

# Permanent Establishment and Transfer Pricing: Two Sides of the Same Coin?

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Does a subsidiary constitute a permanent establishment of its foreign parent company where the relevant treaty requirements are met, that is, it either represents a fixed place of business or it is dependent on, and has the power to contractually bind in its country of establishment, the foreign parent company?

This idea is not, of course, a novel one. The OECD Commentary deals with this issue when it states that “a subsidiary will constitute a permanent establishment for its parent under the same conditions as are stipulated in paragraph 5 as are valid for any other unrelated company” (paragraph 41 of the Comments on article 5 of the OECD Model Convention).

The position of the OECD tax committee has been confirmed by various national decisions (notably the recent Interhome AG decision from the *Conseil d’Etat* (the French supreme court for such matters)).<sup>1</sup>

As well as providing technical analyses regarding the treaty notions of economic dependency and capacity to contract, such case law has encouraged practitioners<sup>2</sup> to opine on how tax administrations could use the concept of a permanent establishment to their advantage in certain situations.

In the current position that domestic tax systems find themselves in (that is, one in which new investigation possibilities have become available to tax administrations while international tax standards increasingly limit the use of domestic tax rules in the fight against tax evasion), what are the situations in which an administration could efficiently wield this permanent establishment weapon?

It has been stated that “*the past few years have seen international companies who are selling their products into France frequently replace distribution agreements, in which the distributor purchases these products in order to resell them in its own name, thereby realising a commercial margin that is fully taxable in France, with commission or commercial agency agreements, which under certain conditions allow it to avoid the profits being taxed in France*”.<sup>3</sup> The same concern has been expressed for “*captive manufacturing companies, such as toll manufacturers*”.<sup>4</sup>

Although recent cases do not genuinely introduce any technical novelties, they do highlight situations in which

many vital business functions are carried out locally through service providers or subsidiaries of foreign companies in a tax efficient manner. However, instead of applying the concept of a permanent establishment, would not domestic transfer pricing tax rules be better suited to deal with this type of situation? Obviously, these two approaches are not mutually exclusive. Nevertheless, the purpose of this article is to examine:

- I. Is it the transfer pricing approach that should be given precedence in this kind of situation because to a certain extent, it underlies the concept of a permanent establishment; and
- II. Where a tax administration finds it difficult to prove the existence of a permanent establishment, will resorting to transfer pricing rules save the day?

## **I. Transfer Pricing Principles Cannot be Ignored When Examining PEs**

### **A. The Same Economic and Legal Analysis**

In certain jurisdictions, the concept of a sales agent is specifically defined. For instance in France, a sales agent is an agent in charge of negotiating and possibly concluding contracts in the name of and on behalf of producers, suppliers or tradesmen. It would therefore seem that a sales agent could constitute a permanent establishment for its principal if its economic dependency thereon were established. Subsidiaries acting as intermediaries in the sale of products on behalf of foreign companies tend to act as brokers in that they do not ordinarily have the ability to contract on behalf of their foreign parent company. Indeed, a broker is an entity which brings the buyer and the seller together in order to facilitate transactions; it does not intervene and contract in the name of either of the parties.

That said, it is interesting to note that the term “agent” used by the OECD Model Treaty is very generic, and no doubt originates from the Anglo-Saxon concept of an agent, which is not a clearly defined legal term for tax treaty purposes. It must not be forgotten that article 5.6 of the OECD Model Treaty defines what does not constitute a permanent establishment, that is, the activity of “*a broker, general commission agent or any other agent of an independent status*”. The “person” who could constitute a permanent establishment pursuant to article 5.5 of the model treaty is defined by way of exclusion, that is, a person “*other than an agent of an independent status to whom paragraph 6 applies*”. The OECD Commentary to article 5 (5) clarifies that persons whose

activities may create a permanent establishment for the enterprise may be either individuals or companies. The person's legal capacity is irrelevant provided that he or she habitually exercises the authority to conclude contracts in the name of the foreign enterprise. This is what the *Conseil d'Etat* pointed out in the *Interhome AG* decision when it held that the court which it was hearing an appeal from made a legal error by not seeking to establish whether "*Interhome Gestion de facto and not merely de jure exercised powers that enabled it to bind its parent company in commercial dealings*".

It is not only the French courts that follow this line of thinking. Indeed, the Italian Supreme Court in the well-known Philip Morris cases stated that the participation of representatives of an Italian group company in connection with the conclusion of contracts between its foreign group member and an Italian third party might be regarded as an authority to conclude contracts in the name of the foreign company. The OECD clarifying notes on the existence of power of representation did not alter this fact (Italian Supreme Court No. 7682/2002). The draft OECD clarifying notes on the permanent establishment definition specify, however, that the mere fact that a person has attended or even participated in negotiations in a State, between an enterprise and a client, will not be sufficient by itself to mean that the person has exercised in that State an authority to conclude contracts in the name of the enterprise (see proposed new paragraph 33 of the Commentary on Article 5 OECD Model Convention).

On the other hand, even if the authority to conclude contracts exists or if this is habitually exercised, a corporation does not necessarily qualify as a dependent agent of an affiliate company. As the German Supreme Tax Court ruled on 14 September 1994,<sup>5</sup> if the corporation in question has its own business in addition to the agent activity, such a corporation has to be seen as being independent. Consequently, there would be no room left for the allocation of a portion of the overall principal's profit to the country of the agent. Furthermore, just because a corporation is grouped with another this should not in itself result in the assumption that it is a dependent agent (see also Article 5 Para.7 OECD Model Convention). Nevertheless, the remuneration paid to an affiliated agent has to meet the arm's length principles.

One can draw an analogy between this issue and the transfer pricing guidelines with their functional analysis approach, further to which the arm's length remuneration is dependent on the function performed by an affiliated company. Where a subsidiary does more than it is contractually obliged to do, it will be necessary to adjust the remuneration where this is only meant to cover the performance of contracted services. If a broker is paid an amount which is in line with remuneration for just acting as an intermediary only, this remuneration will no longer constitute arm's length remuneration if the broker takes the responsibility for negotiating a contract and/or even concluding it on behalf of the parties. By overstepping the contractual framework of the brokering activity, the functions no longer are those of a broker but those of a commercial agent, and for this activity the "broker" should receive additional remuneration.

In other words, where the activity of a subsidiary is characterised as a permanent establishment, this cannot be dissociated from a transfer pricing analysis. This is all the more true because a permanent establishment requires that

there be dependency (legal or economic), which is also an essential condition for most transfer pricing provisions to apply.

Although the permanent establishment issue does not systematically reduce itself to that of a transfer pricing issue, it is clear that the two concepts are to a great extent interdependent. Once again, the *Interhome AG* decision has underlined this interdependence, specifying that "*the situation could justify the reassessment of the profits of the French subsidiary on the basis of article 57 of the CGI (i.e. the core of the French regulations on transfer pricing)*".<sup>6</sup>

While transfer-pricing analyses may be useful in determining the existence of a permanent establishment, they are clearly essential in determining the profits to be allocated to that establishment.

## B. Attribution of Profits to a PE

In connection with the attribution of business profits of a permanent establishment Article 7.2 of the OECD Model Treaty provides that "*the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment*" are attributed to the permanent establishment. In this regard, the OECD Commentary clearly refers to the transfer pricing issue: "*this corresponds 'to the arm's length principle' envisaged in the comments in relation to article 9*" (Section 7.2.11); further on (in Section 7.2.14) the commentary specifies that "*it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions*". The OECD Discussion draft on the attribution of profits to permanent establishments issued on August 3, 2004 also very clearly highlights this link between the attribution of profits to a permanent establishment to the arm's length principle (see below).

Statements of practice issued by the French tax administration repeat this principle, as they recommend two methods to determine the profits to be attributed to a French permanent establishment: the proportional allocation method (application of a coefficient to the overall results), and the allocation by comparison method which "*consists of comparing the establishment (...) to similar enterprises operating at the same conditions and taking part in the same economic process. The desired result can be obtained by applying the average percentage of net profits recorded in the enterprises chosen as comparable to the turnover of the establishment in question*" (statement of practice issued by the tax administration, 4 H-1414, number 20, March 1, 1995). However, it should be noted that some countries, for example Germany,<sup>7</sup> prefer the direct method over the indirect method in order to allocate a certain portion of the overall profit to the permanent establishment.

The fact that transfer pricing principles are essential in these situations is confirmed by the fact that the arm's length concept is also applied in domestic transactions. With reference to Italian permanent establishments, for example, the tax authorities clarified that the transfer pricing rules are normally applicable to "*any person who professionally carries out an economic activity organised for the manufacturing or the exchange of goods or services*", including "any

*unincorporated businesses and also the Italian permanent establishments of foreign companies”.*

Before tackling the question of the correct method that should be used to establish transfer prices between a foreign company and its permanent establishment, the question of how to determine the profits to be attributed to the permanent establishment must be addressed.

The OECD itself recognises that this issue is not at all simple and that a strict reading of Article 7 and its accompanying commentary has given rise to diverging interpretations. This resulted in the OECD issuing a working paper in relation to this subject in 2001.<sup>8</sup>

This project, which was designed to encourage discussion, amply fulfilled its objective in view of the large number of comments to which it gave rise, notably from both practitioners and international enterprises. However, most of these comments related to the specific case of permanent establishments of banks (part II of the project), which widely operate through branches. This particular issue falls outside the realms of what is discussed here. That being the case, the following will only address the points examined by the OECD in part I of the project, which discusses the general case.

At present the OECD project acknowledges that there are two diverging approaches. The first is based on the notion of a “*relevant business activity*”.<sup>9</sup> In this approach, the profits to be taken into consideration are the profits that the enterprise as a whole draws from the activity carried on by the permanent establishment. The profits to be attributed to the permanent establishment are then attributed in accordance with a method similar to the profit split method. The second approach applies the notion of a “*functionally separate entity*”.<sup>10</sup> In this approach, no overall profit is attributed; instead, the permanent establishment’s profit is determined *directly* by reconstituting the transactions that would have taken place had the company and its permanent establishment constituted separate legal entities.

Here again, recourse to the first approach would result in a “*forced*” choice of method, that is, the “*profit split*” method in this case.

However, the OECD’s project suggests that it is the notion of a “*functionally separate entity*” alone that must apply, first as a “*working hypothesis*”, and ultimately as a general principle and the “*authorised OECD approach*”.<sup>11</sup>

In its project, the OECD, *inter alia*, suggests drawing the following conclusions:

- for the purposes of determining the transfer prices applicable between a company and its permanent establishment, article 9 and all of the detailed principles established in relation thereto by the OECD<sup>12</sup> should apply (except in relation to certain very specific aspects which are not discussed here).<sup>13</sup>
- for the purposes of the OECD Principles on transfer pricing the permanent establishment should be considered as a “*hypothetical enterprise* that is distinct and separate from the enterprise of which it is a permanent establishment”.<sup>14</sup>
- this *hypothetical enterprise* only houses the functions carried out by the actual enterprise through the

permanent establishment in question, as determined on the basis of a functional analysis.<sup>15</sup>

When this project is eventually finalised it will, at least in appearance, simplify the situation, which is quite reassuring in certain regards.<sup>16</sup> Indeed, the same principles will apply to all cases of transfer pricing (i.e., transactions between two companies and, “*by analogy*”,<sup>17</sup> transactions between a company and its permanent establishment in another country). More importantly, where diverging interpretations have, as we have seen above, resulted in giving precedence to only one method<sup>18</sup> for establishing the transfer prices between a company and its permanent establishment, it is all of the methods provided for by the OECD Principles that will apply to this one method in the normal way (including the hierarchy that may exist between them).

### C. Allocation of Functions and Risks to a PE

The approach proposed in the OECD’s current project involves performing a functional analysis in order to determine the functions of the permanent establishment and the risks that it bears (as opposed to the functions and risks of the foreign company from which it emanates).

This is a standard exercise that taxpayers and the administration are now accustomed to in the context of transactions between two separate companies.

Sometimes, it is more difficult than expected to implement in the context of “*task sharing*” between a company and its permanent establishment. In certain cases, the permanent establishment qualification strategy could, from this point of view, result in an outcome that is disappointing for an administration. For example, proving the existence of a local distribution function may not necessarily make it possible to justify attributing a significantly higher profit than that which is already taxed locally in the hands of a commercial agent.

If a commercial agent oversteps its ordinary functions and consequently constitutes a permanent establishment of its principal, notably because it contractually binds its principal vis-à-vis its clients, it would seem relatively easy to consider that, in this case, it is the whole commercial cycle (and therefore the function corresponding thereto) that is performed by the permanent establishment. However, what about other functions, for example marketing, without which the commercial function could not have been carried on? In the absence of dedicated teams in the territory of the permanent establishment (other than the strictly commercial teams which have caused the permanent establishment to be deemed to exist and which in this example are not marketing teams), it seems difficult to imagine that a tax administration could successfully claim that this kind of function is attributable to the permanent establishment. At the end of the day, what is the difference between the company, according to its original definition as an agent, and a permanent establishment so characterised by an administration? Possibly very little from a functional perspective, which should not make it possible to substantially modify the basis of the taxable profit.

The same problem arises from a risk allocation perspective. One might assume that by developing a commercial function in a permanent establishment, the accompanying risks will also be located there, such as in relation to customer credit risk, or even exchange risks in relation thereto. A substantial part of the

various risks inherent in a foreign company's activity as a whole, however, can be of such a nature that it will be particularly difficult to include them as functions of the permanent establishment. This is all the more apparent given that it is difficult to allocate risks even within a single legal entity. Here again, if risks cannot be attributed to the permanent establishment, how can a significant profit be attributed to it?

Even more importantly, the notion of "*entrepreneur*"<sup>19</sup> is fundamental in the choice of an appropriate transfer pricing method. The fact that a legal entity of a group is its main entrepreneur arises in essence from a management decision which forms part of the group's organisation and business model, the challenges that it must face in its industry, its history, its management methods, etc. In the ordinary case in which a functional analysis is performed in relation to several legally separate enterprises, the attribution of this role to one of them is a question of fact, the answer to which reflects the group's organisation as it *effectively* exists. Quite often there is little ambiguity in respect of this.

In practice, depending on the case at hand, a complete buyer-reseller may be the group's entrepreneur (whereby the manufacturers are mere operatives with fewer responsibilities), or it may not be (that is, it may instead be a mere operative, with the group's manufacturer having most of the responsibilities). In any event, such things are relatively clear because companies have clear boundaries.

However, where tax administrations retrospectively deem an entity to be a permanent establishment, this boils down to reconstituting a *hypothetical* entity (to use the very words of the OECD), and attributing to it some functions and risks of an actual entity. Is it possible to go as far as deeming a permanent establishment to be the entrepreneur of an organisation? Although this temptation may exist, this exercise may be difficult wherever the burden of proof lies with an administration, save in exceptional cases. Yet, as most of the profits must revert to the entrepreneur, it will be very difficult to attribute a significant portion of these profits to a permanent establishment if the above is not proved.

Consequently, through such an analysis, it will be possible to demonstrate that a commercial agent that:

- signs contracts on behalf of its parent company; has limited commercial attributions,
- and does not bear any risks or responsibilities, only contributes a very small additional added value (compared to its original agent functions),
- and therefore that only a very small additional profit can be attributed to the permanent establishment (that is, on top of what was already attributed to the subsidiary acting as an agent).

## II. PEs and Transfer Pricing: Similar Weapons That are Equally Difficult to Handle

We can consider that the two concepts are, by and large, aimed at the same situations. This is despite the fact that they must be used in two different ways: a legal analysis is necessary as regards permanent establishments (because it is necessary to prove that the parent company is contractually bound by its subsidiary), and an economic analysis is necessary with regard to transfer pricing.

### A. Necessity For a Legal Analysis to Prove the Existence of a PE

As we have seen, faced with a subsidiary of a foreign group, a tax administration will have the choice between two weapons: deeming there to be a permanent establishment or ensuring that its transfer pricing provisions are being complied with. If an analysis that uses transfer pricing concepts seems indispensable in order to establish the existence of a permanent establishment (and then to determine the profits that can be attributed to it), why would tax administrations ever attempt to follow the permanent establishment route at all, and not simply perform a classical transfer pricing analysis at the level of the subsidiary?

In theory, where the tax system in question allows for it, tax administrations could use automatic taxation procedures, which apply where a return is not filed. The consequence of resorting to this procedure could be damaging to the foreign company since the burden of proof lies with the taxpayer requesting the tax relief. Generally, this is a notable difference to transfer pricing reassessments, in which the burden of proof lies with the tax administrations in many countries.<sup>20</sup> This difference in how the dispute is treated is paradoxical, particularly given that, as we have shown, the dispute is based on the same issues as in relation to transfer pricing. In certain jurisdictions, taking into consideration the high stakes, the legislators have very wisely concluded that the taxpayer should be given a chance to regularise its situation and thus avoid automatic taxation. In France, for instance, a multinational that takes appropriate steps to defend its interests can be expected to reply, within the given time period, by filing a complete tax return which declares that the multinational has no taxable basis in France. In such a case, the dispute will then fall under the normal *contradictoire*<sup>21</sup> procedure, in which the burden of proof lies with the administration. Nevertheless, the fact remains that the absence of a declaration will have extended the time limit within which the administration can act to the end of the sixth year after that in which the tax is due (*article L. 169 of the LPF*).

Another disadvantage for the taxpayer is that a permanent establishment reassessment will not be aimed at the same person as a transfer pricing reassessment. With regard to the latter it is the subsidiary that would be reassessed, whereas it is the foreign parent company that would be liable for the tax in the event its subsidiary were to constitute its permanent establishment. The difference may be significant if the subsidiary has losses carried forward. That is, if the subsidiary is subject to a transfer pricing reassessment any adjustment may be offset by losses that can be carried forward (unless minimum taxation rules reduce this effect, for example in Germany; or the ability to carry forward tax losses is time restricted), which would not be available if the parent company was the entity that was liable for the tax.

These disadvantages mainly constitute mechanical consequences of a permanent establishment reassessment, and not so much a decisive advantage for administrations wishing to perform a reassessment. Indeed, the administrations cannot be accused of wishing to avoid the application of the general principle that a taxpayer has the right to be heard before a reassessment is notified. Where an administration considers whether a multinational should be

taxed by virtue of the presence of a permanent establishment, this decision is first and foremost made on the basis of an objective analysis of the technical arguments at the administration's disposal. Although it is undeniable that the permanent establishment issue can arise where a company acts as a commercial agent for a foreign company that is its sole client, it may be slightly premature to consider that the question arises in the same way in relation to any player in an economic manufacturing or distribution chain. That is, and noted above, simply on the grounds that it belongs to an international group. Examples of entities that should not form permanent establishments of their parents are given below.

Without even discussing pure brokerage agreements, a commissionaire agreement, whereby a company acts in its own name but on behalf of a foreign company, should not give rise to a permanent establishment of the foreign company. This is even if the commissionaire were to be considered as an economically dependent agent. As mentioned in the OECD commentary (*Section 5.32.1*), simply because a contract is not effectively concluded in the name of the foreign company, this does not suffice to set aside the possibility of the existence of a permanent establishment. Ultimately, however, it is necessary to examine whether the company can contractually bind the foreign company in its country of establishment (*Section 5.33*). In this regard, in connection with civil law jurisdictions, the legal analysis of the commissionaire agreement leaves little room for doubt: the purchaser of the goods sold by the commissionaire in its own name should only be able to take direct action against the commissionaire, and not against its principal (*Cf.* for instance, in a French context, *CA Paris March 20, 1963, Journ. agrées 1964.251*; *Cass. Com. May 28, 2002, no.00-12.358, Bertola vs. SMB*). However, in the United Kingdom (as is typical in a country governed by common law), it is generally considered that the commissionaire binds the principal when entering into any contract, by virtue of being an agent, albeit an undisclosed agent, the reason being that a third party can sue the principal. Therefore, to try to reduce the risk of a permanent establishment being deemed to exist, in a commissionaire arrangement consideration should be given to including a specific term in the contract that prevents a third party from suing the principal.

An analysis of a toll manufacturing agreement should result in a conclusion that in principle, it merely provides a manufacturing or assembly service for the benefit of its foreign client, and cannot contractually bind its client.

A distribution agreement whereby the distributor keeps its role as buyer-reseller, while most of the risks associated to this reselling activity are contractually transferred to its foreign supplier, should not give rise to a permanent establishment either given that, from a legal perspective, the distributor acts in its own name and on its own behalf.

Of course, the above analyses require that the contracts organising these commercial operations to be sufficiently clear and explicit. If they are not a tax administration could attempt to deem the contract in question to be a commercial agency agreement.

It might, in any event, be difficult for a tax administration to maintain a permanent establishment exists. It could first consider that the above mentioned activities give rise to the constitution of an inventory of raw materials or finished goods

that are legally held by a foreign company, which could in turn constitute a fixed place of business. However, the OECD model treaty (*Article 5.4*) clearly provides that installations that are merely used for storage purposes, or by goods that are warehoused merely for storage or transportation purposes do not give rise to a permanent establishment.<sup>22</sup> The model treaty further provides that the cumulative existence of the above-listed activities does not constitute a permanent establishment either, provided the overall activity remains preparatory and auxiliary (*Article 5.4, f*).

However, it must be pointed out that under Italian treaties there is no provision that replicates Article 5(4)(f) of the OECD Model Convention. Although the absence of such a provision could in theory give rise to an Italian permanent establishment when there is a combination of the above mentioned activities, such a view has never been expressed by the Ministry of Finance or the Italian courts, and indeed has been strongly criticised by Italian scholars. The decisive criterion should still remain whether or not the activity carried out in Italy forms an essential and significant part of the business of the non-resident enterprise (see paragraph 24 of the Commentary on Article 5 OECD Model Convention). An argument to support this view may also derive from the domestic definition of permanent establishment where the provision of Article 5(4)(f) of the OECD Model Convention is reproduced.

It must be also noted that the Italian Supreme Court, in the Philip Morris cases mentioned above, stated that in order to ascertain whether the activities performed in Italy might be considered as having a preparatory or auxiliary character, one must look at the overall activities carried out in Italy with respect to the overall group's activities and not only at the head office activities (Supreme Court No. 3368/2002 and No. 7682/2002). In contradiction to this, however, the proposed OECD clarifications of the permanent establishment definition mentioned above point out that the determination of the existence of a permanent establishment must be done separately for each company of the group (see proposed new paragraph 41.1 of the Commentary on Article 5 OECD Model Convention). Moreover, the Italian Supreme Court has also stated that where an Italian group company monitors the performance of contracts signed between a non-resident group company and an Italian third party this monitoring cannot be regarded as an auxiliary activity (Supreme Court No. 3368/2002 and No. 7682/2002).

In France, the administration might also consider that a foreign company that has products manufactured in France through the intermediary of a toll manufacturer, and which markets them to French clients through the intermediary of an agent, carries on an activity in France within the meaning of article 209-1 of the CGI, based on the case law "*commercial cycle of activities in France*" theory (*CE. June 15, 1942, no.72011, 7th s.s.: RO p. 148; Gaz. Pal. 25-11-1942; CE. May 19, 1965, no.58784, 8th s.s.: BOCD 1965-II-3139; Dupont p. 300; RO p. 352; CE. November 13, 1964, no.50944 and 60449, 8th s. s.: RO p. 186; Dupont 1965 p. 30*). The fact remains, however, that in the context of a tax treaty this argument would largely be unavailable.

It should be stressed that the French tax administration has recently acknowledged the uncertainty created by this analysis for foreign corporations. A proposed piece of legislation, expected to be voted on at the end of December

2004, provides that foreign companies, resident of a Treaty country, could request the French tax administration to opine on whether their operations constitute a permanent establishment in France. Failure to respond to such a request within three months would be deemed to constitute an opinion of the French tax administration that could be relied upon, that no permanent establishment is constituted.<sup>23</sup>

It has been demonstrated that proving the existence of a permanent establishment is not at all straightforward. Even when presence of one is established, in order for this to be worthwhile for a tax administration, it is then necessary to establish that a net profit can be attributed to this permanent establishment. As we saw above, this will necessarily involve an analysis equivalent to the transfer pricing analysis. It is for this reason that the tax administration may prefer to start with the transfer pricing approach.

### B. Necessity for an Economic Analysis to Prove the Violation of the Arm's Length Principle

Intuitively, it would seem that tax administrations should use the transfer pricing weapon against subsidiaries that generate limited taxable profits whilst belonging to highly profitable multinational groups. The following question must therefore be addressed: is the commercial (or manufacturing) entity in question compensated proportionately to its effective functions and the risks that it bears?

Regardless of the importance of the entity's actual functions and the risks borne, such functions and risks must be valued. Administrations may legitimately require this. It is at the heart of the transfer pricing issue.

Very often, multinational enterprises operating in a given country through structures with a "light" functional profile (agents, commissionaires, limited risk distributors, manufacturing sub-contractors, toll manufacturers, etc.) tend to consider that these entities carry on and bear "routine" functions and risks which only justify a moderate profit margin rate.

In order to determine whether a profit margin is in accordance with arm's length dealing, a benchmark based on independent and functionally comparable companies (as is currently performed today and which practically always turns out to be necessary), will not suffice. Indeed, these "routine" functions and risks must be properly put into perspective in the light of the group's other functions and risks in order to convincingly establish that their relative "weight" is truly modest.

The same is true in relation to the question of intangibles: even though a commission agent may have a very modest role in the context of a worldwide group in terms of functions and responsibilities, if in its local market it were to achieve a very significant market share or particularly remarkable brand awareness *using its own means*, its contribution may have had a significant effect on the group's overall success.

All of these questions must first be addressed upstream and in a global perspective. As we have previously mentioned,<sup>24</sup> these crucial points will be dealt with appropriately through an analysis of value creation within the group.

This analysis corresponds to an in-depth economic analysis that is aimed at establishing and describing the deciding factors in the group's industry, its strategy and position compared with competitors, its internal organisation (which

takes place more often in the form of integrated processes than simply as separate functions performed in isolation to one another) and finally the effective role of the various entities in each of the aspects (processes) of this organisation. If at each stage, the items described by comparison to each other are put into perspective, the main factors that create value can be "traced" from the environment outside the group to its internal sources, and how strongly or otherwise a given entity participates in their emergence, their conservation and/or their development can be clearly and conclusively highlighted. Although the OECD principles expressly mention that all of the points between the upper and lower limits of an arm's length range are presumably equally pertinent,<sup>25</sup> this kind of analysis also makes it possible to determine what area within these limits is most appropriate in the particular case of the group in question. Finally, it makes it possible to establish whether a given intangible has particular value for the group.

In the context of the issues discussed in this note, such an analysis will be particularly important in order to confirm, in a more constructed form than a mere affirmation, that a given set of functions and risks are indeed "routine".

If a tax administration discovers a difference between the functions that the entity is claimed to carry on in theory and those that it carries on in practice, which would result in a reassessment, the abovementioned analysis could constitute a particularly efficient tool for the taxpayer to use in order to demonstrate that the difference invoked by the administration does not have any particular economic value, assuming the facts lend themselves to this demonstration.

To take a concrete example, if in a given industry creating value mostly requires mastering complex and strategic processes that are borderline between R&D and Product Marketing, answering the question whether or not a commercial unit (not taking part in these processes) should be considered as a buyer-reseller, and not as an agent, will have little impact on the value creation chain. In other words, in this example it will have been shown that in this specific industry a mere agent and a buyer-reseller can practically be considered to be comparable from a functional point of view!

Indeed, it should be remembered the OECD lays down as the fundamental principle of comparability<sup>26</sup> that two transactions with differences are well and truly comparables if "(...) *no difference (if there are any) between the transactions compared or between the enterprises carrying out these transactions, can have a significant effect on the margin (...)*".

We hope that it has been demonstrated that reaching a convincing conclusion in this area, be it positive or negative, requires an in-depth economic analysis in each particular case.

### III. Conclusion

The permanent establishment approach therefore does not seem to constitute a panacea for the tax administration faced with the threat of profit delocalisation. At the very most, we can agree that the concept of a permanent establishment can be used in this context. However, the use of the permanent establishment argument will not enable tax administrations to avoid carrying out an economic analysis. Such a study is an indispensable part of profit allocation. In any event, *a priori*, it is wrong to always assume that limited profit levels that

correspond to equally limited risks and functions, means the entities concerned are not operating in accordance with arm's length principles.

Of course, in situations that may be considered as extreme, nothing will stop tax administrations, at least initially, from using all of the weapons at their disposal, and from claiming both that a foreign enterprise has a permanent establishment through its subsidiary and that this subsidiary exports profits to the foreign enterprise through unjustifiable transfer pricing. However, it remains to be proven that such a double-barrelled approach would be justified if it were to result in triple or quadruple taxation! Hence, at a time when it is highly questionable whether domestic transfer pricing tax rules, which only in practice focus on dealings with non-residents, are compatible with the European law principle of non-discrimination, an approach which relies on both the finding of permanent establishments and the rules relating to transfer pricing is unlikely to be the solution to tax administrations tax cohesion concerns.

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- 1 CE June 20, 2003 no.224407 sect., Min. c/ Interhome AG: RJF October 2003 no.1147.
- 2 Patrick Donsimoni, *How to evaluate the risk of a subsidiary being characterised as a permanent establishment?* – JCP ed. E no.11 dated March 11, 2004 p. 405; Opinion of Stéphane Austry, the reporter judge on the Interhome AH case; BDCF October 2003 no.130.
- 3 Conclusions of S. Austry, previously cited
- 4 Patrick Donsimoni, previously cited
- 5 BFH, September 14, 1994, BStBl. II 1995, 238.
- 6 Note: in this quote, the further precision provided in brackets is inserted by the authors of the current article.
- 7 See decree of the German tax authorities dated December 24, 1999, Para. 2.3., with reference to decisions of the German Supreme Tax Court.
- 8 OECD 2001, *Discussion draft on the attribution of profits to permanent establishments* (hereafter the "OECD project"). From the outset, this document was prepared in separate parts. Part I, published in February 2001, addresses the issue in a general framework, applicable to any kind of permanent establishment.

Part II, also published in 2001 and revised in March 2003, deals more specifically with permanent establishments of banks. Part III, published in March 2003, concerns the case of "global trading" operations in financial institutions. In its whole, the current document is still in project form. A revised version of Part I was issued on August 3, 2004.

- 9 OECD project, Part I, Section 11.
- 10 OECD project, Part I, Section 19.
- 11 OECD project, Part I, Section 28. Note that, further to the issuing of a revised version of Part I of the OECD Project on August 3, 2004, the *working hypothesis* is now confirmed to have become the "authorised OECD approach". Still, Part I remains a draft. This is because the business community were given one final opportunity to further comment on it before September 28, 2004.
- 12 OECD, 1995 et seq., *Transfer pricing principles for the attention of multinational enterprises and tax administrations*. Hereafter the "OECD Principles".
- 13 OECD project, Part I, Section 51.
- 14 OECD project, Part I, Section 52.
- 15 OECD project, Part I, Section 72 et seq., notably Section 74.
- 16 The question of the possible problems to which this project may give rise in the specific case of banking institutions is not addressed here.
- 17 OECD project, Part I, Section 53.
- 18 The comparable uncontrolled price method, the transactional net margin method, or the profit split method, depending on the different interpretations.
- 19 Main investor, main risk taker of the group, and the entity that is by its nature the best armed to manage these risks, as a result of its qualities, responsibility and functions, etc.
- 20 However, it should be noted that, for example, in Germany the documentation and filing requirements have been increased for international operating companies as of 2003. Therefore, even if the burden of proof has not been shifted from the tax authorities to the taxpayers in legal terms, a major part of the economical burden of complete declaration is now with the taxpayer. Additionally, on October 18, 2004, the German tax authorities issued a draft decree on the income allocation and related duties for cooperation and documentation for further commentary by professionals and taxpayers.
- 21 A procedure in which the taxpayer has a right to be heard before the reassessment is notified
- 22 Nevertheless, in the absence of a double tax treaty, the local law may constitute a permanent establishment in such cases, e.g., in Germany.
- 23 Proposed article L80B 6° of "livre des procédures fiscales", further to a Report prepared by Bruno Gibert, CMS Bureau Francis Lefebvre.
- 24 S. Gelin and A. Le Boulanger – *Tax Planning International Review*, January 2002, *Transfer pricing: from arm's length principle to analysis of value*.
- 25 OECD principles, Section 1.48: "If the conditions of transactions between associated enterprises (for example, the price or the margin) are within the upper and lower limits of the arm's length margin, there will be no need to make an adjustment".
- 26 OECD principles Section 2.7, 2.16 and 2.34, in particular.

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