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 <u>Applicability</u> and <u>Application</u> 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

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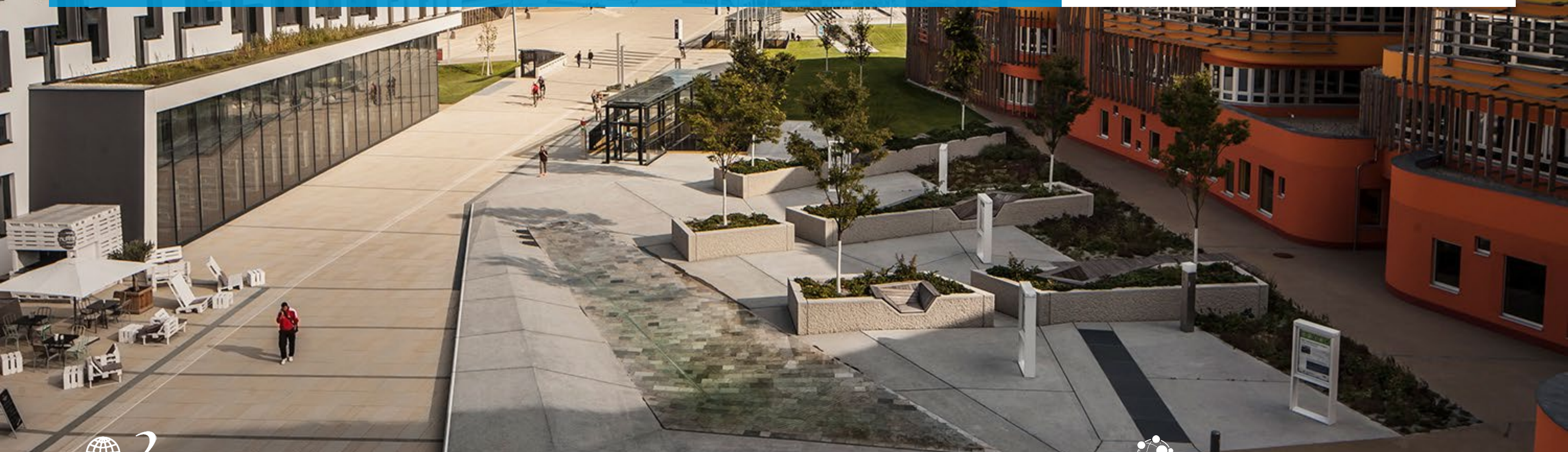

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Introduction on the levels of <u>applicability</u> and <u>application</u> of the principles of profit attribution

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Level of Applicability of Principles of Profit Attribution

Level of Application of Principles of Profit Attribution

Art 7 World

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

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

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

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Case Study 1

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

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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.

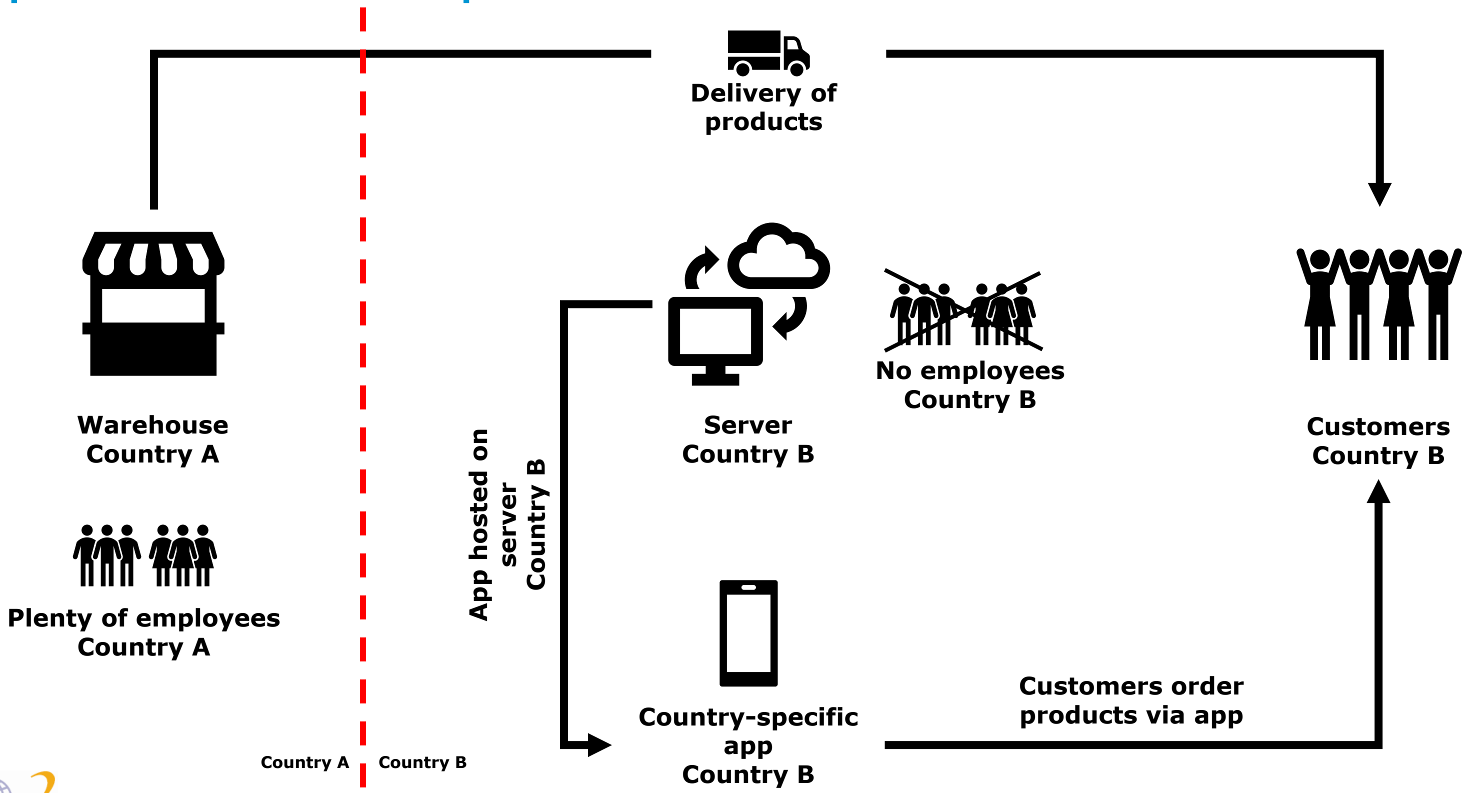
Other considerations

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

Graphical illustration of fact pattern



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

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

Section III

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

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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).

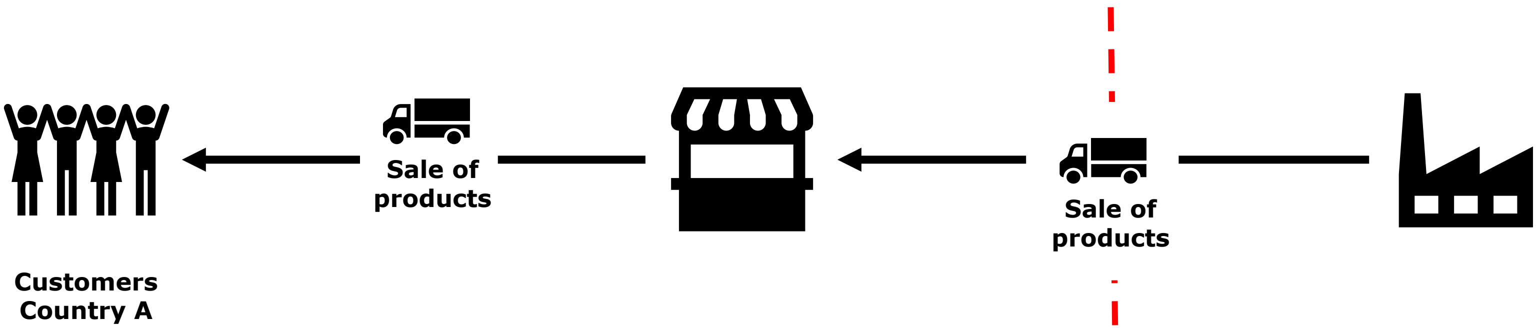
Case Study 2
Applying the profit split method in a PE setting

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**

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

Country A Country B

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

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 **<u>application</u>** 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?

Section IV

Case Study 3 – Profit attribution to dependent agency PEs

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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**?

Section V

Case Study 4 – Sourcing activities

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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

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.

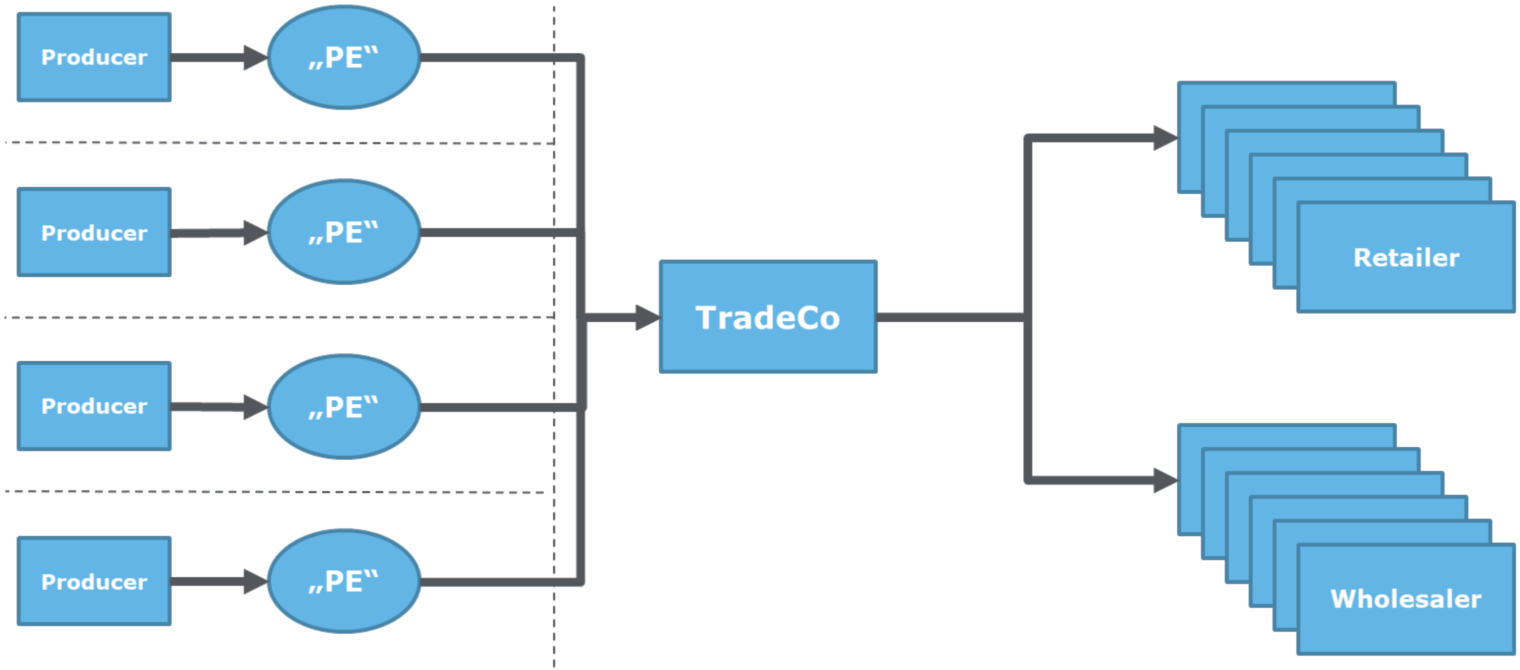
- Regarding the decentralised activities, the various **purchasing/sourcing establishments** also carry out all **relevant risk management functions**.

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



Contact details

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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

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