Practitioners Call for Consistent Transfer Pricing and Profit Attribution Rules

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For the sake of consistency and administrability, the OECD should explicitly endorse use of the arm's-length principle as set out in the transfer pricing guidelines when attributing profit to a dependent-agent permanent establishment, according to practitioners speaking at an OECD public consultation.

Commentators present at the November 7 consultation in Paris argued that the base erosion and profit-shifting project's simultaneous lowering of the dependent-agent PE threshold and blurring of the distinction between profit attribution and transfer pricing principles will likely lead to more frequent disputes and risk of double taxation unless the appropriate interaction of the two concepts is settled.

The issue has taken on heightened importance ever since the OECD released its final BEPS project reports in 2015. While the OECD's report on PE avoidance (action 7) expanded the circumstances in which an entity can be treated as a dependent agent that creates a PE for a nonresident related party, its transfer pricing report (actions 8-10) introduced a framework for allocating risk that bears some similarities to the concept of significant people functions used in the profit attribution context. Because dependent-agent PEs are legally separate entities, they are in principle subject to both the transfer pricing rules under article 9 of the OECD model tax convention and the attribution of profit under article 7.

However, the OECD's 2017 discussion draft on profit attribution fails to specify how the two articles should be jointly applied and in what sequence, according to Alan McLean of Royal Dutch Shell and vice chair of the OECD's Business and Industry Advisory Committee. "We're concerned that there's no agreement on the required ordering of article 7 and article 9 analyses. Our members are concerned that the different ordering may result in different answers, particularly where profits are dependent on levels of gross cost," McLean said. "Even where such differences do not exist, we consider it unnecessarily burdensome to have to complete two separate analyses, both seeking to answer the same question."

The appropriate solution is for the OECD to reaffirm its commitment to the separate-entity principle set out in the authorized OECD approach (AOA) to profit attribution, according to McLean. As part of this effort, the OECD should also consider conforming its implementation guidance with the current transfer pricing guidelines, according to Andrew Cousins of Duff & Phelps.

"The transfer pricing guidelines have moved on significantly since the 2010 report [by the OECD on profit attribution] was written and it's now time to consider whether the AOA would benefit from coordinated revision to align it with the guidelines," Cousins said. "From a compliance perspective, operating two incompatible versions of the arm's-length principle in parallel is a recipe for confusion and conflict."

According to Sol Picciotto of Lancaster University and the BEPS Monitoring Group, the tension should instead be resolved by eliminating the separate-entity approach in favor of a unitary system. He cited the opposition of the U.N. tax committee to the AOA and its uneven adoption by OECD countries as further practical obstacles.

“You can't really fudge that situation," Picciotto said. "You have to reconsider the implications of the AOA in this context, and given that those countries [that reject the AOA] are prominently represented in the United Nations committee and that there are other countries that haven't joined the inclusive framework, we suggest this is an area where the OECD has to work in conjunction with the United Nations committee of experts.”