Financing for Sustainable Development

Transfer Pricing Intermediate Level Regional Workshop
Nairobi, Kenya
5-6 December 2019

ATTRIBUTION OF PROFITS

DESA Department of Economic and Social Affairs

http://www.un.org/esa/ffd/

IBFD

Attribution of profits to PEs

Emily Muyaa, IBFD, The Netherlands

Nairobi, 5 December 2019

Article 7 UN MTC

- **Follows largely the 2008 version of article 7 of the OECD MTC**

- **Wider scope:**
  - (limited) Force of attraction rule

  - Limits the deductibility of certain expenses. This is a critical divergence from OECD 2010 version (and reports on attribution of profits to PE)

- **Allows an apportionment of profits, if customary to use such method. This is another critical divergence from OECD 2010 version (and reports on attribution of profits to PE)**

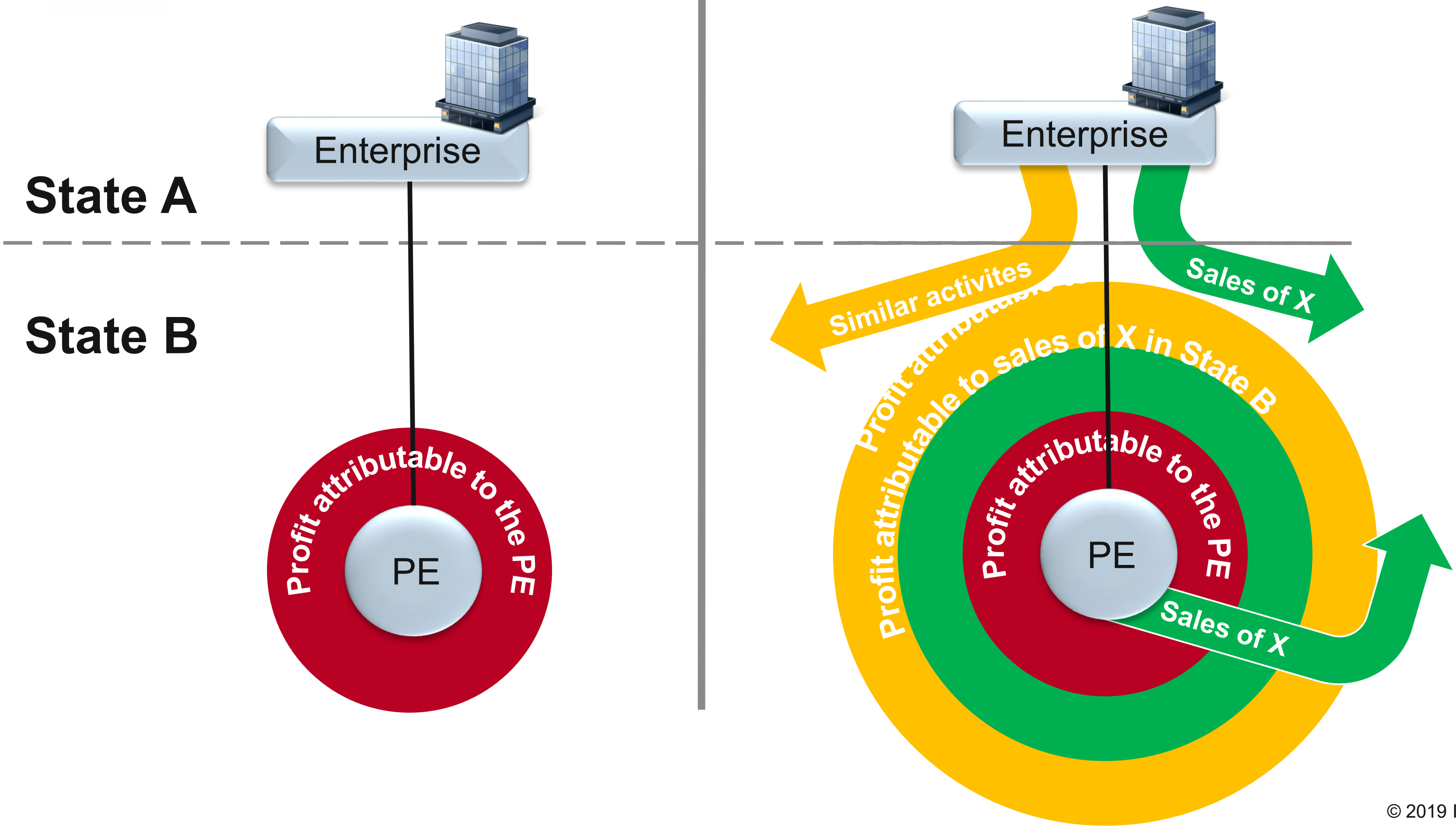
Comparison: Article 7(1) S2 of the OECD and UN MC

Scenario 1

Article 7 of the OECD Model Tax Convention

Scenario 2

Article 7 of the UN Model Tax Convention



Comparison: Article 7(1) S2 of the OECD and UN MC

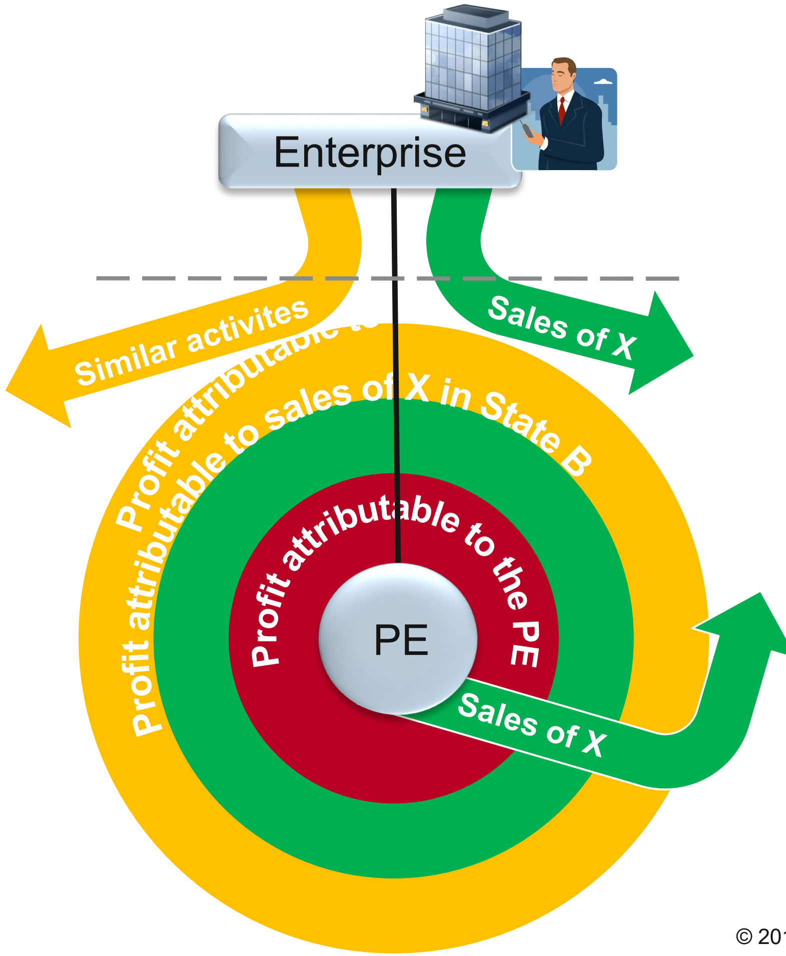
Scenario 2

Limited Force of Attraction

- Provides greater scope for PE State to tax business profits
- Limited by sales or merchandise of the same or similar goods and similar business activities
- Treat those profits as if they were attributable to the PE

Scenario 2

Article 7 of the UN Model Tax Convention



Article 7 OECD – In Both Versions: Two Step Approach

- **Step 1**
  - Construe the PE as a distinct and separate enterprise”: functional and factual analysis
  - Consider whether dealings have taken place and whether they can be recognised
- **Step 2: Determine arm’s length prices**

Step 1: The Axioms of the Hypothesis of the Distinct and Separate Enterprise

- Functions are the starting point: “functional and factual analysis”
- Risks follow functions
- Assets follow functions
- Free capital follows assets and risk

Step 1: Requirements for Recognition of Dealings

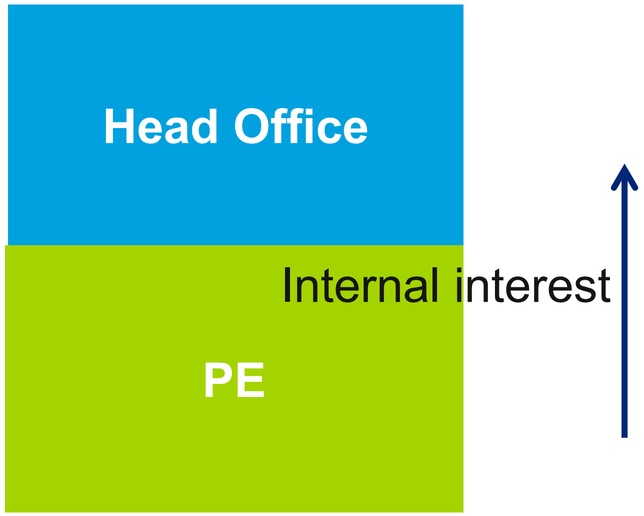
- Real and identifiable event
- Economic substance
- Documentation is consistent with economic substance
- Similar arrangements adapted in independent relations
- No violation of AOA (e.g. segregation of function and risk)

Step 2: Determine Arm's Length Prices

- **Apply the OECD Transfer Pricing Guidelines by analogy**
  - Methods (CUP, RPM, CP (etc))
  - Comparability analysis
  - Etc.

Notional Income and Other Articles

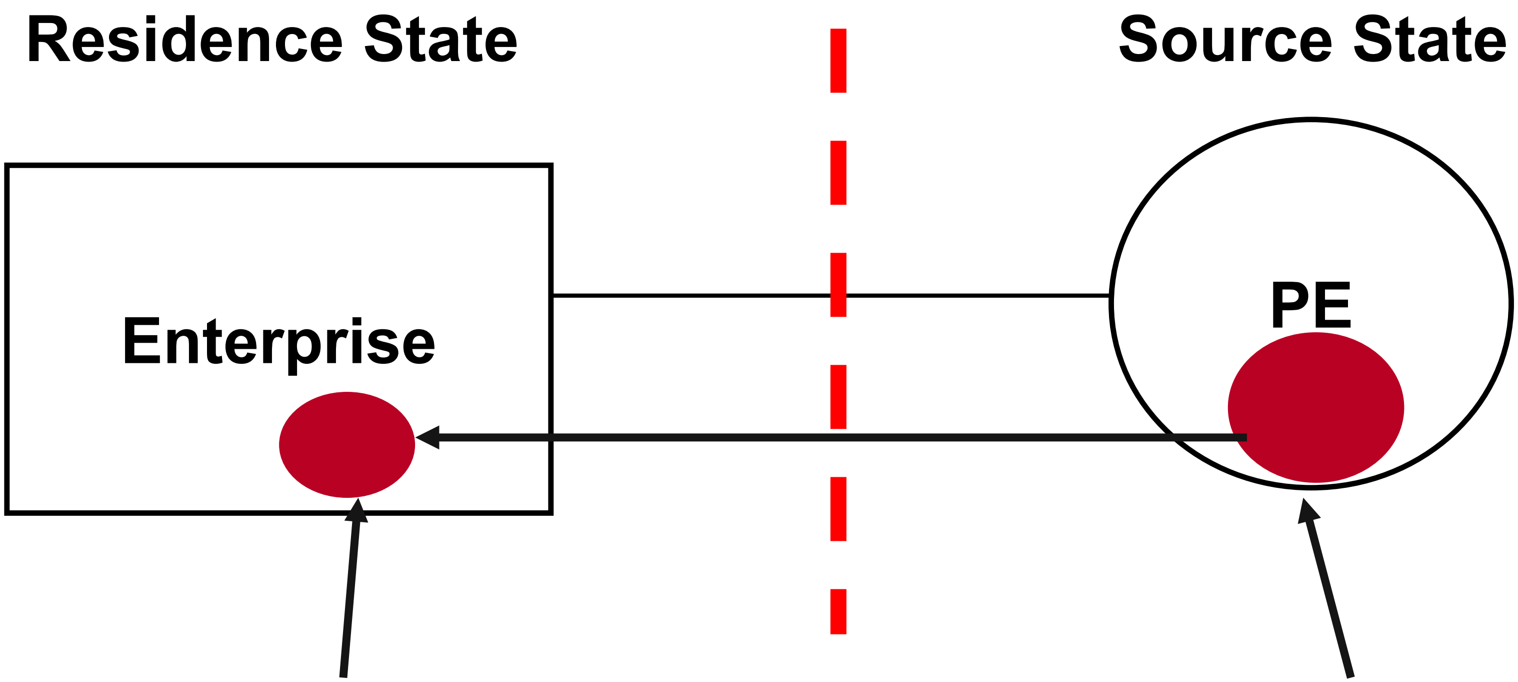
- **Notional income:**
  - Is limited to Article 7
  - Does not extend to other (distributive) articles
  - In this example, Article 11 does not apply
- **Contrast with UN's position**



Steps for the Tax Return: Treaty and Domestic Law

1. **The treaty (“attribution”) allocates the attributable income and costs to the PE**
2. **Accounting: temporary and permanent differences not affected by the treaty**
3. **Domestic law determines limitations of deductions and exemptions of income**

Attribution vs. Measurement



Domestic rules may produce different measure of profits to exempt

Domestic rules may deny deductions for expenses that are attributed to PE

Expenses – OECD Model Comparison (2008 vs. 2010)

Notional payment	Previous Model	2010 Model
Transfer of assets for resale	Cost +	Cost +
Temporary transfer	Shared cost	Rental fee at arm’s length
Royalties	Shared cost	Royalty at arm’s length
Services	Shared cost, with mark up in limited circumstances	Cost +
Good Management	Not deductible	Cost +
Interest	Shared cost, subject to free capital (notional interest allowed for banks)	Notional interest, subject to free capital

Thank You!