the server located in Country B results in the creation of a Permanent Establishment in that Country ➔ which profits may be attributed to the PE in light of Art 7 OECD Model 2017 (AOA)?

- **Option A**: A profit resulting from a service (ie operating a server) ➔ eg a certain (net) cost plus mark-up
- **Option B**: A profit resulting from a distribution activity? ➔ eg a certain operating margin based on the sales in Country B
- **Option C**: No profit at all

Suggested Solution Question 2

- According to the facts of the case, ACo does **not have any employees** in Country B.
- Since the profit attribution between the HQ and the PE has to be carried out in light of Article 7 OECD Model 2017, the **principles of the AOA** are to be applied.
- According to the first step of the AOA (ie the "Hypothetisation of the PE as a separate and independent enterprise") **significant people functions** carried out in Country B are the **trigger for all attributions** (ie attribution of assets, risks, capital and profits [or losses]).
- Based on the facts of the case, **ACo does not have any employees in Country B**. Accordingly, in light of the principles laid down in the AOA, the **key trigger of any attribution is missing**, meaning that **neither assets, risks, capital nor profits can be attributed** to the PE in Country B.
- Therefore, even though Country B (theoretically) has a taxing right, since a PE according to Art 5 OECD Model 2017 is located on its territory, **no profits (or losses) can be attributed to this PE in light of Article 7 OECD Model 2017**, due to the lack of significant people functions carried out on its territory.

Case Study 1
The relevance of significant people functions for the attribution of profits to PEs

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Question 3

Assuming that ACo does have a server in Country B, but rather uses a server located in Country A ➔ does Country B still (theoretically) have a taxing right resulting from the country-specific app?

Suggested Solution Question 3

- In comparison to question 1, **ACo does not have any physical presence any more in Country B**.
- Based upon the OECD Model 2017 (and older versions of the OECD Model), the **lack of "physical presence"** essentially **hinders the creation of any kind of PE** according to Art 5 OECD Model.
- Since there is **just a country-specific app**, **no PE is created at the territory of Country B**, due to the fact that the factual characteristic of a "**fixed establishment**" is **not given** (all other factual characteristics of Art 5[1] are given).
- Based on that, **Country B would not even theoretically have a taxing right**.

Case Study 1
The relevance of significant people functions for the attribution of profits to PEs

Question 4

Assuming that ACo sets-up a subsidiary in Country B (ie BCo) ➔ which Country has the taxing rights among the profits resulting form the activities carried out in Country B (certain exit taxation issues can be neglected)?

Suggested Solution Question 4

- In light of this questions it is assumed that **BCo (a separate legal entity) was established in Country B** in order to carry out different tasks.
- Since **BCo** is a **separate legal entity**, it is to be seen as a "**company**" in light of Article 3(1)(b) OECD Model 2017 as well as an "**associated enterprise**" in light of Article 9(1) in connection with Article 3(1)(c) and (d) OECD Model 2017.
- Accordingly, **Country B** is to be seen as the residence state of BCo, meaning that is **has the taxing right** among the (arm's length) profits of BCo.

Case Study 1
The relevance of significant people functions for the attribution of profits to PEs

Question 5

Assuming that ACo sets-up a subsidiary in Country B (ie BCo) ➔ which profits may be attributed to BCo in light of Art 9 OECD Model 2017?

- **Option A:** A profit resulting from a service (ie operating a server and an app) ➔ eg a certain (net) cost plus mark-up
- **Option B:** A profit resulting from a distribution activity? ➔ eg a certain operating margin based on the sales in Country B
- **Option C:** No profit at all

Suggested Solution Question 5

- In light of this questions it is assumed that BCo (a separate legal entity) was established in Country B. BCo owns a server and reports the associated costs (ie EUR 1.000.000,00) in its profit and loss accounts.
- What is more, BCo operates the country-specific app in Country B (for the purposes of this case study it can be assumed that the app requires different adaptions every year). Since BCo does not have own employees those adaptions are carried out by external providers. The costs for the country-specific app are to be borne by BCo; accordingly, the associated costs (ie EUR 1.000.000,00) are reported in the profit and loss accounts of BCo as well.
- Based upon the facts of the case, it can be assumed that BCo acts as a service provider for ACo, so that ACo can generate sales in Country B. Therefore, BCo is to be remunerated for the services provided to ACo, most likely based upon the application of the (net) cost plus method.
- Analysing the cost base of ACo, the costs resulting from the adaption of the country-specific app are to be qualified as a pass-through item from a transfer pricing perspective. Such pass-through items generally do not allow for the application of a mark-up from a transfer pricing perspective, since BCo essentially did not add any value. Regarding the costs associated to the ownership and provision of the server to ACo, BCo's costs do not have a comparable character, meaning that an arm's length mark-up is to be applied.
- Therefore, **BCo generates an arm's length profit of 100.000,00** (ie 10 % of EUR 1.000.000,00) in the case at hand.

Case Study 1
The relevance of significant people functions for the attribution of profits to PEs

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Question 6

Is there a neutrality of legal forms on the level of application of the principles of profit attribution on the merits?

Suggested Solution Question 6

- As shown in the case study, the notion of **significant <u>people</u> functions** can eventually result in diverging outcomes when it comes to an analysis of Art 7 and Art 9 OECD Model 2017 (ie on the level of application of the principles of profit attribution on the merits).
- If a function is **not carried out by people**, there **cannot be a priceable dealing in light of Article 7 OECD Model 2017**. This eventually results in a situation, where a theoretically existing **taxing right of a Country cannot be exploited**, **since no profits** are attributable to the PE. Based on that Country B had a taxing right of EUR 0,00 in the case at hand (cf Suggested Solution Question 2).
- However, in light of **Article 9 OECD Model 2017** the same setting could eventually result in a taxable profit in Country B, since a **significant function must not necessarily be carried out by people in order to constitute a priceable transaction** (ie the remuneration for the provision of the server). However, also with respect to Article 9, it was shown at the case study, that there could be certain costs blocks, that would also require the performance by people (ie adaption of the country-specific app); since these activities were outsourced to an external service provider, BCo did not add any further value, which means that those pass-through elements just had to be charged to ACo without any mark-up.

Section III

Case Study 2 – Applying the profit split method in a PE setting

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Case Study 2
Applying the profit split method in a PE setting

Facts of the case

- **ACo**, a corporate entity resident in Country A, is the focal business unit within the Group and is to be seen as the principal and an entrepreneur.
- **ACo** carries out the **distribution function** in Country A, heavily invests in marketing activities and has a cutting-edge sales force that perfectly fulfils all customer requirements, thus resulting in unique and valuable intangibles (ie customer base, trademarks and trade names as marketing intangible). It can be assumed that ACo is a **fully-fledged distribution entity** within the Group.
- In **Country B**, ACo has a **production plant** that manufactures the products, which are sold by ACo in Country A. At the production plant ACo employees very well-educated, skilled and trained workforce, which does not just manufacture goods, but also carries out R&D on its own authority and responsibility in order to enhance the product quality, the process quality and in order to develop product and process novelties. The R&D conducted in Country B (by the employees of the production plant) resulted in the creation of unique and valuable trade intangibles (ie process patents). For the purposes of this case study it can be assumed that the production plant in Country B has the functional and risk profile of a **fully-fledged manufacturer**.
- In **Country A** (ie at the head office) ACo employs **100 people** (top management, sales force and different administrative staff).
- In **Country B** (ie at the production plant) ACo employs also **100 people** (local management, production workers and researchers).

Case Study 2
Applying the profit split method in a PE setting

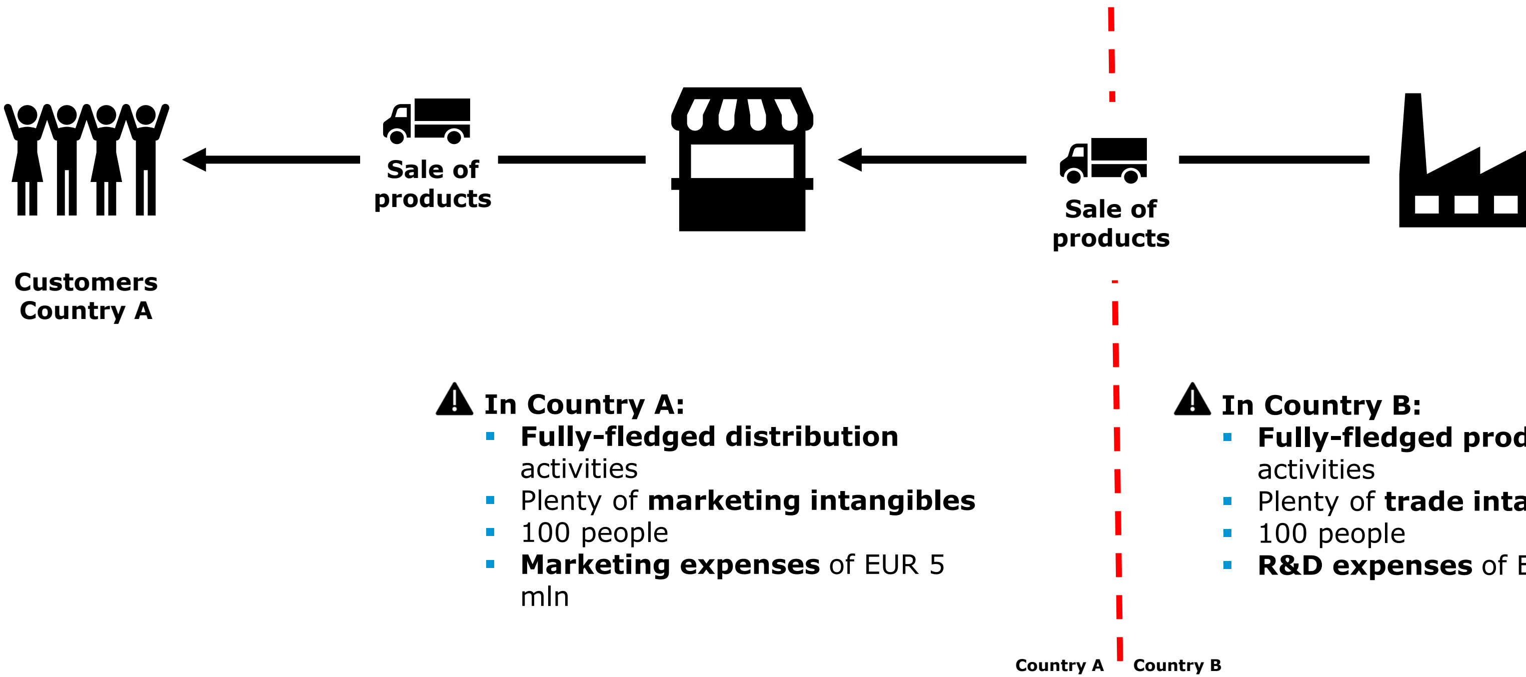
Other considerations

- Based upon the facts of the case ACo contemplates whether the fully-fledged production site in Country B should:
  - either be directly run by ACo or
  - by a subsidiary of ACo that should be set-up in Country B (ie BCo).
- ACo's considerations are purely business driven and are not meant to result in BEPS. However, ACo's management want to know the tax implications of the two possibilities mentioned above.

- On a consolidated basis ACo makes a **turnover** of **EUR 100.000.000,00** and achieves an **EBIT** of **EUR 20.000.000,00**.
- According to **benchmarking** studies conducted by ACo:
  - **LRDs** in the respective industry earn **OMs of 5 %** <u>and</u>
  - **Contract manufacturers** in the respective industry are remunerated with **FCMUs of 5 %** <u>and</u>
  - **Contract researcher** in the respective industry would be remunerated with a **FCMU of 7 %.**
- The **production costs** (in Country B) sum up to **EUR 35.000.000,00**
- The **personnel costs** (excl marketing and R&D staff) sum up to **EUR 30.000.000,00**
- Other **operating expenses** sum up to **EUR 6.500.000.00**
- **Marketing expenses** (in Country A) sum up to **EUR 5.000.000,00**
- **R&D expenses** (in Country B) sum up to **EUR 3.500.000,00**

Case Study 2
Applying the profit split method in a PE setting

Graphical illustration of fact pattern



⚠ **In Country A:**

- **Fully-fledged distribution** activities
- Plenty of **marketing intangibles**
- 100 people
- **Marketing expenses** of EUR 5 mln

⚠ **In Country B:**

- **Fully-fledged production** activities
- Plenty of **trade intangibles**
- 100 people
- **R&D expenses** of EUR 3,5 mln

Case Study 2
Applying the profit split method in a PE setting

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Questions

1. Assuming that **ACo runs the production site in Country B on its own → which Country has the taxing right** among the profits resulting from the production activities?
2. Assuming that **ACo runs the production site in Country B on its own →** which **profits may be attributed to the PE** in light of Art 7 OECD Model 2017 (AOA)?
3. Assuming that **ACo sets-up a subsidiary in Country B** (ie BCo) **→ which Country has the taxing right** among the profits resulting form the activities carried out in Country B?
4. Assuming that **ACo sets-up a subsidiary in Country B** (ie BCo) **→** which **profits may be attributed to BCo** in light of Art 9 OECD Model 2017?
5. Is there a **neutrality of legal forms** on the level of **application** of the principles of profit attribution on the extend?

Excursus – additional questions

1. Assuming that the **productions activities in Country B** are carried out based on the functional and risk profile of a **contract manufacturer**:
   - Which **transfer pricing method** would likely be most appropriate in the case at hand?
   - Would there be a difference with respect to the **attributable profit** if the production activities are (i) carried out via an **associated enterprise** or (ii) a **PE** in Country B?
2. Assuming that the **Group** has an **equity ratio of 50 %**; the management of the group considers to capitalize the production activities in Country B with an equity ratio of 30 %:
   - Could there be any differences with respect to interest, if the production activities are (i) carried out via an **associated enterprise** or (ii) a **PE** in Country B?

Case Study 2
Applying the profit split method in a PE setting

Question 1

Assuming that ACo runs the production site in Country B on its own ➔ which Country has the taxing right among the profits resulting from the production activities?

Suggested Solution Question 1

- The **production facility in Country B** is to be qualified as a **fixed place of business** in light of Article 5(1) OECD Model 2017, since
  - it is **fixed**
  - it is **permanent**
  - ACo **carries out its production activities through** the facilities
  - the production facilities are **at the disposal** of ACo.
- In addition to that, the production facilities of ACo in Country B can also be subsumed under the term "**factory**" in light of **Article 5(2)(d)**, thus constituting a **prima facie PE** in Country B.
- Therefore, **Country B has the taxing right** concerning the business profits attributable to the PE in light of Article 7 OECD Model 2017.

Case Study 2
Applying the profit split method in a PE setting

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Question 2

Assuming that ACo runs the production site in Country B on its own ➔ which profits may be attributed to the PE in light of Art 7 OECD Model 2017 (AOA)?

Suggested Solution Question 2

- Given the facts of the case, the **production activities** carried out by ACo in Country B are based on the functional and risk profile of a "**fully-fledged manufacturer**". What is more, the **distribution activities** carried out by ACo in Country A are based on the functional and risk profile of a "**fully-fledged distributor**".
- Both parties to the transaction make **unique and valuable contributions** (ie [i] marketing intangibles and [ii] trade intangibles). Accordingly, the **profit split method can be seen as the most appropriate method** in the case at hand. Since also routine activities were properly benchmarked, the profit split can be applied in form of a **residual profit split**:
  - The **routine profit** of the **distribution** function sums up to **EUR 5 mln** (= 5 % OM of EUR 100.000.000,00)
  - The **routine profit** of the **production** function sums up to **EUR 1,75 mln** (= 5 % FCMU on EUR 35.000.000,00)
  - Accordingly, the **residual profit** is **EUR 13,25 mln** (= Total profit of EUR 20.000.000,00 minus routine profits)
- The **residual profit of EUR 13,25 mln** has to be **split** among the business units on the basis of appropriate **splitting factor(s)**. For the purposes of this case study the **relation between marketing expenses (ie EUR 5 mln) and R&D expenses (ie EUR 3,5 mln) were considered appropriate.** Accordingly, the residual profit will be **split 59 % / 41 %**:
  - Based on that, the **distribution** function gets a portion of **EUR 7,8175 mln of the residual profit** and
  - The **production** function gets a portion of **EUR 5,4325 mln of the residual profit**.
- Adding up the routine and the residual profits:
  - **Country A** may tax **EUR 12,8175 mln** and
  - **Country B** may tax **EUR 7,1825 mln**.

Case Study 2
Applying the profit split method in a PE setting

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Question 3

Assuming that ACo sets-up a subsidiary in Country B (ie BCo) ➔ which Country has the taxing rights among the profits resulting from the activities carried out in Country B?

Suggested Solution Question 3

- In light of this questions it is assumed that **BCo** (a **separate legal entity**) was established in Country B in order to carry out the "**fully-fledged**" **production activities**.
- Since BCo is a **separate legal entity**, it is to be seen as a "**company**" in light of Article 3(1)(b) OECD Model 2017 as well as an "**associated enterprise**" in light of Article 9(1) in connection with Article 3(1)(c) and (d) OECD Model 2017.
- Accordingly, **Country B** is to be seen as the residence state of BCo, meaning that is **has the taxing right** among the (arm's length) profits of BCo.

Case Study 2
Applying the profit split method in a PE setting

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Question 4

Assuming that ACo sets-up a subsidiary in Country B (ie BCo) ➔ which profits may be attributed to BCo in light of Art 9 OECD Model 2017?

Suggested Solution Question 4

- Since the 2017 Update of the OECD Model, the ALP in light of Article 9 OECD Model is to be understood as a "**functional and factual based arm's length principle**". Comparing this understanding with the arm's length understanding of Article 7 OECD Model 2017 (which was essentially already implemented in 2010 by the AOA), both Articles aim to **achieve a profit attribution based on functions and facts in order to properly price the "real deal"**.
- Based on that, the profit attribution between ACo and BCo follows exactly the same rationale as presented above under "Suggested Solution Question 2" (between HQ and PE).
- Accordingly, again the **residual profit split method** is to be seen as the most appropriate transfer pricing method in the case at hand, which eventually resulting in a **split of (routine and residual) profits** as follows:
  - **Country A** may tax **EUR 12,8175 mln** and
  - **Country B** may tax **EUR 7,1825 mln**.

Case Study 2
Applying the profit split method in a PE setting

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Question 5

Is there a neutrality of legal forms on the level of application of the principles of profit attribution on the extend?

Suggested Solution Question 5

- As shown in this case study, the **level of application** of the principles of profit attribution **on the extend** follows the same understanding, if one compares Article 7 and Article 9 of the OECD Model 2017. Accordingly, it can be reasonably concluded that this (sub-)level is based on a **neutrality of legal forms**.
- However, the **level of applicability** as well as the **level of application on the merits** are not subject to **neutrality of legal forms** due to different reasons.
- Therefore, if the ALP is applicable and is to be applied on the merits, then there is no difference whether functions are carried out by an associated enterprise or a PE, since both, Article 7 and Article 9 OECD Model, essentially follow the same "**functional and factual based arm's length principle**".

Case Study 2
Applying the profit split method in a PE setting

Excursus – Additional Question

Assuming that the **activities in Country B** are carried out based on the functional and risk profile of a **contract manufacturer and contract researcher**:

- Which **transfer pricing method** would likely be most appropriate in the case at hand?
- Would there be a difference with respect to the **attributable profit** if the production activities are (i) carried out via an associated enterprise or (ii) a PE in Country B?

Suggested Solution Additional Question

- Since both activities are carried out with **limited functional and risk depth** and due to the fact that those activities can be qualified as **intra-group (or intra-enterprise) services**, the application of the **(net) cost plus method** seems to be most appropriate in the case at hand.
- Based upon the facts of the case, a **contract manufacturer** would be remunerated with a **FCMU of 5 %** and a **contract researcher** with a **FCMU of 7 %**.
- Accordingly, the **production and research activities** carried out in Country B would result in a **routine profit potential** of **EUR 1,995 mln** (= **EUR 1,75 mln for production** and **EUR 0,245 mln for research**). The entire residual profit is to be taxed in Country A.
- In fact, there is no difference whether the activities are carried out in by an associated enterprise or via a PE. Accordingly, **changes in the functional and risk profile do not change the general understanding of the functional and factual based arm's length principle.** However, the more complex the functional and risk profile of both parties to the transaction, the more complex the application of the ALP.

Section IV

Case Study 3 – Profit attribution to dependent agency PEs

Case Study 3
Profit attribution to dependent agency PEs

Facts of the case and questions

- **ACo**, resident of Country A, is a **fully-fledged production entity** and the **ultimate parent** of the A-Group.
- In order to carry out its **distribution activities in Country B**, ACo has established **BCo** as a **wholly-owned subsidiary**, which is resident of Country B.
- **BCo** carries out its **distribution activities** in Country B based on the **functional and risk profile of a commissionaire**.
- According to benchmarking studies and other comparability data available within/for A-Group:
  - **LRDs** in the respective industry earn **OMs of 5 %** and
  - **Commissionaires** in the respective industry are remunerated with a **commission fee of 3 %**.

Besides that, the following **financial information** are available.

External Sales in Country B	EUR 100.000.000,00
Full Costs of Operation of BCo	EUR 2.000.000,00

Case Study 3
Profit attribution to dependent agency PEs

Questions

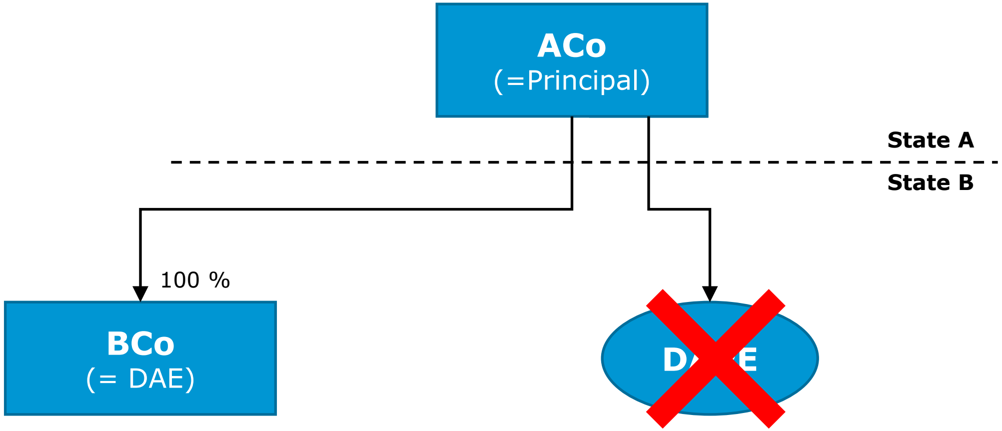
Do the distribution activities of **BCo** (ie the **DAE**) – carried out on behalf of **ACo** (ie the **Principal**) – lead to the creation of a **Dependent Agent PE** (ie a **DAPE**) for ACo in Country B based on:

- The **single-taxpayer approach**,
- The **dual-taxpayer approach** in the interpretation of the **zero-sum-game**, or
- The **(full) dual-taxpayer approach**?

What are the **differences between** the (i) **dual-taxpayer approach** based on the interpretation of the **zero-sum-game** and (ii) the **(full) dual-taxpayer approach**?

Case Study 3
Profit attribution to dependent agency PEs

Graphical illustration and suggested solutions for the single-taxpayer approach

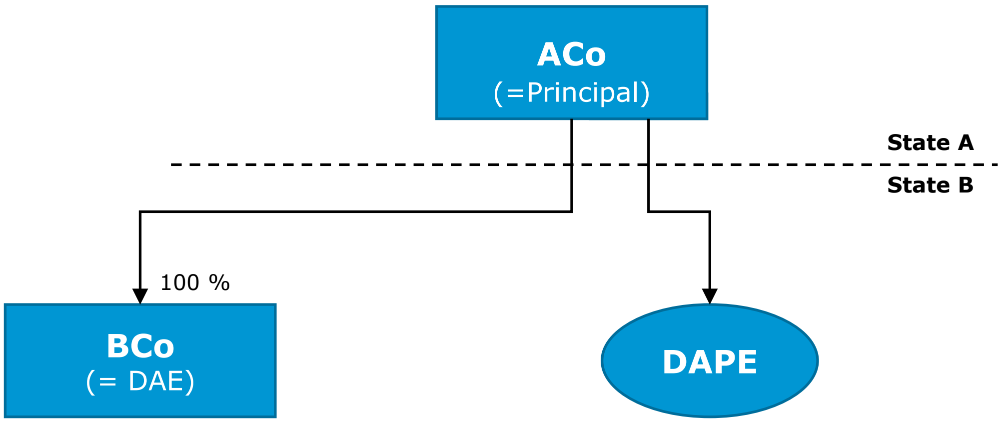


- This approach would result in an **arm's length allocation of taxing rights** amount DTT States.
- This approach would lead to the **least compliance efforts** for both, the taxpayer and the tax administration.

- Based on the **single-taxpayer approach**, the activities carried out by BCo (ie the DAE) in Country B, would **not even lead to the creation of a DAPE** of ACo (ie the Principal) in Country B.
- Since there does **not** exist a **DAPE** in Country B, **no profits** can be attributable to the DAPE on the merits.
- **Country B** is **entitled to tax the profits** resulting from the **commissionaire-like distribution activities** carried out **by the DAE** (EUR 3.000.000,00 minus EUR 2.000.000,00 = **EUR 1.000.000,00**).

Case Study 3
Profit attribution to dependent agency PEs

Graphical illustration and suggested solutions for the dual-taxpayer approach based on the zero-sum-game

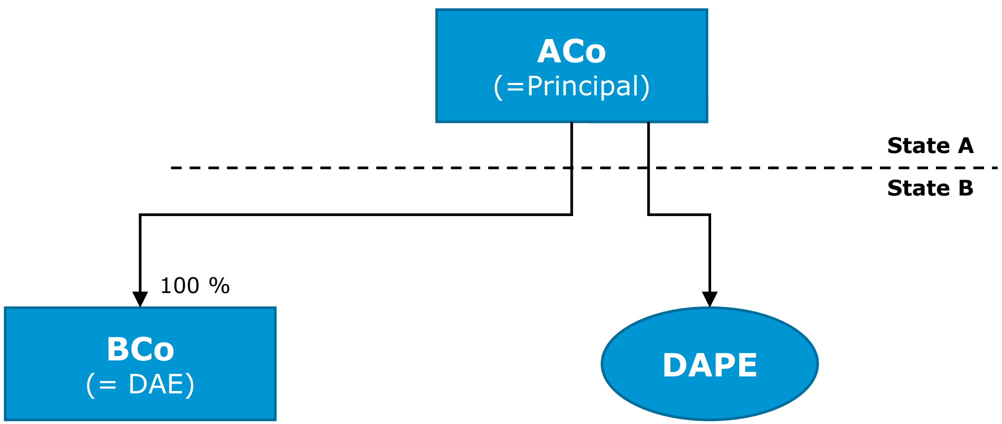


- This approach would result in an **arm's length allocation of taxing rights** amount DTT States.
- This approach would lead to **"slightly" increased compliance efforts** for both, the taxpayer and the tax administration.

- The activities carried out by the DAE in Country B lead to the **creation of a DAPE** of the Principal in Country B.
- Based on the **dual-taxpayer approach** in the interpretation of the **zero-sum-game**, the mere existence of a DAPE in State B, does **not** necessarily mean that any **profits** are **attributable** to the **DAPE** in light of Article 7 OECD Model 2017, as long as the **DAE is properly remunerated** in light of Art 9 OECD Model 2017.
- Since the **DAE is properly remunerated** for its commissionaire-like distribution activities in light of Article 9 OECD Model 2017, **no (additional) profit can be attributed to the DAPE in Country B** (= ie the DAPE is a "zero result PE") ➔ again **Country B may tax profits of EUR 1.000.000,00**.

Case Study 3
Profit attribution to dependent agency PEs

Graphical illustration and suggested solutions for the dual-taxpayer approach



- This approach would result in an **arm's length allocation of taxing rights** amount DTT States.
- This approach would lead to **considerable compliance efforts** for both, the taxpayer and the tax administration.
- This approach is **not in line with the functional and factual based arm's length understanding**.

- Again, the activities carried out by the DAE in Country B lead to the **creation of a DAPE** of the Principal in Country B.
- However, **even though the DAE** might be **properly remunerated** based on a commission fee in light of Art 9 OECD Model 2017 (ie based on its functional and risk profile as a commissionaire), **tax authorities** might **argue** that **additional profits** are to be **attributed** to the **DAPE**.
- Very often **tax authorities typically argue** that (at least) the **profits of an LRD minus the profits of the DAE** are **attributable** to the **DAPE**. Accordingly, the taxable profit attributable to the DAE would again be EUR 1.000.000,00; the profit attributable to the DAPE would be EUR 4.000.000,00 (= EUR 5.000.000,00 minus EUR 1.000.000,00). In total Country B would tax EUR 5.000.000,00.
- This approach is **not in line with the general functional and factual based arm's length understanding**, since Country B tax **profits**, which are **not based on functions, risks and assets with a nexus to its territory**.

Section V

Case Study 4 – Sourcing activities

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

EQUIS ACCREDITED AACSB ACCREDITED AMBA ASSOCIATION OF MBAS ACCREDITED

Case Study 4
Sourcing activities

Facts of the case

- **TradeCo** is a very **well-known and trading company**, which is a supply of all relevant retail and wholesale chains in Country A. **TradeCo** has a very **strong market position**, which is – among others – a result of its strong **customer focus**, the **high quality of its services**, its **marketing strategy**, its **public relation activities**, its **well-trained sales people** and its **market research** and **product portfolio**. Regarding its product portfolio TradeCo is **not just able to be an early adapter regarding new trends**, it is rather also a **trend-setter**. All of these competitive advantages eventually result in **very strong relations to its customers** (ie the leading retail and wholesale chains in Country A).

- **TradeCo** has the **functional and risk profile** of a **fully-fledged distributor**. Accordingly, the **purchasing**/**sourcing** function is one of the **core activities** of TradeCo. However, the **purchasing**/**sourcing function** is not carried out centrally by TradeCo in Country A, but rather **decentralised** in **various Countries** of its suppliers. The main reason for this decentralised network of purchasing/sourcing establishments is to analyse new trends in those countries, which might potentially be also launched in Country A.

Case Study 4
Sourcing activities

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Facts of the case

- From a functional perspective the **employees in the various decentralised purchasing/sourcing establishments** in the different Countries are experts in the area of sourcing, have a **very deep and profound knowledge** and carry out various functions as:
  - Selection and certification of local suppliers based on the criteria laid down by TradeCo,
  - On-going supplier assessments,
  - Calculating sourcing prices and negotiating them with the (potential) suppliers,
  - De-centrally steering the inventory of TradeCo based on a „vendor-managed-inventory" process,
  - Holding decentral stocks
  - Being active in the area of supplier management,
  - Concluding contracts with suppliers in the name of TradeCo,
  - Organising the transport of sourced products from the various countries to State A.

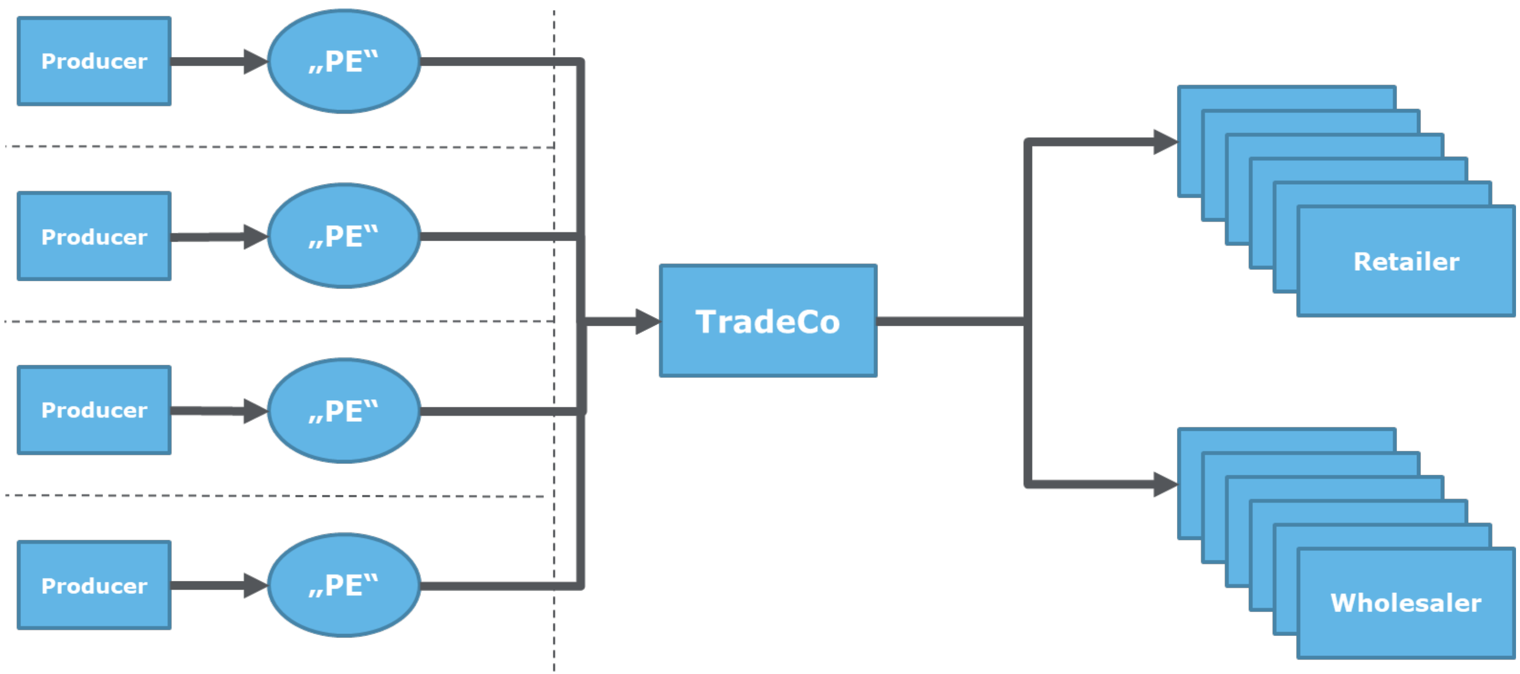
- Regarding the decentralised activities, the various **purchasing/sourcing establishments** also carry out all **relevant risk management functions**.

Questions

1. Do the sourcing activities carried out in the different Countries lead to the creation of PEs of TradeCo?
2. Which profits might be attributable to those PEs (discussion question without number crunching)?

Case Study 4
Sourcing activities

Graphical illustration of fact pattern



Suggested Solution Question 1

- In the case at hand, all criteria of Article 5(1) OECD Model 2017 are fulfilled. The **purchasing/sourcing establishments** of TradeCo in the various countries are (i) **fixed**, (ii) **permanent**, (iii) at the **disposal** of TradeCo and (iv) the **business** of TradeCo is **carried out through them**.
- However, Article 5(4)(d) OECD Model 2017 provides an **exemption for purchasing/sourcing establishments**. In the case at hand, it has to be analysed, whether this exemption is applicable or not.
- Based on the facts of the case, **TradeCo** is obviously to be **qualified as a trading company.** In the OECD Commentary 2017 on Article 5(4)(d) there are plenty of examples, which illustrate whether a **purchasing/sourcing activity qualifies** for the **specific activity exemption or not.** In this respect two questions are of major importance:

    - Is the **purchasing/sourcing activity** a **significant part** of the **entire business operations** of the company?
    - Is the **purchasing/sourcing activity** the **key activity** of the company?

- Especially in the case of **trading companies** (ie companies which sell the sourced products **without material modifications**) one would typically have to conclude that the **purchasing/sourcing activities** are (i) a **significant part** of the **entire business operations** of the company and (ii) the **key activity** of the company.
- Based on the interpretational guidance provided in the OECD Commentary 2017 on Art 5(4)(d) one likely has to draw the conclusion that the given facts of the case suggest the **creation of purchasing/sourcing PEs** of **TradeCo** in various **Countries around the globe**.

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Suggested Solution Question 2

Comparable Uncontrolled Price Method:
Eg based on information of comparable sourcing commissionaires?

Cost-based Remuneration Approaches:
Eg based on the full costs of services of the sourcing PEs plus an appropriate (maybe even very high) mark-up?

Profit Split Method:
Eg due to the fact that both, the HQ and its PEs, make unique and valuable contributions?

Contact details

GrantThornton

VIENNA UNIVERSITY OF
ECONOMICS AND BUSINESS

Dr. Raphael Holzinger, WP/StB
LL.M., LL.M. (WU), MSc (WU), LL.B. (WU), BSc (WU)

Partner and Head of Tax, **Grant Thornton Austria**

Post-Doctoral Teaching and Research Fellow, Institute for Austrian and International Tax Law, **WU**

T + 43 699 1726 1593
Raphael.Holzinger@at.gt.com
www.grantthornton.at