Raffaele Petruzzi and Raphael Holzinger*

# Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era

**The overall topic of profit attribution to dependent agent permanent establishments is a highly complex issue. Various aspects are controversially discussed in literature. From a general perspective, article 7 and article 9 of the OECD Model are both fundamentally based on the arm's length principle, which was initially established in the early 1930s in order to properly account for profit attributions within MNEs. Since its beginnings, the arm's length principle(s) under article 7 and article 9 of the OECD Model have evolved over time. In this respect, especially the OECD's work under the Authorised OECD Approach, BEPS Action 7 as well as under BEPS Actions 8-10 have eventually minimized, or even closed the gap between, the principles of profit attribution under article 7 and article 9 of the OECD Model. This article will analyse the topic of profit attribution to dependent agent permanent establishments, thus dealing with the question as to whether or not different results could/should arise when applying article 7 and article 9 of the OECD Model in a post-BEPS era.**

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## 1. Introduction

### *1.1. Introduction to the topic*

The topic of the attribution of profits to permanent establishments (PEs) has gained a considerable amount of attention in recent years, both from taxpayers and from tax administrations around the world. The work of the OECD in this area, which began in the late 1990s,[1] has resulted in the publication, first in 2008 and then in 2010, of its Report on Attribution of Profits to Permanent Establishments (and the development of the approach known as the "Authorised OECD Approach" or "AOA").[2] The AOA has established the adoption of the arm's length principle (by means of the so-called "separate legal entity approach") as the relevant (and only) principle in order to attribute profits to PEs.

Within the current version of the OECD Model,[3] different concepts of PE can be identified: the "general PE" under article 5(1), the "construction PE" under article 5(3) and the "dependent agent PE" (DAPE) under article 5(5) and (6) are key examples of these concepts. Although the general PE is the ordinary expression of the existence of a PE in a source state, over the past few years, the topic of DAPE has gained considerable importance for the global business activities of multinational enterprises (MNEs), thus raising taxpayers' and tax administrations' awareness on the issues related to it.

This awareness has been embedded also within the scope of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project, which has dedicated an entire Action – BEPS Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status – to developing "changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions" as well as to addressing "related profit attribution issues".[4] However, while the first part of the project on this Action (i.e. the part related to changes to the definition of PE) seems to be completed,[5] at the time of writing, the second part (i.e. the part aimed at addressing issues related to profit attribution) is still being drafted by the OECD and should be completed "before the end of 2016".[6] A new Public Discussion Draft on BEPS Action 7

1. *See* P. Baker & R. Collier, *2008 OECD Model: Changes to the Commentary on Article 7 and the Attribution of Profits to Permanent Establishments*, 63 Bull. Intl. Taxn. 5, p. 199 (2009), Journals IBFD.
2. *See* OECD, *2010 Report on the Attribution of Profits to Permanent Establishments* (OECD 2010), International Organizations' Documentation IBFD.
3. *See OECD Model Tax Convention on Income and on Capital: Condensed Version 2014* (15 July 2014), Models IBFD [hereinafter *OECD Model* (2014)]. Unless otherwise stated, all cited articles refer to this version.
4. *See* OECD/G20, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: Final Report*, p. 13 (OECD/G20 2015), International Organizations' Documentation IBFD [hereinafter *Action 7 Final Report*].
5. *See* id., at Executive Summary.
6. *See* id., at 11.


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was issued on 4 July 2016, providing for some initial ideas on how this topic will be developed in the future work of the OECD.[7]

Meanwhile, many changes in the area of transfer pricing have been introduced by the OECD under the work on BEPS Actions 8-10,[8] concerning the interpretation of issues related to article 9 of the OECD Model and the guidance on the application of transfer pricing rules to associated enterprises (i.e. the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter OECD Guidelines)).[9]

This article will analyse issues related to the interpretation of article 7 of the OECD Model ("Business Profits") and to the current OECD guidance on the topic of the attribution of profits to PEs (i.e. the AOA), with specific reference to the issues related to DAPEs, in light of the amendments already proposed as part of the work on BEPS Action 7 and Actions 8-10.

### *1.2. Research questions*

In light of the current work by the OECD and the various issues related to it, this article will deal with the following questions:

– Is there a different outcome between an arm's length remuneration derived under article 7 or under article 9 of the OECD Model?

– Should there be a different outcome between the application of article 7 and article 9 of the OECD Model?

– What are the effects of the newly introduced principles under BEPS Actions 8-10 on the profit attribution to agent PEs in general?

– Are there specific effects as a result of the changes with respect to DAPEs?

### *1.3. Structure*

Since the article touches upon various aspects, an overview of the structure of the sections and the respective topics is considered useful. In general, the article is meant to analyse issues related to the interpretation of article 7 of the OECD Model ("Business Profits") and to the current OECD guidance on the topic of the attribution of profits to PEs (i.e. the AOA), with specific reference to the issues related to DAPEs, in light of the amendments already proposed within the work on BEPS Action 7 and Actions 8-10.

In order to provide some insights into the evolution of transfer pricing and profit attribution to PEs, section 2. presents the historical background on these issues. In this respect, its evolution will be described starting with the first edition of the Draft Model Convention for the Prevention of Double Taxation and Evasion in 1927 (hereinafter Draft Model (1927))[10] until the latest introduction of the AOA in 2008 and 2010 respectively.

7. *See* OECD, *Discussion Draft on Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7 – Public Discussion Draft* (OECD 2016) [hereinafter *Public Discussion Draft on BEPS Action 7*].
8. *See* OECD, *Aligning Transfer Pricing Outcomes with Value Creation – Actions 8-10: Final Reports*, Executive Summary (OECD 2015), International Organizations' Documentation IBFD [hereinafter *Actions 8-10 Final Reports*].
9. *See* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2010), International Organizations' Documentation IBFD [hereinafter *OECD Guidelines*].
10. *See Annex I – Draft of a Bilateral Convention for the Prevention of Double Taxation*, in *Double Taxation and Tax Evasion, Report Presented by the Committee of Technical Experts on Double Taxation and Tax*

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Section 3. investigates to what extent the principles expressed by the AOA can be applied to double tax treaties concluded before and after the implementation of such principles into the OECD Model and Commentaries, highlighting the numerous interpretational issues embedded within the current background.

As a next step, section 4. illustrates the principles expressed by the AOA, both in general and with specific reference to the case of DAPEs, underling how their main goal was to establish the adoption of the arm's length principle for the attribution of profits to PEs.

The analysis in section 5. questions whether, when applying this principle, the application of article 7, on the one hand, and of article 9, on the other, leads eventually to the same results or not. Although it seems that the application of the arm's length principle does lead to different results in the application of the principle itself under the two articles, it is doubtful whether this application should lead to different results, only based on the different purposes of the two articles. The conclusions to this section highlight how, under the current guidance in a pre-BEPS era, the differences between the two articles might appear to be on a conceptual basis.

These conclusions are even more evident when analysing the amendments introduced by the BEPS Project on the interpretation of the arm's length principle under the work on BEPS Actions 8-10. Therefore, in section 6., some selected topics considered relevant in order to address the issue of the attribution of profits to DAPEs will be explained in detail.[11]

To interlink the analysis of the work carried out under BEPS Actions 8-10 with the current work on profit attribution to DAPEs, section 7. analyses the possible impact of the BEPS work related to article 9 on the future BEPS work related to article 7, as well as the impact that current guidance on article 7 could have on the future BEPS work related to article 9. With reference to the first point, the new guidance on the analysis of risk in commercial and financial relations, the new developments on the entitlement to intangible related returns (and on the DEMPE analysis),the new considerations on the impact of group synergies as well as on the impact of location savings and other local market features will most probably need to be reflected in the new developments on the topic of the attribution of profits to DAPEs. On the other hand, it is also probable that the current guidance on article 7 could impact the future BEPS work related to article 9 (e.g. within the future work of the OECD on transfer pricing issues related to intra-group financing under BEPS Action 4).

Then, in light of the analysis performed in the previous sections, section 8. presents some proposals for future BEPS work related to the attribution of profits to DAPEs, related both to general aims as well as to more specific ones.

Subsequently, section 9. presents the recently published OECD draft proposal under BEPS Action 7, together with some preliminary comments on and considerations of it in order to interlink the analysis previously carried out with the future work of the OECD.

Finally, section 10. presents the overall conclusions of this article.

*Evasion*, League of Nations Document no. C.216.M.85.1927.II (April 1927) [hereinafter *Draft Model* (1927)].

11. I.e. the topics of the delineation of the actual transaction, the analysis of the risk factor, the entitlement to intangible related returns, the impact of group synergies as well as the impact of location savings and other local market features.

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## 2. The Historical Background

The topic of profit attribution to PEs was already dealt with in the first edition of the Draft Model (1927) and has evolved over the years, until the latest introduction of the AOA in 2008 and 2010. Since this evolution is an important aspect in order to properly understand the reasons behind the currently applicable arm's length principle for both enterprises and PEs, sections 2.1.-2.3. will illustrate the historical evolution of this topic.[12]

### *2.1. The origins*[13]

The topic of the attribution of profits to PEs was already included in the wording of the first Draft Model, which was elaborated in 1927 by the League of Nations. In that context, the term PE referred not only to general PEs (whereby including, inter alia, branches, factories, warehouses and offices), but also to "agencies" and "affiliated companies".[14] Therefore, the guidance on this topic referred to any kind of business income generated in a source state.

At that time, profits should have been attributed to a PE based on either the "separate accounting approach" or by mutual agreement between the competent authorities. The "separate accounting approach" was, nevertheless, soon abandoned in the 1928 Model Convention for the Prevention of Double Taxation and Evasion (hereinafter Model (1928)), and the mutual agreement between the competent authorities remained, at that time, the only proposed solution.[15]

However, these ways of attributing profits to PEs were revisited between 1928 and 1933 in light of the work performed first by the American economist Thomas S. Adams, and later by the American lawyer Mitchell B. Carroll.[16]

This work ultimately led in 1933 to the separation of the methodology for attributing profits to PEs (provided under article 3 of the proposed Draft Model (1933)) from the methodology for attributing profits between affiliated companies (provided under article 5 of the proposed Draft Model (1933)).[17] The presence of "legal transactions" in the relationships between affiliated companies was amongst the main reasons for such a separation.[18]

12. Unless otherwise stated, the described principles of profit attribution to PEs apply to the case of general PEs as well as to the case of DAPEs.
13. For more details on this topic, *see*, among others, OECD, *Discussion Draft on the Attribution of Profits to Permanent Establishments*, paras. 1 et seq. (OECD 2001); OECD (2010), *supra* n. 2, at paras. 1 et seq.
14. *See Draft Model* (1927), with reference to the long history of the topic. *See also* E. Reimer, in *Klaus Vogel on Double Taxation Conventions* art. 7, para. 3 (E. Reimer & A. Rust eds., Wolters Kluwer 2015); X. Ditz, in *Doppelbesteuerungsabkommen* art. 7, paras. 14 et seq. (J. Schönfeld & X. Ditz, Verlag Dr. Otto Schmidt 2013).
15. *See Annex I – Bilateral Conventions for the Prevention of Double Taxation in the Special Matter of Direct Taxes,* in *Report on Double Taxation and Tax Evasion Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Document no. C.562.M.178.1928.II. (October 1928) [hereinafter *Model* (1928)]. In the *Model* (1928), the reference to "affiliated companies" was removed. *See* D.L.P. Francescucci, *The Arm's Length Principle and Group Dynamics – Part 1: The Conceptual Shortcomings*, 11 Intl. Transfer Pricing J. 6, 62 et seq. (2004), Journals IBFD. *See* M. Koomen, *Transfer Pricing in a BEPS Era: Rethinking the Arm's Length Principle – Part I*, 22 Intl Transfer Pricing J. 3, sec. 2 (2015), Journals IBFD.
16. *See* M.B. Carroll, *Methods of Allocating Taxable Income* (League of Nations 1933).
17. *See* League of Nations Fiscal Committee, *Report to the Council on the Fourth Session of the Committee – Held at Geneva from June 15th to 26th*, C.399.M.204. 1933.II.A. (League of Nations 1933).
18. *See* Carroll, *supra* n. 16.

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Both methodologies to attribute profits were fundamentally based on the newly introduced "arm's length principle".[19] However, while this principle was the only one to be applied when attributing profits between affiliated companies, when attributing profits to PEs, the arm's length principle was supplemented by other methods aiming at a formulary apportionment of the profits.[20]

Since the Draft Model (1933), the methodologies for attributing profits to PEs, on the one hand, and for attributing profits between affiliated companies, on the other, have evolved in a parallel way: the latter methodologies, under article 5, fully rely on the arm's length principle, while the former ones, under article 3, rely on the same principle, but also provide some deviations from this principle.[21]

### *2.2. The 1963 Model*

The OECD continued to work on the topic of profit attribution to PEs during the decades following the Draft Model (1933). This work led, in 1963, to a new draft of the article dealing with the attribution of profits to PEs, i.e. article 7. Based on this article, profits should have been attributed to PEs based on the so-called "limited" separate accounting principle (or "restricted" arm's length principle).[22]

Additionally, article 7 incorporated paragraphs 3 and 4, which, to some extent, led to some uncertainties on how article 7(2) should have been applied. Indeed, paragraph 3 established that the PE should be allowed to deduct "*expenses which are incurred for the purposes of the permanent establishment*, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere" (emphasis added).[23] This paragraph could generate some diverging views in its

19. *See* Francescucci, *supra* n. 15, at 64. *See* H. Loukota & H. Jirousek, *Internationales Steuerrecht I*, 1 Z 9, paras. 1 et seq. (Manz Verlag). *See* Koomen, *supra* n. 15, at 142.
20. Indeed, supplementary methods were suggested when attributing profits to PEs. For PEs, while any existing separate accounts were considered to be the starting point of the analysis, in the case of (a) not available separate accounts, (b) accounts not producing results in line with "the normal usages of the trade" or (c) impossibility in the determination of the arm's length principle, the attribution of profits could have occurred "by applying a percentage to the turnover" of the PE. *See* League of Nations Fiscal Committee, *supra* n. 17.
    Additionally, when those methodologies were considered as inappropriate, the attribution of profits to PEs could have been made by reference to "a computation based on the total income derived by the enterprise from the activities in which such establishment has participated" (i.e. by using "coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors"). *See* League of Nations Fiscal Committee, *supra* n. 17.
21. *See* sec. 2.2.
22. Indeed, art. 7(2) made reference to "the profits which [the PE] 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" (emphasis added) (*see* art. 7(2) *OECD Model* (1963)). In this respect, art. 7(2) *OECD Model* (1963) contained (and still contains) "the central directive on which the allocation of profits to a permanent establishment is intended to be based" (*See OECD Model Tax Convention on Income and Capital: Commentary on Article 7* para. 10 (20 July 1963), Models IBFD). Even in the light of the *OECD Model* (1963), profits – which the PE would have earned if it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market – had to be attributed to a PE (*see* para. 10 *OECD Model: Commentary on Article 7* (1963)).
23. *See* art. 7(3) *OECD Model* (1963).


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interpretation.[24] Table 1 summarizes the consequences of article 7(2) and (3), of the OECD Model (1963).[25]

**Table 1: Consequences of the application of article 7(2) and (3) of the OECD Model (1963)**

| Internal Dealings | Pricing |
|---|---|
| Transfer/sale of tangible assets/goods (core activities) | At arm's length |
| Transfer of intangible assets | At cost |
| Internal services: General services | At cost |
| Internal services: Specific services | At arm's length |
| General management | At cost |
| Internal interest | Not allowed |

Moreover, paragraph 4 stated that "insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment *on the basis of an apportionment of the total profits of the enterprise to its various parts*, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that *the result shall be in accordance with the principles contained in this article*" (emphasis added).[26] As illustrated by the OECD Commentary (2005),[27] such apportionment of profits could have been based on different criteria (e.g. turnover/commission, wages, working capital), but, nevertheless, should have produced "figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis" (i.e. the method adopted by article 7(2)). Similar to the previous paragraph 3, paragraph 4 could also lead to different interpretations.[28]

The coexistence of these different paragraphs, leading to diverging interpretations on how to attribute profits to PEs, generated issues deriving from an incoherent allocation of taxable profits between different countries, which resulted in double taxation (or less-than-single taxation) of such profits.

24. On the one hand, this paragraph could be seen as simply confirming that, when determining the profits of a PE, it should be possible to deduct the PE's expenses (as would typically be required by the application of the arm's length principle). Indeed, in this respect, para. 3 *OECD Model: Commentary on Article 7* (1963) mentions that this paragraph clarifies the general directive laid down in para. 2 in relation to the expenses of a PE, thus being valuable in order to remove doubt (*see* para. 13 *OECD Model: Commentary on Article 7* (1963)). However, this paragraph could also be seen to deviate from the arm's length principle, whereby allowing for deductibility "only" of the expenses (hence, not allowing the deductibility of any profit element related to these expenses – e.g. markup – or disregarding the deductibility of some kind of expenses – e.g. licence payments).
25. *See* A. Storck, *Tax Planning in International Companies: Selected Issues with Case Studies/Court Decisions – Modul 2: PE and Profit Attribution*, slide 29 (2015).
26. *See* art. 7(4) *OECD Model* (1963).
27. *See OECD Income and Capital Model Convention and Commentary on Article 7* para. 27 (15 July 2005), Models IBFD.
28. On the one hand, this paragraph could be perceived as aiming to simplify the method to determine the allocation of profits to PEs by embedding the possibility to use a sort of "formulary apportionment", which should, however, be in line with "the principles contained in this Article" (i.e. the restricted arm's length principle). On the other hand, this paragraph could be interpreted as allowing for a deviation from the arm's length principle, whenever formulary apportionment is allowed by the contracting state(s).

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### *2.3. The introduction of the AOA*

In order to prevent the issues mentioned in section 2.2., in the late 1990s[29] the OECD started to work on the topic of profit attribution to PEs once again. This work led to the publication, first in 2008 and then in 2010, of the AOA.[30] The AOA aimed at establishing the adoption of the arm's length principle (by means of the so-called "separate legal entity approach") as the relevant (and only) principle in order to attribute profits to PEs.[31] From a systemic point of view, the OECD's work on the AOA was perceived as a change of paradigm, since the previous version of article 7 of the OECD Model was subject to the relevant business activity approach, whereas the new version incorporated the separate entity approach.[32]

Based on this approach, profits should have been attributed to a PE by analysing functions, assets and risks based on the "full" separate accounting principle (or arm's length principle). The new article 7 of the OECD Model (2010), now referred to "the profits [the PE] 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".[33] Additionally, the above-mentioned paragraphs 3 and 4 (*see* section 2.2.) were removed from the text of article 7.

However, the AOA was implemented in different stages in the text of the OECD Model and its Commentaries.[34] This implementation in different stages has generated some diverging views on the way the topic of the attribution of profits to PEs should be analysed. Moreover, another factor adding complexity to this process, resides in the fact that the UN Model and its Commentaries have explicitly rejected the implementation of the AOA.[35]

## 3. The Applicability of the Principles Expressed by the AOA

In the context of the current analysis, it is appropriate to investigate to what extent the principles expressed by the AOA can be applied to double tax treaties concluded before and

29. Baker & Collier, *supra* n. 1, at 199.
30. *See* OECD (2010), *supra* n. 2.
31. *See* id., at paras. 1 et seq.
32. *See* S. Bendlinger, *Paradigmenwechsel bei der Betriebsstätten-Gewinnabgrenzung*, in *Handbuch Konzernsteuerrecht* p. 121 (F. Fraberger et al. eds., 2014); F. Wassermeyer, in *Doppelbesteuerung* art. 7, paras. 175 et seq. (F. Wassermeyer et al. eds., Linde Verlag 2015); Ditz, *supra* n. 14, at art. 7, paras. 89 et seq.; Reimer, *supra* n. 14, at art. 7, para. 77.
33. *See OECD Model Tax Convention on Income and on Capital: Commentary on Article 7* para. 2 (22 July 2010), Models IBFD. *See also* C. Kaeser, in Wassermeyer et al. eds., *supra* n. 32, at art. 7, paras. 417 et seq.
34. Before 2008, the text of the OECD Model and the text of the OECD Model Commentaries incorporated into art. 7 the old view of the OECD on this topic. Between 2008 and 2010, the OECD Commentary on Article 7 (but not the OECD Model) was amended to embed the new OECD approach. The OECD Model was not changed, resulting in an inconsistency between the text of the OECD Model (embedding the old wording of art. 7, which led, as shown in sec. 2.2., to diverging interpretations) and that of the OECD Commentary (providing only for the full separate accounting principle, in line with the newly developed AOA). Finally, in 2010, the OECD Model also embedded a new art. 7, in line with the AOA. (*See also* G. Kofler & F. Rosenberger, *RuSt 2013: Highlights aus dem Workshop Internationales Steuerrecht*, RdW p. 635 (2013).
35. *See UN Model Double Taxation Convention between Developed and Developing Countries* art. 7 (1 Jan. 2011), Models IBFD. *See* paras. 1 et seq. *UN Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 7* (2011).


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after the implementation of such principles into the OECD Model and Commentaries.[36] As mentioned before, the AOA established the adoption of the arm's length principle (by means of the separate legal entity approach) as the relevant principle in order to attribute profits to PEs. Analysing the application of the principles of the AOA is mostly relevant for the practical understanding of whether there are different outcomes as a result of the application of such principles under article 7 or article 9 of the OECD Model.

Moreover, the distinction between the three implementation stages of the AOA into the OECD Model and OECD Commentaries must be highlighted when dealing with the applicability of the AOA in the context of double tax treaties. Finally, the different countries' approaches to interpreting the provisions of tax treaties (i.e. either applying a "static" or a "dynamic" approach) should be considered.

### *3.1. Double tax treaties concluded before 2008*

Double tax treaties concluded before 2008 obviously included the old article 7. Therefore, the question may arise as to whether the principles established by the AOA and embedded into the OECD Commentary could be applied to those treaties. In the context of international tax treaty networks, these "old" treaties form the major part of all currently applicable double tax treaties.

If the "static" interpretation is embraced, later Commentaries might not be considered to affect the interpretation of previously concluded double tax treaties.[37] Therefore, this view would lead to the conclusion that the AOA and the 2008 OECD Model Commentary (as well

36. When dealing with the applicability of the AOA, the general interpretation rules in international law, codified by the *Vienna Convention on the Law of Treaties* (VCLT) (*see Vienna Convention on the Law of Treaties* (1969), Treaties IBFD), should be considered. In this respect, the OECD Model and the OECD Commentaries are of great importance as historical interpretation material. *See* Loukota & Jirousek, *supra* n. 19, at 1 Z 0 paras. 35 et seq. *See also* M. Lang, *Introduction to the Law of Double Taxation Conventions*, paras. 83 et seq. (Linde Verlag 2013).
    However, the wording of a particular double tax treaty is more important than the historical interpretation material, which can only attribute a special meaning to a term if the contracting parties so intended. (*See* Loukota & Jirousek, *supra* n. 19, at 1 Z 0 paras. 35 et seq.; Lang, op. cit., at paras. 83 et seq.; Wassermeyer, *supra* n. 32, at art. 3, para. 78.)
    Moreover, it is argued that the OECD Model and the OECD Commentaries should also be taken into account for those treaties not following the OECD Model, which is, however, in conflict with the interpretation of the terms of the treaties in light of their object and purpose. (*See* Lang, op. cit., at paras. 62 et seq.)
    For more detailed information on the interpretation of double tax treaties, *see* Loukota & Jirousek, *supra* n. 19, at 1 Z 0 paras. 1 et seq.; S. Oesterhelt, *Bedeutung des OECD-Kommentars für die Auslegung von Doppelbesteuerungsabkommen*, ASA 2011/2012, pp. 373, 376 et seq.; Wassermeyer, *supra* n. 32, at art. 1, paras. 31 et seq.
    In the literature, the controversial point is discussed as to whether changes to the OECD Model or OECD Commentaries can affect the interpretation of double tax treaties concluded before the said change (*see* Loukota & Jirousek, *supra* n. 19, at 1 Z 0 paras. 46 et seq.). In this respect, various double tax treaties include a specific interpretation rule to ensure the applicability of the most recent version of the OECD Model and OECD Commentaries. (*See* Lang, op. cit., at paras. 132 et seq.)
37. For this interpretation, *see* M. Lang, *Die Auslegung von Doppelbesteuerungsabkommen als Problem der Planungssicherheit bei grenzüberschreitenden Sachverhalten*, pp. 1865 et seq. (NWB Verlag 2011); *See also* Loukota & Jirousek, *supra* n. 19, at 1 Z 0 paras. 45 et seq.; I. Hofbauer, *Tax Treaty Interpretation in Austria*, in *Tax Treaty Interpretation* pp. 27 et seq. (M. Lang ed., Linde Verlag, 2001). On the specific issue of attribution of profits to PEs and the application of the static interpretation, *see* H. Pijl, *Interpretation of Article 7 of the OECD Model, Permanent Establishment Financing and Other Dealings*, 65 Bull. Intl. Taxn. 6 (2011), Journals IBFD. Based on the opinion expressed by Pijl in this article, the retroactive applicability of the effects of the OECD changes depends on the national laws.

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as the 2010 OECD Model Commentary) should not be relevant for the interpretation of double tax treaties signed before 2008. Consequently, the question of how to attribute profits to a PE should be answered without taking into account the principles introduced by the AOA. The consequence of this interpretation would be that, although the arm's length principle (as embedded into the old article 7(2)) would be the leading principle when attributing profits to PEs, no extensive guidance would be provided. Additionally, the above-mentioned[38] views supporting deviations from the applicability of this principle would still be relevant.

On the other hand, advocates of the "dynamic" interpretation[39] maintain that later Commentaries could affect the interpretation of previously concluded double tax treaties, except in cases where such an interpretation would contravene the wording and meaning of the specific double tax treaty.[40] Therefore, this approach would lead to adopting the AOA principles developed in the Commentary also for treaties signed before the inclusion of the AOA.

### *3.2. Double tax treaties concluded between 2008 and 2010*

Similarly, double tax treaties concluded between 2008 and 2010 do not include the new article 7. Therefore, the same issues presented in section 3.1. are also relevant for the interpretation of these treaties.

For these treaties, however, the question may arise as to whether the contracting parties could and/or would have included any reference to the AOA, either in the text of the treaty or in the text of any interpretational document.[41] The presence of such a reference would provide a clearer indication as to whether the AOA should be applicable. However, in the absence of such reference, the same doubts as presented in the previous section[42] would still be relevant. However, some OECD countries have reserved the right to use the pre-2010 version of article 7 of the OECD Model.[43] Accordingly, these countries do not endorse related changes to the Commentary updated in 2010.[44]

38. *See* sec. 2.3.
39. Advocates of the dynamic interpretation of double tax treaties are, for example, Austria or Germany. In this respect, *see*, among others, S. Oesterhelt, *Bedeutung des OECD-Kommentars für die Auslegung von Doppelbesteuerungsabkommen*, ASA 2011/2012, pp. 373 and 386 et seq. (Editions Weblaw 2011/2012); J. Schönfeld & N. Häck, in Schönfeld & Ditz eds., *supra* n. 14, at para. 98; H. Jirousek, *Die österreichische Position beim Abschluss von DBA*, in *Die österreichische DBA-Politik* p. 23 et seq. (M. Lang, J. Schuch & C. Staringer eds., Linde Verlag 2013); A. Kempf & M. Jakob, *Changes in the Taxation of Permanent Establishments in Germany*, 20 Intl. Transfer Pricing J. 2, p. 101 (2013), Journals IBFD.
40. *See* Loukota & Jirousek, *supra* n. 19, at 1 Z 0 paras. 45 et seq.
41. When talking about the interpretation of international treaties, the VCLT defines that the following should be taken into account: the ordinary meaning, the context, the object and purpose, the "*effet utile*" ("effectiveness"), the interpretation as a living instrument, the "*travaux préparatoires*" ("preparatory work") and potentially the multilinguality of treaties. In this respect, interpretational documents can be seen as *travaux préparatoires*, thus being relevant in terms of interpretation. *See also* Loukota & Jirousek, *supra* n. 19, at 1 Z 0 paras. 1 et seq.
42. *See* sec. 3.1.
43. These member states are: Chile, Greece, Mexico, New Zealand, Portugal and Turkey; paras. 95-97 *OECD Model: Commentary on Article 7* (2010). *See also* the positions of Argentina, Brazil, China, Hong Kong, India, Indonesia, Latvia, Malaysia, Romania, Serbia, South Africa and Thailand; paras. 1-1.2 of the positions *OECD Model: Commentary on Article 7* (2010).
44. *See* S. Paultisch & M. Eckerstorfer, *Implementation of the Authorized OECD Approach: Case Study of Permanent Establishment Profit Determination under the Austria-Germany Income Tax Treaty*, Intl. Transfer Pricing J., p. 185 (2014), Journals IBFD.


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### *3.3. Double tax treaties concluded after 2010*

Double tax treaties concluded after 2010, in some cases, incorporate the new article 7, while in other cases, they still incorporate the old article 7. When the treaty incorporates the new article 7, it is clear that the principles of the AOA are applicable. In the implementation of these principles, countries may need to change or modify their domestic laws.[45]

When, however, the treaty incorporates the old article 7, it is debatable whether the principles introduced by the AOA are applicable or not. In this case, it might be that the parties concluding the treaty did not include the new article 7 because they did not want to enforce its principles. If this is the case, then all of the above-mentioned issues[46] related to the situation before 2008 are still valid.

However, it may be the case that the parties concluding the treaty did not include the new article 7 because of other reasons. For example, the new article 7 may not have been included because of the lack of extensive experience in the application of the AOA by the contracting parties. Another possibility may be that one of the contracting states is not part of the OECD and, therefore, did not feel comfortable with the implementation of the AOA (which, as mentioned before,[47] has been explicitly rejected by the UN). In this case, the question as to whether the AOA should still be considered as applicable or not may be raised.

Nonetheless, even when the AOA is not applicable, the question remains open concerning how the arm's length principle should be applied and to what extent deviations could be considered to this end.

## 4. The Principles Introduced by the AOA

Previous sections have introduced the historical background of the topic of profit attribution to PEs[48] and have given an overview of the applicability of the principles introduced by the AOA to double tax treaties concluded before and after the introduction of such principles.[49] Therefore, the following sections will illustrate those principles, both in general[50] and with specific reference to the case of DAPEs.[51] In this respect, the following sections are of particular importance when addressing the questions of whether there is and whether there should be a different outcome in the application of article 7 and article 9 of the OECD Model.

45. Concerning the AOA principles, Germany already changed the "*Außensteuergesetz* (AStG)" in 2013, where art. 7 *OECD Model* after the AOA changes was eventually implemented. Additionally, the German tax authorities also released a regulation (*Betriebsstättengewinnaufteilungsverordnung* (BsGaV)) in 2014, where detailed guidance on the application of profit attribution to PEs was provided. For more detailed information on the German implementation steps, *see* S. Bendlinger, *Die Betriebsstätte*, in *der Praxis des internationalen Steuerrechts* p. 350 et seq. (S. Bendlinger ed., LexisNexis Verlag 2016), and Kempf & Jakob, *supra* n. 39, at 96 et seq.
46. *See* sec. 3.1.
47. *See* sec. 2.3.
48. *See* sec. 2.
49. *See* sec. 3.
50. *See* sec. 4.1.
51. *See* sec. 4.2.

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### 4.1. *The general principles*

The main goal of the AOA is to establish the adoption of the arm's length principle for the attribution of profits to PEs. This means that the same profits should be attributed to a PE, which it would have earned if it had been a separate legal entity under comparable circumstances.[52] Therefore, to pursue this goal, the OECD introduced the separate legal entity approach, which emphasized the already existing so-called "fiction of independence" of a PE. Table 2 summarizes the consequences of the application of this concept.[53]

**Table 2: Consequences of the "fiction of independence" of a PE**

| Restricted Independence | Full (Absolute) Independence | |
|---|---|---|
| | "AOA Light" | AOA |
| – Model and Commentaries before 2008<br>– No profit realization (unless realized by company on market)<br>– Restricted arm's length approach<br>– Goods at arm's length (core business)<br>– Other internal dealings, only reimbursement of expenses<br>– No internal interest, royalties, rents | – Model and Commentaries between 2008 and 2010<br>– Profit realization even if no realization by company on market<br>– Still limited arm's length approach<br>– No internal interest, royalties, rents, services; only reimbursement of expenses | – Model and Commentaries after 2010<br>– Arm's length approach for all "dealings"<br>– Arm's length royalties, services, rents<br>– Internal interest only for "treasury PEs"<br>– No indirect method<br>– Corresponding adjustment mechanism (similar to article 9(2)) |

In detail, article 7 creates the fiction that companies can enter into dealings with their PEs in order to allocate profits according to the arm's length principle.[54] To do so, the AOA requires a two-step approach, which can be summarized as follows:[55]

– *Step 1 – Functional and factual analysis*:[56] The functional and factual analysis is performed in order to hypothesize the PE as if it were an associated enterprise, which performs functions, assumes risks, owns or uses assets and enters into dealings.[57] In this respect, the relevant functions, risks and assets have to be analysed in order to attribute them to the PE.[58] Accordingly, rights and obligations arising out of transactions between the enterprise and the PE have to be appropriately attributed. The functions of the hypothesized separate and independent enterprise have to be determined. Risks, as

52. *See* M. Petritz, *Die Ergebniszurechnung von Betriebsstätten nach dem "Authorised OECD Approach" (AOA)*, in *Handbuch Verrechnungspreise* p. 613 (S. Bernegger, W. Rosar & F. Rosenberger eds., Linde Verlag 2012); Kaeser, *supra* n. 33, at art. 7, para. 400; D. Brüningshaus, in *Verrechnungspreise 4*, ch. L, para. 70 (A. Vögele, T. Borstell & G. Engler eds., Beck Verlag 2015).
53. *See* Storck, *supra* n. 25, at slide 31.
54. *See* K. Dziurdź, *Attribution of Functions and Profits to a Dependent Agent PE: Different Arm's Length Principles under Articles 7(2) and 9?*, 6 World Tax J. 2, sec. 1 (2014), Journals IBFD.
55. *See* OECD (2010), *supra* n. 2, at paras. 57 et seq.; Bendlinger, *supra* n. 45, at 340 et seq.; L. Verdorner, *The Concept of Dependent Agent Permanent Establishment in Transfer Pricing Theory*, Intl. Transfer Pricing J., p. 128 et seq. (2011), Journals IBFD; U. Andresen, *Regulations Provide Further Guidance on the Application of the Authorized OECD Approach to the Attribution of Profit to Permanent Establishments*, 22 Intl. Transfer Pricing J. 2, p. 79 (2015), Journals IBFD. *See also* Kaeser, *supra* n. 33, at art. 7, paras. 429 et seq.; Ditz, *supra* n. 14, at art. 7, paras. 22 et seq.
56. *See* OECD (2010), *supra* n. 2, at para. 59.
57. *See* Dziurdź, *supra* n. 54, at secs. 1. and 2.; Bendlinger, *supra* n. 45, at 340 et seq.; Verdorner, *supra* n. 55, at 129.
58. *See* OECD (2010), *supra* n. 2, at para. 59.


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well as the economic ownership of assets, have to be attributed based on the significant people functions relevant to the assumption of those risks and assets.[59] Finally, capital has to be attributed based on the assets and risks attributed to the PE. Accordingly, it can be summarized that assets and risks follow functions, and capital follows functions, assets and risks.

– *Step 2 – Pricing*:[60] Based on the functional and factual analysis, the remuneration of the PE is calculated under consideration of the principles of article 9 and the OECD Guidelines by analogy,[61] i.e. "either that none of the differences between the dealing and the transaction between independent enterprises materially affects the measure used to attribute profit to the PE, or that reasonably accurate adjustments can be made to eliminate the material effects of such differences".[62]

Additionally, it is worth underlining that, since the AOA uses transfer pricing principles and the OECD Guidelines are periodically updated, the Preface to the AOA has acknowledged that the principles developed should be applied by taking into account the guidance provided in the OECD Guidelines as so modified from time to time.[63]

### *4.2. The specific guidance for DAPEs*

When talking about the principles of the AOA in light of the attribution of profits to DAPEs, it is worth highlighting that the AOA itself does not affect the currently existing (or the currently reviewed/respective modified) standards under article 5 concerning the existence of a DAPE. The major goal of the AOA is to deal with the tax consequences of such an existing PE in terms of profit attribution.[64] However, this is not fully correct, since the AOA also aims to mitigate some of the so-called "cliff effects", which are generally caused by the application of article 5(5) of the OECD Model, compared to the old version of article 7.[65]

The AOA contains special guidance on the attribution of profits to DAPEs.[66] In this respect, it is underlined that in cases where a PE is constituted due to activities of a dependent agent, the host country may eventually have taxing rights related to two different "legal entities", namely the dependent agent enterprise (DAE) and the DAPE.[67] This differentiation between DAE and DAPE is known as the "dual taxpayer approach", which finally leads to an analysis of two different types of transaction.[68]

First, transactions take place between the associated DAE and the non-resident enterprise (i.e. the principal) that fall under the scope article 9, thus being subject to the arm's length

59. *See* H. Moshammer & M. Tumpel, *Attribution of Profits to a Dependent Agent PE*, in *Dependent Agents as Permanent Establishments* p. 240 (M. Lang et al. eds., Linde Verlag 2014).
60. *See* OECD (2010), *supra* n. 2, at paras. 183 et seq.; Verdorner, *supra* n. 55, at 129.
61. *See* Dziurdź, *supra* n. 54, at 139; Petritz, *supra* n. 52, at 614; OECD (2010), *supra* n. 2, at para. 41; Bendlinger, *supra* n. 45, at 341 et seq.
62. *See* OECD (2010), *supra* n. 2, at para. 183.
63. *See* id., at Preface, para. 10.
64. *See* id., at para. 227.
65. Cliff effects occur in situations of having a PE threshold, which results in cases that are similar but where one reaches the threshold and the other does not. As a result, there may be significant differences in host country taxing rights.
66. *See* OECD (2010), *supra* n. 2, at paras. 236 et seq.
67. In this respect, the OECD Report is not very precise, since a PE is by definition not a legal entity. *See* OECD (2010), *supra* n. 2, at sec. D-5.
68. *See* Kaeser, *supra* n. 33, at art. 7, para. 598; Ditz, *supra* n. 14, at art. 7, para. 37.

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principle. Second, there are transactions (or better still, dealings) between the DAE and the DAPE that eventually lead to the execution of the activities on behalf of the principal by the DAE in the host country, thus being subject to article 7.[69] However, in this respect, the host country only has taxing rights on the profits of the non-resident enterprise where the functions performed on behalf of the principal in the host country meet the PE threshold of article 5.

In order to assess those taxable profits, functions, assets and risks of the DAPE are relevant. For the sake of consistency in terms of attributing profits to PEs, the general principles of the AOA are also applicable in the DAPE context, thus leading to compliance with the arm's length principle. In this respect, the previously described two-step approach has to be followed.[70] Accordingly, the pricing of the dealings, which eventually lead to an attributable profit, follows a factual and functional analysis.[71] To this end, the nature of the functions performed by the DAPE is evaluated. Moreover, it is analysed whether the DAPE undertakes the significant people functions that are relevant to the assumption and/or management of risks or to determining the economic ownership of assets.[72] Concerning the significant people functions, the analysis also has to focus on the skills and expertise of the employees attributed to the DAPE in order to evaluate whether the PE has the capacity to perform different management functions at all. These significant people functions are then used to attribute the associated assets, risks and capital.[73]

However, when analysing the overall transactional framework of such a DAE-DAPE structure, the AOA underlines that the DAE may not perform functions[74] that are relevant for the attribution of assets, risks and profits to the DAPE. As a result, the attribution of profits to the DAPE is hindered.[75] Therefore, the attribution of profits to the DAPE requires the determination and by the same understanding the deduction of the arm's length reward for the services provided by the DAE to the non-resident enterprise. In this respect, it is questionable whether there would remain any profits, which could eventually be attributed to the DAPE after deducting the arm's length reward of the DAE.[76] In this respect, the two-step approach has to be revisited again and the underlying transactional structure has to be evaluated on a case-by-case basis. Accordingly, the respective profits are attributed to the DAPE if the DAE performs the significant people functions relevant to the assumption and/or subsequent management of inventory risk and the significant people functions relevant to determining the economic ownership of the inventory on behalf of the non-resident enterprise.[77] As a result, the economic ownership of the inventory and the respective reward for the assumption of risks are attributable to the DAPE, thus leading to an attributable profit.[78]

69. *See* OECD (2010), *supra* n. 2, at paras. 230 et seq.
70. *See* sec. 4.1. With respect to the application of the principles of the AOA for DAPEs, *see also* Bendlinger, *supra* n. 45, at 393.
71. *See* Kaeser, *supra* n. 33, at art. 7, paras. 429 et seq.
72. *See* OECD (2010), *supra* n. 2, at paras. 231 et seq.; Reimer, *supra* n. 14, at art. 7, para. 87.
73. *See* OECD (2010), *supra* n. 2, at para. 232; Reimer, *supra* n. 14, at art. 7, para. 88; Kaeser, *supra* n. 33, at art. 7, para. 439.
74. These functions are significant people functions relevant to the assumption and/or management of risk, or the significant people functions relevant to the determination of economic ownership of assets.
75. *See* OECD (2010), *supra* n. 2, at para. 233.
76. *See* id., at para. 234.
77. *See* id., at para. 243.
78. *See* id., at para. 234 and paras. 240 et seq.


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However, the "dual taxpayer approach" is not the one and only way to cope with profit attribution to DAPEs. Indeed, the so-called "single taxpayer approach" has been discussed in the literature[79] and applied in the Austria-Germany Income and Capital Tax Treaty (2012).[80] According to this approach, the arm's length reward of the DAE fully extinguishes the profits, which are attributable to the DAPE.[81] The reasoning behind this approach is that the reward between the non-resident enterprise and the DAE is based on article 9, thus being at arm's length. As a result, there cannot be any kind of residual profit attributable to the DAPE, if the reward of the DAE was properly derived based on the functions performed, assets used and risks assumed. Moreover, since the functions of the DAE are the only ones performed in the host country, there cannot be an "extra" profit attributed to the DAPE.[82]

Even though the single taxpayer approach seems to be a viable alternative to the dual taxpayer approach, the OECD has refused its application, mainly based on the following reasons:[83]

- The single taxpayer approach does not lead to a fair allocation of taxing rights among the contracting states, since activities that are carried out in the host state would eventually not lead to a significant tax base, even though the profits are mostly generated there.
- The single taxpayer approach would eventually lead to an inconsistent treatment of different types of PEs (e.g. general PE v. DAPE), which would not in line with the understanding of the arm's length principle. In this respect, the AOA attributes assets, risks and capital (and, ultimately, profits) to a general PE based on the functions performed, even though the PE legally does not own these assets or assumes these risks. However, under the single taxpayer approach, no profits would be attributed to the DAPE, even though they arise from activities carried out in the host state.
- Given a proper understanding of the arm's length principle, different facts and circumstances should eventually lead to different rewards/results and similar facts and circumstances should lead to similar results. However under the single taxpayer approach, this basic understanding of the arm's length principle would be torpedoed, since it would lead to the same result in terms of profit attribution for DAPEs, even where the facts are substantially different. Irrespective of the functional and factual analysis and

79. *See* Dziurdź, *supra* n. 54, at 136; X. Ditz & S. Bärsch, *Gewinnabgrenzung bei Vertreterbetriebsstätten nach dem AOA – ein Plädoyer für die Nullsummentheorie*, 22 Internationales Steuerrecht 11, pp. 411-417 (2013); F. Eisele, *Grenzüberschreitende Funktionsverlagerung* pp. 341-344 (Herne NWB 2003); Baker & Collier, *supra* n. 1, at sec. 3.5. U. Andresen, *Vertreterbetriebsstätte*, in *Betriebsstätten: Handbuch*, at 10.220 and 10.233-10.234 (F. Wassermeyer, U. Andresen & X. Ditz, Verlag Dr. Otto Schmidt 2006); P. Baker & R.S. Collier, *General Report*, in *The Attribution of Profits to Permanent Establishments* sec. 1.2.6 (IFA Cahiers vol. 91B, 2006), Online Books IBFD; S. Bendlinger, *Sinn und Zweck der Vertreterbetriebsstätte*, 63 Österreichische Steuerzeitung 6, sec. 4. (2010); F. Barreiros Rosalem, *The Agent Permanent Establishment Reconsidered: Application of Arts. 5, 7, and 9 of the OECD Model Convention*, 17 Intl. Transfer Pricing J. 1 (2010), Journals IBFD; C. Brodersen & H. von Kolczynski, *The Commissionaire: A Tax-Focused Evaluation from Germany*, 25 Intertax 25, p. 205 (1997).
80. *See Convention between the Republic of Austria and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital and to Trade Tax and Land Tax* [unofficial translation] (2 Feb. 2012), Treaties IBFD [hereinafter *Austria-Ger. Income and Capital Tax Treaty*]. *See also* EAS-Auskunft of the Austrian Ministry of Finance 17.12.2009, BMF-010221/3361-IV/4/2009. *See also* S. Bendlinger, *supra* n. 45, at 392 et seq., who explicitly points out the practical relevance of this pragmatic approach between Austria and Germany.
81. *See* Kaeser, *supra* n. 33, at art. 7, para. 597.
82. *See* OECD (2010), *supra* n. 2, at para. 235. *See also* Dziurdź, *supra* n. 54, at 136 et seq.
83. *See* OECD (2010), *supra* n. 2, at paras. 236 et seq.

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the associated risks and assets of the DAPE's activities, the attribution of profits to a DAPE would be the same.

– According to the general principles of treaty interpretation, it cannot be said that the drafters of a treaty intended to implement redundant articles. However, the single taxpayer approach leads to the redundancy of another treaty provision, namely article 5(5). Eventually, the single taxpayer approach leads to the result that there is no "need" for a provision that deals with the constitution of a DAPE, since no profit attribution will take place anyway.

As a result, the OECD's rejection of the single taxpayer approach has been considered as the logical consequence of the reasons listed above.

## 5. Article 7 versus Article 9: Different Arm's Length Principles?

At this point of the analysis, it is relevant to highlight whether the application of article 7, on the one hand, and of article 9, on the other, eventually leads to the same results or not. The following sections will provide the answer to this question in light of the pre-BEPS context.

### *5.1. The "pillars" of the arm's length principle*

As previously mentioned, the attribution of profits under the articles 7 and 9 was, in origin, dealt with according to the same methodology (i.e. either using the "separate accounting approach" or by mutual agreement between the competent authorities under the Draft Model (1927), and for the latter only, under the Model (1928)), since the definition of PE also included "affiliated companies".[84]

However, the 1933 revision of the Draft Model brought about the separation of these methodologies in light of the fact that PEs could not conclude contracts with their own head office, while two separate entities could do so.

In the case of article 9 (at that time, article 5), the newly established arm's length principle was fundamentally based on the following three pillars:[85]

– the separate entity approach, whereby two entities belonging to the same group should have been considered as independent from each other;
– the relevance of contractual arrangements, whereby the structure adopted by the related parties involved in an intra-group transaction should have been defined with reference to the legal arrangements in place between the different entities; and
– the comparability of the transaction, whereby a "comparison" of "conditions made or imposed" between non-independent enterprises and those between independent enterprises should have been the basis for the assessment of the arm's length nature of an intra-group transaction.

In the case of article 7 (at that time, article 3), instead, the application of the arm's length principle was based on the following two pillars:

84. However, as previously mentioned (*see supra* n. 15), in the *Model* (1928) the reference to "affiliated companies" was removed.

85. *See* R. Petruzzi, *The Arm's Length Principle: Between Legal Fiction and Economic Reality*, in *Transfer Pricing in a Post-BEPS World* (M. Lang, A. Storck & R. Petruzzi eds., Wolters Kluwer 2016).



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- the separate legal entity approach, whereby two parts of the same entity (i.e. head office and PE) should have been considered as two separate legal entities independent from each other; and
- the comparability of the transaction, whereby a comparison of conditions between the head office and the PE, and those between independent enterprises should have been the basis for the assessment of the arm's length nature of an intra-group transaction.

Additionally, while the OECD started developing separate extensive guidance in order to interpret the application of the arm's length principle under article 9 (i.e. the OECD Guidelines), it limited the guidance for the interpretation of the arm's length principle under article 7 to the OECD Model Commentary.

As shown in section 4.1., the main difference between the application of the arm's length principle under the two methodologies resided in the relevance of contractual arrangements.[86] Moreover, as previously explained,[87] defined deviations to the application of the arm's length principle were embedded into article 7.

In order to contravene the effects of both deviations to the different applications of the arm's length principle and the irrelevance of contractual arrangements (i.e. dealings are not contracts) in the case of PEs, the OECD, on the one hand, removed any reference to paragraphs 3 and 4 of article 7 and, on the other, introduced the concept of significant people functions in order to attribute risks and assets, capital and, ultimately, profits to PEs. Moreover, as for article 9, the OECD started developing separate extensive guidelines to interpret the application of the arm's length principle under article 7 (i.e. the AOA).

According to the above-mentioned two-step approach introduced by the AOA, the outcome of the profit attribution to a PE has to be in line with the principles of article 9. When analysing the first step, it should be pointed out that only an allocation takes place, which hypothesizes a separate legal entity. Since the goal of the AOA was to establish the adoption of the arm's length principle for the attribution of profits to PEs, the treatment of a hypothesized separate legal entity should be similar to the treatment of a real separate legal entity.[88] When it comes to the second step, the OECD Guidelines are applied by analogy, meaning that a comparability analysis according to article 9 has to be carried out, followed by the "pricing" (i.e. profit allocation) of the underlying transactions. Such a comparability analysis should scrutinize the following factors:[89]

- *Characteristics of property and services*: the comparison of the features of property or services is a crucial part of the comparability analysis, since these characteristics are some of the strongest drivers of differences in value in the open market.[90]

86. *See* Reimer, *supra* n. 14, at art. 7, para. 87.
87. *See* sec. 4.
88. *See* OECD (2010), *supra* n. 2, at para. 1 et seq.
89. *See OECD Guidelines*, *supra* n. 9, at paras. 1.33 et seq. *See also* G. Kofler, in Reimer & Rust eds., *supra* n. 14, at art. 9, para. 66; Ditz, *supra* n. 14, at art. 9, para. 50; A. Eigelshoven, in *Doppelbesteuerungsabkommen: DBA* art. 9, paras. 97a et seq. (Vogel & Lehner eds., Verlag C.H. Beck 2015); H. Baumhoff & D. Liebchen, *Der Fremdvergleich als Instrument internationaler Einkünfteabgrenzung,* in *Verrechnungspreise international verbundener Unternehmen*, para. 3.39 (Wassermeyer & Baumhoff eds., Verlag Dr. Otto Schmidt 2014).
90. *See OECD Guidelines*, *supra* n. 9, at para. 1.39. *See also* Baumhoff & Liebchen, *supra* n. 89, at paras. 3.41 et seq.

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- *Functional analysis*: for the purpose of a functional analysis, the "economically significant activities and responsibilities undertaken, assets used and risks assumed by the parties"[91] are identified and compared. Moreover, the understanding of the functions performed by a taxpayer within the organizational framework of an MNE helps to determine the legal rights and obligations.[92]
- *Contractual terms*: this factor is of high importance in the comparability analysis, since responsibilities, risks and benefits are agreed upon between the parties either explicitly or implicitly.[93]
- *Economic circumstances*: there are various different economic circumstances that could affect the comparability of transactions, such as geographic location, market size, market structure or competition. In the end, this factor might heavily influence the comparability of transactions in a globalized world.[94]
- *Business strategies*: based on this factor, aspects such as innovation and new product development, assessment of political changes, degree of diversification, and input of existing and planned labour laws or risk aversion are taken into account in order to ensure comparability.[95]

This comparability analysis is then followed by the application of the transfer pricing methods, which eventually leads to a hypothesized arm's length remuneration for the given transactions and services, which is the basis for the profit (or loss) attribution to the PE.

Therefore, after the introduction of the principles expressed by the AOA, the two above-mentioned differences in the application of the arm's length principle based on the two articles (i.e. the deviations to the applications of the arm's length principle and the missing of contractual arrangements in case of PEs) were reduced to one, i.e. the relevance of contractual arrangements.

This (still) existing difference between the application of the arm's length principle based on the two articles is a natural one, since an enterprise cannot enter into legally binding contracts with itself.[96] However, in order to minimize the effects of this difference, the concept of significant people functions has been introduced by the AOA, whereby, in the case of a PE, the allocation of assets, risk and capital under article 7 follows the concept that "assets and risks follow functions and capital follows functions, assets and risks",[97] which is mostly triggered by significant people functions. In the case of separate legal entities, instead, assets, risks and capital are attributed based on the contractual arrangements in place.

Hence, the question may be raised as to whether this fundamental difference in the application of the arm's length principle does (and should) lead to different results whereby leading to two different "arm's length principles".

91. *See OECD Guidelines*, *supra* n. 9, at para. 1.42; Baumhoff & Liebchen, *supra* n. 89, at paras. 3.45 et seq.
92. *See OECD Guidelines*, *supra* n. 9, at para. 1.42.
93. *See* id., at para. 1.52.
94. *See* id., at para. 1.55; Baumhoff & Liebchen, *supra* n. 89, at paras. 3.69 et seq.
95. *See OECD Guidelines*, *supra* n. 9, at para. 1.59; Baumhoff & Liebchen, *supra* n. 89, at paras. 3.78 et seq.
96. *See* Dziurdź, *supra* n. 54, at 135; Ditz, *supra* n. 14, at art. 7, paras. 90 et seq.
97. *See* Dziurdź, *supra* n. 54, at 140; Reimer, *supra* n. 14, at art. 7, para. 87.


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### 5.2. *Different outcomes from the application of the two articles?*

In order to answer the first question (whether the application of the arm's length principle does lead to different results), an analysis of the relevance of contractual arrangements under article 9 is required. The analysis performed in the literature[98] shows that this relevance, although quite strong in the first guidance provided by the OECD (i.e. the 1979 Report[99]) has become increasingly weak in subsequent guidance, first in the Guidelines published in 1995[100] and then in those published in 2010.[101] However, based on the 2010 OECD Guidelines, contractual arrangements do still play an important role in the application of the arm's length principle under article 9. Therefore, it seems that the application of the arm's length principle does lead to different results in the application of the principle itself under the two articles.

The answer to the second question (whether the application of the arm's length principle should lead to different results), requires, instead, an analysis of the scope of the two articles (i.e. the scope of article 7 and of article 9).

The title of article 7 ("Business Profits") and that of article 9 ("Associated Enterprises") seem to suggest that the two articles have different purposes, even though both can be seen as distributive rules. According to the OECD Commentaries, article 9 "deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises … on other than arm's length terms."[102] Therefore, article 9 provides that the tax authorities of a contracting state may assess the remuneration of transactions (if so allowed by their national rules), which were based on special relations (i.e. associated enterprises).[103] In other words, if a tax administration is entitled, by its national rules, to assess the profits of an enterprise deriving from transactions with other related parties (e.g. transfer pricing rules), article 9 would allow such an entitlement also from a treaty perspective, as far as the assessment is limited to the arm's length amount. Ultimately, the main goal of article 9 seems not to be the allocation of taxing rights to contracting states, but rather to provide them with the possibility to utilize taxing rights existing under their national laws.[104] However, these taxing rights are also limited by article 9 (i.e. any assessment of an amount exceeding the arm's length principle should be restricted by article 9).

On the other hand, article 7 is meant to allocate "taxing rights with respect to the business profits of an enterprise of a Contracting State to the extent that these profits are not subject to different rules under other Articles of the Convention".[105] In this respect, business profits shall only be taxed in the residence state unless the enterprise carries out the business in

98. *See* Petruzzi, *supra* n. 85.
99. *See* OECD, *Transfer Pricing and Multinational Enterprises*, paras. 24, 35, 89, 151-159 and 183-191 (OECD 1979).
100. *See* OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, paras. 1.28f, 1.36-1.41 (OECD 1995).
101. *See OECD Guidelines*, *supra* n. 9, at ch. IX, paras. 9.11 et seq., 9.21, 9.39, 9.53-9.56, 9.106-9.113, 9.168 et seq. and 9.171-9.184.
102. *See* para. 1 *OECD Model: Commentary on Article 9* (2014).
103. *See* para. 2 *OECD Model: Commentary on Article 9* (2014).
104. *See* Kofler, *supra* n. 89, at art. 9, paras. 7 et seq.
105. *See* para. 1 *OECD Model: Commentary on Article 7* (2014); *see also* Reimer, *supra* n. 14, at art. 7, paras. 1 et seq. and 58 et seq.

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the source state through a PE situated therein.[106] As a result, article 7(1) can be understood as a provision that allocates taxing rights among contracting states. However, the AOA included a new perspective on the allocation of business profits in article 7. In this respect, article 7(2) states that "the profits that are attributable in each Contracting State to the permanent establishment … 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".[107] In addition, article 7(3) includes the following sentence:

> Where … a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise …[108]

Therefore, also in this case, the tax administration of the PE state, in order to tax the profits attributed to the PE, should be entitled by its national laws to do so.[109] Ultimately, when reading these three paragraphs in combination, it seems that article 7 has a "dual scope". First, it is a distributive rule. However, it is also a rule that is meant to ensure the utilization of taxing rights existing under the national laws of the contracting states. Additionally, as for article 9, these taxing rights should be limited to any amount not exceeding the arm's length principle.

Therefore, it is doubtful whether the application of the arm's length principle should lead to different results only based on the different purposes of the two articles. In fact, the proposed analysis under the AOA needs to be evaluated and compared with the transfer pricing mechanisms under article 9 in order to identify possible differences.

### *5.3. Some conclusions in a pre-BEPS era*

As briefly outlined in section 4.1., the analysis of the arm's length nature of an underlying transaction between associated enterprises requires a comparability analysis, which is meant to scrutinize whether conditions are imposed that differentiate from those conditions that would have been imposed between independent enterprises in a comparable uncontrolled transaction.[110]

In order to carry out a comparability analysis, the five comparability factors have to be examined. This examination is by nature twofold since both the factors affecting the controlled transaction as well as the factors affecting the uncontrolled transaction have to be examined.[111] Each comparability factor can have a different influence on different types of transactions, which means that each comparability factor can either be highly important or not important at all for certain transactions. As a result, they have to be evaluated on a case-by-case basis without providing for a certain "receipt" on how they have to be weighted in each situation. As previously mentioned,[112] factors relevant in the context of a comparability analysis are characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies.

106. *See* art. 7(1) *OECD Model* (2014).
107. *See* para. 2 *OECD Model: Commentary on Article 7* (2014).
108. *See* para. 3 *OECD Model: Commentary on Article 7* (2014).
109. *See* Reimer, *supra* n. 14, at art. 7, para. 55.
110. *See OECD Guidelines*, *supra* n. 9, at para. 1.33.
111. *See* id., at para. 1.38.
112. *See* sec. 5.1.


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However, when analysing the functional and factual analysis of the AOA, all of the above-mentioned comparability factors, apart from the contractual terms, can be replaced by one, namely the allocation aspects of the AOA.[113] Indeed, the analysis considers the underlying functions, assets and risks to identify the significant activities and responsibilities.

From a legal point of view, the PE itself does not own assets or assume risk. Therefore, the AOA simply uses another approach to carry out the functional analysis by looking for significant people at the PE who carry out significant functions to manage the underlying risks.[114] Moreover, the ownership of assets, for which people at the PE perform the significant functions, are attributed to the PE. The same is true for capital, which is attributed to the PE based on the attributed assets and risks. Accordingly, the major difference between the profit allocation under article 7 and article 9 is the absence of contracts in the PE context, which could eventually lead to different results under the arm's length principle of article 7 and the arm's length principle of article 9.

However, the issue of contractual arrangements between associated enterprises has to be understood in a wider sense. Even in the pre-BEPS era, the OECD Guidelines have, indeed, stated that:

> In transactions between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.[115]

Accordingly, it could be argued that the contractual arrangements are, of course, relevant comparability factors, but their importance must not be overestimated since the actual conduct of the parties can diverge from the contractually agreed terms and has to be considered accordingly.

In conclusion, under the current guidance in a pre-BEPS era, the differences between the two articles might appear to be on a conceptual basis only, since the aim of the AOA is the hypothesizing of the PE as a separate legal entity and should not lead to relevant differences accordingly.

## 6. Selected Changes Introduced by the BEPS Project

The OECD/G20 BEPS Project has substantially changed the guidance on the interpretation of the arm's length principle under the work on BEPS Actions 8-10. The implementation of those changes will substantially amend the text of the OECD Guidelines.[116] As far as the topic of attribution of profits to DAPEs is concerned, instead, the work on BEPS Action 7 has, as yet, not provided any final outcome.

113. *See* step 1 of the AOA described in sec. 4.1.
114. *See* OECD (2010), *supra* n. 2, at paras. 57 et seq. *See also* Reimer, *supra* n. 14, at art. 7, paras. 77 et seq.
115. *See OECD Guidelines*, *supra* n. 9, at para. 1.53.
116. *See Actions 8-10 Final Reports*, *supra* n. 8.

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As a matter of fact, the work on BEPS Actions 8-10 will most probably have the strongest impact among all BEPS Actions, since the proposed changes will be directly implemented into the OECD Guidelines, thus becoming immediately effective guidance available to both taxpayers and tax administrations when interpreting the arm's length principle.

In sections 6.1.-6.5., some changes introduced by the BEPS Project will be explained in more detail. This analysis will provide the basis for answering the research questions concerning the effects of the newly introduced principles under BEPS Actions 8-10 on the profit attribution to PEs and, especially, to DAPEs. In this respect, the topics of the delineation of the actual transaction, the analysis of the risk factor, the entitlement to intangible related returns, the impact of group synergies, as well as the impact of location savings and other local market features have been selected as relevant in order to address the issue of the attribution of profits to DAPEs.

### *6.1. The delineation of the actual transaction*[117]

One of the most relevant changes introduced by the BEPS Project consists of the newly developed approach to delineating the actual transaction. To elaborate in greater detail, the work, the aim of which was to revise section D of Chapter I of the existing OECD Guidelines,[118] contains various changes to the current setting concerning the comparability analysis for transfer pricing purposes. In this context, the OECD is suggesting that the delineation of the actual transaction undertaken is of fundamental relevance in any transfer pricing analysis and that this has to be examined in light of the actual conduct of the parties.[119] Therefore, contractual arrangements should only be the starting point of the analysis; hence, the role of contractual arrangements will necessarily lose more of its former relevance. Indeed, the new paragraph 1.42 states that:

> A transaction is the consequence or expression of the commercial or financial relations between the parties. The controlled transactions may have been formalised in written contracts which may reflect the intention of the parties at the time the contract was concluded in relation to aspects of the transaction covered by the contract … Where a transaction has been formalised by the associated enterprises through written contractual agreements, those agreements provide the starting point for delineating the transaction between them … The terms of a transaction may also be found in communications between the parties other than a written contract.[120]

Accordingly, the relevance of the contracts is reduced to the extent that they can simply be seen as the starting point for delineating the actual transaction.

Bearing in mind these conclusions, the new paragraph 1.120 provides that:

> In performing the analysis, the actual transaction between the parties will have been deduced from written contracts and the conduct of the parties. Formal conditions recognised in contracts will have been clarified and supplemented by analysis of the conduct of the parties and the other economically relevant characteristics of the transaction … Where the characteristics of the transaction that are economically significant are inconsistent with the written contract, then the actual transaction will have been delineated in accordance with the characteristics of the transaction reflected in the conduct of the parties. Contractual risk assumption and actual conduct with respect to risk assumption will have been examined taking into account control

117. For some contributions on this topic, *see also* S. Gonnet, *Risks redefined in Transfer Pricing Post-BEPS*, in Lang, Storck & Petruzzi eds., *supra* n. 85.
118. *See Actions 8-10 Final Reports*, *supra* n. 8, at paras. 1.33 et seq.
119. *See* id., at paras. 1.42 and 1.119 et seq.
120. *See* id., at para. 1.42.



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> over the risk … and the financial capacity to assume risk … and consequently, risks assumed under the contract may have been allocated in accordance with the conduct of the parties and the other facts … Therefore, the analysis will have set out the factual substance of the commercial or financial relations between the parties and the accurately delineated actual transaction.

The wording of paragraph 1.120 is of special importance since it explicitly mentions the factual substance of the commercial relations with respect to a comparability analysis under article 9.

Moreover, BEPS Actions 8-10[121] explicitly underline that improperly delineated transactions could eventually lead to cases of non-recognition of transactions, thus resulting in double taxation. Hence, "every effort should be made to determine the actual nature of the transaction and apply arm's length pricing to the accurately delineated transaction, and to ensure that non-recognition is not used simply because determining an arm's length price is difficult."[122] Consequently, the mere fact that transactions often do not take place between independent parties cannot lead to an automated non-recognition of associated party transactions.[123] In other words, the mere fact that the transaction may not be seen between independent parties does not mean that it does not have the characteristics of an arm's length arrangement.[124] This means that the non-recognition can be seen as the last resort, if the arm's length nature of the transaction cannot be proven. Vice versa, a proper delineation of the underlying transaction minimizes the risk of non-recognition, thus leading to more legal certainty. The question is how to "make use" of this legal certainty. In this respect, the answer is straightforward. The OECD wanted to establish a transfer pricing framework where the contractual arrangement between the associated parties cannot be "misused" to prove transactional facts that do not reflect the underlying substance of the commercial and financial relations. Accordingly, the OECD's work on Actions 8-10 concerning the delineation of transactions does not lead to disregarding contracts, but to a framework where the conduct of the parties and the contractual arrangement should reflect each other in order to comply with the arm's length principle.

As a result, the formalistic approach of putting much emphasis on contractual arrangements (already under reservation in a pre-BEPS era[125]) might change to a substance-over-form treatment, whereby the contractual arrangements should be "tested" against the actual conduct of the parties: if the two are aligned, the remuneration of the transaction follows the arrangement deriving from the analysis of the contracts; if not, the remuneration should, instead, be adjusted in order to consider the different actual conduct of the parties.[126]

Therefore, in the future, the outcomes of the analysis under article 9 and of the analysis under article 7 might be more aligned as far as the topic of actual conduct of the parties is concerned.

121. *See* id.
122. *See* id., at para. 1.122.
123. *See* id., at para. 1.122.
124. *See* id., at para. 1.123.
125. *See OECD Guidelines*, *supra* n. 9, at para. 1.53.
126. *See* S. Wilkie, *Transfer Pricing Aspects of Intangibles: The License Model*, in Lang, Storck & Petruzzi eds., *supra* n. 85.

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### *6.2. The analysis of risk in commercial and financial relations*[127]

Since the delineation of the actual transaction is of crucial importance in a post-BEPS era, the OECD has also provided further guidance on the analysis of risk in commercial and financial relations. This is mainly due to the fact that risk is a relevant factor where the contractual arrangement and actual conduct of the parties might often be inconsistent with each other. In transactions between independent parties, varying risk levels generally lead to varying expected returns/remuneration. Accordingly, the increased assumption of risk would generally be compensated by an increase in expected returns, i.e. the "level and assumption of risk … are economically relevant characteristics … in determining the outcome of a transfer pricing analysis".[128]

In order to comply with the arm's length principle (i.e. to properly delineate transactions), the OECD has suggested a six-step approach to accurately analyse the risk of the underlying transactions. The approach can be summarized as follows:[129]

– *Step 1 – Identify economically significant risk with specificity*:[130] In this respect, BEPS Actions 8-10 highlight that there are various risks that could eventually influence the transaction and there are various ways to categorize these risks. However, to be more precise, the OECD has come up with a categorization, whereby defining (i) strategic or marketplace risks, (ii) infrastructure or operational risks, (iii) financial risks, (iv) transactional risks and (v) hazard risks.[131] This first step of risk identification can be seen as a part of a broader functional analysis on the value creation within an MNE, thus leading to the possibility of properly delineating transactions.[132]

– *Step 2 – Contractual assumption of risk*:[133] The second step deals with the determination of how the previously identified (economically significant) risks are contractually assumed by the associated enterprises. Accordingly, the OECD further indicates the importance of the delineation of the actual transactions. In this respect, the "contractual assumption of risk constitutes an ex ante agreement to bear … [the] costs associated with the ex post materialisation of downside outcomes of risk in return for … [the] benefit associated with the ex post materialisation of positive outcomes." However, it has to be pointed out that the ex ante contractual assumption of the risk also has to be interlinked with clear evidence of a commitment to assume the risk prior to its materialization. Otherwise, the contractual arrangement and the actual conduct of the parties would not fit, or would just fit from an ex post perspective. However, this would not be in line with the general idea of contractual arrangements, which are meant to lay the foundation for a transaction from an ex ante perspective. Moreover, it does not neces-

127. For some contributions on this topic, *see also* Gonnet, *supra* n. 117. I. Verlinden, D. Ledure & M. Dessy, *The Risky Side of Transfer Pricing: The OECD Base Erosion and Profit Shifting Reports Sharpen the Rules on Risk Allocation under the Arm's Length Standard*, 23 Intl. Transfer Pricing J. 2, p. 109 et seq. (2016), Journals IBFD.
128. *See Actions 8-10 Final Reports*, *supra* n. 8, at para. 1.56.
129. *See* id., at para. 1.60.
130. *See* id., at paras. 1.71-1.76; Verlinden, Ledure & Dessy, *supra* n. 127, at 110.
131. *See also* P. Fris, S. Gonnet & R. Meghames, *Understanding Risk in the Enterprise: The Key to Transfer Pricing for Today's Business Models*, 21 Intl. Transfer Pricing J. 6, pp. 395 and 396 et seq. (2014), Journals IBFD, who suggested a similar concept of risk identification and concluded that the proper identification of risk is a first step in the proper pricing of the underlying transactions.
132. Based on the same understanding, *see* Fris, Gonnet & Meghames, *supra* n. 131, at 396 et seq.
133. *See Actions 8-10 Final Reports*, *supra* n. 8, at paras. 1.78-1.81; Verlinden, Ledure & Dessy, *supra* n. 127, at 110 et seq.


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sarily mean that a contractual exchange of high risk for higher income or lower risk for lower income is automatically in line with the arm's length principle. In addition, the remaining steps with respect to the assumption and management of the underlying risk are of great relevance to accurately delineate the given transactions.

- *Step 3 – Functional analysis in relation to risk*:[134] The scope of this step is to determine how the associated parties to the transaction assume and manage the risks through a functional analysis. In this respect, it has to be determined (i) which enterprise performs the control and risk mitigation functions, (ii) which enterprise encounters the upside or downside consequences of the underlying risks and (iii) which enterprise has the financial capacity to assume the risks borne by the transactions.
- *Step 4 – Interpreting steps 1-3*:[135] As previously mentioned, the identification and determination of the contractual assumption of risks is just part of the six-step approach. The interpretation step aims to determine whether the contractual assumption of the risk is consistent with the conduct of the parties. This is done by analysing "(i) whether the associated enterprises follow the contractual terms … and (ii) whether the party assuming risk, as analysed under (i), exercises control over the risk and has the financial capacity to assume risk." Accordingly, the 4th step delineates the actual transaction and has to be understood in combination with the 5th step (allocation of risk). If the interpretation of steps 1-3 leads to the result that the contractual arrangement and the actual conduct of the parties resemble one another, the 5th step can be skipped, since the risk is properly allocated between the parties. As a result, the 6th step concerning the pricing of the transaction should be directly accessed.
- *Step 5 – Allocation of risk*:[136] As mentioned above, the 5th step can be seen as a regulating mechanism if the 4th step reveals that the first three steps were not carried out properly. Accordingly, the risk has to be allocated among the parties to the transaction based on their real conduct, which results in a proper delineation of the transaction taking the risks intro consideration.
- *Step 6 – Pricing of the transaction, taking account of the consequences of risk allocation*:[137] Once the previous steps resulted in properly delineated transaction under consideration of all relevant characteristics of the transaction,[138] the actual transfer price can be derived, taking into account the financial and other consequences of risk. In this respect, control functions entitle for an appropriate compensation, which will basically be the consequences of the allocation of risk. Moreover, this allocation "entitles" the party for both, upside and downside consequences of the underlying risk. However, if a

134. The OECD gave more detailed information on the application of the functional analysis in relation to risk. Different examples can be found in the *Actions 8-10 Final Reports*, *supra* n. 8, at paras. 1.82-1.85. Moreover, a detailed analysis was drawn by Verlinden, Ledure & Dessy, *supra* n. 127, at 111 et seq.
135. *See Actions 8-10 Final Reports*, *supra* n. 8, at paras. 1.86-1.97.
136. *See* id., at paras. 1.98-1.99.
137. *See* id., at paras. 1.100-1.106.
138. Due to the OECD's work on the BEPS Project, the main comparability factors laid down in the *Actions 8-10 Final Reports* are: (i) the contractual terms of the transaction, (ii) the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices, (iii) the characteristics of property transferred or services provided, (iv) the economic circumstances of the parties and of the market in which the parties operate, and (v) the business strategies pursued by the parties.

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party contributes to the control function but does not assume the risk of the underlying transaction, than an adjusted return may be appropriate to comply with the arm's length principle.

With reference to the newly introduced six-step approach for the risk analysis, the question may arise as to whether there are any conceptual differences left in the risk analysis under article 7 and article 9 of the OECD Model, since both of them are now straightforwardly interlinked with the actual conduct of the parties with respect to the functions performed. Accordingly, the gap between article 7 and article 9 of the OECD Model is further narrowed, thus being an indicator for the application of the same arm's length principle leading to the same arm's length results.

### *6.3. The entitlement to intangible related returns*[139]

Another key topic analysed by the OECD work on BEPS Actions 8-10 is the issue of who is entitled in an MNE to the intangible related returns. Indeed, the entitlement to such returns is one of the most important concerns for MNEs when dealing with intangible assets from a transfer pricing perspective.[140] However, intangibles do not just create positive returns but also lead to costs and other types of effort in relation to different functions. In this respect, the OECD has highlighted the following functions (known as "DEMPE functions") as key drivers of the entitlement to intangible related returns:[141]
- development;
- enhancement;
- maintenance;
- protection; and
- exploitation.

The OECD notices that, generally, the legal owner of the intangible assets receives the proceeds from the exploitation of intangibles, even though other group members also carry out some of these DEMPE functions. As a result, the arm's length principle requires a compensation for the respective performance of functions, assumption of risks or employment of assets.[142] Concerning the determination of the arm's length compensation, the following challenges may arise:[143]
- there is a lack of third-party comparables;
- there is a lack of comparability between the intangibles in question;
- the legal ownership and use is split within the MNE;
- the effects of a certain intangible on the MNE's income cannot be determined;
- the level of integration within the MNE is unique, which means that their contribution to the DEMPE functions of an intangible can hardly be compared;
- the realization of the positive effects of an intangible may not correspond with the periods of performance of the DEMPE functions; and

139. For some contributions on this topic, *see also* Wilkie, *supra* n. 126.
140. For a detailed analysis, *see* M. Greinert, *Verrechnungspreisbestimmungen für einzelne Bereiche des Liefer- und Leistungsaustausches*, in Wassermeyer & Baumhoff, *supra* n. 89, at paras. 6.547 et seq.; T. Borstell, *Internationales Recht*, in Vögele, Borstell & Engler, *supra* n. 52, at ch. B, paras. 155 et seq. and paras. 221 et seq.
141. *See Actions 8-10 Final Reports*, *supra* n. 8, at para. 6.32.
142. *See* id., at para. 6.32.
143. *See* id., at para. 6.33.



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- MNEs' structures with respect to separate ownership, assumption of risks, funding, control and decision-making may not be found in independent transactions.

However, even though these challenges may appear when determining the arm's length remuneration of the underlying DEMPE functions, the described approach is very much in line with the arm's length principle, namely to hypothesize separate legal entities that enter into transactions based on conditions that would be imposed among independent parties. It is obvious, indeed, that independent third parties would require remuneration if they perform DEMPE functions and/or assume the associated risk and/or use assets respectively.

In combination with the delineation of the actual transaction, the following steps should be undertaken to analyse the commercial and financial relations of the transaction:[144]
- identification of the relevant intangibles with respect to the economically significant risks associated with the DEMPE functions;
- identification of the contractual arrangements in order to determine the legal ownership and other terms and conditions of legal arrangements;
- identification of the functions performed by the parties to the transaction under consideration of the risks assumed/managed and/or assets used;
- checking of whether the contractual arrangement and the actual conduct of the parties are consistent and identifying whether the parties have the capacity to assume the DEMPE-related risks;
- delineation of the transaction based on the legal ownership, other contractual arrangements and the actual conduct of the parties taking into consideration contributions to the DEMPE functions, risks assumed and assets used; and
- determination of an arm's length price for the underlying transactions.

Accordingly, the new guidance on intangible assets is very much in line with the general tendency of an in-depth determination of the real conduct of the contracting parties (or the real substance of the transaction), rather than strictly sticking to some kind of written document. However, as previously pointed out, contractual arrangements are not senseless now, but the MNEs are fostered to arrange their transaction in a way consistent with what they have contractually agreed upon in order to comply with the arm's length principle. The contractual arrangements are still the starting point for any transfer pricing analysis involving intangibles.[145] In this respect, contractual evidence can be found in numerous sources ranging from written contracts and public records (e.g. patent or trademark registrations) to correspondence among the parties. However, if such contractual evidence is not in line with the actual conduct of the parties, such evidence is "overruled", thus resulting in a substance-over-form approach.

Again, also the analysis of the entitlement of intangible related returns shows the OECD's tendency in applying a substance-over-form approach with reference to the actual conduct of the parties. Since this is of main importance in order to close any conceptual gaps between the application of article 7 and article 9 of the OECD Model, the new guidance promotes the underlying theses of this article.

144. *See* id., at para. 6.34.
145. *See* id., at para. 6.35.

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### 6.4. The impact of group synergies

Group synergies may either have positive or (in some cases) negative effects on the MNE as a whole and can result from numerous factors, such as combined purchasing power, elimination of duplications of different processes and bureaucratic hurdles, scale and scope of production and sales organizations, and credit worthiness, all resulting from the size and management of the MNE.[146] However, group synergies always raise questions concerning comparability (and respective adjustments), since synergistic effects generally do not appear (even in cases of strong cooperation) among independent parties.

In this respect, BEPS Actions 8-10 have clarified the issue of incidental benefits and pointed out how "the term incidental refers to benefits arising solely by virtue of group affiliation and in the absence of deliberate concerted actions or transactions leading to that benefit. The term incidental does not refer to the quantum of such benefits or suggest that such benefits must be small or relatively insignificant".[147] Accordingly, the size of the synergistic effect is not important at all; the one and only question to be answered is whether the benefit resulted solely from the group affiliation or not. If so, no special compensation has to be granted for those synergistic effects.[148]

However, if the group synergies arise because of deliberate concerted group actions in combination with a clear structural advantage or disadvantage, then the effect has to be considered within the functional and comparability analysis.[149] Accordingly, the synergistic effects have to be divided among the contributing parties. In this respect, the following must be defined: (i) the nature of the advantage or disadvantage, (ii) the amount of benefit or detriment provided and (iii) how this benefit or detriment should be divided within the MNE.[150]

Nevertheless, the question arises as to how to divide the benefits or detriments among the members of the MNE.[151] In this respect, BEPS Actions 8-10 state that the group synergies resulting from deliberate concerted group actions should be divided in proportion to their contribution to create the resulting synergistic effect. For example, the synergistic effects of volume purchase discounts could be divided based on the relative purchase volume of the MNE members.[152]

Group synergies have an impact on many aspects of an enterprise. To this end, one of the most commonly referred to examples is the credit rating of a company, the ultimate and synthetic expression of its credit risk.[153] From a transfer pricing perspective, the ratings of each entity of an MNE should be established by reference to the separate entity approach. Therefore, the parent and the associated enterprises generally have different ratings based on their risk profiles.[154] However, a pure consideration of stand-alone ratings does not lead

146. *See* Baumhoff & Liebchen, *supra* n. 89, at paras. 3.92 et seq.
147. *See Actions 8-10 Final Reports*, *supra* n. 8, at para. 1.158.
148. *See* id., at para. 1.158.
149. *See* id., at para. 1.159.
150. *See* id., at para. 1.161.
151. *See* Baumhoff & Liebchen, *supra* n. 89, at paras. 3.92 et seq.
152. *See Actions 8-10 Final Reports*, *supra* n. 8, at para. 1.162.
153. For some contributions on this topic, *see* R. Petruzzi, *Transfer Pricing Aspects of IntraGroup Financing* (Wolters Kluwer 2016). *See also* Baumhoff & Liebchen, *supra* n. 89, at para. 3.98. *See also Actions 8-10 Final Reports*, *supra* n. 8.
154. *See* R. Holzinger, *Transfer pricing aspects of intra-group financing in light of the OECD BEPS project* p. 66 (2015); *see also* A. Storck, *Die Bestimmung marktüblicher Verrechnungspreise für konzerninterne*


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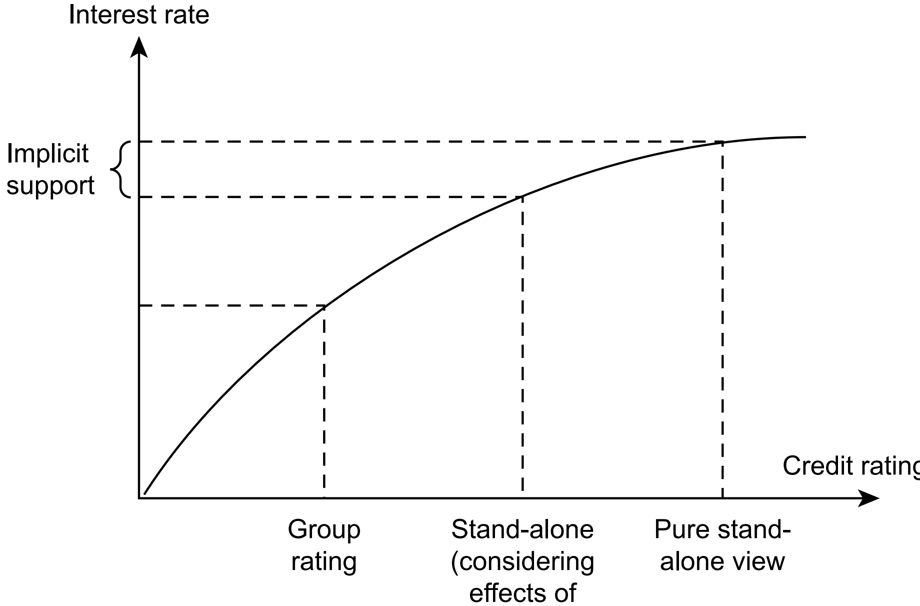
to a satisfactory outcome. Indeed, the impact of the so-called "implicit support" should be considered.[155] Figure 1 indicates the idea of implicit support in an MNE's rating procedures.

**Figure 1: The effect of implicit support on credit ratings***




* *See* Holzinger, *infra* n. 154, at 67; J. Mattson, *Implicit support within intra-group financing* p. 22 (2010).

However, in a PE context, these rating aspects are a major deviation from the separate legal entity approach embedded in the AOA, since the "factual situation of a PE determines that it necessarily has the same credit rating as the enterprise of which it is part".[156] Under the AOA, the hypothesized separate and independent PE requires an appropriate attribution of the enterprise's free capital (quasi equity) so that the PE can properly carry out the functions and assume the associated risks. These attributions are just carried out for tax purposes in order to derive an appropriate tax basis at the source state. However, the attribution of the free capital (for tax purposes) does not have any effect on the creditworthiness of the enterprise as a whole, since the respective funds and the PE belong to/are part of the enterprise anyway. This basic understanding leads to the conclusion that the PE is attributed the creditworthiness of the enterprise as a whole and does not require its own credit rating.[157]

*Darlehen*, in *Oestreicher, Modernisierung des Unternehmenssteuerrechts* p. 35 (A. Oestreicher ed., NWB Verlag 2013).

155. *See* A. Storck, *The Financing of Multinational Companies and Taxes: An Overview of the Issues and Suggestions for Solutions and Improvements*, 65 Bull. Intl. Taxn. 1, p. 40 (2011), Journals IBFD; C. Burnett, *Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach*, 6 World Tax J. 1, pp. 65 et seq. (2014), Journals IBFD.
156. *See* OECD (2010), *supra* n. 2, at Part I, paras. 100 et seq., and Part II, para. 31.
157. *See* id., at Part I, para. 100. There might be an exception to this general rule when it comes to regulatory reasons (e.g. banks).

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However, if the guiding principle underlining the AOA is the separate legal entity approach, the question may arise as to whether the newly developed guidance under BEPS Actions 8-10 on the group synergies should also have an impact on issues related to the attribution of profits to PEs.[158]

### *6.5. The impact of location savings and other local market features*

Other features that might influence comparability and arm's length nature of a transaction are those related to the market in which the MNE is operating. The OECD identifies "location savings" and "other local market features" among the most relevant examples of these.

Location savings are an effect of operating in a certain geographic market where costs are lower (e.g. labour costs), thus resulting in cost savings. In this respect, difficulties may arise concerning the evaluation of these differences and the determination of appropriate comparability adjustments.[159] These location saving effects were formerly only important with respect to business restructuring.[160] However, due to the BEPS changes, these aspects have to be considered for all types of transaction where such location savings could occur.

However, the inclusion of these location savings in the transfer pricing analysis requires some preliminary steps:[161]
– whether location savings exist or not has to be identified;
– the amount of the location savings has to be determined;
– the extent to which "location savings are either retained by a member or members of the MNE group or are passed on to independent customers or suppliers" has to be determined; and
– in cases where not all of the location savings are passed on to independent customers or suppliers, "the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings" has to be determined.

With respect to the comparability adjustments, a functional analysis could result in proper comparables of independent enterprises that do not pass on location savings to customers or suppliers. In such a situation, these comparables are a reliable indication on how to allocate the location savings within the MNE.[162] However, in situations where no such comparables exist, the allocation of location savings within the MNE should be based on a proper analysis of all functions performed, assets used and risks assumed by the relevant associated enterprises in the respective markets.[163] Similar conclusions have been reached with reference to other local market features.[164]

Accordingly, the newly introduced understanding of the impacts of location savings and other local market features for a proper arm's length remuneration under article 9 of the OECD Model is based on the functional analysis. As pointed out before, the functional analysis under article 9 of the OECD Model is mostly in line with the first step of the analy-

158. *See* Petruzzi, *supra* n. 85.
159. *See Actions 8-10 Final Reports*, *supra* n. 8, at para. 1.139.
160. *See OECD Guidelines*, *supra* n. 9, at para 9.148-9.153.
161. *See Actions 8-10 Final Reports*, *supra* n. 8, at para. 1.141.
162. *See* id., at para. 1.142.a.
163. *See* id., at para. 1.143.
164. *See* id., at paras. 1.144-1.151.



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sis provided under the AOA. Accordingly, the work under BEPS Actions 8-10 might impact the future work under BEPS Action 7 on this topic.

## 7. The Way Ahead

In light of the new guidance introduced by the BEPS Project on BEPS Actions 8-10, analysis may be carried out into the impact that can be expected from the future work of the OECD on the topic of profit attribution to PEs, with specific reference to the case of DAPE.

From a general standpoint, in the post-BEPS era, the application of the arm's length principle and the relevance of its pillars described in section 5.1. will be amended.[165]

The pillar of the separate entity approach (separate legal entity approach, in the case of PEs) seems to be safeguarded: both the guidance under article 9 and under article 7 seems not to be questioned. However, some exceptions may be provided in the case of, for example, group synergies and credit rating.[166] The BEPS Actions 8-10 Final Reports clarified that some synergistic effects might derive from being part of the group.[167] However, in this respect, a differentiation has to be made between incidental benefits (such as benefits that solely derive from being part of the group alone) and synergistic benefits deriving from deliberate concerted group activities.[168] The reason for such differentiation is the fact that incidental benefits should not require an arm's length remuneration, whereas benefits deriving from deliberate concerted group activities do. To account for such benefits, a proper comparability analysis has to be carried out, which is strongly backed up by the fact that the OECD implemented these thoughts on group synergies in the first chapter of the guidelines, thus being applicable to all kinds of transaction.[169]

As far as the pillar of the relevance of the contractual arrangements is concerned, it seems that the guidance under article 9 is going into the direction of reducing it, hence aligning this point to the one made under article 7. In this regard, the concept of "actual conduct of the parties" seems very similar to the one of "significant people functions". Contractual arrangements are only the starting point of a proper comparability analysis, which is eventually being amended by an analysis of the actual conduct by reference to the economically relevant characteristics of the underlying transaction.[170]

As far as the pillar of the comparability of the transaction is concerned, it seems that the guidance provided by the BEPS Project is going in the direction of either providing less reliance on the comparability analysis to methodologies fundamentally based on it (*see* guidance on commodities[171] and guidance on low value-adding services[172]) or providing more relevance to methodologies less reliant on such analysis (*see* guidance on use of financial valuations[173] and guidance on use of profit split[174]). In this aspect, both article 9 and article 7 are aligned.

165. *See* Petruzzi, *supra* n. 85.
166. *See* sec. 6.4.
167. *See Actions 8-10 Final Reports*, *supra* n. 8, at paras. 1.157 et seq.
168. *See* Petruzzi, *supra* n. 85. *See Actions 8-10 Final Reports*, *supra* n. 8, at paras. 1.164-1.167, 1.170-1.173, 6.81.
169. *See* Petruzzi, *supra* n. 85.
170. *See Actions 8-10 Final Reports*, *supra* n. 8, at paras. 1.42-1.50, 1.81.
171. *See* id., at paras. 2.16A et seq.
172. *See* id., at paras. 7.43-7.65. For some contributions on this topic, *see also* G. Maisto, *Transfer Pricing Aspects of Low Value-Adding Services*, in Lang, Storck & Petruzzi eds., *supra* n. 85.
173. *See Actions 8-10 Final Reports*, *supra* n. 8, at paras. 6.153-6.178.
174. *See* id., at 55-61.

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Therefore, it seems that in a post-BEPS era the guidance on the interpretation of the arm's length principles under the two articles will look more similar and lead to closer results. It may therefore be questioned as to how the BEPS work related to article 9 could impact on the future BEPS work related to article 7, and how the current guidance on article 7 could impact the future BEPS work related to article 9.

As far as the first question is concerned (i.e. how the BEPS work related to article 9 could impact on the future BEPS work related to article 7), the above-mentioned new concepts developed as amending the OECD Guidelines could potentially impact on the future guidance provided by the AOA in general, and with specific reference to the attribution of profits to DAPEs. Indeed, the new guidance on the analysis of risk in commercial and financial relations,[175] the new developments on the entitlement to intangible related returns (and on the DEMPE analysis),[176] the new considerations on the impact of group synergies[177] as well as on the impact of location savings and other local market features[178] will most probably need to be reflected in the new developments on the topic of the attribution of profits to DAPEs. Ideally, they should be reflected within the scope of the entire AOA: indeed, as mentioned before,[179] the Preface to the AOA has acknowledged that the principles developed should be applied by taking into account the guidance provided in the OECD Guidelines as so modified from time to time.[180]

On the other hand, it is also probable that the current guidance on article 7 could impact the future BEPS work related to article 9. For example, the current methodologies to allocate capital to PEs, developed under the AOA, could eventually impact the future question of how to allocate capital between associated enterprises, something that the OECD will face within its work on transfer pricing issues related to intra-group financing (under BEPS Action 4).[181]

## 8. Proposals for the Future BEPS Work Related to the Attribution of Profits to DAPEs

In light of the analysis performed in the previous sections, the future work of the OECD on the attribution of profits to DAPEs under BEPS Action 7 should be inspired by some general aims as well as by some more specific ones.

In general, it should be clarified that the existence of a DAPE in a country does not, per se, automatically provide that country with more tax revenues compared to the case of the non-existence of a DAPE. The question of existence of a PE, indeed, is just the first step in order to justify taxing powers related to business profits by a source state and it is just a preliminary one in relation to the question of how much profits that state can tax. The second question should be assessed only after a careful analysis of the taxing rights arising from the application of article 7.

175. *See* sec. 6.2.
176. *See* sec. 6.3.
177. *See* sec. 6.4.
178. *See* sec. 6.5.
179. *See* sec. 4.1.
180. *See* OECD (2010), *supra* n. 2, at Preface, para. 10.
181. For some contributions on this topic, *see also* A. Russo, *Interest Deductions and Transfer Pricing Aspects of Intra-Group Financing*, in Lang, Storck & Petruzzi eds., *supra* n. 85.


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The second point that might need to be clarified is whether, whenever an agent is remunerated at arm's length by its principal, based on the functions it performs, the risks it undertakes, the assets it employs and, in general, the assessment of any relevant factor driving its remuneration, there is still the need to assess whether the agent's country would need to be entitled to any further taxing right deriving, eventually, from the existence of a DAPE of the principal in its country (i.e. the dual taxpayer approach). The assessment of the existence of a DAPE in the country of the agent might, indeed, generate numerous compliance issues for the principal without leading, at the end of the day, to a substantial increase in the taxing rights of the source country due to the fact that the agent is already remunerated at arm's length for all the activities it performs. This situation might be frustrating also for a tax auditor, who might spend a considerable amount of time identifying whether a DAPE exists without being able to ultimately assess any related extra taxable base. To this end, a reconsideration of the OECD's view on the single taxpayer approach, within the scope of the work on the attribution of profits to DAPE, might be beneficial in order to reduce a relevant amount of the compliance burden on taxpayers and of the administrative burden on tax auditors. Indeed, the OECD's reasons for rejecting the application of this approach under the current guidance in the AOA appear to be less strong in a post-BEPS era.

Moreover, the OECD's work on BEPS Action 7 should also try to align the outcome of the application of the arm's length principle resulting from article 7 and from article 9 to avoid distorting the views on these topics, to avoid phenomena of tax arbitrage (or even tax planning) and, ultimately, to promote consistency and allow "neutrality of the system".

To this end, as far as the relevant functions are concerned, the understanding of "significant people functions" should be aligned with that of "actual conduct of the parties".

As far as the risks are concerned, the outcomes of the "risk analysis" under article 9 and under article 7 should be the same. Therefore, the notions of "control over risks" and "financial capacity to assume risks" should also be introduced in the new developed guidance under the AOA.

As far as the assets are concerned, the related profit allocation should be the same, disregarding whether in the source state there exists a PE rather than an enterprise. Indeed, if it is true that the allocation of the assets themselves might differ (since this is based, for article 7, on significant people functions, while for article 9 it is based on the contractual arrangements), still the remuneration driven by the assets should not necessarily follow a legalistic allocation, but rather a substantial one. Otherwise stated, it should be driven by the two notions of "significant people functions" (in the case of article 7) and "actual conduct of the parties" (in the case of article 9), which, as mentioned before, should be aligned.

Moreover, as far as the allocation of capital is concerned, this should be driven by considerations related to corporate finance decisions, rather than by inflexible rules.[182] To this end, the guidance provided under article 7 might prove useful in order to simplify the answer to these questions.

Finally, the OECD will undoubtedly need to face new questions and challenges deriving from the work performed under the current guidance provided under BEPS Actions 8-10 and under BEPS Action 7 (with specific reference to the issues related to commissionaire

182. *See* Petruzzi, *supra* n. 153.

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arrangements). For example, it would need to be clarified whether a reconsideration of the entire wording of the AOA (and not only the wording related to DAPE) is needed, following the changes provided by BEPS Actions 8-10. Another example would be any clarification which might be needed on how to address issues related to the relation between remuneration of a DAPE and that of a low risk distributor. Indeed, the current changes introduced by BEPS Action 7 potentially place the two different functional profiles of business entities closer (*see*, for example, the case of "flash title") and might, therefore, need coordination between the two.

## 9. The New OECD Draft Proposal under BEPS Action 7

On 4 July 2016, the OECD published a new Public Discussion Draft on BEPS Action 7 resulting from the follow-up work on BEPS Action 7, providing a proposal for additional guidance on the attribution of profits to PEs.[183] Specifically, the paper aims to provide further guidance on how the changes made by the work under BEPS Action 7 and BEPS Actions 8-10 impact on the attribution of profits to PEs.[184]

This document, which does not represent the consensus views of the OECD's Committee on Fiscal Affairs, seeks comments on the topic of the attribution of profits related to the following two issues:[185]

- DAPEs, including those created through commissionaire and similar arrangements; and
- warehouses as fixed places of business PEs.

For the purposes of this article, the focus will be placed on the first issue. The following sections will summarize the conclusions of the OECD Discussion Draft on BEPS Action 7 as well as provide some preliminary considerations of it.

### *9.1. The new OECD draft proposal*

The OECD Discussion Draft on BEPS Action 7 analyses the topic of the attribution of profits related to DAPEs by means of four examples, providing for detailed fact patterns, and proposes solutions to the specific scenarios presented.

In example 1, the OECD presents the case in which a non-resident enterprise acts as a principal and engages an associated enterprise in the source state (i.e. a DAE) to perform activities giving rise to a DAPE under article 5(5) and (6) of the OECD Model.[186] In this example, the attribution of profits to the DAPE is in line with the current principles established by the AOA and the dual taxpayer approach. The example clearly shows that, when the functional analysis is in line with the contractual arrangements between the principal and the DAE and the former appropriately remunerates the latter (i.e. transactions between the two entities are at arm's length), no extra profit is left for the DAPE. Accordingly, the analysis of

183. *See Public Discussion Draft on BEPS Action 7*, *supra* n. 7.
184. *See* id., at para. 11.
185. *See* id., at para. 12.
186. Under the fact pattern of this example, functions are performed, risks are assumed and assets are employed either by the principal or by the DAE on its own. The DAE does not perform significant people functions on behalf of the principal. Hence, the OECD concludes that no profits of the latter are attributed to the DAPE and that the source state is entitled to tax only the profits of the DAE.*See Public Discussion Draft on BEPS Action 7*, *supra* n. 7, at paras. 21-39.


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the existence of a DAPE is in fact just a disappointing administrative burden for both the taxpayer and tax administration, which does not eventually lead to any additional profits being allocated to the source state (accordingly, no additional taxes). Therefore, the single taxpayer approach would be helpful in order to reduce this extra administrative burden.

In example 2, the scenario presented in example 1 is slightly modified. In this case, although the principal contractually assumes some risks (i.e. the inventory risk and the customer credit risk), the DAE has control over those risks and financial capacity to assume them.[187] In this example, again, the attribution of profits to the DAPE is in line with the current principles established by the AOA and the dual taxpayer approach. However, the example clearly shows that, when the functional analysis is not fully in line with the contractual arrangements between the principal and the DAE, some extra revenues (or extra costs) should be attributed to the DAE in order to align the remuneration of the latter with the functions it performs, risks it assumes and assets it employs. This is also in line with the new guidance provided by the work on BEPS Actions 8-10. However, the extra revenue attributed to the DAPE is generally not based on the application of the principles of the AOA, but rather caused by the inappropriately remunerated functions of the DAE under article 9 of the OECD Model. Accordingly, the question that remains open is whether the dual taxpayer approach hypothesized by the OECD does actually provide the best solution to these issues. The existence of a DAPE in the source state might add some administrative burden to the principal and tax administration without, nevertheless, substantially increasing the taxing rights of the source state. Accordingly, the single taxpayer approach would be helpful again. The "extra remuneration" assigned to the DAPE could be still allocated to the source state, if all the activities performed by the DAE are remunerated by the principal by an arm's length compensation. Accordingly, distinguishing between the activities performed by the DAE on its own account and activities performed on behalf of the principal just leads to administrative burdens in a situation where a "smoother" approach (single taxpayer approach) would be available.

In example 3, the scenario presented in example 2 is slightly modified this time. The principal does not engage the DAE in the source state, but rather sends an employee (constituting a DAPE of the principal) in the source state to perform the activities performed in the previous example by the DAE.[188] In this example, again, the OECD's result is perfectly in line with the currently applicable principles established by the AOA and the dual taxpayer approach. In this case, the application of the single taxpayer approach or of the dual taxpayer approach would not make any difference, since the DAE is not involved anymore in the activities of the principal. The source state would be entitled to tax the same amount of profits as in the previous example, consistently with the fact that the same activities are performed in its territory. This example, hence, shows that the assessment of the existence

187. In this case, the source state is entitled to tax more profits than in the previous case as a result of the higher amount of risks assumed by the DAE. However, those risks, although undertaken by the DAE, are "split" between those undertaken on its own account and those undertaken on behalf of the principal. The DAE, in this example, does perform significant people functions on behalf of the principal and, consequently, assets and risks should be attributed to the DAPE. Therefore, the OECD concludes that the remuneration related to those risks is attributed, partially, to the DAE and partially to the DAPE.*See Public Discussion Draft on BEPS Action 7*, *supra* n. 7, at paras. 40-57.

188. In this case, the OECD concludes that the source state is entitled to tax the same profits as in the previous example, although those profits derive completely from the activities performed by the DAPE (since the DAE does not perform, anymore, the related functions).*See Public Discussion Draft on BEPS Action 7*, *supra* n. 7, at paras. 58-68.

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of a DAPE is still useful (and that, therefore, paragraphs 5 and 6 of article 5 are still needed). However, in this case, this assessment would bring a substantial amount of revenue to the source state. Hence, the extra administrative burden for the taxpayer, as well as the extra efforts by the source state's tax administration in assessing the existence of the DAPE, would be justified. Therefore, this solution does not contradict the ones identified in the case of the previous examples.

In example 4, the scenario presented in example 2 is slightly modified. In this case, the focus is placed on the customer credit risk and on the connected activities related to the credit provision by the principal and the DAE.[189] In this example, the attribution of profits to the DAPE is again in line with the current principles established by the AOA and the dual taxpayer approach (although, the outcome of the risk analysis performed might raise numerous questions). However, the considerations made above with reference to example 2 would be valid for this example as well. The use of the single taxpayer approach, combined with the non-distinction between the activities performed by the DAE on its own account and those performed on behalf of the principal would allow the source state to obtain the same taxable income as in the solution proposed by the OECD. Nevertheless, there would be no need to assess the existence of a DAPE, thus avoiding the above-mentioned issues for both taxpayer and tax administration.

### *9.2. Summarizing the considerations on the new OECD draft proposal*

In general, the new OECD Discussion Draft on BEPS Action 7 provides some useful guidance on how the changes made by the work under BEPS Action 7 and BEPS Actions 8-10 will impact on the attribution of profits to PEs. The examples provided by the OECD clearly identify some key issues related to the attribution of profits to DAPE, which will be relevant to resolve in a post-BEPS era. The proposed solutions seem in line with the current principles developed by the AOA and the dual taxpayer approach. However, alternative approaches to the latter (e.g. the use of the single taxpayer approach) might prove useful in the situations identified above.

Furthermore, by providing guidance by means of examples, some other issues (e.g. some of the ones identified in section 6.) have not been analysed. Therefore, a more general guidance concerning the implementation of the entire new guidance developed under BEPS Actions 8-10, as indicated in sections 7. and 8., might be needed in the future in order to identify, for example, how the newly developed guidance on entitlement to intangible related returns, the impact of group synergies, as well as the impact of location savings and other local market features will be applied in the case of the existence of DAPEs.

## 10. Conclusions

This article has analysed issues related to the interpretation of article 7 of the OECD Model ("Business Profits") and to the current OECD guidance on the topic of the attribution of

189. In this case, although the principal contractually assumes the customer credit risk, the control over those risks and the financial capacity to assume them is spread between the principal and the DAE. The risks, although undertaken by the DAE, are "split" between those undertaken in its own account and those undertaken on behalf of the principal. The DAE, does perform significant people functions on behalf of the principal and, consequently, assets and risks should be attributed to the DAPE. Therefore, the OECD concludes that the remuneration related to those risks is attributed partially to the DAE and partially to the DAPE. *See Public Discussion Draft on BEPS Action 7*, *supra* n. 7, at paras. 69-84.


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profits to PEs (i.e. the AOA), with specific reference to the issues related to DAPEs, in light of the amendments already proposed within the work on BEPS Action 7 and Actions 8-10.

Section 2. presented the historical background on these issues, describing their evolution from the first edition of the Draft Model in 1927, until the latest introduction of the AOA in 2008 and 2010.

Section 3. investigated to what extent the principles expressed by the AOA can be applied to double tax treaties concluded before and after the implementation of such principles into the OECD Model and Commentaries, highlighting the numerous interpretational issues embedded within the current background.

Section 4. illustrated the principles expressed by the AOA, both in general and with specific reference to the case of DAPEs, underling how their main goal was to establish the adoption of the arm's length principle for the attribution of profits to PEs.

Nevertheless, the analysis performed in section 5. questioned whether, when applying this principle, the application of article 7, on the one hand, and of article 9, on the other, leads eventually to the same results or not. Although it seems that the application of the arm's length principle *does* lead to different results in the application of the principle itself under the two articles, it is doubtful whether this application *should* lead to different results, only based on the different purposes of the two articles. The conclusions to this section highlighted how, under the current guidance in a pre-BEPS era, the differences between the two articles might appear to be on a conceptual basis.

These conclusions are even more evident when analysing the amendments introduced by the OECD/G20 BEPS Project on the interpretation of the arm's length principle under the work on BEPS Actions 8-10. Therefore, section 6. explained in detail some selected topics considered as relevant in order to address the issue of the attribution of profits to DAPEs, i.e. the topics of the delineation of the actual transaction, the analysis of the risk factor, the entitlement to intangible related returns, the impact of group synergies, as well as the impact of location savings and other local market features.

Consequently, section 7. analysed the possible impact of the BEPS work related to article 9 on the future BEPS work related to article 7, as well as the impact that the current guidance on article 7 could have on the future BEPS work related to article 9. With reference to the first point, the new guidance on the analysis of risk in commercial and financial relations, the new developments on the entitlement to intangible related returns (and on the DEMPE analysis),the new considerations on the impact of group synergies as well as on the impact of location savings and other local market features will most probably need to be reflected in the new developments on the topic of the attribution of profits to DAPEs. On the other hand, it is also probable that the current guidance on article 7 could impact the future BEPS work related to article 9 (e.g. as part of the future work of the OECD on transfer pricing issues related to intra-group financing, under BEPS Action 4).

In light of the analysis performed in the previous sections, section 8. presented some proposals for the future BEPS work related to the attribution of profits to DAPEs. The points underlined in this section relate both to some general aims as well as to some more specific ones.

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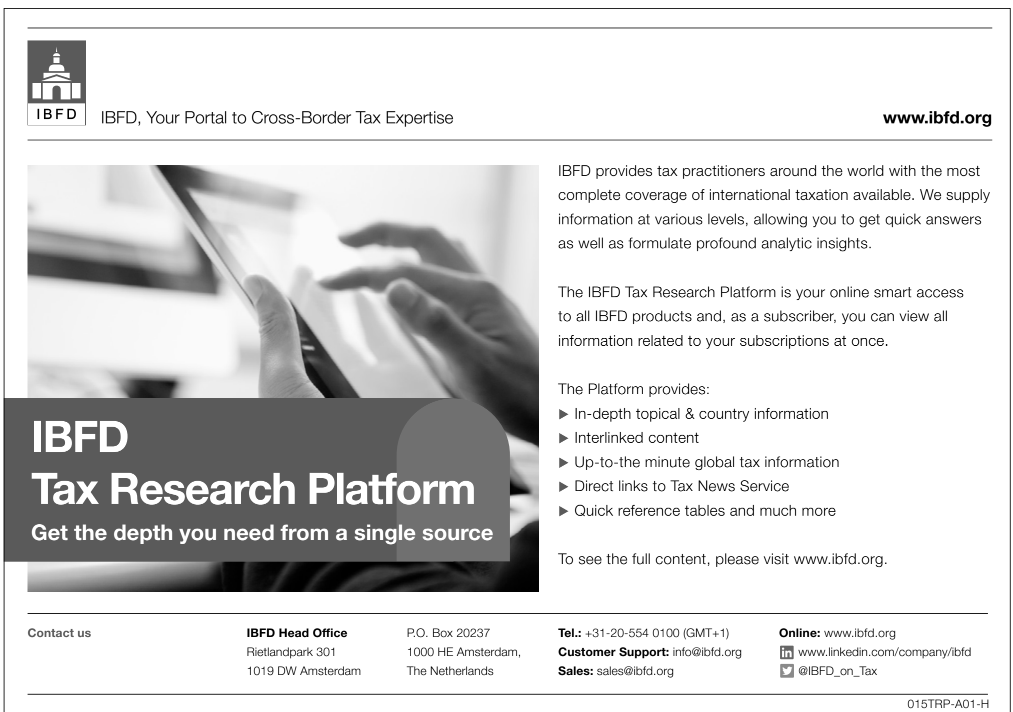
Finally, section 9. presented the recently published OECD Discussion Draft on BEPS Action 7 together with some preliminary comments on and considerations of it.

As a result of this analysis, it can be concluded that the work of the OECD should sufficiently take into account the challenges described in this article and that it may benefit from the proposals indicated therein.

In general, the application of article 7 and of article 9 should be based on the same arm's length principle. Some different outcomes might still be generated in some circumstances; this is, indeed, a natural consequence of the way the two articles (and the related guidance) have developed over the years. These different outcomes may perhaps only be avoided only if the wording of the two articles and of the two sets of guidelines (i.e. the OECD Guidelines on one side and AOA on the other) would be "merged" into a single guideline, as was originally the case.

However, even in the absence of such a "utopian change", these different outcomes should be the exception rather than the rule. This could be achieved only if it would be clarified, under the guidance to both articles, that (i) the separate (legal) entity approach is preserved, without any deviation, (ii) contractual arrangements are not the relevant factors driving the remuneration, i.e. profits follow functions (i.e. significant people functions or actual conduct of the parties), risks (i.e. connected to the notions of "control over risk" and "financial capacity to assume risk") and assets (following the notion of "function"), and (iii) capital allocation should follow considerations related to corporate finance decisions.

To this end, not only should the guidance provided by the AOA on the topic of DAPE be revisited, but perhaps the entire wording of the document should be amended.



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