Additional Guidance on the Attribution of Profits to Permanent Establishments

BEPS ACTION 7

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Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7

INCLUSIVE FRAMEWORK ON BEPS

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Foreword

The integration of national economies and markets has increased substantially in recent years, putting a strain on the international tax rules, which were designed more than a century ago. Weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moves by policy makers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created.

Following the release of the report *Addressing Base Erosion and Profit Shifting* in February 2013, OECD and G20 countries adopted a 15-point Action Plan to address BEPS in September 2013. The Action Plan identified 15 actions along three key pillars: introducing coherence in the domestic rules that affect cross-border activities, reinforcing substance requirements in the existing international standards, and improving transparency as well as certainty.

After two years of work, measures in response to the 15 actions were delivered to G20 Leaders in Antalya in November 2015. All the different outputs, including those delivered in an interim form in 2014, were consolidated into a comprehensive package. The BEPS package of measures represents the first substantial renovation of the international tax rules in almost a century. Once the new measures become applicable, it is expected that profits will be reported where the economic activities that generate them are carried out and where value is created. BEPS planning strategies that rely on outdated rules or on poorly co-ordinated domestic measures will be rendered ineffective.

Implementation is now the focus of this work. The BEPS package is designed to be implemented via changes in domestic law and practices, and via treaty provisions. With the negotiation for a multilateral instrument (MLI) having been finalised in 2016 to facilitate the implementation of the treaty related measures, 67 countries signed the MLI on 7 June 2017, paving the way for swift implementation of the treaty related measures. OECD and G20 countries also agreed to continue to work together to ensure a consistent and co-ordinated implementation of the BEPS recommendations and to make the project more inclusive.

Globalisation requires that global solutions and a global dialogue be established which go beyond OECD and G20 countries. A better understanding of how the BEPS recommendations are implemented in practice could reduce misunderstandings and disputes between governments. Greater focus on implementation and tax administration should therefore be mutually beneficial to governments and business. Proposed improvements to data and analysis will help support ongoing evaluation of the quantitative impact of BEPS, as well as evaluating the impact of the countermeasures developed under the BEPS Project.

As a result, the OECD established an Inclusive Framework on BEPS, bringing all interested and committed countries and jurisdictions on an equal footing in the

Committee on Fiscal Affairs and all its subsidiary bodies. The Inclusive Framework, which already has more than 100 members, will monitor and peer review the implementation of the minimum standards as well as complete the work on standard setting to address BEPS issues. In addition to BEPS Members, other international organisations and regional tax bodies are involved in the work of the Inclusive Framework, which also consults business and the civil society on its different work stream

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Executive summary

The definition of permanent establishment (PE) included in tax treaties is crucial in determining whether a non-resident enterprise must pay income tax in another State. To prevent the use of certain common tax avoidance strategies that have been used to circumvent the existing PE definition, the Report on *Preventing the Artificial Avoidance of Permanent Establishment Status* (Action 7 Report, OECD 2015) recommended changes to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties, as a result of the work on Action 7 of the BEPS Action Plan.

In particular, that Report contained changes to tackle arrangements through which a non-resident enterprise makes sales in a jurisdiction through a commissionaire or a dependent agent that does not formally conclude contracts in the jurisdiction, thereby avoiding taxation in the jurisdiction despite having the type of economic nexus that justifies the recognition of a taxable presence. The report also included changes to prevent the exploitation of the specific exceptions to the PE definition provided for by Art. 5(4) of the OECD Model Tax Convention (2014), an issue which is particularly relevant in the case of digitalised businesses. These changes were incorporated into Article 5 as part of the 2017 Update of the OECD Model Tax Convention.

As to the profit attribution rules, the Report concluded that the changes to the definition of PE in Article 5 of the OECD Model Tax Convention did not require substantive modifications to the existing rules and guidance on attribution of profits to PEs under Article 7 of the OECD Model Tax Convention. However, the Report did mandate the development of additional guidance on how the existing rules of Article 7 would apply to PEs resulting from the changes in the Report (in particular for PEs outside the financial sector), taking into account the revised guidance contained in the Report on *Aligning Transfer Pricing Outcomes with Value Creation* (Actions 8-10 Report, OECD 2015).

Under this mandate, the Committee on Fiscal Affairs issued two public discussion drafts on the attribution of profits to permanent establishments (in July 2016 and June 2017). Interested parties were invited to comment on the proposed additional guidance regarding the application of the rules in Article 7 of the OECD Model Tax Convention to PEs resulting from the changes to Article 5 of the OECD Model Tax Convention.

The guidance contained in this report, which has been prepared considering the comments received, sets out high-level general principles outlined in paragraphs 1-10 and 26-44 for the attribution of profits to permanent establishments in the circumstances addressed by the Report on BEPS Action 7. Importantly, countries agree that these principles are relevant and applicable in attributing profits to permanent establishments.

In particular, the additional guidance covers permanent establishments arising from Article 5(5), including examples of a commissionnaire structure for the sale of goods, an online advertising sales structure, and a procurement structure. It also includes additional guidance related to permanent establishments created as a result of the changes to Article 5(4), and provides an example on the attribution of profits to permanent establishments arising from the anti-fragmentation rule included in Article 5(4.1).

1. Introduction

1. Action 7 of the BEPS Action Plan mandated the development of changes to the definition of "permanent establishment" ("PE") in Article 5 of the OECD Model Tax Convention ("MTC") to prevent the artificial avoidance of PE status through the use of commissionnaire arrangements to avoid Article 5(5), and through reliance on the specific activity exemptions of Article 5(4). It also mandated that the work should address related profit attribution issues. The result was the 2015 Final Report on Action 7, "Preventing the Artificial Avoidance of Permanent Establishment Status" ("the Report on Action 7").

2. Paragraph 19 of the Report on Action 7 (at p. 45) states that the changes to Article 5 "*do not require substantive modifications to the existing rules and guidance concerning the attribution of profits to a PE under Article 7 [of the MTC], but … there is a need for additional guidance on how the rules of Article 7 would apply to PEs resulting from the changes in this report …. There is also a need to take account of the results of the work on other parts of the BEPS Action Plan dealing with transfer pricing, in particular the work related to intangibles, risk and capital*".

2. Attribution of Profits to Permanent Establishments Resulting from Changes to Article 5(4) and the Commentary

3. The Report on Action 7 provides for changes to be made to Article 5(4) of the MTC and the Commentary thereon.

4. As explained in the Executive Summary of the Report on Action 7 (at p. 10): *"Depending on the circumstances, activities previously considered to be merely preparatory or auxiliary in nature may nowadays correspond to core business activities. In order to ensure that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) is modified to ensure that each of the exceptions included therein is restricted to activities that are otherwise of a 'preparatory or auxiliary' character. … "BEPS concerns related to Art. 5(4) also arise from what is typically referred to as the 'fragmentation of activities'. Given the ease with which multinational enterprises (MNEs) may alter their structures to obtain tax advantages, it is important to clarify that it is not possible to avoid PE status by fragmenting a cohesive operating business into several small operations in order to argue that each part is merely engaged in preparatory or auxiliary activities that benefit from the exceptions of Art. 5(4). The anti-fragmentation rule proposed in [this report] will address these BEPS concerns."*

The Report on Action 7 includes revised Commentary on Article 5(4) which contains examples of circumstances in which specific activities will not be considered preparatory or auxiliary in nature. For example, paragraph 22 of the revised Commentary states (at p. 31 of the Report on Action 7): *"Where, for example, an enterprise of State R maintains in State S a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in State S, paragraph 4 will not apply to that warehouse since the storage and delivery activities that are performed through that warehouse, which represents an important asset and requires a number of employees, constitute an essential* *part of the enterprise's sale/distribution business and do not have, therefore, a preparatory or auxiliary character."*

5. Under Article 7 of the MTC, the profits to be attributed to a PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that cause it to be a PE. As noted earlier, this principle applies regardless of whether a tax administration adopts the authorized OECD approach as explicated in the 2010 Report on the Attribution of Profits to Permanent Establishments. [1] Thus, after it has been established that a PE exists due to activities specified in Article 5(4) that are not preparatory or auxiliary in nature, the attribution of profits to the PE should be determined under an analysis of the amounts of revenue and expense that the PE would have recognized if it were a separate and independent enterprise.

6. The anti-fragmentation rule recommended in the Report on Action 7 (at p. 39) is contained in the new paragraph 4.1 of Article 5. It prevents paragraph 4 from providing an exception from PE status for activities that might be viewed in isolation as preparatory or auxiliary in nature but that constitute part of a larger set of business activities conducted in the source country by the enterprise (whether alone or with a closely related enterprise) if the combined activities "*constitute complementary functions that are part of a cohesive business operation"*

7. Article 5(4.1) applies in two types of cases. First, it applies where the non-resident enterprise or a closely related enterprise already has a PE in the source country, and the activities in question constitute complementary functions that are part of a cohesive business operation. A determination will need to be made as to whether the activities of the enterprises give rise to one or more PEs in the source country under Article 5(4.1). The profits attributed to the PEs and subject to source taxation are the profits derived from the combined activities constituting complementary functions that are part of a cohesive business operation considering the profits each one of them would have derived if they were a separate and independent enterprise performing its corresponding activities, taking into account in particular the potential effect on those profits of the level of integration of these activities. Examples of this type of fact pattern are contained in new paragraph 30.4 of the revised Commentary (at pp. 40-41 of the Report on Action 7).

8. The second type of case to which Article 5(4.1) applies is a case where there is no pre-existing PE but the combination of activities in the source country by the non-resident enterprise and closely related non-resident enterprises results in a cohesive business operation that is not merely preparatory or auxiliary in nature. In such a case, a determination will need to be made as to whether the activities of the enterprises give rise to one or more PEs in the source country under Article 5(4.1). The profits attributable to each PE so arising are those that would have been derived from the profits made by each activity of the cohesive business operation as carried on by the PE if it were a separate

and independent enterprise performing the corresponding activities, taking into account in particular the potential effect on those profits of the level of integration of these activities.

[1] This guidance is not intended to extend the application of the authorized OECD approach to countries that have not adopted that approach in their treaties or domestic legislation.

9. The following example is illustrative and offers a conceptual framework summarising the attribution of profits to PEs deemed under Article 5(1). The proposed analysis of this example is governed by the AOA contained in the 2010 version of Article 7. However, the attribution of profits to a PE in any particular case will be governed by the applicable tax treaty.

Example Illustration the Attribution of profits to Permanent Establishments under Article 6 (4)

Example 1: Warehousing, Delivery, Merchandising and Information Collection Activities

Facts

10. OnlineCo is a company resident in Country R that sells goods through an online platform directly to customers in various markets including Country S. The goods are purchased from unrelated suppliers. OnlineCo operates a warehouse in Country S which is staffed by 25 employees of OnlineCo. OnlineCo leases the warehouse from an unrelated owner. The employees handle the receipt of shipments from suppliers, the stocking of the goods, and the execution of deliveries to customers in Country S, using independent delivery service providers, in accordance with instructions from OnlineCo's head office.

11. OnlineCo also has an office in Country S which is located in a different place than the warehouse. OnlineCo's office is staffed by 15 people, which are responsible for the merchandising of OnlineCo's products and the collection of information from OnlineCo's customers in Country S.

12. There is a tax treaty in effect between Country R and Country S that prevents Country S from taxing the business profits of an enterprise resident in Country R, except for profits attributable to a PE of that enterprise in Country S. Under the treaty, the profits attributable to a PE are the profits that the PE would have derived 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 other parts of the enterprise. The treaty's definition of PE includes the changes to Article 5(4) of the MTC recommended in the Report on Action 7, including the addition of paragraph 4.1.

Analysis

13. Provided that the business activities carried on by OnlineCo at the warehouse and at the office constitute complementary functions that are part of a cohesive business operation, the warehouse and the office constitute two PEs in Country S under Article 5(1) of the MTC, as each of these locations is a fixed place of business through which the business of OnlineCo is partly carried on, and the overall activity resulting from the combination of the activities carried on in Country S is not of a preparatory or auxiliary character.

14. Under Article 7, the profits attributable to the warehouse PE of OnlineCo are those that the PE would have derived if it were a separate and independent enterprise performing the same storage and delivery activities.

15. Under step one of the AOA, the functional and factual analysis shows that OnlineCo's personnel located in Country R deal with the purchasing of goods from unrelated suppliers and the sale of goods to third party customers. Accordingly, OnlineCo's head office is hypothesised to have OnlineCo's rights and obligations arising from the transactions between OnlineCo and the unrelated suppliers and also between OnlineCo and its customers.

16. This analysis also indicates that the personnel of the PE are responsible for leasing the warehouse and hiring the independent service providers for delivery in Country S. Consequently, the PE is hypothesised to have OnlineCo's rights and obligations arising from the transactions between OnlineCo and the owner of the warehouse and also between OnlineCo and the independent delivery service providers.

17. The functional and factual analysis also demonstrates that the significant people functions relevant to the management of the warehouse are performed by the personnel of the PE in Country S. Accordingly, the PE is hypothesised to be the economic owner of the warehouse.

18. Additionally, step one of the AOA requires the recognition of an internal dealing between the PE and the head office. In this example the dealing is hypothesised as the provision of storage and delivery services by the warehouse PE to the head office.

19. Under step two of the AOA, the guidance in the TPG is applied by analogy to determine the arm's length pricing of the internal dealing between the PE and the head office. In this case, that pricing would equal the amount that OnlineCo would have had to pay if it had obtained the storage and delivery services from an independent enterprise in Country S (attributing to such service provider ownership of the assets of OnlineCo related to such functions, and assumption of the risks of OnlineCo related to such functions).

20. Under Article 7, the profits attributable to the office PE of OnlineCo are those that the PE would have derived if it were a separate and independent enterprise performing the merchandising and collection of information activities.

21. Under step one of the AOA, the functional and factual analysis shows that the personnel of the PE is responsible for the merchandising and collection of information activities in Country S. Accordingly, the PE is hypothesised to have OnlineCo's rights and obligations arising from any dealings with unrelated parties in the process of providing the merchandising and collection of information services.

22. This analysis also indicates that the significant people functions relevant to the management of the office are performed by the personnel of the PE in Country S. Accordingly, the PE is hypothesised to be the economic owner of the office.

23. Step one of the AOA requires the recognition of an internal dealing between the PE and the head office. In this example the dealing is hypothesised as the provision of merchandising and collection of information services by the office PE to the head office.

24. Under step two of the AOA, the guidance in the TPG is applied by analogy to determine the arm's length remuneration of the internal dealing between the PE and the

head office. In this case, such pricing would equal the amount that OnlineCo would have had to pay if it had obtained the same merchandising and collection of information services from an independent enterprise in Country S (attributing to such service provider ownership of the assets of OnlineCo related to such function, and assumption of the risks of OnlineCo related to such function).

3. Attribution of profits to permanent Establishments Resulting from changes to Article 5(5) and 5(6) and the commentary

25. The Report on Action 7 provides for changes to be made to Article 5(5) and (6) of the MTC and the Commentary thereon.

26. Paragraph 9 of the Report on Action 7 (at p. 15) states: "*As a matter of policy, where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business. The changes to Article 5(5) and 5(6) and the detailed Commentary that appear [in this report] will address commissionnaire arrangements and similar strategies [to] better reflect this policy.*"

27. The Report on Action 7 recommends that Article 5(5) be amended to provide that, subject to Article 5(6), an enterprise has a PE in a Contracting State where a person acts in that State on behalf of the 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,*" and the contracts are either in the name of the enterprise, or for the transfer of goods or services by the enterprise.

28. The Report on Action 7 recommends that Article 5(6) be amended to provide that, although a PE will not be deemed to exist under Article 5(5) if the person acting in a Contracting State for the enterprise is doing so in the ordinary course of its business as an independent agent, a person will not be considered to be an independent agent if it acts "*exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related*". The meaning of "closely related" is addressed in a separate subparagraph of Article 5(6).

29. Whilst the changes made to Article 5(5) and 5(6) by the Report on Action 7 have modified the threshold for the existence of a deemed PE under Article 5(5), they have not modified the nature of the deemed PE: the non-resident enterprise "*shall be deemed to have a permanent establishment in [the State in which the dependent agent acts on its behalf] in respect of any activities which that person [i.e. the dependent agent] undertakes for the [non-resident] enterprise*". Therefore, any approach on how to attribute profits to a PE that is deemed to exist under the pre-BEPS version of Article 5(5) should therefore be applicable to a PE that is deemed to exist under the post-BEPS version of Article 5(5).

4. Attribution of Profits to Permanent Establishments Resulting from Changes to Article 5(5) and 5(6) and the Commentary

30. Once it is determined that a PE exists under Article 5(5), one of the effects of paragraph 5 will typically be that the rights and obligations resulting from the contracts to which Article 5(5) refers will be properly allocated to the permanent establishment.

However, it is important to note that this does not necessarily mean that the entire profits resulting from the performance of these contracts should be attributed to the permanent establishment. The determination of the profits attributable to a permanent establishment resulting from the application of Article 5(5) will be governed by the rules of Article 7; clearly, this will require that activities performed by other enterprises and by the rest of the enterprise to which the permanent establishment belongs be properly remunerated so that the profits to be attributed to the permanent establishment in accordance with Article 7 are only those that the permanent establishment would have derived if it were a separate and independent enterprise performing the activities that the dependent agent performs on behalf of the non-resident enterprise[2].

31. Therefore, the profits to be attributed to a PE identified under Article 5(5) are to be determined in accordance with Article 7 of the relevant tax treaty. Article 7 is grounded on the basic principle that the profits attributable to a PE are those that the PE would have derived if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions. This principle applies regardless of whether a tax administration adopts the authorized OECD approach ("AOA") contained in Article 7 in the 2010 version of the MTC as outlined in the 2010 Report on the Attribution of Profits to Permanent Establishments ("2010 Profit Attribution Report"), or any other approach used to attribute profits under a previous version of Article 7 of the MTC. [3]

32. When a PE is deemed to exist under Article 5(5) due to the activities of an intermediary[4], those activities are relevant to two taxpayers in the host country: the intermediary (which may be a resident of the host country) and the PE (which is a PE of a non-resident enterprise). The arm's length reward to the intermediary for the services it provides to the non-resident enterprise is one of the elements that needs to be determined and deducted in calculating the profits attributable to the PE under Article 7.

33. In some cases the intermediary and the non-resident enterprise are associated enterprises. In these scenarios, both Article 9 and Article 7 of the MTC come into play in determining the total amount of profits to be taxed in the host country. While Article 9 will permit adjustments of the profits of the associated enterprises if the terms and conditions of the transactions between the associated enterprises (i.e. the non-resident enterprise and the intermediary) are not consistent with the arm’s length principle, Article 7 will determine the basis on which profits are attributable to the PE of the non-resident enterprise. Guidance on the application of Article 9, which embodies the arm's length principle, is contained in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("TPG").

[2] See paragraph 35.1 of the Commentary on Article 5, at page 23 of the BEPS Report on Action 7, which is intended to be included in the 2017 update of the Model Tax Convention.

[3] As noted earlier, this guidance is not intended to extend the application of the authorized OECD approach to countries that have not adopted that approach in their treaties or domestic legislation.

[4] For the purposes of this guidance, the term "intermediary" means a person, whether or not an employee of the enterprise, who acts on behalf of the enterprise and is not doing so in the course of carrying on a business as an independent agent within the meaning of Article 5(6). In the Authorised OECD Approach, this is referred to as a dependent agent enterprise (see Sections B-6 and D-5 in Part I of the 2010 Report on the Attribution of Profits to Permanent Establishments).

34. The MTC and its Commentary do not explicitly state whether a profit adjustment under Article 9 should precede the attribution of profits under Article 7. However, many jurisdictions find it logical and efficient first to accurately delineate the actual transaction between the non-resident enterprise and the intermediary and to determine the resulting arm's length profits while others may decide to undertake an Article 7 analysis first and then to apply Article 9 to adjust the profits of the associated enterprises (i.e. the non-resident enterprise and the intermediary). In any case, the order in which Article 7 and Article 9 are applied should not impact the amount of profits over which the source country has taxing rights as a result of the activities of the intermediary on behalf of its associated non-resident enterprise in the source country. The approach adopted by a jurisdiction should be applied consistently and could be made public for purposes of transparency and certainty for taxpayers. Furthermore, any approach to the application of Articles 7 and 9 to cases of deemed PEs under Article 5(5) must ensure that there is no double taxation in the source country, i.e., taxation of the same profits in the hands of the PE (under profit attribution rules) and in the hands of the intermediary (under transfer pricing rules). Therefore, jurisdictions are expected to have in place within their domestic legal and/or administrative systems the necessary principles, doctrines, or other mechanisms to eliminate double taxation in the source country.

35. It is relevant to address the implications that the transfer pricing work under BEPS Actions 8-10, in particular in relation to the assumption of risks, may have on the determination of the arm's length remuneration to the intermediary for the services it provides to the non-resident enterprise and, as a result of that, on the profits attributable to the PE. The guidance produced under BEPS Actions 8-10 and incorporated in Chapter I of the TPG clarified that contractual allocations of risk assumption are respected only when they are supported by the actual control over risks and the financial capacity to assume the risk. The guidance in Section D.1.2 of Chapter I of the TPG established, among other things, that where the party contractually assuming the risk does not control the risk or does not have the financial capacity to assume the risk, that risk should be allocated to the enterprise exercising control and having the financial capacity to assume the risk.

36. Such risk allocation under the TPG is solely for the purpose of determining the taxable profits of the associated enterprises and therefore does not involve any non-recognition of their transaction or the legal relationships created by their transactions with others. In other words, the allocation of risks for transfer pricing purposes does not change the facts on which the application of Article 5(5) is predicated – that is:

- the intermediary is acting in a Contracting State on behalf of the non-resident enterprise;
- in doing so, the intermediary habitually concludes contracts (or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the non-resident enterprise); and
- those contracts are either in the name of the non-resident enterprise, or for the transfer of the ownership of, or for the granting of the right to use, property owned by the non-resident enterprise, or for the provision of services by the non-resident enterprise.

37. In a PE context, the legal and factual position is that there is no single part of an enterprise which legally owns the assets, assumes the risks, possesses the capital or contracts with separate enterprises. The mechanism to determine the attribution of risk assumption to a PE will depend on the applicable tax treaty in a given case.

38. For instance, Article 7 and its Commentary in the 2010 version of the MTC reflect the AOA, which is further developed in the 2010 Profit Attribution Report. The AOA uses the notion of "significant people functions" for attributing risk assumption and economic ownership of assets to a PE. For a detailed discussion see paras. 21-27 and 68-71 of Part I of the 2010 Profit Attribution Report.

39. While there may be functions that would be considered both significant people functions for the attribution of risk for the purposes of the AOA and risk control functions for the purposes of Article 9, the conclusion cannot be drawn that these two concepts are aligned or can be used interchangeably for purposes of Article 7 and Article 9.

40. Having said that, when both Article 7 and Article 9 are applicable (i.e. the intermediary and the non-resident enterprise are associated enterprises) and the functions performed by the intermediary can qualify as significant people functions for the attribution of a specific risk to the PE and as risk control functions for the allocation of a risk under Article 9, it is important to ensure that the risk to which those functions relate is not simultaneously allocated to the intermediary (subject to the conditions laid out in Section D of Chapter I of the TPG) and attributed to the PE (under Article 7). Accordingly, where a risk is found to be assumed by the intermediary under the guidance in Section D.1.2 of Chapter I, such risk cannot be considered to be assumed by the non-resident enterprise or the PE for the purposes of Article 7. Otherwise, double taxation could occur in the source country through taxation of the profits related to the assumption of that risk twice, i.e. in the hands of both the PE and the intermediary.

41. It should be noted that the host country's taxing rights are not necessarily exhausted by ensuring an arm's length compensation to the intermediary. As noted earlier, one of the elements to determine and deduct in calculating the profits attributable to the PE is an arm's length reward to the intermediary. Depending on the facts and circumstances of a given case, the net amount of profits attributable to the PE may be either positive, nil or negative (i.e., a loss). In particular, when the accurate delineation of the transaction under the guidance of Chapter I of the TPG indicates that the intermediary is assuming the risks of the transactions of the non-resident enterprise, the profits attributable to the PE could be minimal or even zero.

Administrative approaches to enhance simplification

42. The 2010 Profit Attribution Report notes that there may be administratively convenient ways of recognising the existence of a PE under Article 5(5) and collecting the appropriate amount of tax resulting from the activity of the intermediary. While the 2010 Profit Attribution Report provides such guidance in the framework of the AOA, jurisdictions which do not apply the AOA may also adopt mechanisms aimed at simplifying taxpayers' compliance with tax obligations related to the existence of a PE in the source country. The adoption of such administratively convenient procedures in the host country would not alter the taxing rights of the home country or the host country Furthermore, the adoption of simplification procedures by a jurisdiction should not undermine the ability of the non-resident enterprise to eliminate double taxation under Article 23 of the applicable tax treaty.

43. It is also important to note that the potential burden on a non-resident enterprise of having to comply with host country tax and reporting obligations in the event it is determined to have an Article 5(5) PE cannot be dismissed as inconsequential, and nothing in this guidance should be interpreted as preventing host countries from

continuing or adopting the kind of administratively convenient procedure mentioned above[5]. For instance, a number of countries actually collect tax only from the intermediary even though the amount of tax is calculated by reference to activities of both the intermediary and the Article 5(5) PE[6].

Examples Illustrating the Attribution of Profits to Deemed Permanent Establishment under Article 5(5)

44. The following examples are illustrative and offer a conceptual framework, based on the principles established in the previous paragraphs, summarising the attribution of profits to PEs deemed under Article 5(5). The examples should not be interpreted as prescribing specific arm's length arrangements in actual cases. The proposed analysis of these examples is governed by the AOA contained in the 2010 version of Article 7. However, the attribution of profits to a PE in any particular case will be governed by the applicable tax treaty.

45. It should be noted that many tax treaties contain a version of Article 7 that does not require the use of the AOA. In cases governed by those treaties, the method of attributing profits to a PE for the purpose of Article 7 of the applicable treaty might differ significantly from the AOA. This might be a function of the interrelation between the treaty and the domestic law of the jurisdiction where the PE is located (e.g., if the treaty expressly permitted the use of a customary domestic law apportionment approach, and domestic law contained such an approach). In other cases, the treaty might expressly prohibit the recognition of notional dealings between the PE and the non-resident enterprise of which it is a part (e.g., treaties with a version of Article 7 based on the United Nations Model Double Taxation Convention between Developed and Developing Countries). Therefore, the examples below should not be understood as representing the only appropriate approach to attributing profits to a PE.

Example 2: Commissionnaire structure (related intermediary)

Facts

46. TradeCo, a company resident in Country R, buys and sells widgets. SellCo, a commonly owned company resident in Country S, performs marketing and sales activities on behalf of TradeCo in Country S as a commissionnaire, meaning that SellCo sells widgets in its own name to buyers in Country S but is able to rely on TradeCo under the commissionnaire agreement to satisfy the obligation to deliver the widgets to the buyers. SellCo does not own the widgets at any point, nor does it have any entitlement to the amounts paid by the buyers for the widgets. Those amounts belong to TradeCo. Personnel of SellCo are responsible for warehousing the inventory and determining and monitoring the appropriate inventory levels. For the purposes of this example it is assumed that TradeCo pays SellCo a commission equal to a percentage of the sales revenue received by TradeCo from sales made by SellCo on behalf of TradeCo in Country S. SellCo's business consists solely of its activities for TradeCo. TradeCo has no operations of its own in Country S and makes no sales to customers in Country S other than those made by SellCo on its behalf.

[5] See Part I of the 2010 Profit Attribution Report, footnote 12.

[6] See Part I of the 2010 Profit Attribution Report, at para. 246.

47. There is a tax treaty in effect between Country R and Country S that prevents Country S from taxing the business profits of an enterprise resident in Country R, except for profits attributable to a PE of that enterprise in Country S. Under the treaty, the profits attributable to a PE are the profits that the PE would have derived 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 other parts of the enterprise. The treaty's definition of PE includes the changes to Article 5(5) and Article 5(6) of the MTC recommended in the Report on Action 7.

Analysis

48. Under Article 5(5), TradeCo has a PE in Country S, as SellCo habitually concludes contracts there on behalf of TradeCo for the sale of goods by TradeCo, and SellCo does not do so as an independent agent.

49. Under Article 9, the remuneration that TradeCo pays to SellCo is found to be at arm's length, taking into account its functions performed, assets used and risks assumed.

50. Under Article 7, the profits attributable to the PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that SellCo performs on behalf of TradeCo.

51. Under step one of the AOA, the functional and factual analysis shows that TradeCo's personnel located in Country R deal with the purchasing of the widgets from third party suppliers. This analysis also indicates that the sales of the widgets to the final customers are concluded by personnel of SellCo on behalf of TradeCo in Country S. Accordingly, the PE is hypothesised to have TradeCo's rights and obligations arising from the transactions between TradeCo and the final customers and also from the transaction between TradeCo and SellCo.

52. The functional and factual analysis also demonstrates that the significant people functions relevant to the assumption of inventory risk and to the disposition of the inventory are performed by the personnel of SellCo on behalf of TradeCo in Country S. Accordingly, the PE is hypothesised to be the economic owner of the inventory and the party assuming the inventory risk.

53. Additionally, step one of the AOA requires the recognition of an internal dealing between the PE and the head office. In this example the dealing is hypothesised as the sale of the goods by the head office to the PE.

54. Under step two of the AOA, the guidance in the TPG is applied by analogy to determine the arm's length pricing of the internal dealing between the PE and the head office. In this case, such pricing would equal the amount that TradeCo would have received if it had sold the goods to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of TradeCo in Country S (attributing to such party ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions).

55. In the PE's tax computation, this amount would be deducted as cost of goods sold, and the remuneration paid to SellCo would also be a deductible expense, as well as other expenses wherever incurred for the purpose of the PE.

56. For reasons of administrative convenience, the tax administration in Country S may choose to collect tax only from SellCo even though the amount of tax is separately calculated by reference to the tax liability of SellCo and the PE.

57. The analysis would be the same in the example above if the facts were the same except for the following: SellCo does not conclude sales in Country S as a commissionnaire but rather performs activities in Country S under a services agreement with TradeCo that provides for the fee payable to SellCo to be equal to a percentage of the sales revenue received by TradeCo from sales to customers in Country S, and the effect of the arrangement is that SellCo habitually plays the principal role leading to the routine conclusion of sales by TradeCo in Country R to customers in Country S without material modification of the terms and conditions on which the customers offer to purchase the goods.

Example 3: Sale of advertising on a website (related intermediary)

Facts

58. SiteCo, a company resident in Country R, owns the rights in a website. SellCo, an associated company resident in Country S, performs marketing activities on behalf of SiteCo in Country S under a services agreement with SiteCo that provides for the fee payable to SellCo to be equal to a percentage of the sales revenue received by SiteCo from sales of advertising space to customers in Country S. The effect of the arrangement is that SellCo habitually plays the principal role leading to the routine conclusion of sales by SiteCo in Country R to customers in Country S without material modification of the terms and conditions on which the customers offer to purchase the advertising space. Personnel of SellCo in Country S are responsible for deciding on the appropriate amount, type and form of advertising. SellCo's business consists solely of its activities for SiteCo. SiteCo has no operations of its own in Country S and makes no sales to customers in Country S other than those made by SellCo on its behalf.

59. There is a tax treaty in effect between Country R and Country S that prevents Country S from taxing the business profits of an enterprise resident in Country R, except for profits attributable to a PE of that enterprise in Country S. Under the treaty, the profits attributable to a PE are the profits that the PE would have derived 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 other parts of the enterprise. The treaty's definition of PE includes the changes to Article 5(5) and Article 5(6) of the MTC recommended in the Report on Action 7.

Analysis

60. Under Article 5(5), SiteCo has a PE in Country S, as SellCo habitually plays the principal role leading to the routine conclusion of sales by SiteCo in Country R to customers in Country S without material modification of the terms and conditions on which the customers offer to purchase the advertising space.

61. Under Article 9, the remuneration that SiteCo pays to SellCo is found to be at arm's length, taking into account its functions performed, assets used and risks assumed.

62. Under Article 7, the profits attributable to the PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that SellCo performs on behalf of SiteCo.

63. Under step one of the AOA, the functional and factual analysis shows that the sales of advertising space to customers are made, in substance, by personnel of SellCo on behalf of SiteCo in Country S. Accordingly, the PE is hypothesised to have SiteCo's rights and obligations arising from the transactions between SiteCo and the final customers and also between SiteCo and SellCo.

64. This analysis also reveals that the significant people functions relevant to the assumption of the risk associated with determining the amount, type and form of advertising are performed by the personnel of SellCo on behalf of SiteCo in Country S. Accordingly, the PE is hypothesised to be the party assuming that risk.

65. Additionally, the analysis under step one of the AOA entails the recognition of an internal dealing between the PE and the head office. In this example the dealing is hypothesised as the sale of advertising space by the head office to the PE.

66. Under step two of the AOA, the guidance in the TPG is applied by analogy to determine the arm's length pricing of the internal dealing between the PE and the head office. In this case, that pricing would equal the amount that SiteCo would have received if it had sold the rights to the advertising space to an unrelated party performing the same or similar activities under the same or similar conditions that SellCo performs on behalf of SiteCo in Country S (attributing to such party ownership of the assets of SiteCo related to such functions, and assumption of the risks related to such functions.

67. In the PE's tax computation, this amount would be a deductible expense, and the remuneration paid to SellCo would also be a deductible expense, as well as other expenses wherever incurred for the purpose of the PE.

68. For reasons of administrative convenience, the tax administration in Country S may choose to collect tax only from SellCo even though the amount of tax is separately calculated by reference to the activities of both SellCo and the PE.

Example 4: Procurement of goods (related intermediary)[7]

Facts

69. TradeCo, a company resident in Country R, has as its core business the procurement and sale of widgets. BuyCo, a commonly owned company resident in Country S, performs procurement activities on behalf of TradeCo in Country S, purchasing widgets as agent on behalf of TradeCo, and in the name of TradeCo, from unrelated suppliers in Country S. BuyCo does not own the widgets at any point, nor does it have any entitlement to the amounts paid by TradeCo's customers for the widgets procured by BuyCo. Those amounts belong to TradeCo. Personnel of BuyCo are responsible for warehousing the inventory and determining and monitoring the appropriate inventory levels. Assuming, for the purpose of this example, that the form of compensation is appropriate in light of the facts and circumstances of the case, suppose

[7] The attribution of any profits to a PE in a situation like the one described in this example may be precluded under the 2008 version of Article 7(5) of the MTC, which states that *"No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise."*

that TradeCo pays BuyCo a commission equal to a percentage of the cost of purchases made by BuyCo on behalf of TradeCo in Country S. BuyCo's business consists solely of its activities for TradeCo. TradeCo has no operations of its own in Country S.

70. There is a tax treaty in effect between Country R and Country S that prevents Country S from taxing the business profits of an enterprise resident in Country R, except for profits attributable to a PE of that enterprise in Country S. Under the treaty, the profits attributable to a PE are the profits that the PE would have derived 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 other parts of the enterprise. The treaty's definition of PE includes the changes to Article 5 of the MTC recommended in the Report on Action 7.

Analysis

71. Under Article 5(5), TradeCo has a PE in Country S, as BuyCo habitually concludes contracts there on behalf of TradeCo; BuyCo does not do so as an independent agent; and the procurement of widgets for resale is not an activity of a preparatory or auxiliary character in relation to TradeCo's business.

72. Under Article 7, the profits attributable to the PE are those that the PE would have derived if it were a separate and independent enterprise performing the activities that BuyCo performs on behalf of TradeCo.

73. Under Article 9, the remuneration that TradeCo pays to BuyCo is found to be at arm's length taking into account its functions performed, assets used and risks assumed.

74. Under step one of the AOA, the functional and factual analysis shows that TradeCo's personnel located in Country R deal with the sale of the widgets to third party customers. This analysis also indicates that the purchase of the widgets from unrelated suppliers in Country S is concluded by personnel of BuyCo on behalf of TradeCo in Country S. Accordingly, the PE is hypothesised to have TradeCo's rights and obligations arising from the transactions between TradeCo and the unrelated suppliers in Country S and also between TradeCo and BuyCo.

75. The functional and factual analysis also demonstrates that the significant people functions relevant to the assumption of the inventory risk and to establishing the ownership of the inventory are performed by the personnel of BuyCo on behalf of TradeCo in Country S. Accordingly, the PE is hypothesised to be the economic owner of the inventory and the party assuming the inventory risk.

76. Additionally, step one of the AOA requires the recognition of an internal dealing between the PE and the head office. In this example the dealing is hypothesised as the sale of inventory by the PE to the head office.

77. Under step two of the AOA, the guidance in the TPG is applied by analogy to determine the arm's length pricing of the internal dealing between the PE and the head office. In this case, such pricing would equal the amount that TradeCo would have had to pay if it had purchased the widgets from an unrelated supplier performing the same functions in Country S that BuyCo performs on behalf of TradeCo (attributing to such supplier ownership of the assets of TradeCo related to such functions, and assumption of the risks related to such functions.

78. In its tax computation, the PE will deduct the amounts paid for the widgets in Country S and other expenses incurred by BuyCo in performing the procurement functions for TradeCo, as well as the remuneration paid to BuyCo, as well as other expenses wherever incurred for the purpose of the PE.

79. For reasons of administrative convenience, the tax administration in Country S may choose to collect tax only from BuyCo even though the amount of tax is separately calculated by reference to the activities of both BuyCo and the PE.

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Additional Guidance on the Attribution of Profits to Permanent Establishments

BEPS ACTION 7

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