

Base Erosion and Profit Shifting (BEPS)

Public Discussion Draft

BEPS Action 7

Additional Guidance on Attribution of Profits to Permanent Establishments

22 June-15 September 2017



DISCUSSION DRAFT ON ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

The Report on Action 7 of the BEPS Action Plan (Preventing the Artificial Avoidance of Permanent Establishment Status) mandated the development of additional guidance on how the rules of Article 7 of the OECD Model Tax Convention would apply to PEs resulting from the changes in the Report, in particular for PEs outside the financial sector. The Report indicated that 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. Importantly, the Report explicitly stated that the changes to Article 5 of the Model Tax Convention do not require substantive modifications to the existing rules and guidance on the attribution of profits to permanent establishments under Article 7 (see paragraph 19-20 of the Report).

Under this mandate, the Committee on Fiscal Affairs released in July 2016 a discussion draft for public comments (“2016 Discussion Draft”) and held a consultation with public commentators in October 2016. The over 400 pages of comments submitted by commentators on the 2016 Discussion Draft highlighted the importance of developing guidance that would be relevant for all countries, regardless of their approach to attributing profits to permanent establishments. Commentators also identified a number of issues in the draft guidance which required further clarification, such as the impact of the revised guidance on risk in Chapter I of the OECD Transfer Pricing Guidelines, and the impact of the analysis under Article 9 for purposes of Article 5.

Considering the comments received as well as the positions of countries, the Committee on Fiscal Affairs recommended pursuing the work under a different approach to the one adopted in the 2016 Discussion Draft. Accordingly, Working Party No. 6 has developed this new Discussion Draft, which replaces the 2016 Discussion Draft.

This new Discussion Draft sets out high-level general principles outlined in paragraph 1-21 and 36-42 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, this Discussion Draft 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). It is important to note that, unlike the 2016 Discussion Draft, this Discussion Draft does not contain numerical examples; this is to avoid drawing conclusions from this guidance on the level of profitability of the intermediary or the permanent establishment. The profits of the intermediary and the permanent establishments should be determined under the relevant articles in the applicable tax treaty (i.e. Article 7 and, when applicable Article 9) based on the specific facts and circumstances of the case.

Interested parties are invited to send their comments on this discussion draft. Comments should be sent by **15 September** at the latest by email to TransferPricing@oecd.org in Word format (in order to facilitate

their distribution to government officials). They should be addressed to the Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

Please note that comments are not sought on the 2016 Discussion Draft or on the changes to the PE definitions that have been agreed under Action 7 and which were published in the 2015 Final Report, "Preventing the Artificial Avoidance of Permanent Establishment Status." Commentators should concentrate solely on the proposed guidance in this Discussion Draft on the application of Article 7 to determine the attribution of profits to PEs.

The OECD intends to hold a public consultation on the additional guidance on the attribution of profits to permanent establishments in **November 2017** at the OECD Conference Centre in Paris, France. Registration details for the public consultation will be published on the OECD website later in September. Speakers and other participants at the public consultation will be selected from among those providing timely written comments on the discussion draft.

Please note that all comments on this discussion draft will be made publicly available. Comments submitted in the name of a collective "grouping" or "coalition", or by any person submitting comments on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

DISCUSSION DRAFT ON ADDITIONAL GUIDANCE ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

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”.

CHANGES TO ARTICLE 5(5) AND 5(6) AND THE COMMENTARY

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

4. 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.”

5. 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.

6. 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).

7. 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).

ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS RESULTING FROM CHANGES TO ARTICLE 5(5) AND 5(6) AND THE COMMENTARY

8. 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.¹

9. 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.

10. When a PE is deemed to exist under Article 5(5) due to the activities of an intermediary², 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.

¹ 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.

² 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).

11. 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").

12. 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.

13. 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.

14. 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.

15. 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.

16. 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.

17. 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.

18. 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.

19. 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

20. 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.

21. 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.³ 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

³ See Part I of the 2010 Profit Attribution Report, at para. 246.

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.⁴

Examples illustrating the attribution of profits to deemed PEs under Article 5(5)

22. 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 approach to the attribution of profits to a PE, including the applicability of the AOA, in any particular case will be governed by the applicable tax treaty.

EXAMPLE 1: COMMISSIONNAIRE STRUCTURE (RELATED INTERMEDIARY)

Facts

23. 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. 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.

24. 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

25. 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. 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

⁴ See Part I of the 2010 Profit Attribution Report, footnote 12.

TradeCo—in this case, such profits would equal the amount of TradeCo’s revenue from sales of goods to customers in Country S⁵ minus:

- (1) 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)⁶,
- (2) other expenses, wherever incurred, for the purposes of the PE⁷, and
- (3) the arm’s length remuneration of SellCo.

Article 9 and the Transfer Pricing Guidelines are applicable, either directly or by analogy, in determining the amounts of (1), (2) and (3).

26. 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.

27. 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 2: SALE OF ADVERTISING ON A WEBSITE (RELATED INTERMEDIARY)

Facts

28. 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. 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.

⁵ This is equivalent to attributing to the PE the sales revenue resulting directly or indirectly from the contracts to which Article 5(5) refers.

⁶ This is conceptually equivalent to the amount paid by the PE for the inventory ‘purchased’ from TradeCo. This would correspond to a “dealing” under the AOA.

⁷ For activities undertaken by TradeCo (as home office) on behalf of the PE, this would include an arm’s length allocation of expenses associated with these activities, or, under the AOA, a ‘dealing’ between the PE and TradeCo (as home office) associated with TradeCo’s activity on behalf of the PE.

29. 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

30. 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. Under Article 7, the profits attributable to the PE in this case, would equal the amount of SiteCo's revenue from sales to customers in Country S⁸ minus

- (1) 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)⁹,
- (2) other expenses, wherever incurred, for the purposes of the PE¹⁰, and,
- (3) the arm's length remuneration of SellCo.

Article 9 and the Transfer Pricing Guidelines are applicable, either directly or by analogy, in determining the amounts of (1), (2) and (3).

31. 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 3: PROCUREMENT OF GOODS (RELATED INTERMEDIARY)

Facts

32. 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

⁸ This is equivalent to attributing to the PE the sales revenue resulting directly or indirectly from the contracts to which Article 5(5) refers.

⁹ This is conceptually equivalent to the amount paid by the PE for the rights to the advertising space from SiteCo. This would correspond to a 'dealing' under the AOA.

¹⁰ For activities undertaken by SiteCo (as home office) on behalf of the PE, this would include an arm's length allocation of expenses associated with these activities, or, under the AOA, a 'dealing' between the PE and SiteCo (as home office) associated with SiteCo's activity on behalf of the PE.

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. 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 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.

33. 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

34. 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. 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—in this case, such profits 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)¹¹ minus:

- (1) the amounts paid by TradeCo to unrelated suppliers in Country S,
- (2) other expenses, wherever incurred, for the purposes of the PE¹², and
- (3) the arm's length remuneration of BuyCo.

Article 9 and the Transfer Pricing Guidelines are applicable, either directly or by analogy, in determining the amounts of (2) and (3).

35. 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 SellCo and the PE.

¹¹ This is equivalent to attributing to the PE the rights and obligations associated with the procurement of widgets resulting directly or indirectly from the contracts to which Article 5(5) refers.

¹² For activities undertaken by TradeCo (as home office) on behalf of the PE, this would include an arm's length allocation of expenses associated with these activities, or, under the AOA, a 'dealing' between the PE and TradeCo (as home office) associated with TradeCo's activity on behalf of the PE.

ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS RESULTING FROM CHANGES TO ARTICLE 5(4) AND THE COMMENTARY

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

37. 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.”

38. 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.”

39. 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. 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.

40. 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.”

41. 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).

42. 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.

43. 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 4: WAREHOUSING, DELIVERY, MERCHANDISING AND INFORMATION COLLECTION ACTIVITIES

Facts

44. 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.

45. OnlineCo has also 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.

46. 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

47. 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.

48. 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—in this case, such profits, would equal (1) 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)¹³ minus:

- (2) the employees' compensation paid in Country S,
- (3) the amounts paid to unrelated service providers in Country S such as the delivery service companies,
- (4) the amount of the rent paid to the warehouse owner and other expenses related to the maintenance and operation of the warehouse, and
- (5) any other expenses wherever incurred, for the purpose of the PE¹⁴.

Article 9 and the Transfer Pricing Guidelines are applicable, by analogy, in determining the amount of (1) and (5) above.

49. 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—in this case, such profits, would equal (1) 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)¹⁵ minus:

- (2) the employees' compensation paid in Country S and

¹³ This is equivalent to attributing to the PE the rights and obligations associated with the purchase of storage and delivery services resulting directly or indirectly from the contracts to which Article 5(5) refers.

¹⁴ For activities undertaken by OnlineCo (as home office) on behalf of the PE, this would include an arm's length allocation of expenses associated with these activities, or, under the AOA, a "dealing" between the PE and OnlineCo (as home office) associated with OnlineCo's activity on behalf of the PE.

¹⁵ This is equivalent to attributing to the PE the rights and obligations associated with the purchase of merchandising and collection of information services resulting directly or indirectly from the contracts to which Article 5(5) refers.

- (3) any other expenses, wherever incurred, for the purposes of the PE¹⁶.

Article 9 and the Transfer Pricing Guidelines are applicable, by analogy, in determining the amount of (1) and (3) above.

¹⁶ For activities undertaken by OnlineCo (as home office) on behalf of the PE, this would include an arm's length allocation of expenses associated with these activities, or, under the AOA, a 'dealing' between the PE and OnlineCo (as home office) associated with OnlineCo's activity on behalf of the PE.