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From the AOA to the New Article 7:

The Attribution of Profits to PEs under the OECD MTC

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Sumário

A aprovação do novo Artigo 7.º da Convenção Modelo OCDE culmina mais de uma década de trabalho no desenvolvimento do método mais adequado para a imputação de lucros a Estabelecimentos Estáveis (EEs). A importância desta nova disposição não é exclusivamente limitada à aplicação e interpretação das Convenções para Evitar a Dupla Tributação. A legislação interna da maioria dos Estados segue de muito perto as regras referentes à imputação de lucros previstas nas Convenções para Evitar a Dupla Tributação. De facto, em muitos casos, existe pouca ou mesmo nenhuma diferença entre a legislação doméstica e convencional no que se refere à imputação de lucros a EEs. O presente artigo começa por explicar as razões pelas quais a imputação de lucros a EEs assume relevância no panorama internacional. Em seguida, analisa o contexto que levou a OCDE a desenvolver um novo método de imputação de lucros a EEs e explica os procedimentos necessários para aplicação desse novo método. Posteriormente, procede a uma análise dos parágrafos incluídos na nova redacção do Artigo 7.º, bem como as razões para as alterações ou eliminação de parágrafos da anterior versão. Finalmente, tece algumas considerações sobre o possível impacto desta nova disposição.

Abstract

The adoption of a new Article 7 to the OECD Model Tax Convention culminates more than a decade of work of the development of the better approach for attributing profits to Permanent Establishments (PEs). The relevance of this new provision is not limited to the interpretation and application of tax treaties. Most States follow very closely on their domestic laws the same rules on attribution of profits that apply under tax treaties. In many cases effectively there is little, if any, distinction between domestic and tax treaty law regarding the attribution of profits to PEs. This article starts by explaining the reason why the attribution of profits to PEs is so relevant in the international context. It then analyzes the

background that led to the development of a new approach regarding the attribution of profits to PEs by the OECD and explains the steps that need to be performed under the new approach. Subsequently provides an analysis of each paragraph of the new version of Article 7 as well as the reason for the deletion or amendments to the paragraphs of the previous version. Finally it makes some considerations about the possible impact of this provision.

1. - Introduction

On 22 July 2010 the OECD Council approved an update to the OECD Model Tax Convention[1] ("OECD MTC") and related Commentary. Probably the most significant change arising from the 2010 update is the inclusion of an entire new version of Article 7 ("business profits") regarding the taxation of permanent establishments (PEs) that culminates more than a decade of work of the development of the better approach for attributing profits to PEs.

Although the work performed by the OECD relates exclusively with the interpretation and application of the MTC the fact is that its impact is considerably wider in practice. In fact, reality reveals that most

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[1] See the OECD document THE 2010 UPDATE TO THE MODEL TAX CONVENTION of 22 July 2010, available at http://www.oecd.org/dataoecd/23/43/45689328.pdf. For an overview of the 2010 updates, see *inter alia*, Stef van Weeghel & Jan Gooijer, *The 2010 OECD MC Amendments and the Revised TP Guidelines: An Overview*, in DENNIS WEBER AND STEF VAN WEEGHEL (eds.), THE 2010 OECD UPDATES – MODEL TAX CONVENTION & TRANSFER PRICING GUIDELINES: A CRITICAL OVERVIEW, 3-17 (2011) Kluwer Law International BV, The Netherlands.

States follow very closely on their domestic laws the same rules on attribution of profits that apply under a Double Tax Convention ("DTC"). In many cases effectively there is little, if any, distinction between domestic and tax treaty law regarding the attribution of profits to PEs[2].

The purpose of this paper is then to analyze the developments that led to the inclusion of a new Article 7 of the OECD MTC in the 2010 update to the OECD MTC. In that regard, first some background information is provided in order to explain the relevance of Article 7 regarding the taxation of business profits as well as the issues surrounding its interpretation which led to the need of developing a new interpretation regarding the attribution of profits to PEs by the OECD. Then it follows a description of the approach which was developed by the OECD for the proper interpretation and application of the attribution of profits to PEs. An analysis of each of the new paragraphs of the new Article 7 is then made explaining its meaning and the reasons for the wording now adopted. Finally some thoughts are given about the possible impact of this new provision.

[2] See Philip Baker and Richard Collier, *Attribution of Profits to Permanent Establishments*, IFA General Report, 91b CAHIERS DE DROIT FISCAL INTERNATIONAL (2006) (60th Congress of the International Fiscal Association, Amsterdam, 2006), at 28.

2. - Background

2.1. - Relevance of Article 7

Article 7 of the OECD MTC is the key provision that provides the rules for the attribution of profits to PEs, through which an enterprise of one Contracting State has in the other Contracting State. Article 7 has two functions[3]. The first function reflects one of most fundamental principles in international tax law according to which business profits are taxable only in the State of residence of the person carrying on the enterprise, unless that person carries on a business in the other State through a PE. The PE concept plays then an important role in allocating tax rights.

The second function is that once a PE is considered to be established in the source (host) State in accordance with the rules provided in Article 5, such State acquires a right to tax those profits but only so much of them which are attributable to that PE. In that regard, although the existence of a PE is the required threshold to trigger source taxation of business income obtained by non residents[4] there is, under the OECD MTC, a rejection of the *force of attraction principle*[5]: the right to tax of the host State

[3] See PHILIP BAKER, DOUBLE TAXATION CONVENTIONS, (2010 loose-leaf edition) Sweet & Maxwell, p. 7-24.

[4] See Brian J. Arnold, *Threshold Requirements for Taxing Business Profits under Tax Treaties*, BULLETIN OF INTERNATIONAL FISCAL DOCUMENTATION 10 IBFD (2003), at 478.

[5] Under the force of attraction principle, the taxation of the foreign enterprise in the host state is not limited to the profits which are attributable to the respective PE but rather are extended to:

a) other business profits, dividends, interest and royalties arising from even though such income is clearly not attributable to the permanent establishment (general force of attraction);
b) business profits similar to those carried on by a permanent establishment (restricted force of attraction).

does not extend to profits that the enterprise may derive from the State otherwise than through the PE[6]. For the purposes of determining the profits which are attributable to the PE and which are subject to the taxing jurisdiction of the host state the principle is that the profits to be considered are those which the PE might be expected to make if it were a separate entity engaged in the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE.

The relevance of determining the profits attributable to a PE should consider the relationship between[7] Articles 7 and 23 dealing with the elimination of double taxation. Article 7 is addressed to the host State in determining the amount of profits that are attributable to the PE and that consequently can be taxed in that state. Article 23 is addressed to the residence state of the person carrying on the enterprise for determining the amount of income with respect to which relief from double taxation must be granted.

Overall it can be said that Article 7 plays a central role in facilitating cross-border trade and investment since: (i) it minimizes the risks of exposure of non-resident enterprises to taxation in other (host) jurisdictions and (ii) avoids inappropriate attribution of profits where a permanent establishment is found to exist.

The issue of the allocation of profits to PEs has always been a highly complex topic in international tax law due the different views on the interpretation of Article 7. The roots of the problem relied on the somehow "schizophrenic character" between the juridical reality that the PE is part of the worldwide

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[6] The OECD MTC clearly rejects the general force of attraction as stated in paragraph 12 of the Commentary to Article 7 of the OECD MTC. See, Irene J.J. Burgers, *OECD – Analysis Art. 7 OECD Model Convention: Allocation of Profits to a Permanent Establishment* (2011 IBFD Loose-Leaf).

[7] See Raffaele Russo, *Application of Arm's Length Principle to Intra-Company Dealings: Back to the Origins*, INTERNATIONAL TRANSFER PRICING JOURNAL 1, IBFD (2005), at 7.

enterprise and the economic reality that each function fulfilled by one part of an enterprise should be properly remunerated. In particular, it was considered[8] that neglecting internal dealings between PE and general enterprise did not reflected a fair allocation of profits to the respective States where parts of the enterprise were located. Therefore and notwithstanding the undisputable importance of the PE in the allocation of taxing rights to the source State, practice had revealed the existence of a considerable variation in the domestic laws of States regarding the principles to be applied in attributing profits to PEs. That lack of a common interpretation of Article 7 shown to be a concern for global business as it could lead to situations of double taxation or less than single taxation.

2.2. - Issues on the interpretation of Article 7

2.2.1. – Determining the profits attributable to the PE under Article 7 (1)

One of the issues surrounding the interpretation of Article 7 referred to the approach followed under paragraph 1 for determining the profits of an enterprise. Article 7 (1) allows the host State to tax the profits that are attributable to the PE located in its territory by stating that:

> The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may

[8] See Irene J.J. Burgers, *supra* note 6.

be taxed in the other State but only so much of them as is attributable to that permanent establishment.

The question was precisely how to interpret the expression "*profits of an enterprise*". The Commentary itself did not provided much guidance on this issue, aside from confirming that the right of the host State to tax did not extended to the profits that an enterprise derived from that State otherwise than through the PE. This reference was in fact no more then the express statement of the rejection of the force of attraction principle as regards the taxation of the profits attributable to a PE.

Therefore, the relative ambiguity and lack of further guidance led to the development of different interpretations of paragraph 1. Two major approaches were identified by the OECD[9] as being the most commonly practiced by the different States: the *relevant business activity approach* and *the functionally separate entity approach*.

Under *the relevant business activity* approach (often called *single entity* approach) paragraph 1 of Article 7 imposes a limit on the profits that could be attributed under paragraph 2 to a PE. The profits to be attributed cannot exceed the profits that the whole enterprise would earn from the relevant business activity. The relevant business is determined either by reference to the profit of the enterprise as a whole of to a particular business activity in which the PE has participated[10]. The wording of paragraph 1 with the reference to *but only so much of them* [the worldwide profits of an enterprise - BdS] *as is attributable*

[9] See paragraphs 61 to 79 of the OECD *Report on the Attribution of Profits to Permanent Establishments* of 17 July 2008 (2008 Report).

[10] See paragraphs 64 and 65 of the 2008 Report and Irene J.J. Burgers, *The New OECD Approach on Profit Allocation: A Step Towards Neutral Treatment of Permanent Establishments and Subsidiaries*, 10 FLA. TAX REV. 1 (2009), at 59.

to that permanent, could be interpreted as supporting a cap on the profits to be attributed to the PE. The profits attributable to the PE would have to be traceable to the profits of the general enterprise[11]. The profits of the whole enterprise are those earned from transactions with third parties and those earned from transactions with associated enterprises, the latter of which being subject to adjustments according to the application of transfer pricing rules if they did not reflected the application of arm's length principle.

Differently, in case of the *functionally separate entity* approach, there is no limit to the profit attributed to the PE by reference to the profits of the enterprise as a whole. Under this approach, paragraph 1 of Article 7 is interpreted as not affecting the determination of the quantum of the profits that are attributed to the PE. Article 7 (1) is interpreted as merely confirming the rejection of the force of attraction principle resulting from the existence of a PE. Therefore, the emphasis is placed on paragraph 2 and the profits to be attributed to the PE are the profits that the PE would have earned at arm's length as if it were a distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by the arm's length principle under Article 7 (2). The functionally separate entity approach may ultimately allow an attribution of profits to the PE even though no profit has yet been realized by the general enterprise.

In a nutshell, the key differences between the two approaches are as follows:

- Under the *relevant business activity* approach the starting point is to determine the worldwide profits of the enterprise and then individual income elements and expenses within this worldwide profit are attributed to the PE by applying the principle stated in Article 7 (2)[12] (or

[11] See Kees van Raad, *Deemed Expenses of a Permanent Establishment*, 28 INTERTAX 4 (2000), at 162-167.

[12] See Philip Baker and Richard Collier, *supra* 2 note at 30.

apportioned under Article 7 (4)). This means that only transactions with third parties or between associated enterprises are taken into account. No profit is earned from a transaction between the PE and the enterprise which it is part.

- Under the *functionally separate entity* approach the starting point is to deem the PE to be an enterprise entirely separate from the general enterprise. This requires construct the internal PE profit where deemed income and deductions (between PE and Head Office) are taken into account.

2.2.2. – The relation between Article 7 (2) and Article 7 (3): the deduction of expenses

The central directive regarding the allocation of profits to PEs is contained in paragraph 2 of Article 7 that provides that:

> Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

The purpose of this directive is to provide for neutrality in calculating the base for the taxation of both PEs and subsidiaries in the host state in order to achieve similar results for both incorporated and unincorporated entities. In that regard Article 7 (2) provides for the deemed independence rule for the calculation of the profits of the PE, through the application of the arm's length principle. The same

principle is embodied in Article 9 in what refers to the transfer prices between related (separate but associated) entities.

Much of the problems[13] regarding the attribution of profits to PEs lied in paragraph 3 of Article 7[14] that referred that:

> In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere

The issue was whether transactions between the general enterprise and the PE ("dealings") were to be considered for tax purposes at the cost actually paid by the general enterprise to third parties or at the price that would have been charged between parties at arm's length, i.e. with inclusion of a profit element. The independent enterprise principle in Article 7 (2) indeed implied the use of arm's length

[13] See Kees van Raad, *supra* note 11 and Raffaele Russo, *Tax Treatment of "Dealings" Between Different Parts of the Same Enterprise under Article 7 of the OECD Model: Almost a Century of Uncertainty*, BULLETIN – TAX TREATY MONITOR 10, IBFD (2004), at 477-479 and Irene J.J. Burgers, *supra* note 10.

[14] See Hans Pijl, *The 2010 Elimination of Article 7-3 (1963): Rise and Fall of an Article* in DENNIS WEBER AND STEF VAN WEEGHEL (eds.), in supra note 1, at 37-49 or Richard Vann, *Do We Need 7(3)? History and Purpose of the Business Profits Deduction Rule in Tax Treaties* (March 16, 2011) in J. TILEY, ed., STUDIES IN THE HISTORY OF TAX LAW, Hart Publishing, (Forthcoming); SYDNEY LAW SCHOOL RESEARCH PAPER No. 10/18, available at SSRN: http://ssrn.com/abstract=1787805 (access on 8 October 2011).

pricing between general enterprise and PE. However, the 2008 OECD Commentary to Article 7 (3)[15] contained several "exceptions" to the arm's length principle, though it said there was no difference of principle between paragraphs 2 and 3 of Article 7[16]. Those exceptions refer to specific kinds of dealings between the PE and the enterprise which it is a part:

- *Temporary transfers of assets*[17] – the Commentary starts by referring that where goods are supplied for resale, whether in finished state, or as raw materials of semi-finished goods, it will normally be appropriate to allocate a profit measure by arm's length principle[18]. However, in case of temporary transfer of assets from one part of the enterprise to the other a mere deduction of costs takes place (with no consideration) which, in case of machinery,[19] it would

[15] Notably paragraphs 33 to 37 of the 2008 Commentary to Article 7 (3) of the OECD MTC.

[16] See paragraph 29 of the 2008 of the Commentary to Article 7 (3) which refers:

> It fact, while the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying paragraph 2, there is no difference in principle between the two paragraphs.

[17] See paragraph 17.3 (second part) of the 1995-2005 Commentary and paragraph 33 of the 2008 Commentary to Article 7 (3).

[18] See paragraphs 15 and 17.3 of the 1995-2005 Commentary and paragraph 33 (first part) of the 2008 Commentary to Article 7 (3).

[19] The Canadian case *Cudds Pressure* is a clear-cut example regarding the issue of the temporary transfer of machinery and the related deduction of expenses (*Cudds Pressure Control Inc. v. The Queen, 1995, 95 DTC 599 (TCC)*). The case referred to a US corporation – *Cudd Pressure Control Inc* – that provided several technical services (snubbing services) to oil drilling industry. In particular it brought two snubbing units and some employees into Canada. It was not disputed that these operations constituted a PE in Canada. The issue arose because *Cudd Pressure* claimed deduction costs corresponding to the rent of the two snubbing units which it would have paid in case it were an independent enterprise. If the PE had been an

correspond to the depreciation costs related to its use. This represents an exception to Article 7 (2) because arguably the rental value of an asset is not determined by the amount of the historic depreciation but by market pricing[20] (i.e. typically the enterprise would have charged a price including a profit element if it would have rented the machinery to a third party rather than to a PE and therefore a mark-up should be added).

- *Intangibles*[21] – Also in this case only a mere deduction of costs is allowed (without any mark-up for profit or royalty). The justification for this exception is because it is difficult to allocate ownership of the intangible right to one part of the enterprise. According to the Commentary this is due to the fact that there is only one legal entity so it is not possible to allocate legal ownership to a particular part of the enterprise. The reasoning followed by the Commentary is in itself a denial of the central directive provided in paragraph 2 of Article 7. The purpose of

independent enterprise, then it could have rented the snubbing units from the head office and therefore it would have incurred a rental expense. The Court considered that this rent was a mere notional payment by the PE to its head office, thus not a deductible expense. The PE could have merely claimed depreciation costs for the period during which the units were used in Canada.

For comments on this case see, *inter alia*, Ian Roxan, *Judicial Overrides of Double Tax Conventions: The case of a Permanent Establishment*, 25 INTERTAX 11 (1997), at 367-78 or David A. Ward, *Attribution of Income to Permanent Establishments,* 48 CANADIAN TAX JOURNAL 3 (2000), at 559-576.

[20] See I.J.J. Burgers, *The OECD Report "Attribution of Profits to Permanent Establishments": A Commentary*, 49 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 3 IBFD (1995), at 141 which clearly refers that the border line questions is not whether the enterprise actually charged a price including an appropriate profit in the normal course of its business, but whether it is likely that it would have charged such price if it transfers a similar machinery in the course of its business to third parties.

[21] See paragraph 17.4 of the 1995-2005 Commentary and paragraph 34 of the 2008 Commentary to Article 7 (3).

this provision is precisely to deem the PE as it was a separate and independent enterprise in order to determine the profits attributable to it. To deny a mark-up payment between PE and head office because one is referring to the same legal entity was considered as a contradiction in terms[22] between the wording of the OECD MTC in paragraph 2 and its Commentary regarding paragraph 3.

- *Services*[23] – Regarding services a distinction was made. If the trade of the enterprise or a part thereof is the provision of services or the main activity of the PE is to provide specific services that provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise it is appropriate to charge a profit margin. However in most common cases the provision of services refers to general administrative expenses (e.g. to provide a common system of training) case in which no mark-up should be charged and only costs should be allocated.
- *Good management*[24] – also no notional figure for profits of management is accepted for practical reasons.
- Interest charges from transfer of funds[25] – Again the Commentary provides for a distinction. In case of external interest paid by a company to finance the activities of the PE (i.e. debts incurred by the head office to finance the PE), a deduction of interest was allowed. In the other

[22] See Raffaele Russo, *supra* note 13, at 478 and Kees van Raad, *supra* note 11, at 165.

[23] See paragraphs 17.5 to 17.7 of the 1995-2005 Commentary and paragraphs 35 to 38 of the 2008 Commentary to Article 7 (3).

[24] See paragraph 21 of the 1995-2005 Commentary and paragraph 38 of the 2008 Commentary to Article 7 (3).

[25] See paragraphs 18.1 to 18.3 of the 1995-2005 Commentary and paragraphs 41 to 43 of the 2008 to Commentary to Article 7 (3).

cases, there is a general rule on ban deductions for internal debts and receivables (with the exception of financial enterprise such as banks). The argument is that:

- from the legal point of view payment of interest within same enterprise is a formal act incompatible with the true legal nature of PE.
- From an economic point of view, internal debts and receivables may prove to be non-existent, since if an enterprise is solely or predominantly equity funded it ought not be allowed to deduct interest charges that it has manifestly not had to pay.

Again this reasoning leads to the same remarks as regards intangibles. To rely the denial of interest deductions based on the fact that from the legal perspective head office and PE are one and the same entity is contradictory with the central directive of paragraph 2 of Article 7 that requires deeming the PE as a separate and independent enterprise.

Overall it could be said that these exceptions were difficult to justify. The notion of treating the PE as independent enterprise would be entirely consistent to treat the PE as incurring expenses in the same terms as an independent third party. The fact is that the use of cost basis for PE was generally not acceptable for subsidiaries and constituted therefore a deviation to treating the PE as an independent enterprise from its head office.

2.3. - Historical evolution

In order to properly understand the new wording of Article 7, it is necessary to consider the historical background of the OECD's work over the years on the issue of the attribution of profits to PEs.

Already in 1977 some changes were made to Article 7 and to its Commentary. Some years later in 1984 the OECD addressed the issue of the attribution of profits to PEs by releasing a report specifically regarding banks[26]. Again a couple of years later, more precisely in 1993, the OECD issued a report on the attribution of profits to PEs[27]. At the time this report suggested changes to the Commentary on Article 7 that were then incorporated in the 1994 update to the OECD MTC and which constituted the last amendments to (the Commentary) Article 7 before the most recent updates in 2008 and 2010 of the OECD MTC.

The publication of the OECD Transfer Pricing Guidelines[28] in 1995 on the application of the arm's length principle to transfer pricing between associated enterprises left open the application of its principles within single entity. Therefore, in the beginning of 1998, the OECD Working Party 6 started a project with a view at re-examining Article 7. The idea was then to analyze how the principles developed in the Transfer Pricing Guidelines which address the application of the arm's length principle to transactions between associated enterprises under Article 9 could apply in the context of the relationship between a PE and the general enterprise to which it belongs.

[26] *The Taxation of Multinational Banking Enterprises*, in TRANSFER PRICING AND MULTINATIONAL ENTERPRISES – THREE TAXATION ISSUES, OECD 1984. See for a comment on this report, I.J.J. BURGERS, TAXATION AND SUPERVISION OF BRANCHES OF INTERNATIONAL BANKS: A COMPARATIVE STUDY OF BANKS AND OTHER ENTERPRISES 1991 (IBFD), at 453-470.

[27] See the OECD report ATTRIBUTION OF INCOME TO PERMANENT ESTABLISHMENTS. For an analysis of this report see I.J.J. Burgers, *supra* note 20.

[28] 1995 OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (also referred as "Transfer Pricing Guidelines").

As a consequence, in February 2001 the OECD released a draft report for public comment concerning the attribution of profits to a permanent establishment[29] that focused on general issues (Part I) and issues relating with the banking sector (Part II) considering the common use of PEs within this sector. The draft report contained a Working Hypothesis[30] which, according to the OECD, represented the preferred method for the attribution of profits to PEs. The basis for the Working Hypothesis was to look how far the treatment of a PE[31] as an hypothetical distinct and separate enterprise could be taken and how the guidance in the OECD Transfer Pricing Guidelines could be applied, by analogy, for the purpose of attributing profits to a PE in accordance with the arm's length principle provided in Article 7 (2).

This was followed by the release for public comment in March 2003 of revised drafts versions related with the banking sector (Part II) and global dealing (Part III).

A revised and expanded version of Part I[32] (general considerations) was released for public comments in August 2004. Upon the publication of this report, the Working Hypothesis developed in 2001 was

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[29] The OECD document entitled DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS.

[30] For an analysis see Josine van Wanrooij, *Attribution of Profits to a Permanent Establishment: The OECD Model, the Working Hypothesis and the Dutch Approach*, BRITISH TAX REVIEW 3 (2004), Sweet & Maxwell, pp. 238-280.

[31] It should be stressed that the OECD work did not involved an analysis of the PE concept for the purposes of Article 5. This work is now being performed with the release of discussion draft on the definition of "permanent establishment" in the OECD Model Tax Convention entitled INTERPRETATION AND APPLICATION OF ARTICLE 5 (PERMANENT ESTABLISHMENT) OF THE OECD MODEL TAX CONVENTION, of 12 October 2011 available at http://www.oecd.org/dataoecd/23/7/48836726.pdf (accessed on 15 October 2011).

[32] For a comment see Mary C. Bennett and Carol A. Dunahoo, *The Attribution of Profits to a Permanent Establishment:*

renamed as the authorized OECD Approach ("AOA"). At the same time, revised versions of Parts II and III were released to previous commentators. In December 2006 further revised versions of Parts I-III were released. Meanwhile, an initial draft version of Part IV (insurance sector) was released for public comment in June 2005. Following public consultation, a revised draft of Part IV was released in August 2007, followed by further consultation.

In 17 July 2008 the final Report was released[33]. The Report is divided into four Parts: Part I (general considerations), Part II (special considerations for applying the AOA to banks), Part III (special considerations for applying the AOA to global trading) and Part IV (special considerations for applying the AOA to insurance companies). This Report replaced all the previous drafts of the various Parts and it was considered to represent the better approach to attributing profits to PEs. At the same time the OECD Committee for Fiscal Affairs ("CFA") recognized the existence of differences between some of the conclusions provided in the 2008 Report and the interpretation of Article 7 that was reflected in the Commentary on Article 7 prior to the adoption of this Report (1995-2005 Commentary). Therefore it considered that, in order to provide maximum certainty to both taxpayers and tax administrations on how profits should be attributed to PEs, the adoption of the AOA should be made in two steps[34]. The first step was to provide guidance in the interpretation of existing treaties based on the wording of the former Article 7. Therefore the text of the 1995-2005 Commentary to Article 7 was revised to take into

Issues and Recommendations, 33 INTERTAX 2, pp. 51-67.

[33] See OECD REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS of 17 July 2008 (also referred in this article as "2008 Report").

[34] See Mary Bennett, *Article 7 – New OECD rules for attributing profits to Permanent Establishments*, in DENNIS WEBER AND STEF VAN WEEGHEL (eds.), *supra* note 1 at 25-26.

account the conclusions of the 2008 Report that did not conflict with the previous Commentary. A revised Commentary on Article 7 was then included in the 2008 updates to the OECD MTC. According to the Recommendation approved by the OECD Council, the 2008 Report was considered a source of guidance[35] for the interpretation of Article 7 to the extend that its conclusions do not conflict with the 2008 Commentary on this provision[36].

The second step consisted in the drafting of a new article 7[37] for adoption in future treaties (and amendments to existing treaties) which could allow the full implementation of the AOA and the conclusions stated in the 2008 Report. This was complemented with the updated commentary and also with release of the "*2010 report on the attribution of profits to permanent establishments"*[38], of 22 July.

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[35] Specific references to the 2008 Report may be found in paragraphs 16, 17, 20, 26, 40, 49, 50 of the 2008 Commentary to Article 7.

[36] See paragraph 7 of the 2008 Commentary to Article 7 which clearly states that:

> "[…] this Commentary has been amended to incorporate a number of conclusions of the Report that did not conflict with the previous version of this Commentary, which prescribed specific approaches in some areas and left considerable leeway in the others. The Report therefore represents internationally agreed principles and, to the extent that it does not conflict with this Commentary, provides guidelines for the application of the arm's length principle incorporated in the Article." [underlined BdS]

[37] See *inter alia*, on the discussion of a draft of the new Article 7, Catherine Bobbett and John F. Avery Jones, *The Proposed Redraft of Article 7 of the OECD Model*, BULLETIN FOR INTERNATIONAL TAXATION 1 IBFD (2010), at 20-27, Josine S.A. van Wanrooij, *Comments on the Proposed Article 7 of the OECD Model Convention*, 37 INTERTAX 5 (2009), pp. 298-206 or Mary Bennett and Raffaele Russo, *Discussion Draft on a New Art. 7 of the OECD Model Convention*, INTERNATIONAL TRANSFER PRICING JOURNAL March/April IBFD (2009), at 73-80.

[38] See OECD 2010 REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS, of 22 July (also referred in this article as "2010 Report").

This report did not made any changes to the conclusions stated in the 2008 report previously referred. It merely conformed terminology and updated cross-references to the 2010 version of Article 7 and also the 2010 revision to the Transfer Pricing Guidelines.

2.4. - The Authorized OECD Approach

Considering the existing conflicting views, the purpose of the OECD was to establish a better and broader consensus regarding the interpretation and practical application of Article 7 for the purposes of interpreting tax treaties based on the OECD MTC. That would allow achieving the goal of minimizing the risk of double (or less than single) taxation.

The focus was on formulating the most preferable approach to attributing profits[39] to a permanent establishment under Article 7 considering the modern-day multinational operations and trade. The work performed by the OECD in the development of the AOA was not constrained by either the original intent of by the historical practice and interpretation of Article 7[40].

The AOA[41] requires a two-step process to determine the profits attributable to a PE. The first step is to perform a functional and factual analysis in order to hypothesize the PE as a separate and independent

[39] Reference should be made to the fact that under the AOA the same principles are applied to attribute either losses or profits. In that regard reference to "profits" should be understood *latu sensu* as applying similarly to losses. See in this regard paragraph 5 of 2008 Report.

[40] See paragraph 4 of the 2008 Report.

[41] See, *inter alia*, Philip Baker and Richard Collier, *2008 OECD Model: Changes to the Commentary on Article 7 and the Attribution of Profits to Permanent Establishments*, BULLETIN FOR INTERNATIONAL TAXATION 5/6, IBFD (2009), at 199-203 and Mary Bennett, *The Attribution of Profits to Permanent Establishments: The 2008 Commentary on Art. 7 of the*

enterprise, undertaking functions, owning and/or using assets, assuming risks and entering into dealings with the enterprise which it is part and transactions with related and unrelated enterprises. The second step requires determining the remuneration of any dealings by applying the Transfer Pricing Guidelines by analogy. The result of the two steps allows determining the profits of the PE from all its activities being these transactions with unrelated parties, transactions with related parties (by directly applying the Transfer Pricing Guidelines) and dealings[42] ("transactions") with other parts of the enterprise (under the AOA).

As a preliminary remark it should be stressed that one of the most significant changes[43] of the AOA was the specific support for adopting the functionally separate entity approach. The OECD considered this to be the preferred approach for two major types of reasons:

- *Consistency*:
    - With the wording of article 7 and the embodied arm's length principle as it does not impose any cap on the profits attributable to the PE that may affect the determination of the attributable profits under the arm's length principle.
    - A similar type of analysis is performed in case the PE was a separate and legally distinct enterprise under Article 9.

OECD Model Convention, EUROPEAN TAXATION 9 IBFD (2008), at 467-471.

[42] Dealings refer to a change of functions, economic ownership of assets and/or risks within the same enterprise. Transactions refer to different enterprises.

[43] See in this regard, Philip Baker and Richard Collier, *supra* note 41 at 200, who stress, however, that the OECD devoted little attention to the possibility that the single entity approach might actually be the better approach.

- *Simplicity*:
    - It does not require the host State – contrarily to the relevant business approach – to determine the worldwide profits of the enterprise.

2.4.1. – First Step: *hypothesizing the PE as a distinct and separate enterprise*

2.4.1.1. - Functions performed by the PE

Performing a *functional and factual analysis* was considered the most appropriate way to hypothesize the PE as a distinct and separate enterprise. This was already used in situations involving associated enterprise for the purposes of applying Article 9 as it underpins the arm's length principle. The guidance provided in the Transfer Pricing Guidelines on the functional analysis is then applicable[44] in the PE context in order to determine the "activities" of the hypothesized distinct and separate enterprise. That requires determining which activities and responsibilities of the enterprise are associated with the PE and to what extent. Additionally it requires determining in what capacity those functions are performed (i.e. if the services are performed for another part of the enterprise or as a function of the PE on its own).

However it was also recognized that within the context of Article 7 there is a fundamental difference: a PE is essentially a tax fiction. In other words, legally a PE and head office is one and the same entity.

[44] See paragraph 90 of the 2008 Report which states that:

> "The guidance in the Guidelines on functional analysis seems capable of being applied fairly directly in the PE context […] [underlined BdS]"

There is no single part of the enterprise that legally owns assets, assumes risks, possesses capital or enters into contracts. Therefore for the purposes of taking into account risks assumed and assets used, the legal analysis performed under the functional analysis of the Transfer Pricing Guidelines could not be directly and fully applicable[45]. It was necessary for these purposes to supplement the functional analysis to allow placing the PE as a distinct and separate enterprise. This was made with recourse to the *significant people functions* analysis. The functional and factual analysis should identify the functions performed by personnel – people functions – and the significance they have in generating profits. Reference is made to the fact that people functions can range from support or ancillary functions to significant people functions relevant to the attribution of economic ownership of assets and/or the assumption of risks. Accordingly, the AOA attributes[46] to the PE those risks for which the significant functions relevant to the assumption and/or management of risks are performed in the PE and also attributes to the PE the economic ownership of assets for which significant functions relevant to the economic ownership are performed by people in the PE. In addition the AOA also sets forth different approaches to attribute free capital to the PE support the functions it has performed, the risks assumed and the assets attributed to it.

A further reference to the application of the guidance of the Transfer Pricing Guidelines is made for the purposes of the comparability of conditions. In Chapter I of the Transfer Pricing Guidelines a number of factors are taken into account such as: identifying characteristics of property and services, contractual

[45] Reference is made also in paragraph 90 of the 2008 Report that:

"The main difficulties are with determining how to take into account risks and assets used".

[46] See paragraph 18 of the 2008 Report.

terms, economic circumstances and business strategies. Such comparability factors should be considered, by analogy[47], when undertaking the functional and factual analysis for the purposes of determining the conditions of the hypothesized distinct and separate and to ensure that they are the same or similar to the PE. The AOA takes into account these conditions of the enterprise to the extent that those conditions are related to the performance of the PEs functions[48].

2.4.1.2. - Risks attributed to the PE

The starting point is that naturally businesses may be subject to a wired variety of risks such as inventory risk, credit risk, currency risk, interest rate risk, market risk, product liability and warranty risk, regulatory risk, etc. Within the context of associated enterprises it is possible to assign risks between parties by contractual arrangements. Such legally binding contractual arrangements for the purposes of allocating risks to a particular part of the enterprise are not possible when dealing with one and the same entity. The enterprise as whole bears a risk. Under the AOA it is however possible to treat the PE as assuming risks. In that regard, the PE should be considered as assuming risks[49] for which the significant

[47] The guidance on comparability is applied by analogy as naturally the Transfer Pricing Guidelines are based on a comparison of conditions of controlled and uncontrolled transactions between related enterprises rather than hypothesized distinct and separate and separate enterprises as the case of PE/general enterprise.

[48] An example may be found in paragraph 93 of the 2008 Report regarding a distributor. It may be relevant to determine any peculiar business strategy related with the performance of the distributor's functions by the PE (e.g. market penetration) which may be important for the comparability analysis to be performed under the second step between dealings of the PE and general enterprise and transactions between unrelated enterprises.

[49] A common example is that a PE should be generally treated as assuming risks arising from negligence of employees

people functions relevant to the assumptions of risks are performed by personnel of the PE at the PE's location. In this regard, significant people functions for the assumption of risks refer to the active decision making functions with regard to the initial acceptance and management of risks[50]. The PE will be attributed any risks inherent in, or created by, its own significant people functions. A different issue related to possible dealings or transactions related to the subsequent transfer or risks or to the transfer of the management of those risks to different parties of the enterprise or other enterprises[51]. A PE may be considered as assuming a risk and use the services of another part of the enterprise manage that risk giving rise to separation between the risk allocated the PE and the management of that risk done by another part of the enterprise. A risk may also be transferred to another part of the enterprise if there is documentation evidencing the intention of engage in a dealing to transfer the risk and that other part of the enterprise performs the significant people function relevant to the management of the risk. It should be stressed that documentation by itself may not be sufficient to recognize such transfer since a part of the enterprise which has initially not assumed a risk cannot be deemed to have subsequently taken over

engaged in the functions performed by the PE.

[50] For instance excess of inventory risk is likely to be regarded as initially being assumed by that part of the enterprise that makes the active decisions related to inventory levels. Credit risk is likely to be regarded as initially assumed by that part of the enterprise that decides to conclude a sale to a particular customer after having reviewed the creditworthiness of this customer. A question may arise however where a review of the creditworthiness of each customer is performed by one part of the enterprise before a sale is concluded by another part of the enterprise. In such a case, the functional and factual analysis would have to examine whether the people in charge of reviewing the customers'creditworthiness are in effect the ones making a decision that leads to the assumption of credit risk, or if they act as a support function for the PE which ultimately makes the decision of whether or not to sell to a particular customer.

[51] See Mary Bennett *supra* note 41, at 468.

that risk unless it is also managing the risk. Therefore "risks follow functions" under the AOA as a risk cannot be separated from function.

2.4.1.3. - Attribution of assets

For the purposes of attribution of assets to the PE it is necessary to determine which assets are economically owned and/or used by the PE and in which capacity. In that regard, the functional and factual analysis examines all the facts and circumstances to determine: (i) the extent to which assets of the enterprise are used in the functions performed by the PE and (ii) conditions under which those assets are used.

Within the PE context, the assets legally belong to the whole enterprise of which the PE is a part. Therefore it is necessary to attribute economic ownership[52] of the assets. One possible approach would be booking location: to nominate which part of the enterprise economically owns the assets. Although simple and administrable this solution was considered as potentially providing an incentive to abuses which could lead to inappropriate location of profits. The decision was then to generally attribute the assets to the part of the enterprise which performs significant people functions relevant to the determination of economic ownership of the assets. It is relevant to stress that the AOA gives guidance on the allocation of assets by providing a distinction between tangible assets and intangible assets. Regarding *intangible assets*, economic ownership is then based on where the relevant significant people

[52] Economic ownership is the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the income attributable to the ownership of assets, right to depreciate the asset and the potential exposure to gains or losses from the appreciation or depreciation of the asset).

functions are performed. The significant people functions relevant to determining the economic ownership of intangibles are those which require active decision-making regarding the taking on and management of individual risk and portfolios of risks associated with the development of intangible property. In other words, it is relevant to determine the nature of the critical decision-making process and the level at which those decisions are taken. These functions may comprise:

- In case of *internally developed intangibles* – designing the testing specifications and processes within which the research is conducted, reviewing and evaluating the data produced by the tests, setting the stage posts at which decisions are taken and actually taking the decisions on whether to commit further resources to the project or abandon it, etc.
- In case of *acquired trade intangibles* - the evaluation of the acquired intangible, the performance of any required follow-on development activity, and the evaluation of and management of risks associated with deploying the intangible asset.
- In case of *marketing intangibles* - functions related to the creation of and control over branding strategies, trademark and trade name protection, and maintenance of established marketing intangibles.

However and as regards *tangible assets*, a broad consensus was reached for applying "use" as the basis for attributing economic ownership, in the absence of circumstances in a particular case that warrant a different view. This was considered as a pragmatic solution which would reach to a similar result that the functional and factual analysis. Therefore:

- If the PE is treated as the economic owner of the asset it will be entitled to deductions for depreciation and interest (in case the asset was wholly or partially debt-financed).
- If the PE is treated as the lessee it will be entitled to deductions in the nature of rent.

2.4.1.4. - Attribution of free capital

Enterprises require capital to fund day-to-day activities, costs of acquiring assets and also assuming risks. In that regard it was recognized that a PE would need to have an arm's length of free capital[53] for tax purposes. The purpose is that under the arm's length principle a PE requires sufficient capital to support the functions it undertakes, the assets that economically owns and risk assumed. It should be noted that in what refers to creditworthiness there is a general assumption[54] that PEs enjoy the same creditworthiness as the enterprise of which is a part.

The rule is then that capital follows assets and risks. The question to be made is how much free capital is needed to cover those assets and support the risks assumed? The process of attributing capital is based on two different stages:

- *Measure the risks and value of the assets* attributed to the PE. The AOA does not prescribe a method to valuate assets giving the book value, the fair market value and the original purchase price or cost price as options. It is just necessary that it is consistent from year to year.
- *Determine the free capital needed to support the risks and assets* attributed to the PE. The OECD recognized the existence of different authorized approaches to attribute free capital each one of them with their strengths and weaknesses and that there is no single arm's length amount of free capital but rather a range of potential capital attributions within which it is possible to determine an amount of free capital that can meet the necessary arm's length result.

[53] Free capital is funding that does not give rise to a tax-deductible return in the nature of interest.

[54] An exception being where for regulatory reasons the capital attributed to the PE of one jurisdiction is not available to meet liabilities incurred elsewhere in the enterprise. See paragraph 130 of the 2008 Report.

The criteria adopted have different starting points which put either more emphasis on the actual structure of capital of the PE is a part (like the capital allocation approach) or, alternatively, on the capital structures of comparable independent enterprises (e.g. the thin capitalization approach)[55]. Briefly, three different methods are considered appropriate:

- *Capital attribution approach*: which is based on the proportion of assets and risks attributed to the PE (e.g. 10% risks and assets leads to 10% of the enterprise's free capital).
- *Economic capital allocation approach:* that has been suggested for the banking context. The starting point is that all types of risks should be taken into account and not only the risks which are considered by regulators[56] and may have impact on profitability.
- *Thin cap approach*: the PE is required to have the same amount of capital as would an independent enterprise carrying on the same or similar activities under the same or similar conditions in the State of the PE

A forth method, the *quasi thin capitalization/regulatory minimum capital approach* is also considered specifically for banks. Although not an AOA[57], it may be acceptable as a safe harbour as long as it does not lead to more profits being attributed to the PE as it would result from the ones attributed under the AOA.

[55] See Mary Bennett and Raffaele Russo, *supra* note 37, at p. 281.

[56] See Irene J.J. Burgers, *supra* note 2.

[57] See paragraph 160 of the 2010 Report.

Considering the different acceptable methods for the attribution of free capital, a possible issue could arise of double taxation or non-taxation where the State of the enterprise (when computing the PE income for the purposes of granting double taxation relief) and the PE State (which computes the PE profit that may be taxed in accordance with Article 7) apply different methods. The solution for this possible mismatch is provided in the Commentary[58] and now expressly in the OECD MTC in paragraph 3 of the new Article 7 as further explained below.

2.4.1.5. - Dealings

The first step of the authorized OECD approach a functional and factual analysis of the PE is undertaken in the process of constructing the hypothetical separate and independent enterprise, engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise. Functions, assets, risks and free capital are attributed to the PE together with the income and expenses arising from transactions with other enterprises (both associated and independent). As referred, the arm‘s length price of transactions with associated enterprises can be

[58] See paragraph 48 of the 2008 Commentary to Article 7 (3) which provides that the State of residence will accept for purposes of computing double taxation relief, the attribution of free capital as determined by the State of source, if:

(i) the difference in capital attribution results from conflicting domestic law choices of capital attribution methods, and

(ii) there is agreement that the host state has used an authorised method and such approach produces an arm's length result.

determined by applying directly the Transfer Pricing Guidelines. However, the language of Article 7(2) goes on to require that the profits to be attributed to the PE must also be based on the hypothetical separate and independent enterprise, acting as such also in its dealings with other parts of the enterprise. Thus, in fully hypothesizing the PE, it is necessary to identify and determine the nature of the internal dealings with the rest of the enterprise of which it is a part. These "transactions" between the hypothesised parts of a single enterprise that can be recognised under the provisions of the AOA, although with no legal consequences, they are inferred for the purpose of determining the PE's profits. This implies a need for a greater scrutiny for recognizing dealings between the PE and the general enterprise than between associated enterprises. Similarly a greater scrutiny will be required regarding the documentation that supports those dealings because within a single entity there are no contractual terms to analyze as occurs between associated companies.

The greater scrutiny means that a certain threshold needs to be passed before a dealing is accepted as equivalent to a transaction that would have taken place between independents at arm's length. Essentially this is due to the fact that a dealing within a single legal entity is not something which is self-evident but is a construct, the existence of which is inferred solely for the purposes of attribution of profits to the PE. The starting point for evaluating a dealing will typically be the accounting records and internal documentation of the PE which are able to evidence the existence of a dealing. Terms of a transaction may also be found in correspondence/communications between parties other than a written contract[59]. So, one should look to accounting records together with any contemporaneous internal

[59] The AOA treats dealings as analogous to transactions between associated enterprises and so it applies the Transfer Pricing Guidelines (guidance found in particular in paragraphs 1.28 and 1.29) by analogy.

documentation, purporting to transfer risks, responsibilities and benefits from one part of the enterprise to another part. The AOA recommends that effects are given to the documentation provided that:

- The documentation is consistent with economic substance of the activities taken place in accordance with a functional and factual analysis.
- arrangements documented do not differ from the ones that would be adopted by comparable independent enterprises.
- The dealing presented in the documentation does not violate the principles of the AOA – e.g. segregating risks from functions.

Recognition of a dealing will occur if it is based on a real and identifiable event, i.e. there is an economically significant transfer of risks, responsibilities and benefits as a result of the dealing. The determination of whether such real and identifiable event occurred will be made by performing a functional and factual analysis. Otherwise the dealing should be disregarded and re-characterised by analogous application of the Transfer Pricing Guidelines.

2.4.2. – Second Step: *determining the profits of the PE*

The second step of the AOA determines the profit of the hypothesized separate enterprise so created. The dealings will then be compared to transactions of independent enterprises performing the same or similar functions, using the same or similar assets, assuming same or similar risks. The analysis takes into account the five comparability factors used in the Transfer Pricing Guidelines: characteristics of property of services; contractual terms (in case of PE reference is to the "terms of the dealings"); economic circumstances; and business strategies. The AOA considers that all the factors (with the

exception to contractual terms[60]) can be applied directly to evaluate dealings as they are essentially based on facts.

The arm's length pricing of dealings is determined by applying by analogy using the traditional methods used by the Transfer Pricing Guidelines for transactions between legal entities whether:

- *Transactional* (comparable uncontrolled price, resale price and cost-plus); or
- *Based on profit* (profit split and transactional net margin method).

The most appropriate method to reach an arm's length compensation should be chosen taking into account the functions performed, the assets and risks assumed by the PE.

2.4.3. – AOA and dependent agents

The issue around the attribution of profits to dependent agents[61] is whether the AOA would be applicable in the similar terms to the one under the regular case of PE under Article 5 (1). The controversy[62] is to determine whether there may be a profit attributable to the agency PE in excess of

[60] For contractual terms the application to dealings is made by analogy using the guidance provided in paragraphs 1.28 and 1.29 of the Transfer Pricing Guidelines.

[61] The characterization of an agency PE is provided by Article 5 (5) which refers that:

> "where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise hall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise [...]"

[62] See for instance the Indian case *Morgan Stanley*, Supreme Court of India, 9 July 2007, with comments by Hans Pijl,

the arm's length remuneration paid to the dependent agent. In other words, if it is possible to attribute a separate profit to an agency PE once the agent had an arm's length reward for the service provided. In this regard there are two different approaches[63]:

- The *single taxpayer approach* - which is based on the premise that the agency PE profit is zero by definition. Once the dependent agent is remunerated on an arm's length basis no further loss or profit can be attributed to the host State. Therefore, this arm's length remuneration extinguishes any PE tax liability because there is no additional profit to the attributed to the agency PE.

Morgan Stanley: Issues regarding Permanent Establishment and Profit Attribution in Light of the OECD View, BULLETIN FOR INTERNATIONAL TAXATION 5 IBFD (2008), at 174-182. The case refers to the US company Morgan Stanley and Co. Inc (MSCO*)* which had one of the companies – Morgan Stanley Advantage Services Private Limited (MSAS) in India. This Indian company rendered back office activities to MSCO for which it received a payment – cost plus a mark-up of 29%. One of the issues of the case was which amount of profits should be attributed to the PE located in India. In that regard, the Indian Supreme Court decided that:

> *As regards the attribution of further profits to the PE of MSCo where the transactions between the two are held to be at arm's length, we hold that the ruling is correct in principle provided that an associated enterprise (MSAS) is remunerated on an arm's length basis taking into account all the risk-taking functions of the multinational enterprise. In such a case nothing be left to attribute to the PE. The situation would be different if the transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such case, there would be need to attribute profits to PE for those functions/risks that have not been considered.*

[63] See Hans Pijl, *The Zero-Sum Game, the Emperor's Beard and the Authorized OECD Approach*, EUROPEAN TAXATION 1 IBFD (2006), at 29-35 or Carlos Eduardo Costa M.A. Toro, *Different Methods of Attributing Profits to Agency PEs*, TAX NOTES INTERNATIONAL, 2 February 2009, at 421-445.

- The *dual taxpayer approach* (the AOA approach for agency PEs) - leads to the recognition of two different taxpayers (the PE and the agent) where it is possible to have a separate attribution of profit or loss to the PE. The OECD believed that the same principles adopted for the other types of PEs should be applied regarding agents[64]. As a matter of consistency there would be no reason to apply a different approach for agency PEs. Therefore, profits should be attributed to the agency PE on the basis of the assets and risks of the non-resident enterprise relating to the functions performed by the former on behalf of the later[65]. The AOA takes the functions performed in the host state as the starting point for the attribution of profits. Under the notion that assets and risks follow functions, the functional and factual analysis would determine the assets and risks to be attributed to the agency PE. In accordance, the agency PE is not the dependent agent per se. Its existence is apart from the dependent agent and is derived because the general enterprise in the home state has a dependent agent in the host state. Following this approach it is not only the income earned by the dependent agent itself that is relevant but also the income of the general enterprise earned through its agency PE in the host

[64] See for critics Philip Baker and Richard Collier, *supra* note 2 at 33 who refer that the wording of Article 5 (5) which specifically deems the enterprise to have a PE "in respect of any activities which that person [the dependent agent] undertakes" does not seem to support the OECD view. In addition they refer to some practical issues as they consider being extremely difficult to calculate what profit should be attributed to the PE in excess of the remuneration at arm's length to be paid to the dependent agent. The implementation may also be difficult to the documentation requirements. Finally these authors also raise the question whether is there any point in pursuing this issue: since the dependent agent enterprise is resident within the host State, if that State considers that there are further risks or assets to be attributed to the functions of the dependent agent, this State has always the option to challenge the arm's length remuneration paid to the agent.

[65] See Carlos Eduardo Costa M.A. Toro, *supra* note 62 at 432-433.

State. The payment to the dependent agent should be considered an expense in ascertaining the agency PE's profits.

3. - The New Article 7 of the OECD MTC

3.1. - Overview

As referred, the adoption in 2010 of a new version of Article 7 was based on the fact that the OECD Committee on Fiscal Affairs recognized that there were a few differences between some conclusions of the AOA provided in the 2008 Report and the interpretation of Article 7 under the existing Commentary at the time. This was the case of certain dealings which might not have been recognized under the previous Commentary (e.g. the recognition of internal dealings in the form of loans when there is a treasury function, outside the financial sector, economic ownership of intangibles and the related internal royalties, etc.)

The newly adopted Article 7 has four paragraphs which provide for a full implementation of the AOA and read as follows[66]:

Article 7

BUSINESS PROFITS

[66] The new wording of Article 7 of the OECD MTC as per comparison with the previous version is highlighted in the following terms: ~~strikethrough~~ for deletions and ***bold italics*** for additions.

1. ~~The profits~~ ***Profits*** of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise ***that are attributable to the permanent establishment in accordance with paragraph 2*** may be taxed in ***that*** ~~the~~ other State ~~but only so much of them as is attributable to that permanent establishment~~.

2. ~~Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment~~ ***For the purposes of this Article and Article [23A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are*** the profits ~~which~~ it might be expected to make if it were a ~~distinct and~~ separate ***and independent*** enterprise engaged in the same or similar activities under the same or similar conditions ~~and dealing wholly independently with the enterprise of which it is a permanent establishment~~, ***taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise***.

3. ~~In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.~~ ***Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.***

4. ~~Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.~~

~~5. 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.~~

~~6. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.~~

~~7.~~ Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

As per comparison with the 2008 version, the new Article 7 is reduced from seven to four paragraphs in which:

- one paragraph stays the same - paragraph 7 which is renumbered as paragraph 4;
- two paragraphs are slightly amended – paragraphs 1 and 2;
- four paragraphs are deleted – paragraphs 3, 4, 5 and 6;
- one new paragraph is introduced on relief of double taxation – paragraph 3.

3.2. - Article 7 (1): the distributive rule

There are minor changes to the wording of the 2008 version of Article 7 which are aimed at avoiding misinterpretations of this paragraph. In that regard the words *but only so much of them as is attributable to that PE* are eliminated as they could indicate a reference to the relevant business approach, namely that the State of source could only tax the profits of the PE as long as the enterprise had realized profit. As referred with the functionally separate entity approach there is no cap on the profits to be attributed to the PE. Furthermore with somehow identical purpose the reference to *the* profits was deleted together with adding a reference to paragraph 2. The purpose is again to clarify that the purpose of Article 7 is not to allocate the overall profits of the general enterprise the PE and the enterprise's other parts. The profits attributable to the PE should be determined as if the PE were a separate and independent enterprise and therefore profits may be attributed even if the general enterprise had not realized any profit or is in a loss position. The same reasoning applies for a situation where the PE has no profits even if the general enterprise has made profits.

In a nutshell: Article 7 (1) does not affect the quantum of the profits that are to be attributed to the PE. It merely confirms that the right to tax of the host country does not extend to profits that the enterprise may derive from the State otherwise than through the PE, i.e. rejection of the force of attraction principle resulting from the existence of the PE.

3.3. - Article 7 (2): attribution of profits

As referred, the purpose of Article 7 (2) is to determine how the profits should be attributable to a PE. In that regard the current wording fully incorporates the functionally separate entity approach of the

AOA by adding the reference to *the functions performed, assets used and risks assumed through the PE and through other parts of the enterprise*. Also relevant is the fact that it is now clearly stated that the AOA is applicable for both the State of source (where the PE is located) which taxes the attributable profits under Article 7 and the State of residence (of the enterprise) that has to provide the double taxation relief under Article 23. This is stated by the opening wording of paragraph 2 when refers that for *the purposes of this article* [article 7 – BdS] *and Article [23 A] [23 B]*. This clarification is as much relevant as previous analysis had revealed that the provisions of the OECD MTC and Commentary concerning symmetry between Article 7 (2) and Article 23 were confusing and unsatisfactory[67].

In addition it should also be referred that this paragraph now includes the expression *separate and independent enterprise* in order to make clear that the arm's length principle is to be applied to both dealings and controlled transactions which affect the amount of profits attributable to the PE.

3.4. - Article 7 (3): double taxation relief

Paragraph 3 of Article 7 constitutes a whole new paragraph and deals with some situations of double taxation relief. The general rule is provided in Paragraph 2 of Article 7 that, as referred above, now makes (more) clear that it applies to both the PE State and the residence State. In that regard, in most cases it ensures that double taxation is eliminated in the sense that the amount of profits attributed to a

[67] The wording *in each Contracting State* seemed indeed to require such symmetry. See for an analysis Brian J. Arnold, *Fearful Symmetry: The Attribution of Profits to "Each Contracting State*, BULLETIN FOR INTERNATIONAL TAXATION 8 (2007), pp. 321-337.

PE by both the PE State and the residence State will be determined through the application of the same principles. For that purpose, the Commentary states that insofar as each Contracting State agrees that the taxpayer has determined the profits attributable to the PE in the same manner in each Contracting State and in conformity with paragraph 2, both States should refrain from adjusting the profits on a different arm's length basis[68]. Therefore, as long as the taxpayer has chosen a point in the arm's length range and has used the result to determine the profits attributable to the PE in making its declaration to both States' tax authorities, neither State should make an adjustment claiming that a different point in the arm's length range should be used[69].

There may, however, be cases where, both States do not reach such an agreement. The OECD recognizes that in some cases the (2010) Report and the Transfer Pricing Guidelines may allow different interpretations of paragraph 2 and therefore, despite the fact that both States are taxing in accordance with the mandate of paragraph 2 of Article 7, double taxation may arise. The purpose of paragraph 3 is then to ensure that double taxation is relieved in those cases.

[68] As referred by A.J.A Stevens in "Herzien art. 7 OESO-Modelverdrag", NEDERLANDS TIJDSCHRIFT VOOR FISCAAL RECHT, Sdu Fiscale & Financiële Uitgevers 2010, the new Article 7 and related Commentary focus primarily on the taxpayer: if the profit allocation is based on the rules of Article 7 (2) and achieve an arm's length result, Contracting States should refrain from making any adjustment.

[69] If either State makes an adjustment to the taxpayer and determines profits attributable to the PE in a manner that is not consistent with the arm's length mandate of Article 7(2), the taxpayer may use all available remedies, include domestic legal remedies (*e.g.* the courts) and the mutual agreement procedure under Article 25 to address the fact that it has not been taxed by that State in accordance with the treaty. In that case, there is no need to invoke Article 7(3).

For example, if a taxpayer declares an amount of profit attributable to the PE which is not arm's length, one State may adjust the profits to bring them within the arm's length range, while the other State may wish to make an adjustment to a different point in the arm's length range. Paragraph 3 of the new Article 7 is intended to deal with this type of situation[70]. Where one State has adjusted the taxpayer's non-arm's length profits to an arm's length amount, paragraph 3 of Article 7 will require the other State, to the extent it agrees that the adjustment is arm's length and that there is double taxation, to provide a corresponding adjustment to the tax payable in that other State on the profits that would otherwise be taxed in both States.

This paragraph 3 of Article 7 is in the author's view a major achievement in the wording of this provision in the sense that it is modelled on paragraph 2 of Article 9 (Associated Enterprises) of the OECD MTC. Thus, it applies to each State with respect to an adjustment made by the other State. As is the case under Article 9(2), a corresponding adjustment is not automatically required to be made[71] under Article 7(3) simply because the profits attributable to the PE have been adjusted by one of the States. Regardless of which State makes the initial adjustment, the other State is required to make a corresponding adjustment only if it considers that the initial adjustment is justified both in principle and as regards the amount. If there is a dispute between the parties concerned as to the amount or character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 (Mutual Agreement Procedure) should be implemented, as is the case for an adjustment under Article 9(2). Indeed, if one of the two States adjusts the profits attributable to the PE without the other State's granting a

[70] See A.J.A Stevens, *supra* note 68.

[71] See on this Mary Bennett, *supra* note 34 at 27 and paragraph 66 of the Commentary to the new Article 7.

corresponding adjustment to the extent needed to avoid double taxation, the taxpayer will be able to use the mutual agreement procedure of Article 25(1), and if necessary the arbitration procedure of Article 25(5), to require the competent authorities to agree that either the initial adjustment by one State or the failure of the other State to grant a corresponding adjustment is not in accordance with the provisions of the treaty.

The Commentary to Article 7 includes an alternative version of Article 7(3), which may be preferred by some States that believe disputes should be the subject of a mutual agreement procedure between the two States' competent authorities. This alternative version imposes a reciprocal legal obligation[72] on the two Contracting States to eliminate double taxation through the mechanism of the mutual agreement procedure.

The goal of the 2010 update to the OECD MTC is then to ensure that the combination of Articles 7, 23 and 25 will guarantee that all cases of double taxation under Article 7 are eliminated.

3.5. - The deleted provisions

Under the AOA only paragraphs 1, 2 and 3 of Article 7 are considered necessary for the purpose of determining the profits attributable to a PE. Therefore it was a natural outcome that following the adoption of the AO, four paragraphs of the OECD 1963-2008 versions of Article 7 were deleted:

[72] Reference is made to the fact that the *Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement.*

- Ever since *Article 7 (3)* was included it gave rise to doubts about its interpretation[73]. Its deletion was then made considering several reasons[74]. First, because its wording could be interpreted as an exception to the arm's length principle provided in paragraphs 2. In addition it was considered to be unnecessary as the allocation of expenses to the PE already derived from the application of the functionally separate entity approach under paragraph 2. This now means that:
    - If a dealing is recognized between the PE and other part of the enterprise which would give rise to an expense if occurring between independent entities, an arm's length charge must be allocated to the PE;
    - If no dealing is recognized but the expenses incurred by the general enterprise are related to the activities of the PE, they should also be considered for the purpose of determining the PEs profits.

  In other words, paragraph 2 of the new Article 7 now mandates that all relevant expenses must be allocated to the PE, either through the deduction of the expense incurred to a third party or through the deduction of an arm's length charge for an intra-entity notional expense.
- *Article 7 (4)* allowed the profits to be attributed to a PE not to be determined on the basis of separate accounts or through an estimation of arm's length profits by simply apportioning the total profits of the enterprise by reference to various formulae. The OECD view had been to consider this method of allocation not to be the most appropriate one in determining the PE's profits and therefore it already referred that it should be used only exceptionally. With the

[73] See Hans Pijl *supra* note 14 at 37-49 or Richard Vann, *supra* note 14.

[74] See paragraph 40 of the 2010 Commentary to Article 7 and Mary Bennett and Raffaele Russo, *supra* note 34 at 77.

drafting of the new Article 7 and the implementation of the AOA in full it was somehow a natural outcome that this provision was deleted as this allocation method is not considered to be in line with the separate and independent entity fiction of the AOA[75].

- Similarly *Article 7 (5)* was deleted as it was not consistent with the arm's length principle. Under the AOA there is not need to have a special rule in case of PEs that perform "mere purchase of goods or merchandise for the enterprise". It was considered that there should be no limit to the attribution of profits to PE in such cases, apart from the limit imposed by the operation of the arm's length principle[76]. In other words, the deletion of this paragraph 5 is justified[77] because the general rules on attribution of profits to PEs should be applied[78].
- In what refers to *Article 7 (6)*, it stated that the profits attributable to the PE had to be determined by the same method year by year unless there was good a sufficient reason to the contrary. This paragraph became obsolete[79] as now only the AOA is considered an acceptable method for attributing profits to PEs.

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[75] See paragraph 41 of the 2010 Commentary to Article 7.

[76] See Mary Bennett, *supra* note 34.

[77] See paragraph 43 of the 2010 Commentary to Article 7.

[78] See paragraph 57 of the 2008 Report.

[79] See paragraph 42 of the 2010 Commentary to Article 7

4. - Impact of the new Article 7[80]

4.1. - Interpretation

The Commentary on the OECD MTC is a widely-accepted guide to the interpretation and application of tax treaties[81]. Considering that today there are more than 3000 tax treaties, it is hardly necessary to stress the importance of the Commentaries on the provision of the OECD MTC for the purpose of interpretation of corresponding provisions of tax treaties. It is then important to consider the impact of the OECD developments regarding the AOA concerning the interpretation of existing and future DTCs.

The OECD general principle regarding interpretation is that existing tax treaties should, as far as possible, be interpreted in the spirit of the revised Commentary, to the extent that the text of those treaties is based on the text of the Model to which that Commentary applies. The position followed is that later changes to the Commentary that correspond to mere clarifications should be relevant in interpreting and applying provisions of tax treaties concluded before the adopted of those changes.

[80] Also a relevant topic that the author will not deal with in this paper is to analyse the possible impact of Article 7 and the AOA regarding the non-discrimination in tax treaties (Article 24 (3) of the OECD MTC) and in EU Law.

[81] See on this issue, *inter alia*, Peter J. Wattel and Otto Marres *The Legal Status of the OECD Commentary and the Question of Static or Ambulatory Interpretation of Tax Treaties*, 43 EUROPEAN TAXATION 7/8 IBFD (2003) at 222-235. DAVID A. WARD et al, THE INTERPRETATION OF INCOME TAX TREATIES WITH PARTICULAR REFERENCE TO THE COMMENTARIES ON THE OECD MODEL, IBFD (2005) or FRANK ENGELEN, INTERPRETATION OF TAX TREATIES UNDER INTERNATIONAL LAW – A STUDY OF ARTICLES 31, 32 AND 33 OF THE VIENNA CONVENTION ON THE LAW OF TREATIES AND THEIR APPLICATION TO TAX TREATIES, IBFD (2007) Doctoral Series no. 7.

Differently is naturally the case of revisions that lead to change in the meaning of the previously existing wording[82].

Concerning the specific topic of the AOA and the attribution of profits to PEs there are: (i) the 2008 Commentary to Article 7 which is complemented by the 2008 Report on the Attribution of Profits to Permanent Establishments and (ii) and the 2010 Commentary to the new Article 7 which is complemented by the 2010 report on the Attribution of Profits to Permanent Establishments. In that regard the OECD Council adopted a Recommendation according to which it suggests that:

- Provisions of DTCs that were drafted on the basis of the pre-2010 Article 7 should follow the related 2008 Commentary to Article 7 as well as the guidance provided in the 2008 Report to the extent that its conclusions do not conflict[83] with that Commentary;
- Provisions of DTCs that are drafted on the basis of the 2010 Article 7 should follow the related 2010 Commentary to Article 7 as well as the guidance provided in the 2010 Report.

In any case both 2008 and 2010 versions of Article 7 and related Commentary remain in print for ease reference.

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[82] See paragraphs 33 to 36.1 of the Introduction to the OECD MTC. Differently see Michael Lang, *Later Commentaries of the OECD Committee on Fiscal Affairs, Not to Affect the Interpretation of Previously Concluded Tax Treaties*, 25 INTERTAX 1 (1997), at 7-9

[83] As it is the case with the recognition of internal interest dealings that is accepted under paragraph 185 of the 2008 report but banned under paragraph 42 of 2008 Commentary to Article 7. See Hans Pijl, *Interpretation of Article 7 of the OECD Model, Permanent Establishment Financing and Other Dealings*, BULLETIN FOR INTERNATIONAL TAXATION IBFD (2011), at 297-299.

4.2. – Implications on other tax treaty provisions

One of the issues that arose with the new Article 7 was the question of whether the "functionally separate entity" approach which applies for purposes of determining profits attributable to a PE under that Article had impact in other Articles of the OECD MTC. For example, the question was raised whether a notional interest or real property rental payment from a PE to the head office of the enterprise of which the PE is a part would, if taken into account in determining the profits attributable to the PE under Article 7, also be treated as creating notional income for the enterprise which could be taxed by the PE State under Article 11 (Interest) or Article 6 (Income from Immovable Property).

The Commentary[84] now clarifies that the separate and independent enterprise fiction that is mandated by paragraph 2 is restricted to the determination of the profits that are attributable to a PE. It does not extend to create notional income for the enterprise which a State could tax as such under its domestic law by arguing that such income is covered by another Article of the OECD MTC. In that regard it is considered that the fiction mandated by paragraph 2 does not change the nature of the income derived by the enterprise[85]; it merely applies to determine the profits attributable to the PE for the purposes of Articles 7, 23 A and 23 B. However it is recognized that some States consider that, as a matter of policy,

[84] See paragraphs 28 and 29 of the 2010 Commentary to Article 7.

[85] Therefore, the fact that, under paragraph 2, a notional interest charge could be deducted in determining the profits attributable to a PE does not mean that any interest has been paid to the enterprise of which the PE is a part for the purposes of paragraphs 1 and 2 of Article 11. The separate and independent enterprise fiction does not extend to Article 11 and, for the purposes of that Article, one part of an enterprise cannot be considered to have made an interest payment to another part of the same enterprise.

the separate and independent enterprise fiction that is mandated by paragraph 2 should not be restricted to the application of Articles 7, 23 A and 23 B but should also extend to the interpretation and application of other Articles so as to ensure that PEs are, as far as possible, treated in the same way as subsidiaries. These States may therefore consider that notional charges for dealings which, pursuant to paragraph 2, are deducted in computing the profits of a PE should be treated, for the purposes of other Articles of the treaty, in the same way as payments that would be made by a subsidiary to its parent company. In that regard, two alternatives are considered in the Commentary:

- States may include in their tax treaties provisions according to which charges for internal dealings should be recognised for the purposes of Articles 6 and 11 (to the extent that such taxation is provided for under domestic law, which typically it is not the case).
- States may wish to provide that no internal dealings will be recognised in circumstances where an equivalent transaction between two separate enterprises would give rise to income covered by Article 6 or Article 11.

4.3. – Interaction with domestic law

A relevant clarification[86] is also the relationship between paragraph 2 of Article 7 and domestic law. Paragraph 2 determines the profits that are attributable to a PE for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a PE have been determined in accordance with paragraph 2 of Article 7, it is clarified that it is up for the domestic law of each Contracting State to determine whether and how such profits should be taxed as long as there is

[86] See paragraph 30 of the 2010 Commentary to Article 7.

conformity with the requirements of paragraph 2 and the other provisions of the Treaty. Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the remaining provisions of the Treaty and, in particular, paragraph 3 of Article 24 which provides that taxation on a PE which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

4.4. – Treaty policy

The current impact of the new Article 7 in terms of the States' treaty policy diverges: in some States new guidance is being issued[87] in order to implement the AOA. Other States are however reluctant to adopt the new approach. In particular it is interesting to note the position of many non-OECD countries concerning the new Article 7. Many of them expressed their views that they will continue to apply the 2008 version of Article 7 and related Commentary[88].

[87] See for instance in the Netherlands the Decree of the Dutch State Secretary of Finance of 15 January 2011, No. IFZ2010/00457M, with comments by Frank Potgens and A.J.A. Stevens in "Winstallocatie vaste inrichtingen", NEDERLANDS TIJDSCHRIFT VOOR FISCAAL RECHT, Part I and II, Sdu Fiscale & Financiële Uitgevers 2011 or Lucia Sahin and Bart le Blanc, "Netherlands - The Dutch Approach to the Attribution of Profits to Permanent Establishments", 51 EUROPEAN TAXATION 6, IBFD 2011, at 245-252.

[88] See the positions of the non-OECD countries regarding Article 7 and its Commentary. *Argentina*, *Brazil*, India, *Indonesia*, *Latvia*, *Malaysia*, *Romania*, *Serbia*, *South Africa*, *Thailand* and *Hong Kong, China* reserved the right to use the 2008 version of Article 7 and related Commentary.

5. Conclusions

The development of the AOA and the introduction of a new Article 7 of the OECD MTC represent the end of a long pathway aimed at achieving an international consensus on the attribution of profits to PEs. It is considered to be a more faithful interpretation of the arm's length principle that is inherent in Article 7. In that regard it remunerates more dealings at arm's length than the previous approach. From an efficiency perspective, the AOA leads to a more neutral treatment between PEs and subsidiaries. In fact the functionally separate entity approach will lead to a similar treatment between subsidiaries and PEs as far as the functional and comparability analysis is concerned[89].

Hopefully it will contribute to remove much of the uncertainty that surrounded the application of this provision and consequently avoiding possible situations of double taxation or double non-taxation. In any case it will be particularly interesting to analyze how in the near future both taxpayers and tax authorities will follow the guidance of the AOA in the new and old versions of Article 7.

[89] Naturally that the AOA does not deem the PE as a subsidiary and provides in paragraph 84 of the 2008 Report that:

> "There are generally economic differences between using a subsidiary and PEs. Application of the AOA will not achieve equality of outcome between subsidiaries and PEs where there are economic differences between them. The legal form chosen, PE or subsidiary, may have some economic effects that should be reflected in the determination of taxable profits".

In the end, as referred by Irene J.J. Burgers *supra* note 10 at 72-76, the OECD arguments for not deeming subsidiaries as PEs can be summarized in the fact that there are legal requirements posed to subsidiaries that are not related with people functions and which cannot therefore be applied within the PE context.