ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS: IT’S TIME FOR CONVERGENCE

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1. Introduction

The latest public discussion draft BEPS Action 7: Additional Guidance on Attribution of Profits to Permanent Establishments proposes very specific changes to Article 5 and the commentary of the OECD Model Tax Convention. As demonstrated below, these changes suggest that it may be time to scrap the authorised OECD approach for the attribution of profits to permanent establishments.

2. Article 5, Article 7, Article 9, and Transfer Pricing

Permanent establishments (“PEs”) are defined in Article 5 of the OECD Model Tax Convention. Paragraph 7(2) of the OECD Model Tax Convention indicates that, where a PE is deemed to exist,

...the profits that are attributable to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

In short, paragraph 7(2) of the OECD Model Tax Convention basically calls for a functional analysis to be carried out to allocate arm’s length profits to a PE. The functional analysis is part of the comparability analysis, as indicated in the OECD Transfer Pricing Guidelines. This then leads to the determination of an arm’s length price or profit, again based on the guidance included in the OECD Transfer Pricing Guidelines.

The PE is brought to life as a construed taxable entity that is similar to any other associated entity of an MNE group. This PE, as it is then created out of thin air for taxation purposes, becomes an “associated enterprise” that falls within the reach of Article 9 of the OECD Model Tax Convention. The PE, which is so produced, meets with every characteristic found in paragraph 9(1) of the OECD Model Tax Convention. First, an “enterprise of a Contracting State participates directly or indirectly in the management,

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control or capital of an enterprise of the other Contracting State”. Second, “conditions are made or imposed between the two enterprises in their commercial or financial relations”. For greater certainty, paragraph 3(1) of the OECD Model Tax Convention indicates that the “term ‘enterprise’ applies to the carrying on of any business.”

In other words, there is no meaningful or relevant difference in this course of action under Article 7 of the OECD Model Tax Convention in comparison with the process underlined in Article 9 of the OECD Model Tax Convention that, once again, relies on the OECD Transfer Pricing Guidelines for its implementation. The determination of an arm’s length price under Article 9 requires a comparability analysis centred on the guidance coming from the OECD Transfer Pricing Guidelines, and then the implementation of the related findings through a transfer pricing method that is also recognized by the OECD Transfer Pricing Guidelines. For greater certainty regarding that specific matter, Article 9 has been enshrined in the OECD Transfer Pricing Guidelines since 1979.4

3. A “Working Hypothesis”

Despite this statement of facts, the OECD undertook to develop a “working hypothesis” in the late 1990s in answer to “considerable variation in the domestic laws of OECD Member countries regarding the taxation of PEs.”5 From that “working hypothesis” was born the so-called “authorised OECD approach” (“AOA”).

Part I, Section B of the latest version of the Report on the Attribution of Profits to Permanent Establishments (2010 Report on PEs), published on July 22, 2010, offers the “Statement of principles used to attribute profits to a PE”. It primarily indicates that a PE should be considered as a “separate entity” for transfer pricing purposes.

The AOA indicates that the profits attributed to a PE are:

- the profits that the PE would have earned at arm’s length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.6

Under the AOA, a two-step analysis is therefore required. The first step entails a “functional and factual analysis, conducted in accordance with the guidance found in the [OECD Transfer Pricing] Guidelines.”7 The second step pertains to the “remuneration of any dealings between the hypothesised enterprises [that] is determined by applying by analogy the Article 9 transfer pricing tools (as articulated in the [OECD Transfer Pricing] Guidelines [...]”8

As it can be seen, the "two-step" analysis leans heavily on the OECD Transfer Pricing Guidelines — for obvious reasons, since the OECD is intent on maintaining the “arm’s length principle” as the international standard for any dealings between related parties, including PEs.

This suggests that the relevance of the AOA is becoming more and more questionable. It may be time for the OECD to affirm without reservation that Article 7 and Article 9 of the OECD Model Tax Convention must be applied within the guidance included in the OECD Transfer Pricing Guidelines. There may not be further needs for an AOA that is essentially a replica of the OECD Transfer Pricing Guidelines — a document that went from 262 pages in 1995/1997 to 612 pages in 2017.

In other words, there is nowadays more than enough guidance to properly implement the arm’s length principle without the 241-pages long AOA. Assuming that the specific guidance on the "special considerations" for PEs of banks is deemed relevant, it should be included in a future edition of the OECD Transfer Pricing Guidelines.

4. Suggested Changes to the OECD Draft

With these considerations in mind, paragraph 16 of the draft should be modified to refer to the guidance included in Chapter I of the OECD Transfer Pricing Guidelines instead of some pre-alleged BEPS guidance included in the 2010

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5 Discussion draft on the Attribution of Profits to Permanent Establishments (Parts I and II), February 8, 2001 ed. (OECD Publishing, 2001), para. 2.


7 ibid., Part I, Subsection B-1, para. 10.

8 ibid.
Report on PEs. “Significant people functions”, as they are labelled, are in fact evocative of the attempt by the OECD to inject the RACI matrix approach (Responsible, Accountable, Consulted, and Informed) in the profit split methods in 2014.9 “Significant people functions” are irrelevant just like the RACI matrix approach was misinformed.

In the same line of reasoning, paragraph 17 of the draft should be removed. It is facetious to suggest artificially-induced differences between “significant people functions for the attribution of risk for the purposes of the AOA” based on Article 7 of the OECD Model Tax Convention and “risk control functions for the purposes of Article 9”.

In layman’s terms, the colour black remains black to the eyes, whether it is seen in a black and white environment or a colour environment. It also stays black whether brightness and contrast are light, dark, or in-between.

More to the point, it is likely not a coincidence that “Article 9 and the Transfer Pricing Guidelines are applicable, either directly or by analogy” in every example included in the draft to determine the “arm’s length remuneration” of a PE.

The time has indeed come for the OECD to state without reservation that Article 7 and Article 9 of the OECD Model Tax Convention must be applied within the guidance included in the OECD Transfer Pricing Guidelines.

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SPLITTING, SPRINKLING, AND STRIPPING: THE LATEST ON THE SMALL BUSINESS PROPOSALS

— Cameron Mancell, CFP®, Analyst, Wolters Kluwer

In recent weeks, Minister of Finance Bill Morneau has been actively responding to criticisms of the small business proposals. It began when the Minister responded with the series of tweets:

- The rules are designed to help businesses grow — not shelter personal income from tax. Canadians deserve #TaxFairness.
- We’re consulting about closing unfair loopholes. We will NOT raise taxes on small business.
- Our proposals will protect #smallbiz ability to invest, grow & create good, middle-class jobs.
- #TaxFairness changes would only take effect going forward.
- If your family members make a meaningful contribution to your business, these changes will not affect you.
- Our proposals will not raise taxes. We have lowest #smallbiz tax in the #G7 and we’re keeping it that way.
- If you are investing profits back in your business or investing to create jobs, these changes will not affect you.
- Our proposals are targeted only at specific loopholes. Most #smallbiz won’t be affected.

Morneau also recently met with the Canadian Medical Association (“CMA”), who represent medical practitioners and have been very vocal about the proposals. The CMA provided members a letter-writing tool to contact their local MPs, and so far 4,500 letters have been sent. The CMA is advocating for the extension of the consultation period and a stakeholder engagement.

The Minister hosted a conference call to reassure concerned MPs, who have been bombarded with complaints about the proposals. On September 5, the Minister held a conference with small business owners and the media in Kelowna, BC, where he acknowledged that the public has identified technical issues with the proposals, which he is open to tweaking. Before the House of Commons session resumed, the Liberal caucus attended two short retreats, one of the main topics of which included the tax proposals. Liberal MP Wayne Long, Saint John–Rothesay, stated that he will stand up for his constituents by voting against these tax proposals. Hon. Wayne Easter, who chairs the House of Commons Standing Committee on Finance, has been critical of how the consultation on the proposals has been conducted.

According to a recent publication by CTV News, the Minister stated “the government will look at the potential unintended consequences being raised, [and the] two-thirds of small business owners in Canada that earn $73,000 per year or less won't be impacted 'at all' by the tax changes.” Also according to CTV News, the government is confident that “the most impact will be felt by those business owners who are making $150,000 a year or more, or those who have money to tuck away after contributing the annual maximum to RRSPs and TFSAs.” The Prime Minister has also insisted that these measures will only affect high-income earners.

CURRENT ITEMS OF INTEREST

Employment Insurance Rate for 2018

The government announced that the employment insurance (“EI”) premium rate for 2018 will be 1.66% of insurable earnings. This is up from 1.63% in 2017, but remains considerably lower compared to 1.88% from 2013 to 2016. Also note that Budget 2017 expanded EI benefits in various respects, and originally estimated that EI premiums would increase to 1.68% as a result. The maximum insurable earnings for 2017 is $51,300, but the limit for 2018 has yet to be announced.

RECENT CASES

Minister’s application for an order to compel oral interviews dismissed

The Minister of National Revenue undertook an audit of the respondent corporate taxpayer in relation to that taxpayer’s compliance with the transfer pricing rules. In the course of the audit, the minister requested that approximately 25 employees of the corporation be made available for an interview with the minister’s representative. That request was refused by the taxpayer, which agreed to written questions but not oral interviews. The minister then brought an application before the Federal Court, requesting the issuance of a compliance order under section 231.7 of the Income Tax Act.

The application was dismissed. The Federal Court held that while it agreed with the general interpretation put forward by the minister with respect to the powers granted under section 231.1, the taxpayer was also correct in arguing that such powers, while broad, were not unlimited. In the Court’s view, a compliance order under section 231.7 could be issued only if the minister proved that the taxpayer did not comply with section 231.1. On the agreed facts, however, the taxpayer had provided the minister with every opportunity to inspect, audit, and examine its books and records and to inspect its property. The Court held as well that paragraph 231.1(1)(d) of the Act was not so wide as to provide the minister with an unlimited right to conduct oral interviews, and that the minister’s interpretation of the statutory provisions imposed a much broader form of examination for discovery than allowed before the Tax Court of Canada without any of the procedural safeguards. In this case, written questions would provide the minister with the information sought. Finally, the Court held that the order sought by the minister did not meet the principle of proportionality. The time and cost involved in interviewing 25 individuals in numerous locations was not proportional to the information being sought, since the litigation before the Tax Court would resolve the issues which were the focus of the requested interviews.

¶49,761, MNR v. Cameco Corporation, 2017 DTC 5102

Minister required to pay interest on amount refunded to taxpayer

The taxpayer appealed to the Tax Court from a reassessment issued by the Minister of National Revenue. The minister obtained a jeopardy order under section 225.2 of the Income Tax Act (the “Act”) and, pursuant to that jeopardy order, the taxpayer forwarded the amount of $12.75 million to the minister. The jeopardy order was set aside three months later, and the taxpayer requested in writing that the payment made be refunded to him, with interest. The principal amount was repaid, without interest, and the taxpayer brought an application for judicial review of the minister’s decision not to pay interest. The application was dismissed and the taxpayer appealed from that dismissal.
The appeal was allowed. The appellate Court held that if the amount in question was refunded under subsection 164(1.1) of the Act, then the taxpayer would be entitled to interest on the refund paid. The issue for determination, therefore, was whether subsection 164(1.1) of the Act applied. Pursuant to that subsection the minister is required to pay interest where each of the conditions set out in the subsection are met and where no jeopardy order had been granted in respect of the amount assessed. The Court held that the setting aside of the jeopardy order meant that subsection 164(1.1) should be read as if that jeopardy order had never been issued. Since the appellant had appealed the reassessments to the Tax Court and had applied in writing for the refund, the other conditions imposed by subsection 164(1.1) had been met, and the Minister was consequently required to pay interest on the amount refunded. The minister’s decision not to do so was, in the Court’s view, both incorrect and unreasonable, and the decision of the Federal Court upholding the minister’s decision was set aside.

¶49,760, Grenon v. MNR, 2017 DTC 5101

Appeal dismissed where required election not properly filed by taxpayer

In 2010, the taxpayer disposed of two rental properties and, in her return for that year, declared a taxable capital gain from that disposition. She subsequently filed a T1 Adjustment Request for 2010 in which she claimed an offsetting capital gain deduction. The minister, however, issued a reassessment in which the capital gain deduction was disallowed on the grounds that the taxpayer had not, as required, declared a capital gain or claimed a capital gain deduction resulting from a subsection 110.6(19) election in her return for the 1994 tax year. The Minister’s reassessment was confirmed, and the taxpayer appealed. Counsel for the appellant argued that the taxpayer was entitled to the capital gains exemption on the subject properties and that she had done everything she believed to be necessary to make the election and claim the exemption, and that the capital gain deduction should therefore be allowed.

The appeal was dismissed. The Court held that the issue for determination was whether the minister was justified in disallowing the capital gain deduction claimed by the appellant. The Court reviewed the steps which were required in order for a taxpayer to perfect a section 110.6 election. It held that, while it was satisfied that the appellant had every intention of complying with the statutory requirements for such election, and even if the requisite forms were filed, it was admitted that the taxpayer had not complied with the additional reporting and filing requirements. Even though the taxpayer had the necessary intent, she did not follow through on the election. In view of the fact that the appellant did not fulfil all of the requirements for such election, the Court’s conclusion was that the minister was justified in disallowing the claimed capital gain deduction.

¶49,755, Estate of McCullock-Finney v. The Queen, 2017 DTC 1092

Bankrupt required to make additional debt repayments prior to discharge

The bankrupt filed an assignment in bankruptcy in which the proven claims of the Canada Revenue Agency (“CRA”) comprised approximately 93% of the total proven claims, or about $500,000. As the personal income tax debt of the bankrupt made up more than 75% of the proven unsecured claims, the bankruptcy was governed by section 172.1 of the Bankruptcy and Insolvency Act. The bankrupt applied for an absolute discharge and that application was opposed by the CRA, which argued that the bankrupt should, prior to discharge, be required to make additional payments towards her estate and her tax debt.

The bankrupt was discharged absolutely upon making a payment of $30,000 to the estate. The Registrar in Bankruptcy indicated that the issues for determination were whether the circumstances supported an order discharging the bankrupt’s unsecured liabilities, and, if so, what terms of discharge were appropriate in the circumstances. The Registrar noted that, in the case of high-tax bankruptcies, the jurisprudence consistently stresses deterrence as a guiding factor in making those determinations. The application of the principles from that jurisprudence supported an order discharging the bankrupt’s unsecured liabilities. However, the bankrupt’s circumstances also mandated an order requiring her to make additional payments in respect of those liabilities. While the bankrupt had, for the most part, complied with her duties under the statute, there was also no evidence that she had made payments toward her income tax debt during a nine-year period when she had the financial means to do so. As well, the bankrupt had made payments in respect of other debts in preference to her tax debt. Overall, the Registrar concluded that, in light of the need for specific and general deterrence, and considering the bankrupt’s age, earning potential, and ability to pay, it was appropriate that the
bankrupt be required to pay the sum of $30,000 toward her unsecured liabilities. The Registrar ordered that the bankrupt be discharged absolutely upon payment of $30,000 to the Trustee in Bankruptcy.

¶49,762, Re Hertz, 2017 DTC 5103

INTERNATIONAL NEWS

Switzerland Consulting on New Corporate Tax Reforms


The Swiss Federal Council has launched a consultation on a new package of corporate tax reforms, drawn up in the wake of a previous failed attempt to overhaul the system.

The Federal Council said the tax proposal 17 (“TP17”) package will help make Switzerland a more appealing location, ensure that companies continue to benefit from a competitive tax framework, and have less of an impact on the federal budget than its previous proposals.

In February, the Government lost a referendum on its Corporate Tax Reform III (“CTR III”) package, which would have abolished a range of special tax arrangements for status companies in an effort to meet evolving international standards on harmful tax competition. It swiftly convened a steering group to draw up new proposals.

The TP17 package was presented by the steering committee to the Federal Council in June. The Council largely accepted the committee’s recommendations, and asked the Federal Department of Finance to prepare a consultation draft.

According to the Federal Council, Switzerland’s current system for corporate taxation “no longer meets international requirements, which is having an increasingly negative impact on Switzerland as a location.”

TP17 contains the following measures:

- The special arrangements for cantonal status companies, under which they pay only a reduced profit tax or no tax at all, will be abolished;
- The cantons will be required to introduce patent box regimes, under which profits from patents and similar rights will be separated from other profits and taxed at a lower level, with the relief to be no more than 90 per cent;
- The cantons will be given the option of introducing additional tax deductions of up to 50 per cent for research and development activities;
- The dividend taxation for “natural persons” will be increased to 70 per cent at federal and cantonal level;
- The cantons’ share of direct federal tax receipts will be increased from 17 per cent to 20.5 per cent;
- The cantons will be permitted to include the capital associated with financial interests, patents, and similar rights at a reduced level in the capital tax calculation;
- Companies that relocate their headquarters to Switzerland will be able to benefit from additional amortization in the first “few” years of operations;
- Swiss operating companies of foreign companies will be entitled to the flat-rate tax credit, which prevents international double taxation; and
- The minimum requirements for family allowances will be increased by CHF30.

The Federal Council estimates that TP17 will impact the federal budget by around CHF750 million (US$787.1 million). It will provide a temporary supplementary contribution of CHF180 million to financially weak cantons from 2024.

The consultation will close on December 6. The Federal Department of Finance intends to submit the proposals to parliament in spring 2018. The earliest that TP17 can enter into force is 2020.
UK Confirms Tax Changes in Second Finance Bill 2017


The UK Government has released the draft of a second Finance Bill 2017, with measures reintroduced that were dropped from the first Bill (which went on to become a shorter Finance Act 2017 earlier this year) owing to the snap election held in June.

The draft includes new penalties for those who enable the use of tax avoidance schemes that are later defeated by HMRC; an update on the rules around company interest expenses, to ensure big businesses cannot use excessive interest payments to reduce the amount of tax they pay; and changes to prevent individuals from using artificial schemes to avoid paying the tax they owe on their earnings.

The new Bill will also abolish permanent non-dom status, so that those who have lived in the UK for many years pay UK tax in the same way as UK residents. It includes a reduction in the dividend allowance from £5,000 (US$6,638) to £2,000 from April 2018, thus limiting the difference in tax treatment between those who work through their own company, and those who work as employees or self-employed; and a reduction to the Money Purchase Annual Allowance from £10,000 to £4,000. This latter change is intended to limit the extent to which people can recycle their pension savings to gain extra tax relief.

John Cullinane, CIOT Tax Policy Director, said: “The contents of the Bill are pretty much as we expected — that is, the measures dropped from the pre-election Finance Bill. The only measures dropped appear to be a clause on landfill tax and two clauses on Customs enforcement powers. We are expecting some significant proposals on landfill tax to be announced next week which will feed into the third Finance Bill of the year, in December.”

He highlighted that the Bill will be the second-longest Finance Bill ever, adding: “The most significant measures in the Bill are probably changes to corporation tax and to the regime for non-UK domiciles. The two schedules on corporation tax loss relief and interest deductibility now run to 303 pages between them, not far off half the Bill on their own. The Bill also contains clauses paving the way for Making Tax Digital, substantial changes to the rules for fulfillment businesses, and a range of anti-avoidance measures, including penalties for enablers of avoidance schemes.”

"At 674 pages it will be beaten only by the 703-page Finance Act 2012. While much of the new legislation will only apply to larger businesses this will still represent a further complicating of the tax system, both by lengthening the code and through the process of change."

EU Finance Ministers Seek ‘Equalization Tax’ on Tech MNEs


The finance ministers of France, Germany, Italy, and Spain have put their names to a letter proposing a new approach to the taxation of multinational digital companies in the EU.

The letter, addressed to the Estonian Presidency of the EU, calls for the introduction of a tax based on revenue, in addition to existing taxes on companies’ profits, to be known as an “equalization tax.”

It says: “We ask the EU Commission to explore EU-law-compatible options and propose any effective solutions based on the concept of establishing a so-called ‘equalization tax’ on the turnover generated in Europe by the digital companies. The amounts raised would aim to reflect some of what these companies should be paying in terms of corporate tax. This proposal is practical. It does not call into question the essential work on the common corporate tax base (CCTB) and consolidated common corporate tax base (C CCTB). The Commission could decide to propose a legislative initiative accordingly. It will demonstrate our commitment to appropriately tax the companies of the digital economy in a way that reflects their genuine activity in the EU.”

The letter says large companies should not be allowed to pay “minimal” taxes to EU treasuries while conducting substantial levels of business.

The development is significant as it shows there is growing support for new EU laws to tackle profit shifting, with France and Germany having recently pushed the idea of corporate tax harmonization.
It also comes days after Estonia, which is currently holding the six-month rotating presidency of the EU (until end-2017), warned at a recent conference on this issue that unilateral approaches to digital taxation are ineffective.

The Estonian presidency said it is aiming to obtain an agreement on the harmonization of EU tax rules in this area by the end of its presidency of the EU.