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The Authorized OECD Approach for the attribution of profits to Permanent Establishments in a Post-BEPS World

-An analysis of the Authorized OECD Approach for the attribution of profits to Permanent Establishments which arise from commissionaire arrangements under BEPS Action 7

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Abstract

The BEPS Project has led to unprecedented changes in international taxation rules. In this respect, the recent changes made to the definition of permanent establishment (PE) under BEPS Action 7 target aggressive tax structures used by multinationals enterprises (MNEs). Due to the narrow scope of Article 5(5) and 5(6), taxpayers easily managed to escape the existing definition of PE with the use of tax avoidance strategies, such as commissionaire arrangements. Therefore, some revisions of Action 7 particularly concern the PE threshold provided by Article 5(5) with respect to commissionaire arrangements.

The revisions have also arisen questions as to whether the profit attribution rules in connection with the newly proposed PEs will be affected by the BEPS suggestions. In this regard, the Report on BEPS Action 7 had noted the importance of additional guidance for the attribution of profits to the post-BEPS PEs resulting from the changes. Finally, the Additional Guidance on the Attribution of Profits to Permanent Establishments which deals with the attribution of profits to the newly proposed PEs under Action 7 has been released on 22 March 2018.

The revised concept of PE ultimately has implications for the application of the Authorized OECD Approach (AOA) for the attribution of profits to PEs. This thesis will analyze the functional and factual analysis performed within the first step of the AOA for the attribution of profits to PEs which arise from commissionaire arrangements under Action 7. The analysis will be based on the general principles of the AOA and the high-level principles provided by the Additional Guidance, with the specific reference to the BEPS work on risk assumption under Actions 8-10. The thesis will also touch upon the PE threshold proposed by Action 7 that concerns commissionaire arrangements.
List of abbreviations

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<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>AOA</td>
<td>Authorized OECD Approach</td>
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<td>BEPS</td>
<td>Base Erosion Profit Shifting</td>
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<td>DAE</td>
<td>Dependent Agent Enterprise</td>
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<td>DAPE</td>
<td>Dependent Agent PE</td>
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<td>DTC</td>
<td>Double Tax Convention</td>
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<td>OECD’</td>
<td>The Organisation for Economic Co-operation and Development</td>
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Bibliography
1. Introduction

1.1. Background problem

The current international tax policy discussions on the concept of permanent establishment (PE) are very intense. This is to a certain extent due to the OECD/ G 20 Base Erosion and Profit Shifting (BEPS) initiative that is expected to impact business environments on a global scale. In brief, the BEPS package aims to counter tax avoidance, ensuring that profits will be taxed “where economic activities take place and value is created”\(^1\). As part of the BEPS initiative, Action 7 proposed amendments to the PE definition provided by Article 5 of the OECD Model Tax Convention (MTC) for the purposes of countering artificial avoidance of a PE status.\(^2\) In this sense, the amendments recommended by *the Report on Preventing the Artificial Avoidance of Permanent Establishment Status* (The Report on Action 7) to Article 5(5) and 5(6) particularly concern commissioner arrangements (or similar strategies).\(^3\) As a result, the 2017 Update of the OECD MTC also contains the recent changes made to Article 5 under Action 7.\(^4\)

In relation to the profit attribution rules, the OECD confirmed that the changes to the definition of PE are not expected to affect the current rules on the attribution of profits to PEs.\(^5\) However, additional guidance was needed to facilitate the application of Article 7 of the OECD MTC for the newly proposed PEs.\(^6\) Since the BEPS work on transfer pricing rules was not complete back then, the OECD first issued two public discussion drafts on the attribution of profits to PEs in July 2016 and June 2017 respectively.

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\(^3\) Id., p. 9-10.


\(^6\) Id.
The drafts received hundreds of comments by interested parties on how the application of Article 7 should be adjusted to the BEPS implications.

Finally, after having considered the comments received, the OECD published the new report *Additional Guidance on the Attribution of Profits to Permanent Establishments* (Additional Guidance) on March 22, 2018.7 The Additional Guidance describes rules for the attribution of profits to PEs which are deemed to exist as a result of the recent modifications made by BEPS Action 7 to the concept of PE. It is a well-known fact that the PE concept is one of the most complex and challenging issues in international taxation rules. The attribution of profits to PEs, accordingly, is as highly complex as the concept of PE, the history of which can be traced back to the work of the League of Nations in 1920s.8

Currently, the international taxation rules concerning the attribution of profits to PEs are regulated by Article 7(2) of the OECD MTC.9 As a background guidance for the application of Article 7, the OECD also published the *Report on the Attribution of Profits to Permanent Establishments* (the Report 2008), which was revised in 2010 (the Report 2010) given that Article 7 was updated in the 2010 version of the OECD MTC.10 The “landmark” Report concerns core issues relating to profit allocation between a head office and a PE by identifying the intra-company “transactions” taking place between them.11 The approach introduced by the Report is called the “Authorized OECD Approach” or the “AOA” that is

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based on the idea that the arm’s length principle of Article 9 is applicable for the attribution of profits to PEs under Article 7.\textsuperscript{12}

As a consequence of the changes, the question arises as to whether the broader scope of Article 5 will require different considerations in respect to the profit attribution rules under the AOA. Likewise, the impact of the Additional Guidance on the current guidance of the AOA needs to be examined while taking into account other BEPS implications that might affect the profit attribution rules. The present thesis will highlight the issues arising from the BEPS impact on the application of the AOA for the attribution of profits to PEs which are created by commissionaire arrangements in accordance with the post-BEPS versions of Article 5(5) and 5(6).

1.2. Objectives

The thesis will analyze the application of the AOA for the attribution of profits to PEs which arise from commissionaire arrangements due to the changes made by Action 7 to Article 5(5) and 5(6). The analysis will be based on the principles provided by the Additional Guidance, with the specific reference to the BEPS work on risk assumption under Actions 8-10. To achieve the objective, the following questions will be addressed:
- How the AOA will be performed for the attribution of profits to dependent agent PEs which are deemed to exist due to the recent changes proposed to Article 5(5) and 5(6) under Action 7?
- How the AOA will be applied for the attribution of profits to a dependent agent PE – if the dependent agent (commissionaire) and the non-resident enterprise (principal) are associated enterprises?
- How the application of the AOA for the attribution of profits to dependent agent PEs arising from commissionaire arrangements will be affected by the BEPS work on risk allocation under Actions 8-10?

\textsuperscript{12} OECD (2010), supra n. 10, para. 53.
The analysis of the AOA will be performed through examining the functional and factual analysis undertaken within the first step of the AOA. Therefore, the thesis will start with the analysis of the general application of the first step of the AOA. By way of the analysis of the AOA, the thesis also seeks to analyze the principles put forward by the Additional Guidance that govern the profit attribution rules in a post-BEPS world. The recent changes made by Action 7 to Article 5(5) and 5(6) that concern commissionaire arrangements and the rationale for the changes will also be discussed in this study.

1.3. Delimitations

This thesis seeks to address the post-BEPS implications for the application of the functional and factual analysis undertaken by the AOA for the attribution of profits to PEs which arise from commissionaire arrangements under Action 7. The author aims to analyze the practical aspects of the AOA in the modern-day world. Therefore, the historical development of the AOA and OECD materials will not be addressed in this study.

The subject matter of the thesis is to investigate the challenging issues arising from the application of the AOA in the wake of the BEPS era. For that reason, the thesis will not address the question of whether a PE exists under the previous version (2014) of Article 5. However, the author will describe the changes made to Article 5(5) and 5(6) under Action 7 that concern commissionaire arrangements and, moreover, the circumstances resulting in the changes will be discussed in the thesis.

As stated in the Report on Action 7, the Additional Guidance was specifically developed to describe the post-BEPS rules for the application of Article 7 for “PEs outside the financial sector”. Therefore, the analysis of the AOA from the BEPS perspective will only be limited to the general considerations articulated in the Report on The Attribution of Profits to

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Permanent Establishments (2010). Accordingly, the special considerations for applying the AOA to the certain PEs are beyond the scope of this paper.

The thesis will also examine the risk control functions under BEPS Actions 8-10 in relation to the risk allocation between the PE and the commissionaire intermediary. However, other work of the BEPS-Project that might affect the application of the AOA will not be mentioned in this thesis. In other words, when examining the application of the AOA for PEs arising out of commissionaire arrangements, the thesis will consider the BEPS work on the allocation of risks under Actions 8-10.

In the AOA context, the thesis will examine the functional and factual analysis taken under the first step of the AOA. As for the second step of the AOA, it must be stated that basic knowledge for the meaning and the application of the second step will be presented. However, a comprehensive analysis of the second step will not be addressed in this thesis.

1.4. Methods & Materials

The scientific discipline to conduct this study is based on the traditional legal method. In the context of the traditional legal method, the development of the legal discipline will be analyzed with the references to the OECD materials and legal doctrines. In relation to the AOA, the Report on the Attribution of Profits to Permanent Establishments (2010) and Article 7 of the OECD MTC (2010 and later versions) with their commentaries are used as the primary sources. As regards the application of the AOA to PEs arising from commissionaire arrangements under Action 7, the BEPS Report on Action 7 and the Additional Guidance are used as the main sources. In fact, this thesis is a complex study of the Report (2010), the OECD MTCs, the Report on Action 7, the Additional Guidance and the BEPS work on risk assumption under Actions 8-10. The complex study will examine the functional and factual analysis undertaken by the AOA for the
attrition of profits to PEs which are found to exist due to the post-BEPS implications with respect to commissionaire arrangements

Due to the post-BEPS importance of the assumption of risk for the attribution of profits to dependent agent PEs, *the Report on Aligning Transfer Pricing Outcomes with Value Creation* (The Report on Actions 8-10) will also be examined. It should be noted that a considerable amount of legal doctrines is used to examine the topic. However, the OECD materials are used as much as possible and an emphasis is put on the primary sources.

1.5. Outline

The thesis will start with a general overview of Article 7, and the OECD rules regarding the attribution of profits to PEs will be outlined (Chapter 2). It will be followed by the detailed analysis of the first step of the AOA where the author will explain each element of the functional and factual analysis of the AOA through relying on examples and explanations (Chapter 3). Chapter 4 will give a very brief overview of the second step of the AOA. Finally, Chapter 5 will deal with the interaction between the AOA and the BEPS implications that concern the attribution of profits to dependent agent PEs arising from commissionaire arrangements. In this chapter, the BEPS changes to Article 5(5) and 5(6) regarding commissionaire arrangements together with the rationale for the changes will be described. Second, the author will examine to what extent the AOA guidance for dependent agent PEs is applicable for the attribution of profits to PEs resulting from the new approach on commissionaire arrangements. Further, to what extent the BEPS work under Actions 8-10 regarding the risks will affect the risk allocation between parties will be examined. At the end of the chapter, the author will conduct a legal analysis on a case study in which the principles of the AOA will be applied for the attribution of profits to a PE arising from a commissionaire arrangement. The author will attempt to address the subject matter of the thesis in the example. To put it
plainly, the example will describe: (i) elements of the functional and factual analysis of the AOA, (ii) the recent changes made to Article 5(5) and 5(6) according to which a commissionaire arrangement gives rise to a PE, (iii) and, most importantly, the principles put forward by the Additional Guidance in light of the BEPS work on risk assumption. As a result of the analysis made in Chapter 5, the main outcomes of the BEPS work that affect the application of the AOA with respect to a commissionaire dependent agent PE will be concluded.
2. The attribution of profits to Permanent Establishments: The Authorized OECD Approach (AOA)

2.1. Introduction to Article 7 of the OECD MTC

Multinational enterprises (MNEs) have managed to spread business operations across geographical borders thanks to the globalization. It is therefore no surprise that the business profits have become the most debated income under the tax treaty law. The reasoning behind this is simple: tax authorities worldwide seek to protect their respective tax base. Therefore, what it all comes down to is the allocation of profits between source and residence jurisdictions, which concerns the revenue authorities of both countries. While the complexity of international taxation remains, the new BEPS project adds to the challenge of complicated profit allocation rules. In this context, it is obvious that a mismatch between tax jurisdictions may easily lead to double taxation for taxpayers. To eliminate the double taxation, “contracting states commit themselves to relinquishing or restricting their taxing rights” by concluding Double Tax Conventions (DTCs).\(^\text{14}\)

Currently, the international taxation principles governing taxing rights of states over business profits of enterprises are regulated by Article 7 of the OECD MTC.\(^\text{15}\) Accordingly, Paragraph 2 of Article 7 describes the tax treaty mechanism for the attribution of profits to PEs.\(^\text{16}\) Article 7 originated in the work of League of Nations in the 1920s and has gone through several modifications and amendments throughout the history.\(^\text{17}\) Notwithstanding the historical developments, the attribution of profits to PEs is still a subject of continuing discussions among various countries. It is because domestic laws of countries differ when it comes to the technique for the attribution of


\(^{15}\) OECD Model (2014), supra n. 9, Article 7.

\(^{16}\) Id., Article 7(2).

\(^{17}\) For a historical development of Article 7, see Russo, supra n. 8, at p. 5-31.
profits to PEs.\textsuperscript{18} Also, there is no consensus amongst countries for the common interpretation of Article 7.\textsuperscript{19} The lack of common interpretation followed by the inconsistent application of Article 7 might result in double taxation or non-taxation.\textsuperscript{20} To address those misunderstandings, the OECD has released different discussion drafts and reports regarding the attribution of profits to PEs.

According to Article 7 of the OECD MTC, the resident country of an enterprise has a primary right to tax its profits unless the enterprise performs its business activities through a PE located in the source state.\textsuperscript{21} The internationally accepted principle is that, as a general rule, an enterprise “should not be regarded as participating in the economic life of that other state” unless it has a PE situated in that state.\textsuperscript{22} It follows that the source state where the PE is located does not have taxing rights over the profits which are generated by that enterprise provided that those profits are not attributable to the PE.\textsuperscript{23}

The determination of the taxable presence/PE in the source country, which is regulated by Article 5, is the first step undertaken before the allocation of profits. After having established that an enterprise has a PE in a state under a DTC, the question arises as to how profits derived from the activities of the PE should be attributed to it in the source country. In this sense, the determination of the business profits attributable to PEs is important from two perspectives:\textsuperscript{24} (a) from the perspective of the source state which aims to tax business profits attributable to the PE; and (b) from the perspective of the residence state which seeks to determine the amount of income in order

\textsuperscript{20} Id.
\textsuperscript{21} OECD Model (2017), supra n. 4, Article 7(1).
\textsuperscript{22} Id., Commentary on Article 7, para. 11.
\textsuperscript{23} Id., para. 12.
\textsuperscript{24} see Russo, supra n. 8, at p.3.
to grant double taxation relief in accordance with Article 23 of the OECD MTC.

For the purposes of addressing the issue of different interpretations of Article 7, the OECD found it important to apply the arm’s length principle in the PE context. As a consequence, the Authorized OECD Approach for the attribution of profits to PEs was first introduced in the Report on Attribution of Profits to Permanent Establishments in 2008. Given that Article 7 was modified in the OECD MTC 2010, the OECD has revised the Report in 2010 without changing the conclusions reached in the 2008 Report. In this regard, the 2010 Article 7(2) recognizes the full AOA and clearly acknowledges that the principles applied by the Guidelines for the transactions between associated enterprises should be applied by analogy in the context of intra-company “dealings” taking place between the PE and the head office.

2.2. Authorized OECD Approach

To attribute profits to PEs under Article 7(2), the 2008 Report introduced the “functionally separate entity approach” that is known as the “AOA”. According to the “functionally separate entity approach”, it is possible to allocate an entity’s functions, assets and risks to the respective parts of the legal entity. Therefore, the AOA is based on the fiction that the arm’s length principle is applicable to the “dealings” taking place between the PE and the rest of the enterprise. By applying the arm’s length principle, the AOA treats the PE as if it is a hypothetically separate and independent

25 OECD (2010), supra n. 10, para. 3.
26 Id.
27 Id., para. 5.
28 A. Wintsch, Attribution of Profits to Permanent Establishments: The 2008 Article 7 versus the 2010 Article 7 of the OECD Model Tax Convention, 24 Intl. Transfer Pricing J. 5 (2017), Journals IBFD, sec. 2.2.3.
29 OECD (2010), supra n. 10, para. 8.
30 See Huibregtse, supra n. 11, p. 363.
enterprise. In the AOA context, profits are attributed to a PE based on these principles:32
- The PE is “a separate and independent enterprise engaged in the same or similar activities”;
- The PE is independent from the remainder of the enterprise and, therefore, can involve in “dealings” with other parts of the enterprise; and
- Finally, its profits can be determined by applying the arm’s length principle considering the functions performed, risks assumed and assets economically owned by the enterprise through the PE.

Under the AOA, a two-step analysis is required for the profit allocation between the PE and the head office. In the first step, a functional and factual analysis implies that the PE and the remainder of the enterprise of which it is a part are associated enterprises. By way of doing this, the AOA divides the functions undertaken, assets owned, and risks assumed between the hypothetically separate enterprises. It is followed by identifying the internal dealings taken place between the PE and the head office and the transactions taken place between the PE and separate enterprises.33 Under the second stage, the dealings that are identified under the application of the first step are estimated by applying the Guidelines by analogy.34 It means that the dealings are priced with the transfer pricing methods according to the recommendations of the Guidelines. As a consequence of the two-step analysis, the profits and losses of the PE should be determined by considering all its activities: transactions both with unrelated enterprises and with related enterprises, and dealings with the rest of the enterprise.35

32 OECD (2010), supra n. 10, para. 8.
33 Id., para. 10.
34 Id.
35 Id., para. 44.
3. The Functional and Factual Analysis taken under step one of the Authorized OECD Approach (AOA)

3.1. Introduction

As already noted in the previous Chapter, the first step undertaken by the AOA results in the split of the functions, assets, and risks between the PE and the remainder of the enterprise with the aim of identifying the business activities of the PE. The issue which arises in applying the AOA is that a PE is not a separate and independent enterprise, but a legally dependent part of the enterprise. In other words, a PE together with the rest of the foreign enterprise constitute the same legal entity, which means that the assets, risks and capitals belong to the enterprise. Then it is obvious that a PE cannot involve in contractual arrangements, either with the rest of its head office, or with unrelated enterprises since the same entity cannot contract with itself. Therefore, the AOA uses the “functional analysis” instead of the “legal analysis”. In this regard, to hypothesise a PE as a legally separate entity, the AOA suggests that the functional analysis should focus on the physical presence of the persons performing functions in the PE, which is otherwise known as the significant people functions. Therefore, it is important to determine which functions constitute the significant people functions to identify the economically significant activities and responsibilities undertaken by the PE.

The AOA implies that risks and assets should be allocated to a PE depending on the functions performed by persons physically present in the PE. Accordingly, the functions and the management performed by those

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36 OECD (2010), supra n. 10, para. 10.
39 See Monsenego, supra n. 37, p. 134.
people – for example, employees – that play role in generating business for the enterprise are examined, and, depending on the outcome of the analysis, the economic ownership of assets and the assumption of risks are allocated to the PE.  

As a result, the profits/losses are fictionally shared between the PE and the remainder of the enterprise under the AOA.  

In other words, the two-stage analysis results in the isolation of the profits of the PE from the profits of the remainder of the enterprise under the AOA.  

Given that there is the lack of people performing functions in the PE, it is also possible that no risk and asset can be attributed to the PE.

It is also worth highlighting that the AOA acknowledges the use of the periodically updated Guidelines, which means that the general principles concluded by the Report 2010 should be applied by considering the updated guidance provided by the latest Guidelines.  

In this context, while intra-company “dealings” between the PE and the rest of the enterprise are priced by applying the Guidelines by analogy, in contrast, the Guidelines are directly applied for the PE’s “transactions” with other related or unrelated enterprises.

3.2. Functions: which activities are undertaken by a PE?

The Guidelines examine the “functions performed by each of the parties to the transaction” in order to ascertain comparability factors for associated enterprises.  

Under the AOA, “functions” are equated to “activities” of the PE.  

It is identified which activities and responsibilities of the enterprise, and to what extent, are associated with the PE.  

Therefore, it is necessary

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41 OECD (2010), supra n. 10, para. 15.  
42 See Monsenego, supra n. 37, p. 134.  
43 Id., p. 133.  
44 OECD (2010), supra n. 10, at Preface, para. 10.  
45 Id., at paras. 17, 39, 40, 44, 55 and 61.  
47 OECD (2010), supra n. 10, para. 57.  
48 Id., para. 60.
to determine in which capacity the PE performs its “activities”. In cases where a PE is found to exist under Article 5(1) of the OECD MTC, the AOA examines whether the functions are undertaken at the “fixed place”. However, when the PE is deemed to exist in accordance with Article 5(5), the AOA examines all functions that the agent performs on behalf of the enterprise (principal).

The functional and factual analysis conducted by the AOA is not only limited to the examination of the activities performed by the personnel of the PE. Activities undertaken by the personnel of different parts of the enterprise that might generate business profits for the enterprise may also be examined. It follows that the scope of the functional analysis may expand to the consideration of the activities which take place out of the host country of the PE. In doing so, the AOA seeks to identify how the activities are shared between different parts of the enterprise including the PE. Therefore, this analysis tends to be very factual. In this context, the frequency of the physical presence of key employees in different parts of the enterprise, the place where the key decisions are made and the persons to whom employees are reporting are carefully examined.

3.3. Analysis of the risks attributable to a PE

When allocating risks between associated parties under Article 9, it is possible to start with the analysis of the contractual terms agreed between parties, however, there is no written agreement to rest upon in the PE context. As noted above, the risk belongs to the enterprise of which the PE is a part and the PE, as a part of the enterprise, cannot legally bear risks on

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49 Id.
50 Id.
51 Id.
52 Id., para. 62.
53 Id., para. 65.
54 See Monsenego, supra n. 37, p. 135.
its own. Therefore, the AOA implies that the assessment of risks should take into account the significant people functions performed at the PE's location. In other words, in case it is found that the significant people’s functions relevant for the assumption or the management of the risk are performed by the personnel of the PE at the PE’s location, the risk is assigned to the PE. The assessment of the risk assumption under the AOA is based on the physical presence of persons and thus the AOA examines how they involve in the organizational framework of a firm. Therefore, the risk assessment also appears to be fact-specific in the PE context.

For example, assume that personnel of a PE perform a research to seek a development opportunity. The functional and factual analysis finds out that the personnel of the PE are responsible for conducting research and they make several relevant decisions about the development work: they decide on whether/how they should develop the research activities. According to the AOA, the risk should be attributed to the PE, as the significant people functions regarding the assumption and management of the development risk are performed by the personnel of the PE and at the PE’s location.

It is also important to note that the amount of the risks that are attributable to the PE depends on the amount of capital attributed to the PE. Accordingly, the PE cannot assume risks if doesn’t possess capital to maintain the creditworthiness. In cases the PE is found to perform the significant people functions regarding the assumption of the risk, proper amount of capital should be allocated to the PE in order to support the risk, as “capital follows risk” under the AOA.

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57 OECD (2010), supra n. 10, para. 68.
59 Id., para. 71.
60 Id., para. 26.
3.4. Analysis of the assets attributable to a PE

Under the AOA, it must be determined which assets are used by the PE for the exercise of its functions.\textsuperscript{61} Since the legal ownership of the assets belongs to the enterprise – which is not useful in the PE context – the conception of “economic ownership” has been developed by the OECD.\textsuperscript{62} When determining the economic ownership of an asset, the AOA examines the relevance of the significant people functions for the ownership of the asset.\textsuperscript{63} However, the AOA differentiates between tangibles and intangibles. In relation to tangible assets, the OECD acknowledges two main views, as there were two different views of member countries on attributing tangible assets to a PE:\textsuperscript{64}

- the significant people functions; and
- the place where tangible assets are used (where a PE exists, in other words, according to its location in the source state under Art. 5(1)).

According to the OECD, the location where the assets are used – which in most cases is the place where the PE is located – is considered as the pragmatic solution in order to attribute economic ownership of tangible assets to the PE under the AOA.\textsuperscript{65} However, there are some specific circumstances where the pragmatic solution cannot be applied, and in those cases the application of the significant people functions is inevitable. Both techniques used by the AOA and the rationale for the application of them will be described in the following example:

Assume that an enterprise which is a resident in state X has a PE in state Y. The PE which deals with mining activities in the state Y has continuous miners (complex underground equipment) which operate continuously and have a pivotal role in the coal production for the PE. The functional and

\textsuperscript{61} See Huibregtse, supra n. 11, p. 371.
\textsuperscript{62} Id., para. 72.
\textsuperscript{63} Id.
\textsuperscript{64} Id., para. 75.
\textsuperscript{65} Id.
factual analysis finds out that the continuous miners have been installed in the PE and are used only at the PE’s location. It is also found that the workers of the PE control the miners. In this case, the pragmatic solution which allocates an asset to the PE according to the place of the use of the asset is relevant under the AOA. However, assume that the same PE also uses blasthole drills (complex surface mining equipment) and the drills are used in state Y occasionally. The functional and factual analysis finds out that the drills are used in different jurisdictions for the mining activities of the different parts of the enterprise. Therefore, the pragmatic solution cannot be applied for the drills. In such cases, the decision-making regarding the use of the drills must be examined. In case it is determined that the personnel of the head office decide the place and the time for the use of drills, then it is relevant to attribute the economic ownership of the blasthole drills to the head office and not to the PE.

3.4.1. Intangibles

With regard to the allocation of intangibles, the AOA treats trade and market intangibles separately.66 The AOA differentiates between two situations in relation to trade intangibles:67

- when the enterprise itself creates the intangible;
- when the enterprise acquires the intangible from a different enterprise.

In the PE context, the determination of the economic ownership of internally created intangibles rests upon the significant people functions.68 The AOA examines as to whether the personnel of the PE involve in “active decision-making with regard to the taking on and management of individual risk and portfolios of risks associated with the development of intangible property”.69 As it is the case with the internally developed intangibles, the determination of the economic ownership of acquired intangibles is also

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66 See Huibregtse, supra n. 11, p. 371.
67 OECD (2010), para. 82.
68 Id., para. 85.
69 Id.
based on the significant people functions relating to the management of the undertaken risk. However, the functional analysis for acquired trade intangibles might also examine the arrangement of risk management for deploying the intangible and whether further development activity is required for the intangible.\(^{70}\)

By way of example, assume that an enterprise which is resident in State X has a PE in state Y. The PE conducts research activities to develop a new ingredient for a medicine. The AOA requires to examine the nature of the decision-making process regarding the risks in relation to the research activities. In other words, it must be examined whether the personnel of the PE are involved in the decision-making regarding the risks associated with the development of the new ingredient for the medicine. The functional and factual analysis shows that the personnel of the PE decide whether they should use other resources (or abandoning the research) for the development of the research. In such a case, it would be relevant to attach the economic ownership of the intangible to the PE, as the management of the risk associated with the development of the new medicine is undertaken by the personnel of the PE.

3.5. Analysis of the rights and obligations arising from transactions with separate enterprises that are attributable to a PE

When identifying profits and losses attributable to the PE under the AOA, all its hypothesized transactions with related and unrelated enterprises and its dealings with the rest of the enterprise must be analyzed.\(^{71}\) In this regard, the AOA allocates to the PE rights and obligations of the enterprise arising from the enterprise’s transactions with unrelated enterprises.\(^{72}\) If it is hypothesized that the PE enters into transactions with unrelated enterprises,

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\(^{70}\) Id., at paras. 93 and 94.  
\(^{71}\) Id., para. 98.  
\(^{72}\) See Monsenego, supra n. 37, p. 137.
the profits are directly attributed to the PE.\textsuperscript{73} However, in case the enterprise is found to be related to the enterprise of which the PE is a part, the profits are attributed to the PE under the direct application of the Guidelines.\textsuperscript{74} The following example will describe how the attribution of the enterprise’s rights and obligations arising from transactions with unrelated/related enterprises is performed by the functional and factual analysis:

Assume that an enterprise resident in State X has a PE in State Y which is manufacturing products. The functional and factual analysis finds out that the personnel of the PE decide how to implement strategies to manage everyday and exceptional risks relating to the supply chain. In other words, the personnel of the PE control the supply-chain risk management (SCRM). Further, it finds out that the head office does not provide the PE with raw materials (components) or designs (technical requirements for manufactured products). To sum up, the products are manufactured in the PE without any involvement of the head office. In this example, the profits from the sales of the products manufactured by the PE to unrelated enterprises will be directly attributed to the PE. However, the profits from the sales to related enterprises will be attributed to the PE through applying the Guidelines (directly) under Article 9.

3.6. Free capital

As a part of the enterprise, the PE shares the same creditworthiness with the enterprise. In order to support the functions, risks and assets that are attributable to the PE, the AOA implies that the PE should possess an appropriate amount of capital. In other words, “capital follows functions, assets and risks” under the AOA.\textsuperscript{75} The Report 2010 defines the term “free

\textsuperscript{73} Id.; OECD (2010), supra n. 10, para. 98.
\textsuperscript{74} Id.
\textsuperscript{75} K. Dziurdz, 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. (2014), Journals IBFD, p. 140.
capital” as a “funding that does not give rise to a tax-deductible return in the nature of interest”. The attribution of “free” capital to the PE involves two-stage process:

- First, the risks assumed by the PE, the assets economically owned by the PE and functions performed by the PE are identified.
- Second, the free capital to support the risks assumed and to fund the assets owned by the PE is allocated to the PE (the Report recommends several authorized approaches to attribute capital to a PE).

3.7. Recognition of dealings

When a transaction takes place between associated enterprises its existence is self-evident since it is expected to have legal consequences for the enterprises involved. However, the same does not hold true for the “dealings” taking place between the PE and the rest of the enterprise since they are the same enterprise. In the PE context, the AOA equates “dealings” with business transactions concluded between independent enterprises. Therefore, identifiable internal dealings should be determined in order to fully hypothesise the PE as a separate enterprise. For the purposes of the identification of “dealings”, the accounting records of the PE together with the “contemporaneous” internal documentation might be inspected, however, the ultimate decision as to whether such a dealing has taken place should be decided by the functional and factual analysis. Also, it should be stated that there is no special recommendation proposed by the OECD in terms of the identification of the dealings in the PE context. The identification of the “dealings” taking place between a PE and the rest of the enterprise can be illustrated in this example:

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76 OECD (2010), supra n. 10, para. 28.
77 See Nouel, supra n. 55, p. 8.
78 U. Andresen, Brexit to Frankfurt – Risk Transfers as a “Dealing” under the Authorized OECD Approach, 20 Derivs. & Fin. Instrums. 3 (2018), Journals IBFD, sec. 2.2.1.1.
79 OECD (2010), supra n. 10, para. 173.
80 Id., para. 177; see also OECD Model (2017), supra n. 4, Commentary on Art. 7, para. 26.
81 See Nouel, supra n. 55, p. 9.
As described in the previous example (see the example in section 3.4), the functional and factual analysis found out that the economic ownership of the drills was belonging to the head office. The asset was transferred between the PE and different parts of the enterprise to perform activities for the PE in accordance with the instructions given by the personnel of the head office. In this example, it can be concluded that an identifiable dealing has taken place between the PE and the rest of the enterprise.

4. Second Step: determining the profits of the PE based on a comparability analysis

As the functional and factual analysis indicates, the AOA fictionally aligns the profit attribution rules under Article 7 with the transfer pricing rules articulated in Article 9 of the OECD MTC. Therefore, once the dealings between the PE and the rest of the enterprise are determined, the next step taken by the AOA is to make a comparison of those dealings with the transactions between independent enterprises. The comparability analysis in a PE context is conducted in an analogous way to the guidance described in the Guidelines. Choosing the most relevant method is important for the pricing of the dealings taking place between the PE and the rest of the enterprise. In this context, traditional transaction methods include the comparable uncontrolled price method (CUP), the resale price method and the cost-plus method. On the other hand, transactional profit methods include the net margin method and the profit split method.

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82 See Wintsch, supra n. 28, sec. 2.2.2.
83 OECD (2010), supra n. 10, para. 184.
84 OECD Guidelines (2017), supra n. 46, Chapter II, para. 2.1.
85 Id.
5. The AOA for the attribution of profits to dependent agent PEs arising from commissionaire arrangements in light of the BEPS project

5.1. Introduction

Due to the narrow scope of Article 5(5) of the OECD MTC (2014), taxpayers could manage to escape the treaty definition of a PE by opting for commissionaire arrangements rather than agent structures.86 Therefore, BEPS Action 7 proposed changes to Article 5(5) and 5(6) for purposes of countering tax planning opportunities resulting from commissionaire arrangements and similar strategies.87 This chapter will analyze the application of the AOA for the attribution of profits to dependent agent PEs created by commissionaire arrangements as a consequence of the changes made by Action 7 to Article 5(5) and 5(6).

In this regard, the amendments made to Article 5(5) and 5(6) together with the rationale behind them will be discussed in section 5.2. The applicability of the specific guidance of the AOA for the attribution of profits to dependent agent PEs resulting from the new approach on commissionaire arrangements will be examined in section 5.3. Moreover, the question of how the BEPS work regarding the allocation of risks under Actions 8-10 will affect the attribution of profits to the newly proposed PEs will also be addressed in section 5.3.

At the end of the chapter, the general principles of the AOA together with its specific guidance for dependent agent PEs will be applied for the attribution of profits to the PE resulting from the commissionaire arrangement taking into account the high-level principles put forward by

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the Additional Guidance and the BEPS work on risk assumption under Actions 8-10.

5.2. Article 5(5) and 5(6) in light of BEPS Action 7: Commissionaire arrangements

Before moving on the attribution of profits to PEs which arise due to commissionaire arrangements, it is necessary to discuss the recent changes made to Article 5(5) and 5(6) under Action 7 and the circumstances resulting in the changes. In a PE context, Article 5(5) of the OECD MTC provides the PE threshold for agency PEs and the exception to the definition of agency PE is provided by Article 5(6). According to the pre-BEPS version of Article 5(5), a person, who “habitually exercises the authority to conclude contracts in the name of the enterprise” is deemed to be a PE of that enterprise. However, due to the different interpretations between civil law and common law countries, the terms “authority to conclude contracts in the name of the enterprise” were leading to controversy among countries. In civil law jurisdictions, only the conclusion of contracts “in the name of” principal would create “legal bindingness” for the principal. Therefore, an agent could trigger a dependent agent PE in cases where it acts in the name of its principal. In commissionaire arrangements, an agent sells products “in its own name on behalf of” a foreign principal although the ownership of products belongs to the principal. Therefore, the scope of pre-BEPS version of Article 5(5) excludes a commissionaire as agency PE. It also means that the third party

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88 OECD Model (2014), supra n. 9, Article 5(5) and 5(6) respectively.
89 V. Dhuldhoya, The Future of the Permanent Establishment Concept, 72 Bull. Intl. Taxn. 4a/Special Issue (2018), Journals IBFD, sec. 2.2.2.
cannot sue the principal since they have no contractual relationship between them.\textsuperscript{92}

On the other hand, in common law jurisdictions, if the contract is concluded on behalf of principal the agent binds the principal and this relationship is not affected whether the contract is concluded in the name of the principal or not.\textsuperscript{93} In this sense, the Commentary on Article 5(5) also clarifies that if contracts concluded by the agent is “binding” to the principal, the terms “authority to conclude contracts in the name of the enterprise” should apply in cases where even those contracts are not literally concluded “in the name of the enterprise”.\textsuperscript{94} However, the interpretational problem of the terms “in the name of” was giving rise to divergences between common law and civil law countries in respect to the tax treatment of commissionaires.

The possibility of having indirect representation in civil law countries led to excessive use of commissionaire arrangements by MNEs where the principal could participate in the economic life of the host state without having a PE.\textsuperscript{95} Companies are also willing to opt for commissionaire arrangements because both contractors win and lose proportionately from “the successful penetration of the market”, as the commissionaire receives a percentage of the sales as a commission.\textsuperscript{96} Since the commissionaire does not own the products it sells, the profits it receives from the sales cannot be taxed in the source country and thus only the commission it receives from the principal is subject to tax in the source country.\textsuperscript{97}

Therefore, commissionaire arrangements resulted in the transfer of the ownership of intangibles and inventories together with the associated profits

\textsuperscript{94} OECD Model (2014), supra n. 9, Commentary of Article 5, para. 32.1.
\textsuperscript{95} See Dhuldhoya, supra n. 89, sec. 2.2.2.
\textsuperscript{96} See Schön, supra n. 58, p. 285.
\textsuperscript{97} See Cottani, supra n. 93, at p. 163.
to principals located in low-tax jurisdictions, which of course raised concerns among countries. Based on the reasons discussed above, the Report on Action 7 suggests that a person who acts on behalf of the non-resident enterprise “and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise” will be deemed to be a PE of that enterprise if those contracts are:

“a) in the name of the enterprise, or
b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
c) for the provision of services by that enterprise”.

As already noted, a PE cannot be deemed to exist under commissionaire arrangements according to the pre-BEPS version of Article 5(5) of the OECD MTC. However, the post-BEPS version of Article 5(5) acknowledges that concluding contracts for the transfer of the principal’s property on behalf of the principal is enough to trigger an agency PE. Consequently, a commissionaire arrangement where the commissionaire acts on behalf of the principal will give rise to a PE in the BEPS context.

In this context, the Report on Action 7 also addresses the abuse of “independent agent” exception. According to the pre-BEPS version of Article 5(6), an agent acting in its ordinary business course cannot be deemed as PE in the source state. Action 7, however, recommends that an agent is not independent if it “acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related”. In relation to the “closely related” enterprises, it concludes that an agent

98 P. Drobnik, The Attribution of Profits to a Dependent Agent PE – If the Dependent Agent Is a Commissionaire (Wholly Owned Subsidiary) of the Principal, 25 Intl. Transfer Pricing J. 3 (2018), Journals IBFD, sec. 2.2.
100 OECD Model (2017), supra n. 4, Article 5(5).
101 OECD Model (2014), supra n. 9, Article 5(6).
should be considered acting “exclusively or almost exclusively” on behalf of a closely related enterprise if its sales made to unrelated persons contain less than 10 per cent of the sales made by the agent.\textsuperscript{103} However, the 10 per cent requirement is arbitrary and factual assessment should be conducted in accordance with the local tax law.\textsuperscript{104}

Moreover, it should be stressed that the concept of the “closely related enterprise” should not be viewed same as the concept of “associated enterprises”. According to the new Paragraph 8 added to Article 5 of the OECD MTC (2017), in order to be considered as closely related enterprises, one should have “control of the other” or both should be “under the control of the same persons or enterprises”.\textsuperscript{105} Further, having “50 per cent of the beneficial interest in the other” will give rise to closely related enterprises.\textsuperscript{106}

5.3. The AOA for the attribution of profits to dependent agent PEs: Current Guidance and the BEPS impact

In this section, the author will discuss the AOA perspective on the attribution of profits to dependent agent PEs in the wake of the BEPS project. Its applicability with respect to the dependent agent PEs (DAPEs) arising from commissionaire arrangements under Action 7 will be examined with the specific references to the principles recommended by the Additional Guidance and the BEPS work on risk assumption under Actions 8-10.

Despite the fact that the DAPE threshold provided by Article 5(5) was amended under Action 7, the applicability of the AOA will not be affected by the new changes, as the nature of the DAPE has not been changed by the

\textsuperscript{103} Id., at p. 26.
\textsuperscript{105} OECD Model (2017), supra n. 4, Article 5(8).
\textsuperscript{106} Id.
BEPS implications.\textsuperscript{107} With regard to the newly proposed DAPEs, the main outcome is that the rights and obligations arising out of sales contracts – which are addressed by Article 5(5) – will be properly allocated to the DAPEs.\textsuperscript{108} In terms of the profit attribution to the DAPEs, Article 7 of the relevant tax treaty will be applicable.\textsuperscript{109} Likewise, the general principles of the AOA will preserve its applicability for the attribution of profits to the DAPEs arising from commissionaire arrangements in cases where a contracting state applies the AOA (as outlined in 2010 Report) for the purposes of Article 7. However, how the profits should be attributed to the newly proposed DAPEs under the AOA raises some issues considering that the local related party (the commissionaire agent) should also be attributed an arm’s length remuneration under Article 9.

The AOA provides specific guidance for the attribution of profits when a DAPE arises under a DTC.\textsuperscript{110} When a PE is deemed to exist due to the activities of a dependent agent enterprise (the DAE), two taxable legal entities arise in the source country – the DAE itself (which is always a resident for the purposes of this contribution) and the DAPE (which is a PE of a foreign non-resident enterprise (the principal)).\textsuperscript{111} In such a case, two legal entities are subject to corporate income tax in the source country and even though both of them are under the legal umbrella of the same entity, two taxpayers are registered in the source country.\textsuperscript{112}

In relation to the DAPEs arising from commissionaire arrangements, when the DAE and the principal appear to be associated enterprises, Article 9 will examine whether the commission fee paid to the DAE is in accordance with the arm’s length principle, in contrast, Article 7 will deal with the

\textsuperscript{108} Id., para. 31, p. 13.
\textsuperscript{109} Id.
\textsuperscript{110} OECD (2010), supra n. 10, para. 227-247.
\textsuperscript{111} Id., para. 230.
\textsuperscript{112} See Verdoner, supra n. 31, at p. 128.
attribution of profits to the DAPE arising from the activities of the DAE, namely the related intermediaries under commissionaire arrangements. Simply speaking, while transactions taking place between the DAE and the principal are subject to Article 9, dealings taking place between the DAPE and the DAE that results in the execution of activities by the DAE on behalf of the principal falls under Article 7.\textsuperscript{113}

The two-step analysis (See Chapter 3 and 4) that the AOA requires for the attribution of profits to other PEs is also applicable in the DAPE-DAE context.\textsuperscript{114} In this sense, the first step of the AOA will distinguish the functions that the DAE performs on its own account from the functions the DAE undertakes on behalf of the principal.\textsuperscript{115} As already discussed in section 3, the functions, assets and risks that are attributable to the DAPE must be determined under the functional and factual analysis. When identifying the nature of the functions that are performed by the DAE on behalf of the principal, the functional and factual analysis examines whether the DAE performs the significant people functions in connection with “the assumption and/or management of risks or to determining the economic ownership of assets”.\textsuperscript{116} Therefore, the AOA takes into account the knowledge and the skills of the employees of the DAE in determining whether the DAPE's capacity is fair enough to conduct different management functions on behalf of the principal.\textsuperscript{117} Accordingly, in cases the first step of the AOA finds out that, for example, the personnel employed by the DAE perform the significant people functions in connection with the management and/or assumption of the inventory risk and to determining the economic ownership of the inventory on behalf of the principal, the respective profits associated with the inventory risk

\textsuperscript{113} Raffaele Petruzzi and Raphael Holzinger, Profit Attribution to Dependent Agent Permanent Establishments in a Post-BEPS Era, IBFD, 2017, p. 276.
\textsuperscript{114} OECD (2010), supra n. 10, para. 232.
\textsuperscript{115} Id.
\textsuperscript{116} Id.
\textsuperscript{117} See Petruzzi&Holzinger, supra n. 113, p. 276.
together with the “economic ownership” of the inventory should be attributed to the DAPE.\textsuperscript{118}

The AOA highlights that the DAE is unlikely to perform the significant people functions with regard to the risks and assets on behalf of the principal and, as a result, the attribution of profits to the DAPE might be reduced or eliminated in practice.\textsuperscript{119} For that reason, as a possible solution, the arm’s length compensation that the principal pays to the DAE for its services might be determined and deducted in order to calculate the profits attributable to the DAPE.\textsuperscript{120} In the DAPE’s tax computation, this reward is calculated as a deductible expense. The specific difference of the profit attribution mechanism under the AOA is that it is possible to attribute profits to the DAPE even after having deducted the arm’s length reward under Article 9. This principle, which is called as the “dual taxpayer approach” and supported by the AOA, is different from the “single taxpayer approach”. Under the “single taxpayer approach”, the arm's length reward to the DAE results in zero profit being attributed to the DAPE.\textsuperscript{121} The “single taxpayer approach” is based on the idea that the local related intermediary/DAE and the DAPE is the same entity and since the arm's length reward to the DAE fully reflects the functions, assets and risks attributable to the DAE, no profit can be attributable to the DAPE, and, as a result, the arm's length compensation extinguishes the DAPE’s profits.\textsuperscript{122} The OECD has rejected this approach based on the following justifications:\textsuperscript{123}

- First, the single taxpayer approach does not consider the assets and risks arising from the activity carried out in the source country and, as a result,

\textsuperscript{118} OECD (2010), supra n. 10, para. 243.
\textsuperscript{119} Id., para. 233.
\textsuperscript{120} Id., para. 234.
\textsuperscript{121} See Dziurdź, supra n. 75, p. 137.
\textsuperscript{122} Id.; S.B. Law, Profit Attribution to Permanent Establishments – A Tax Treaty Perspective on the “Single Taxpayer” Approach, 72 Bull. Intl. Taxn. 3 (2018), Journals IBFD, sec. 2; see also Petruzzi&Holzinger, supra n. 113, p. 277.
\textsuperscript{123} OECD (2010), supra n. 10, paras. 236-239.
the respective profits that are generated in the source jurisdiction are ignored. It of course leads to an unfair allocation of the tax-sharing rights between the residence state and the source state, as in any case zero profit is attributable to the DAPE in the source country;

- The single taxpayer approach treats DAPEs differently than other types of PEs. Under the AOA, the risks and assets that are created due to the functions performed by the DAPE are assigned to the DAPE, notwithstanding the fact that they legally belong to the principal. With regard to the same risks and assets, the single taxpayer approach attributes zero profit to the DAPE, even though they arise from the activities that the principal performs through the DAPE in the host country. This distinction is not consistent with the aims of Article 7 and the arm's length principle.

- In terms of profit attribution to DAPEs, different facts and circumstances would lead to the same result under the single taxpayer approach, which is contrary to the essence of the arm's length principle.

- Finally, the single taxpayer approach results in the redundancy of Article 5(5), as there will be no profit consequences for DAPEs even in cases where the DAPE's activities generate profits for the principal.

Contrary to the single taxpayer approach, the AOA – “the dual taxpayer approach” recognizes that there might be excess risks/assets that legally do not belong to the DAE and in cases it is found that additional risks/ assets are related to the functions that are carried out by the DAE on behalf of the principal in the host state, those risks/assets together with the respective profits should be attributed to the DAPE.124 Due to the discriminatory treatment of DAPEs compared to other types of PE, the author also finds the single taxpayer approach unfair. In the author’s opinion, it is reasonable to properly apply both Article 7 and Article 9 in order to find out the profits attributable to the DAE, the DAPE and the principal. In this context, the Report (2010) and the MTCs together with their Commentaries do not

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124 Id., para. 234; see also Dziurdź, supra n. 75, p. 138.
indicate the order of whether Article 9 or Article 7 should be applied first in relation to the profit attribution in the DAE-DAPE context. Therefore, which article should precede the other has arisen questions among countries.

From the BEPS perspective, the Additional Guidance also does not recognize a hierarchy between two articles and acknowledges that the order of application of Article 7 and 9 should not affect the amount of profits to which the host country has taxing rights. Further, any approach chosen by the country in connection with the priority of the application of articles should be used consistently and should not result in double taxation in the host country. In other words, the same profits should not be taxed by the host country both in the context of the DAPE under the AOA and in the context of the DAE under transfer pricing rules.

When applying the AOA for the attribution of profits to the DAPEs arising from commissionaire arrangements, it is important to consider the BEPS work on the assumption of risks, as the new guidance for the allocation of risks between parties might affect the determination of the arm’s length reward to the DAE, which would also have an impact on the profits attributable to the DAPE. Under the new guidance of the Revised Guidelines, the OECD has suggested applying a six-step approach to accurately allocate the risks between parties. The fifth step incorporated in the new Chapter I of the Guidelines clarifies that the party assuming the risk is the enterprise which has both the actual control over the risk and the financial capacity to assume the risk. In other words, the new six-step framework excludes the party as assuming the risk if it is found that the

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125 OECD, Additional Guidance (2018), supra n. 107, para. 35.
126 Id.
127 Id.
128 Id., para. 36.
130 Id., para. 1.98.
party does not actually control the risk. The elements of the “control over risk” are defined by paragraph 1.65 of the new Chapter I of the Revised Guidelines under the Report on Actions 8-10:\(^{131}\)

“… the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.”

From the wording of the new Guidelines it might be concluded that the Revised Guidelines on the “control over risk” put weight on “the decision-making function” in respect to the management of the risk. The same notion is also referred by the Report (2010) with respect to the assumption/management of risk in a PE context:\(^{132}\)

“...the significant people functions relevant to the assumption of risks are those which involve active decision-making.”

From this perspective, the “control over risk” elements seem to have conceptual similarity with the notion of active decision-making required within the significant people functions under the AOA.\(^{133}\) In this context, the determination of the “control over risk” takes into account the “decision-making” with regard to the risk control, which is also performed under the AOA in cases where the significant people functions relating to the assumption of the risk are determined taking into account the involvement of the personnel of the DAE in the “active decision-making” relevant for the risk management. My view is that this similarity between the “significant people functions” and the “control over risk” functions regarding the “decision-making” element will facilitate the risk assessment

\(^{131}\) Id., 1.65.
\(^{132}\) OECD (2010), supra n. 10, para. 25.
\(^{133}\) See Cottani, supra n. 93, at p. 183.
in the DAE, the DAPE and the principal context. However, some issues might arise from the allocation of risks between the DAE and the DAPE when it is found that it is the DAE that is controlling the risk under the Revised Guidelines.

If the DAE and the principal are associated enterprises and a DAPE is deemed to exist under Article 5(5) both Article 9 and Article 7 are applicable. As already noted, the Additional Guidance does not provide the order of application for articles and the AOA examines the significant people functions in attributing risks/assets to a PE. The issue arises in cases where the significant people functions relating to the risks/assets are performed by the personnel of the DAE on behalf of the principal. It is because while the functions performed by the DAE will qualify as the significant people functions for the attribution of specific risk to the DAPE under the AOA (Article 7), in contrast, the same risk will be allocated to the DAE, as the latter performs the risk control functions in accordance with the Revised Guidelines (Article 9).

In such cases, the Additional Guidance clarifies that the simultaneous allocation of the same risk to the DAE and the DAPE must be prevented. Consequently, if it is the DAE who is assuming the risk under the new Section D.1.2 of Chapter I, the DAPE and the principal cannot assume that risk, as the allocation of the risk both to the DAE (in line with the new Section D of Chapter I of the Guidelines) and to the DAPE (under the AOA) would lead to double taxation in the source country. This is also called a “no double-counting” principle that prevents the assumption of the same risk twice in the DAE-DAPE context. It means that the significant people functions under the AOA and the risk control functions under Article 9 cannot be applied

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134 OECD (2010), supra n. 10, para. 68.
135 See Drobnik, supra n. 98, sec. 6.1.
136 OECD, Additional Guidance (2018), supra n. 107, para. 41.
137 Id.
138 Supra n. 135.
“interchangeably”. The conclusion that can be drawn from this is that the significant people functions “relevant to the assumption and/or management of risks” undertaken by the DAPE on behalf of the principal will also be considered as the “risk control functions” undertaken by the DAE under the revised Guidelines, leading to the overlap between two functions (two articles). However, the “risk control functions” will lead to the assumption of the risk by the DAE, not by the DAPE according to the Revised Guidelines. In such cases, it is clearly possible that — where the commission fee of the DAE is determined based on the arm’s length principle — the DAPE can be attributed zero profit. In such cases, profits will only be attributable to the DAE and as a result, the source country will only tax the DAE.

Even though the Additional Guidance outlines that the profits attributable to the DAPE should not be extinguished by the arm’s length reward to the DAE, I do believe that the overlap between two functions should be clarified at the OECD level, otherwise, the overlap might lead to incorrect conclusions. First, under the Revised Guidelines, it is clear that in cases the significant people functions are found to be undertaken by the DAE, it will be considered as a mismatch between the contractual assumption and the actual control over the risk and, as a result of the application of Article 9 in priority to Article 7, all profits can be attributed to the DAE. However, the AOA will allocate the same risk together with the respective profits to the DAPE based on the significant people functions relevant for the assumption of the same risk. In my view, the OECD should decide on the hierarchy between Article 7 and Article 9. From a practical standpoint, I do believe that Article 9, which is more “concrete” or more “specialized” than Article 7, should be applied in priority to Article 7, and the source state should first determine the arm’s length reward to the DAE in accordance with the correct transfer pricing analysis. However, the fact that the reward to the

139 OECD, Additional Guidance (2018), supra n. 107, para. 40.
140 Id., para. 42.
commissionaire is at arm’s length should not stop tax authorities from examining the existence of the DAPE under Action 7 and attributing profits to it. The source country should proceed to the facts and circumstances of the case from the perspective of Article 7 and examine the possibility of profit attribution to the DAPE under the AOA (for example, there might be the excess of the arm’s length reward to the DAE; also, the excess of the inventory risk performed by the DAE on behalf of the principal that does not belong to the DAE). After the examination, the arm’s length compensation determined under Article 9 can be deducted as an expense in the DAPE’s tax computation. Having hierarchy between Articles 7 and 9 will also eliminate a need to calculate the profits separately both in the DAPE and in the DAE context, that, in my view, is additional tax assessment burden for the source state.

Second, it must be assured that the risk analysis under the Revised Guidelines and under the AOA will lead to the same result for the source state. For purposes of reaching the same risk analysis in the DAE-DAPE context, the wording of the AOA outlined in the Report could be revised by the OECD, taking into account the BEPS work on risk assumption under Actions 8-10. Even though the Preface to the Report (2010) recognizes the application of the AOA in accordance with the updated Guidelines, the overlap between the significant people functions and the risk control functions in relation to the risk assumption can lead to controversy among countries.

Finally, due to the reason that profits attributable to the DAPE appear to be “nil or negative” in cases where it is the DAE assuming the risk under the Revised Guidelines, some support the use of the “single taxpayer approach” by source states in a post-BEPS world. Although the use of the

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141 Id.
142 Petruzzi&Holzinger, supra n. 113, p. 295; see also Law, supra n. 122, sec. 2.
“single taxpayer approach”\textsuperscript{143} by the source country seems to work smoothly in the BEPS world, in contrast, I do believe that the use of the single taxpayer approach would affect the neutrality of the tax system, as the profit attribution under the AOA (or any other approach) would differ depending on the type of a PE. Secondly, if the arm’s length compensation to the DAE (which is paid by the principal to the DAE) fully exhausts the profits that can be attributable to the DAPE, then determination of whether the DAPE exists under Action 7 by the source country would be pointless. Finally, if all profits were attributed to the DAE even in cases where the circumstances and facts are different, it would lead to the redundancy of Article 5(5) of the Treaty. However, the Additional Guidance also states that the source’s state’s taxing right cannot be extinguished by the arm’s length compensation to the DAE and the facts and circumstances of a given case should also be examined in the context of the attribution of profits to DAPEs for the purposes of Article 7.\textsuperscript{144}

5.5. Example illustrating the attribution of profits to the DAE (related intermediary) and the DAPE with the use of the AOA

The example given in this section is intended to illustrate the use of the AOA to attribute profits to the DAPE which arises from a commissionaire arrangement under Article 5(5). Assume the following fact pattern:

Katu, a company resident in Country X, manufactures cell phone cases. Since Katu has no physical presence in Country Y, it has a commissionaire agreement with ComisCo (which is a wholly owned subsidiary of Katu) according to which ComisCo performs selling activities for Katu's products in Country Y. According to the commissionaire agreement, it is Katu who

\textsuperscript{143} For example, Austria-Germany Income and Capital Tax Treaty uses the single taxpayer approach according to which the arm’s length compensation to the DAE exhausts any additional profits that can be attributable to the DAPE. 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, Treaties IBFD.

\textsuperscript{144} OECD, Additional Guidance (2018), supra n. 107, para. 42.
owns the products and even though ComisCo sells phone cases in its own name on behalf of Katu, all payments made by buyers for the cases belong to Katu. The commission fee that Katu pays to ComisCo is 11% mark-up on the costs. Another fact is that ComisCo concludes sales contracts only on behalf of Katu and doesn’t perform commissionaire activities for other enterprises. The tax treaty between Country X and Country Y is patterned on the OECD MTC.

5.5.1. Analysis of the case with respect to Action 7, the special guidance of the AOA for the attribution of profits to DAPEs and the high-level principles put forward by the Additional Guidance

When analyzing this case in the BEPS context, Country Y will first consider the suggestions made by Action 7 to the concept of dependent agent PE under Article 5(5) and 5(6). In this case, ComisCo “habitually” concludes sales contracts on behalf of Katu and in doing so, ComisCo acts “exclusively on behalf of” one enterprise, namely Katu. Consequently, the commissionaire arrangement between Katu and ComisCo gives rise to a DAPE, meaning that Country Y, as the source state, will have a taxing right over the business profits attributable to the DAPE under Article 7 of the OECD MTC.

After having determined the taxable presence in its territory, the next stage concerns the attribution of profits to the DAPE under Article 7(2). For the purposes of the subject matter of this thesis, the AOA will be used for the attribution of profits to the DAPE. According to the specific guidance of the AOA for DAPEs, Country Y has right to tax the business profits of the DAPE and the commission fee that Katu pays to ComisCo for its services.\footnote{OECD (2010), supra n. 10, para. 230.} As already noted before, the two-step analysis of the AOA is also applicable in the context of DAPEs.\footnote{Id., para. 232.} In this sense, the AOA aims to identify functions undertaken by ComisCo on its own and on behalf of the
Katu.\textsuperscript{147} In doing so, the commissionaire service that ComisCo provides to Katu will be priced under Article 9 and the profits that are attributable to the DAPE will be determined with the use of the two-step analysis under the AOA.\textsuperscript{148}

Assume that the functional and factual analysis taken under the first step of the AOA finds out that ComisCo is responsible for managing the inventory and determining inventory levels of the products (phone cases) and it is the employees of ComisCo (at ComisCo’s office in Country Y) who involves in active decision-making in connection with the management of inventory risks. In such cases, where the significant people functions are performed by the DAE (ComisCo) on behalf of the principal (Katu), the AOA outlines that the risk is assumed by the DAPE.\textsuperscript{149} Since the significant people functions are undertaken by the DAPE, the economic ownership of the inventory (asset) is also attributed to the DAPE.\textsuperscript{150}

In this case, ComisCo’s employees conclude sales contracts with third parties, meaning that the DAPE created by the commissionaire also possesses the rights and obligations of Katu arising from the contracts (to which Article 5(5) refers). Finally, as an identifiable “dealing” taking place between the DAPE and Katu, the sale of phone cases (together with the consideration of the DAPE’s function as managing inventory) will be priced under the Guidelines by analogy and the arm’s length reward of this amount together with the commission fee paid to ComisCo will be deducted as cost in the DAPE’s tax computation (there might be other expenses, for example, the arm’s length amount of the expenses associated with the activities that the principal (Katu) undertakes on behalf of the DAPE).\textsuperscript{151}

For the purposes of this example, it is also assumed that the commission fee

\textsuperscript{147}Id.
\textsuperscript{148}Id.
\textsuperscript{149}Id., para. 243.
\textsuperscript{150}Id.
\textsuperscript{151}OECD, Additional Guidance (2018), supra n. 107, para.56; see also Drobnik, supra n. 98, sec 5.1.
that Katu pays to ComisCo is at arm’s length. It is also worth noting that – as an administratively convenient way – Country Y may collect tax only from ComisCo, however, the amount of taxes in the DAPE’s computation must be calculated separately from the taxes that ComisCo is subject to in Country Y as the DAE.152

Now, the same scenario will be developed with different circumstances. To briefly describe the allocation of profits to the principal, with the same facts and circumstances in mind, assume that the functional and factual analysis finds out that Katu keeps title to the inventory until it is delivered to third parties by ComisCo and it is the people employed by the head office of Katu who decides on the risk management associated with the inventory. In this context, the functions performed by ComisCo only include identifying customers, placing their orders and performing sales activities in Country Y. In such a case, the contractual allocation of the inventory risk corresponds to the actual control over the inventory risk. Therefore, even though the DAPE arising from the commissionaire arrangement is deemed to exist, the source state, Country Y, cannot tax the DAPE since ComisCo acts as a mere sales agent in Country Y, and Katu, which is contractually assuming the risk also has the actual control over the risk. As a result, the economic ownership of the inventory together with the reward for risk assumption will be attributed to Katu and thus resulting no profit attributable to the DAPE. Consequently, the DAE – ComisCo will only be subject to tax for the commissionaire activities it performs for Katu and even though the DAPE is deemed to exist under Article 5(5) with the reference to Action 7, the DAPE will not be taxed in the source country.

152 See OECD (2010), supra n. 10, para. 246; see also OECD, Additional Guidance (2018), supra n. 107, para. 57.
5.5.3. Analysis of the case in order to describe the overlap between the “significant people functions” under the AOA and the “control over risk” functions under the Revised Guidelines

In this subsection, the analysis of the case will take into account the guidance on risk assumption provided by Actions 8-10, moreover, the interaction between the AOA and new Section D of Chapter I of the Guidelines will be described. In case the analysis starts with the application of Article 9, the contractual terms of the commissionaire agreement between ComisCo and Katu needs to be examined first, as it is a “starting point” for any transfer pricing analysis.\(^\text{153}\) Assume that against to the contractual terms of the agreement, it is determined that the personnel of ComisCo – alongside performing selling activities for Katu – also manage the inventory levels and perform the significant people's functions with regard to the assumption of the inventory risk. It means that the contractual assumption of the risks and assets does not correspond to the actual control over them. Consequently, the personnel of the ComisCo are considered as performing the “control over risk” functions under the Revised Guidelines.\(^\text{154}\) In the context of the AOA, the personnel of ComisCo are also considered performing the significant people functions in relation to the inventory (asset) and inventory risk.\(^\text{155}\) However, since the priority is given to the application of Article 9, the new Section D of Chapter I of the Guidelines applies to the fact situation and the significant people functions performed by ComisCo on behalf of Katu qualify as the risk control function in this context. Based on this analysis, the inventory risk and the economic ownership of the inventory (asset) together with associated profits are allocated to ComisCo, not to the DAPE. The inventory risk cannot be allocated to the DAPE, as that would result in the double taxation

\(^{153}\) OECD, Actions 8-10 Final Report (2015), supra n. 129, Sec. D.1, at para.1.42; see also Barreiros Rosalem, supra n. 55, sec. 3.2, at p. 17.

\(^{154}\) Id., para. 1.65.

\(^{155}\) As already discussed, the AOA allocates profits to the DAPE if the significant people functions are performed by the personnel of the DAE and at the location of the DAE.
in Country Y.\textsuperscript{156} Therefore, the reward for the assumption of the inventory risk together with the commission fee is allocated to ComisCo. The analysis carried out showed that it is possible that no profit is attributable to the DAPE in case the application of Article 9 takes into account the risk allocation guidance articulated in the Revised Guidelines. Consequently, the DAPE will not be subject to tax in Country Y.

\footnote{OECD, Additional Guidance (2018), supra n. 107, para. 41.}
6. Conclusion

This thesis aimed to analyze the application of the AOA for the attribution of profits to the DAPEs arising from commissionaire arrangements as a result of the changes made to the concept of DAPE by Action 7, with the specific reference to the BEPS work on the allocation of risks under Actions 8-10. First, it has been concluded that in case a DAPE arises from a commissionaire arrangement under Action 7, the general principles of the AOA together with its specific guidance for DAPEs will be applicable for the attribution of profits to the DAPE, and the rights and obligations arising out of sales contracts with third parties under the commissionaire arrangement will be properly allocated to the DAPE.

When a DAPE arises from a commissionaire arrangement the source country has taxing rights over the profits of both the DAPE and the DAE. In case the DAE and the principal happen to be associated enterprises, both Article 9 and Article 7 are applicable. Without reference to the BEPS guidance on risk allocation, it has been concluded that both articles will be applicable in the DAE-DAPE context and, moreover, there is no guidance of whether the application of any article should precede the other. However, the order of application of articles (i) should not affect the amount of profits “over which the source country has taxing rights” and (ii) should not result in double taxation in the source country.

The preface to the Report acknowledges that the AOA should be applied by considering the Guidelines “modified from time to time”.157 Therefore, the author also examined certain issues arising from the interaction between the AOA and the Revised Guidelines in relation to the risk allocation. As a consequence of the Revised Guidelines on risk, it was concluded that in cases where the risk is assumed by the DAE according to new Section D of Chapter I of the Guidelines under Article 9, the same risk cannot be

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157 OECD (2010), supra n. 10, Preface, para. 10.
assumed by the DAPE for the purposes of article 7. The reasoning behind this is that it would otherwise lead to double taxation through double counting of the same profits associated with the risk in the context of both the DAPE and the DAE. Therefore, “no double-counting principle” introduced by the OECD should be respected for the attribution of profits in the DAPE-DAE context.

It was also concluded that if the significant people functions regarding the assumption of risk are performed by the personnel of the DAE on behalf of the principal and it is found that the actual control over the risk is performed by the personnel of the DAE under the Revised Guidelines, then the significant people functions qualify as the risk control functions and thus the profits associated with the risk are allocated to the DAE. However, this conclusion is in conflict with the specific guidance of the AOA for the attribution of profits to DAPEs, as the same risk should be attributed to the DAPE under the AOA. In this regard, the Additional Guidance addresses only the double taxation issue and clarifies that the same risk should not be counted twice in the context of both the DAE and the DAPE. In the author's opinion, the OECD should decide on the hierarchy between Article 7 and 9. Moreover, the author concluded that it would be reasonable to apply the Article 9 in priority to Article 7. First, the source state should determine the arm’s length reward to the DAE under Article 9 and even in cases where it is found that the commission fee is at arm's length, the tax authorities should proceed with finding out whether the DAPE is deemed to exist under Action 7. After having determined the taxable presence – the DAPE, the source country must examine the fact situation from the perspective of Article 7 to find out whether there are excess risks/assets that do not belong to the DAE and that are related to the functions that the DAE performs on behalf of the principal. By proposing this hierarchy and mechanism, the author also supports the “dual taxpayer approach” and believes that the arm’s length reward to the DAE should not exhaust the profits attributable
to the DAPE. To sum up, having hierarchy between Articles 7 and 9 will also eliminate additional tax assessment burden for the source state.

It was also concluded that in case the significant people functions performed by the personnel of the DAE qualify as the risk control functions in accordance with the Revised Guidelines under Article 9, the risk together with the associated profits is allocated to the DAE. As a result, it is possible that in some cases there would be no profit attributable to the DAPE. This outcome reminds the mechanism that happens under the so-called “single taxpayer approach”. As already discussed, such an approach assumes that the arm’s length remuneration to the DAE “extinguishes” profits attributable to the DAPE without having examined the fact situation from the perspective of Article 7 and as a result, the source country only taxes the DAE. The author does not agree with this approach and believes that the applicability of this approach can give rise to some concerns. First, the attribution of profits to DAPEs will be treated differently compared to general PEs under the “single taxpayer approach” that can harm the tax neutrality in the source state. Secondly, the assets, the risks and the associated profits will not be attributed to DAPEs even though the significant people functions are performed in the source country by the DAE on behalf of the principal. Consequently, if the arm’s length reward to the DAE exhausts the profits attributable to the DAPE then the existence of Article 5(5) of the Treaty that gives rise to DAPEs would be redundant. Consequently, an examination of whether a DAPE is deemed to exist under Action 7 would be pointless. To sum up, the author finds the application of the “dual taxpayer approach” important in the BEPS context.

It was also concluded that in some cases the DAE does not perform the significant people functions and even though the DAPE arises from the DAE’s commissionaire activities under Action 7, the DAPE might be attributed zero profit provided that it is the personnel of the principal (non-resident enterprise) who perform the significant people functions with
respect to the risk/asset. In such cases, the contractual allocation of the risk corresponds to the actual control over the risk under the Revised Guidelines, therefore, all profits can be properly allocated to the principal. Consequently, no profit will be attributed to the DAPE, and the DAE will only be taxed for the commissionaire activities that it performs for the principal.
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